The Czech Fiscal Council

CZECH FISCAL COUNCIL

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OPINION

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on the development of general government finances and fiscal and budgetary policy

Pursuant to Section 21(2)(c) of Act No. 23/2017 Coll., on the Rules of Budgetary Responsibility (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 been informing the public about its conclusions on a quarterly basis.

Initial economic situation

The Czech economy continued to grow in the second quarter of this year. Gross domestic product (GDP) grew by 1.9% year-on-year (y-o-y), with household consumption (+1.2 p.p.) and gross fixed capital formation (+1.9 p.p.) making the largest contributions. Change in inventories (-1.3 p.p.) had the opposite effect. On a quarter-on-quarter basis, GDP rose by 0.4%, with the international trade balance making a significant contribution (+0.6 p.p.). Whilst exports rose by 0.9% quarter-on-quarter (q-o-q), mainly thanks to exports of motor vehicles, computers and electrical equipment, imports remained unchanged q-o-q. In the service sector, turnover rose by 1.0% q-o-q, with the transportation and storage sector making the largest contribution, where turnover increased by 2.5%.

Wage growth remains robust and widespread across all sectors. The total volume of wages and salaries rose by 7.5% y-o-y in the second quarter. In July, the general unemployment rate stood at 3.4% and remains one of the lowest in the EU. Inflation in the same month remained below 2% y-o-y. Growth in consumer prices was dampened in particular by y-o-y falls in food prices (-3.1%) and electricity and gas prices (-6.7%); conversely, the main factors pushing prices up were the rise in so-called owner-occupied housing costs (6.0%) due to increases in property prices and the cost of construction work, as well as the rise in fuel prices (16.8%).

The economic growth outlook has not changed significantly with the new forecasts. For 2026, the Ministry of Finance (MF CR) expects real GDP growth of 1.9% and the Czech National Bank 2.1%; for 2027, the figures are 2.4% and 2.7% respectively. The average wage is expected to rise by more than 7% in 2026 and by around 6% in 2027. Both institutions also agree that, in 2027 – after four years – the economy will be operating above its potential output level.

General government finances and fiscal policy settings for the coming years

At the end of August, the state budget recorded a cash deficit of CZK 186.1 billion. **After the necessary adjustment for timing discrepancies in cash flows from the EU, the deficit stood at CZK 209.8 billion**. The deficit is thus, for the third month running, approximately CZK 50 billion worse y-o-y compared with the same month last year. Therefore, it seems likely that the approved deficit of CZK -310 billion (after adjustment for EU flows) will be met or will be close to the approved figure.

The state budget is being supported by rapidly growing revenue. Value-added tax is rising by 8.3% at national level, whilst personal income tax is up by as much as 12.0%. Social security contributions (6.4%) and corporate income tax (6.5%) are also showing solid growth. Overall expenditure is developing as expected, as at the end of August it stood at around 65% of the budgeted full-year expenditure, as was the case last year.

The local government sector showed a cash surplus of CZK 60.5 billion at the end of June, with regions reporting a surplus of CZK 32.1 billion, municipalities CZK 9.1 billion and the City of Prague CZK 19.3 billion. Although health insurance companies reported a slight surplus (CZK 1.2 billion) at the end of July, this was due to an advance payment of CZK 13.1 billion made by the central government in April for state-insured persons, covering the months of November and December.

- Draft State Budget for 2027

The CFC notes that the draft **state budget for 2027 is significantly expansionary and that the MF CR forecasts a general government deficit of 3.5% of GDP.** According to the MF CR documentation on the state budget, the structural balance is set to rise by 1 p.p. of GDP (from 2.5% of GDP to 3.5% of GDP), which is the highest increase since the Covid-19 pandemic, and the level of the structural balance is expected to **exceed the level reached during both years of the pandemic**. The CFC points out that, based on the data submitted by the MF CR, the general government balance that would be achieved if all budgetary assumptions were met stands **at approximately 3.7% of GDP**.

The draft thus continues the trend set by the 2026 budget, which was drawn up in contravention of the legislation in force at the time, and marks a shift from gradual, moderate consolidation towards a marked increase in both deficits and general government debt. Whilst the state budget deficit (adjusted for timing differences in financial flows from the EU) stood at CZK 287.4 billion in 2024 and CZK 249.9 billion in 2025, a deficit of CZK 310 billion is expected in 2026 and CZK 389 billion in 2027. **The trajectory of deficit reduction has turned into a gradual increase, amounting to CZK 140 billion in nominal terms over two years**.

This is logically reflected in the expected higher general government deficits in the so-called Maastricht terms as a percentage of GDP. **In 2024, the general government deficit stood at 2.0% of GDP; in 2025, it was 2.1% of GDP; in 2026, a deficit of 2.7% of GDP is expected; and in 2027, the deficit is projected to exceed 3.5% of GDP.** Such fiscal expansion has practically no parallel since our accession to the EU, apart from specific and crisis periods (e.g. the 2009 financial crisis, the Covid-19 pandemic). **With this proposal, the government is also abandoning the commitment set out in its policy statement to maintain general government finances *"close to a balanced budget, and safely below the 3% deficit threshold"***, as a deficit below this level will certainly not be achieved in 2027.[1]

The CFC conceptually understands the application of the European escape clause for defence expenditure (in accordance with the COFOG methodology); however, its proposed use is contingent upon confidence that **the European Commission will retroactively accept all expenditure defined in this way in its entirety as defence expenditure.** In the event of even the slightest non-acceptance or, conversely, an unbudgeted increase in other expenditure, the Czech Republic risks falling into non-compliance with European fiscal rules in the foreseeable future, and thus into the so-called excessive deficit procedure.

Furthermore, the proposed cash balance of CZK 389 billion does not allow for a direct comparison with the original proposal for the cash balance for 2026, as, following the change in fiscal rules, the draft state budget no longer includes expenditure on the so-called repayable financial assistance from the government for the construction of a new nuclear power plant at Dukovany. This will be provided from an extra-budgetary account, and in the spring the government approved an amount of CZK 30 billion for 2027.[2] When compared with the original draft state budget for 2026 (CZK -286 billion), the deficit would therefore have to be increased by this amount and would stand at CZK 419 billion.

The CFC recognises **that this is a draft which may still undergo changes during September and may not be entirely identical to the version the government will ultimately submit to the Chamber of Deputies of the Parliament of the Czech Republic within the statutory deadline.** Nevertheless, the CFC does not expect any systemic changes to be made to the draft and regards

[1] Government Policy Statement | Government of the Czech Republic [available only in Czech].
[2] General Government Budgetary Strategy of the Czech Republic for 2027–2029 | Ministry of Finance of the Czech Republic [available only in Czech].

it as an expression of the government's approach to fiscal policy for at least the next year. In this context, it must therefore highlight the uncertainty surrounding significant budget items relating to expenditure of a mandatory nature. In the areas of pension expenditure and payments for state-insured persons, the government has budgeted for higher amounts than those corresponding to the statutory indexation, though lower than those corresponding to some of its declarations or direct decisions from this year. The statutory pension indexation is estimated at CZK 300 for the average pension and would entail an increase in expenditure of CZK 11 billion; however, the draft budget allocates an increase of CZK 19.2 billion for pensions. The statutory indexation of payments to health insurance companies for state-insured persons would lead to an increase of CZK 2.4 billion; however, a government resolution[3] approved an increase of CZK 21 billion. The draft state budget then shows an increase of CZK 18 billion. The CFC therefore expects that all these items will be explained, finalised and properly budgeted for in the draft that the government will defend in the Chamber of Deputies of the Parliament of the Czech Republic and will continue to monitor them closely.

- Fiscal-Structural Plan for 2027 to 2030

The European Commission has recommended the newly negotiated Fiscal-Structural Plan (FSP) of the Czech Republic for 2027 to 2030 to the Council of the EU for approval. It sets out, on the one hand, the so-called net expenditure path and, on the other, the new projected general government balances for the period in question. In 2027, the FSP forecasts a general government deficit of 2.8% of GDP, followed by a consolidation of general government finances to 2.0% of GDP in 2028, 1.6% of GDP in 2029 and 1.2% of GDP in 2030.

The CFC therefore points out that, in order to achieve this trajectory, it will be necessary to reduce the general government deficit by 1.5 p.p. from the projected 3.5% of GDP (in 2027) as early as 2028. In today's prices, this amounts to between CZK 130 and 140 billion. This is because, by 2028, the government will no longer be able to utilise the European defence expenditure exemption to the same extent as it intends to in 2027, as this exemption will already have been largely exhausted by 2027. The application of the European defence exemption in 2028 would only be possible provided there is a significant increase in defence expenditure above 2% of GDP.

Nevertheless, the FSP anticipates further consolidation in 2029 as well (by a further CZK 40 billion at current prices), which is the year in which the next general election to the Chamber of Deputies is due to take place. Both theory and practice show that consolidation during such periods is extremely difficult, as it entails significant political costs. **In this context, the CFC sees fundamental risks that the targeted trajectory for general government deficits will not be met and does not consider the path for reducing the overall deficit to be credible.**

- Loosening of fiscal rules

In August, the President's veto on a package of acts governing national fiscal rules was overridden. The CFC had previously highlighted the risks associated with the loosening of fiscal rules. These related in particular to the implementation of a new exemption from expenditure limits for transport infrastructure without any quantitative restrictions, the extension of the exemption from spending limits for defence expenditure, and the government's ability to increase budgetary expenditure by up to 10% without the consent of the Chamber of Deputies, even for reasons defined only vaguely in the act.

In this context, the CFC notes and emphasises that it was not necessary to introduce anything into national legislation beyond harmonisation with EU legislation on fiscal rules in order to ensure the feasibility of the proposed state budget for 2027. If the government intends to apply the European exemption (in accordance with the COFOG methodology) for defence expenditure amounting to CZK 70 billion in 2027, it was possible to do so without introducing entirely new national escape clauses into the national fiscal rules.[4] **The CFC is therefore convinced that the loosening of national fiscal**

[3] Resolution of the Government of the Czech Republic No. 358 of 8 June 2026 [available only in Czech].
[4] Opinion of the CFC No. 4/2026 on general government finances and fiscal and budgetary policy | Czech Fiscal Council

rules beyond the scope of European rules was intended to facilitate the drafting of the state budget for the period beginning in 2028.

The CFC reiterates that fiscal rules exist so that the budgetary process adapts to them, rather than the fiscal rules adapting to the budgetary process.

- Rising interest costs

Last but not least, the CFC highlights the risk of an increase in the volume of debt servicing, both in absolute and relative terms. Whilst interest expenditure by the general government sector stood at 0.7% of GDP (CZK 45 billion) in 2021, it is projected to reach 1.5% of GDP (CZK 145 billion) next year.

This is also linked to the gradual rise in interest rates on government bonds, specifically the implicit interest rate (the average interest rate on the entire outstanding debt). **This is currently rising relatively rapidly and stands at 3.5%, its highest level since 2012. The critical level of the implicit interest rate corresponds to the rate of nominal GDP growth**, as reaching this level would mean that it would be extremely difficult for the Czech Republic to reduce or stabilise its general government debt-to-GDP ratio. This is because if nominal GDP were to grow more slowly than the implicit interest rate, the debt-to-GDP ratio would rise even if the Czech general government finances were in balance (this is the threshold of the so-called debt trap).

According to the latest forecast by the MF CR, nominal GDP is set to grow by 4.6% this year and by 6.3% next year. The Czech Republic is therefore still a long way from the situation described above; however, according to the CFC, it is not correct to completely ignore the fact that market yields on 10Y government bonds, which serve as a benchmark of sorts, are currently hovering around the 5.0% mark, and the implicit interest rate will therefore continue to rise as a result of the need to refinance previously issued debt (during a period of low rates) at higher rates.

The higher cost of debt financing will also apply to the announced investment projects. We highlight many issues relating to public investment in our recently published information study, *Investment and Capital Expenditure in Public Finance* [available only in Czech]. Firstly, we show that the term 'investment' is used inconsistently in public debate and that, from an economic perspective, not all expenditure recorded in the accounts as so-called 'capital expenditure' can be regarded as investment. Furthermore, we explain that fiscal multipliers do not constitute a universally applicable argument to suggest that higher investment expenditure is capable of financing its own budgetary costs through additional economic growth. Similarly, in none of the countries we analysed can it be stated that, historically, a reduction in general government debt as a percentage of GDP was driven initially by massive public investment, which would first have increased the debt-to-GDP ratio and subsequently triggered faster economic growth (compared to a scenario in which no investment boom would have occurred), and, as a result, a situation arose where the country "grew out of debt". However, this narrative is often misrepresented in public debate.