Office of the Czech Fiscal Council

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<u>on development of general government finances and fiscal and budgetary policy</u>

Pursuant to the Section 21(2)(c) of Act No. 23/2017 Coll., on the Rules of Budgetary Responsibility, as amended, (hereinafter "Act") the Czech Fiscal Council (CFC) monitors general government finances. As part of this activity, it also seeks to identify risks that may negatively affect the stability of public finances in the short, medium and long term. Since September 2018, the CFC has informed the public of its conclusions on a quarterly basis.

Initial economic situation

The Czech economy has recovered and grows. Gross domestic product (GDP) rose by 0.5% quarter-on-quarter (q-o-q) and 2.6% year-on-year (y-o-y) in the second quarter of this year. Household consumption (+0.5 pp), change in inventories (+0.3 pp), government consumption (+0.2 pp), and gross fixed capital formation (+0.1 pp) contributed positively to q-o-q growth. However, net exports had a negative impact (−0.8 pp). The y-o-y dynamics is similar, with household consumption (+1.6 pp) and change in inventories (+1.4 pp) contributing most to growth, while net exports (−0.8 pp) having a negative impact. Gross value added (GVA) grew by 2.8% y-o-y. The largest contributors to the 0.5% q-o-q growth in GVA were trade, transportation, accommodation and food service (+0.3 pp) and construction (+0.1 pp). Wages and salaries rose very significantly, by 3% q-o-q and 8.3% y-o-y. Median wage rose by 4.8% in real terms. Inflation remains within the tolerance band, with services prices rising faster than goods prices.

The external environment remains a risk for the Czech economy. It will be significantly affected by the agreement between the United States and the European Union on mutual trade, as well as by economic developments in Germany. A key factor for mutual trade between the EU and the US is the imposition of a 15% tariff on imports of most industrial goods from the EU, with a lower or zero rate applying to selected strategic products. On the other hand, 50% tariffs will remain in place for steel, aluminium, and copper as the creation of a quota system for exports of these metals to the US will also be discussed.

For the Czech economy, the shift from globally applicable multilateral trade rules based on low tariffs towards potentially unstable bilateral agreements between trade blocs or even individual states is unfavourable and undesirable in long-term. This is true although the preliminary agreement between the US and the EU (which will be subject to judicial review on the US side and must be implemented legislatively on the EU side) has not fulfilled some of the catastrophic predictions. Stagnating German economy remains as the risk as its GDP fell by 0.3% q-o-q in the second quarter of this year, due to both weak domestic demand and weak exports. Data from the second quarter confirm that since 2019 Germany and Finland has been the only two economies in the EU that has not recorded any economic growth. In contrast, the Czech economy has already grown by 4.7% compared to 2019 level.

A temporary short-term boost for Germany may come from the recent loosening of the so-called debt brake and the establishment of a €500 billion fiscal fund to channel investment into Germany's defence capabilities, infrastructure, digitization, and decarbonization. The optimistic expectations of markets and businesses resulting from the very significant turnaround in German fiscal policy are thus currently offsetting the risks of a deterioration in the global trade and investment environment.

General government finances and fiscal policy settings for the coming years

The most important component of the public finances – the state budget – ended up with a deficit of CZK 165.4 billion at the end of August, although after adjusting for revenues and expenditures related to EU projects, the deficit was CZK 8.7 billion lower (CZK 156.6 billion). The revenue side is positively influenced by the recovering economy, which is reflected in the relatively high growth of tax revenues (including social security contributions). For example, social security contributions show growth of 7.3% (y-o-y), and personal income tax 11.7%. High growth rates can also be found in corporate income tax (8.4% after adjustment for windfall tax) and VAT (6.5%). Based on developments to up to date, it can be assumed that the state budget will collect more than originally budgeted in tax revenues.

Despite the above-mentioned positive trends in tax revenues, the effects of incorrect budgeting in certain revenue and expenditure items, which the CFC explicitly pointed out during the discussion of the draft budget for 2025, are becoming increasingly apparent. On the revenue side, only CZK 7.9 billion has been collected so far from the sale of emission allowances, which clearly shows the unreality of the originally estimated annual revenue of CZK 30 billion. On the expenditure side, the state budget must deal with insufficiently budgeted funds for subsidies for renewable energy sources (RES) and salaries of non-teaching staff in regional education, where the originally considered transfer of this funding to municipalities and regions from September did not take place. The additional expenditure needed to cover the salaries of non-teaching staff is estimated at around CZK 10 billion, with CZK 4.2 billion already been found in the form of a transfer of funds from the EU contributions item.

The situation is considerably more complicated regarding subsidies for RES, where the additional expenditure requirement is around CZK 16 billion. The government used most of its budget reserve (which is intended to cover unexpected events, and therefore the CFC considers its use in this form to be inappropriate) to cover this and drew on claims from unspent expenditure. However, the funds "obtained" in this way are clearly insufficient, and in August, CZK 900 million was even transferred from funds budgeted for flood damage repair to subsidies for RES. Although this procedure is legal under the Budgetary Rules Act (No. 218/2000 Coll.), the CFC considers it a clear violation of the meaning and logic of the structural deficit rule defined in Section 10 of the Act. This rule allows public budget expenditure to exceed the permissible balance **only in very specific cases.** One of these is precisely the response to natural disasters. According to the wording and meaning of this rule, such additional expenditure should be used solely for the purpose specified in the above-mentioned exception, and its use to cover other current expenditure cannot be accepted. If this approach became standard practice, it would create significant scope for circumventing the basic rule of expenditure frameworks, i.e., the legal ceiling on the amount of expenditure that the general government sector is allowed to spend each year.

Unfortunately, the use of flood damage repair funds for other purposes is not limited to this year's budget, as the government also used CZK 14.1 billion of the CZK 30 billion allocated in the 2024 budget for purposes other than flood damage repair. At present, 37.5% of the CZK 40 billion by which expenditure was increased above the expenditure frameworks in the 2024 and 2025 budgets has already been used for non-flood-related purposes.

Other parts of the public finance system are developing in a clearly different way. Municipalities and regions (local government subsector) continue to generate significant surpluses, ended up with a positive balance of CZK 64.5 billion at the end of June. As the CFC has repeatedly stated, such high surpluses cannot be considered economically rational, because the funds collected from taxpayers are not used for public investment or the provision of services to the population, and taxpayers cannot use them for their private consumption or investment either. This shows that the budgetary allocation of taxes is inappropriate (i.e., at the expense of state budget), increasing the state borrowing needs and interest costs.

The public health insurance companies, also in line with the CFC communicated expectations, are gradually falling into deficit. Health insurance companies ended up with a cash deficit of CZK 3 billion. Given that public health insurance companies have been operating with a negative balance for several years, their reserves are gradually being depleted.

Nevertheless, Czech public finances are currently heading towards a result in 2025 that will comply with the applicable statutory fiscal rules and will be the best in terms of the structural and overall balance since 2019. However, in structural balance terms, the Czech Republic will still not be at a level that could be described as healthy and sustainable.

A significant event in the second half of the year is traditionally the preparation and approval of the draft state budget for the next fiscal year. The CFC notes that the draft submitted by the Ministry of Finance to the government essentially confirms its previous comments and opinions. The state budget is being drawn up in a situation of a growing number of costly new priorities (e.g., defence and energy), an increasing volume of automatically indexed mandatory expenditures (pensions, healthcare, education, defence), a shortfall in temporary revenues (windfall tax), and a new, significantly stricter earmarking of revenues from emission allowances, while at the same time fiscal rules are exerting desirable pressure for further consolidation (reducing the structural balance by at least 0.5% of GDP y-o-y). That makes it increasingly difficult to meet the challenge of drawing up the budget. As the CFC has pointed out in the past, if public finances are to be definitively restored to health, this cannot be achieved without limiting the number of priorities, reducing or at least slowing the growth of certain expenditures, or increasing revenues. According to the CFC, this fact will have to be made clear not only to all stakeholders but also to the public, at the latest when the state budget for 2027 is being prepared.

However, these gradually increasing pressures and tensions are already very noticeable in the draft state budget for 2026 submitted by the Ministry of Finance. This is regardless of the fact that the CFC considers it to be only a proposal that has not yet been discussed by the government, and it is unclear in what form the government will approve it. It is even less clear what budget for 2026 will pass through the Chamber of Deputies of the Parliament of the Czech Republic, which will be formed after the October parliamentary elections. Furthermore, the draft does not contain all the supporting documents (e.g., the volume of salary funds for state organizational units and contributory organizations, the breakdown of state budget revenues by type, or expenditures for program financing of chapters) that are necessary to assess its realism and completeness.

Nevertheless, at this stage of work on the state budget, the CFC draws attention to a fact that relates to the setting of a binding expenditure framework for the state budget and state funds, i.e., the legal limit that the government is obliged to respect.

In the current draft state budget for 2026, defence spending is budgeted at CZK 206.5 billion (2.35% of GDP), with CZK 30.7 billion (0.35% of GDP) exempt under budgetary rules.[1] However, expenditures under the Ministry of Defence chapter are budgeted at only CZK 175.8 billion (2.0% of GDP), and the main increase in defence expenditures appears, somewhat counterintuitively, in the Ministry of Transport chapter, where expenditures of CZK 20.1 billion (0.23% of GDP) are designated as such. Given the significant y-o-y increase in defence spending under this chapter (budgeted at CZK 0.1 billion in 2025), the Ministry of Finance or the entire government should clarify which specific expenditures of the Ministry of Transport are newly designated as national defence expenditures, and why the budget of this ministry has changed so suddenly and significantly in terms of national defence compared to previous years. The CFC points out here that the purpose of the exception allowing expenditure to exceed the expenditure framework is to strengthen the state's defence capabilities. Although it is conceivable that the price of some infrastructure projects may increase due to military requirements, it is difficult to accept that this would account for almost 20 % of the Ministry of Transport's proposed budget. A transparent explanation of this increase is therefore necessary to maintain the functionality of fiscal rules, to fulfil the purpose of the approved exemption for defence spending, and to prevent its possible abuse in future years.

[1] The current version of the budgetary rules allows state budget expenditure to exceed the expenditure framework by defence spending exceeding 2% of GDP.

The CFC notes that all the ambiguities mentioned in the implementation of this year's budget and in the preparation of the budget for 2026 point to a clear need for high-quality and transparent budgeting. Only compliance with the basic standards of the budgetary process (the principles of realism and completeness) and the logic of fiscal rules (the use of funds above the expenditure limit strictly and only for a predefined purpose) leads to sustainable and predictable public finances, which are one of the foundations of the stability of the country and its economy.