The Czech Fiscal Council

Office of the Czech Fiscal Council

CZECH FISCAL COUNCIL

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O P I N I O N

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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, the Czech Fiscal Council (hereinafter "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

In the third quarter, gross domestic product ("GDP") grew by 1.3% year-on-year ("y-o-y"). The value of y-o-y GDP growth was mainly driven by household consumption (+1.4 pp) and government consumption (+0.6 pp). Conversely, gross fixed capital formation decreased by 0.8% y-o-y and negatively affected GDP (–0.3 pp). Investment decreased mainly in dwellings, information technology and other machinery and equipment. GDP grew by 0.4% quarter-on-quarter ("q-o-q"), mainly driven by the changes in inventories (+1.1 pp). The gross value added ("GVA") growth of 1.0% y-o-y was mainly driven by the trade, transport, accommodation and food service activities (+0.5 pp). The manufacturing sector contributed to the q-o-q GVA growth of 0.8% (+0.5 pp). Exports of goods increased by 2.2% q-o-q and by 3.6% y-o-y in the third quarter, mainly due to exports of electronic and optical product and motor vehicles. From January to September, the trade balance in goods reached a surplus of CZK 182.9 billion, an annual improvement of CZK 107.1 billion.[1] The volume of wages and salaries in current prices rose by 6.6% y-o-y in third quarter and by 1.8% q-o-q.

Retail sales have been rising month-on-month since June (0.2% in September), for example retail sale via internet and via mail order have risen 17.5% since the beginning of the year. November business confidence increased in the trade, services and construction. Conversely, in industry, business confidence declined due to lower expected manufacturing activity in the coming months. The manufacturing PMI fell to 46.0 points in November from 47.2 in October, which was below market expectations. This was due to a decline in production and new orders, with manufacturers citing continued problems in the automotive sector and the German economy. Thus, the economic development in Germany remains a risk. In the third quarter, the German economy grew only slightly y-o-y (by 0.1%), with government consumption (2.5%) being the main driver of growth, while a significant y-o-y decline is evident in gross fixed capital formation (–2.3%) and net exports (–0.6%). The stagnation is already having an impact on the German labour market (October share of unemployed persons was 6.1%[2]). Large companies continue to announce production cuts and layoffs in the coming years, e.g. ThyssenKrupp and Bosch.[3] Potential risks for the Czech economy are also the possible protectionist measures in the US trade policy resulting from the new administration.

[1] In the methodology of *the Statistics of International Trade in Goods.*
[2] The share of unemployed persons is determined by the Federal Employment Agency (Bundesagentur für Arbeit).
[3] Reuters (11/25/2024), Reuters (11/22/2024).

General government finances and fiscal policy settings for the coming years

The systematic imbalance of general government finances in the Czech Republic, which has long been concentrated at the level of the state budget, continued. At the end of November, the state budget recorded a deficit of CZK 259.2 billion in cash terms; after adjusting for revenue and expenditure related to EU projects, the deficit was CZK 2.5 billion lower. State budget revenues increased by 1.1% y-o-y, dominated by revenues from social security contributions and personal income tax from dependent activity (employment). In contrast, corporate income tax revenues decreased y-o-y, mainly due to the repayment of part of the advance payments made in 2023.[4] In the case of consumption taxes, VAT revenues grew by 4.8% y-o-y, mainly due to the growth in household consumption. Selective consumption tax revenues also showed high y-o-y growth (+10.5%), mainly due to changes in rates and exemptions.

On the revenue side of the state budget, the budgeted revenues from the sale of emission allowances can once again be expected to be unfulfilled. The approved state budget for this year envisaged a revenue of CZK 40.7 billion. Based on the cash performance so far and refined estimates, the CFC believes that the state budget will collect approximately CZK 16 billion for the whole year, i.e. about CZK 24 billion less than the original plan. This shortfall should be partly offset by higher than planned windfall tax revenue. The state budget expected a revenue of CZK 17 billion, but CZK 27.3 billion have already been collected. In this context, the CFC points out that the windfall tax is a one-off and temporary measure, and its higher revenue does not lead to an improvement in a key indicator of the balance of general government finances – the structural balance.

No major risks are yet apparent on the expenditure side of the state budget. Total state budget expenditure stood at 89.2% of the full-year budget at the end of November, slightly below the aliquot. However, it should be noted that the expenditure approved in the amendment for flood damage repair has not yet been spent to a greater extent and can thus be expected to increase in December or to carry over unspent expenditure to the following year.

The full-year deficit of the state budget will most likely be around the approved level of CZK 282 billion (after the amendment to the Act on the State Budget). In this context, however, the CFC reminds that to get a true picture of the state finances, it is important to monitor the state budget result after adjusting for the impact of revenues and expenditures related to the EU budget. The release of up to CZK 41 billion announced by the European Commission, which the Czech Republic could collect before the end of 2024, would improve only the cash balance of the state budget, but not the accrual-based balance which is the only one that is internationally comparable and, unlike the cash balance, is used to assess compliance with the so-called Maastricht convergence criteria. At the same time, it should also be emphasized that when comparing the achieved balance with the balance approved in the Act on the State Budget, it is always necessary to work with a value adjusted for revenue and expenditure related to EU projects.

Other parts of the general government sector develop differently from the state budget. Health insurance companies reported a deficit of CZK 7 billion in cash terms at the end of October, thus heading towards a slightly deficit balance for the full year. In contrast, municipal and regional authorities continue to generate significant surpluses. At the end of October, the cash surplus reached CZK 51.6 billion. By the end of the year, the local government surplus could thus be around 0.8% of GDP. The CFC emphasizes again that such high systemic local government surpluses are not macroeconomically rational (they are taxes collected from taxpayers, which are not used to finance their private consumption, and consequently not public consumption either, which has an impact on GDP), and that it is highly desirable to change the setting of the budgetary determination of taxes to increase the share of the state budget in shared taxes.

From the long-term sustainability of public finances perspective, the CFC closely followed the debate on the so-called "great pension reform", which took place during its discussion and approval in the Chamber of Deputies of the Parliament of the Czech Republic. The final form, which was even approved by the Senate, significantly improves the projected balance of the pension system over the next 50 years

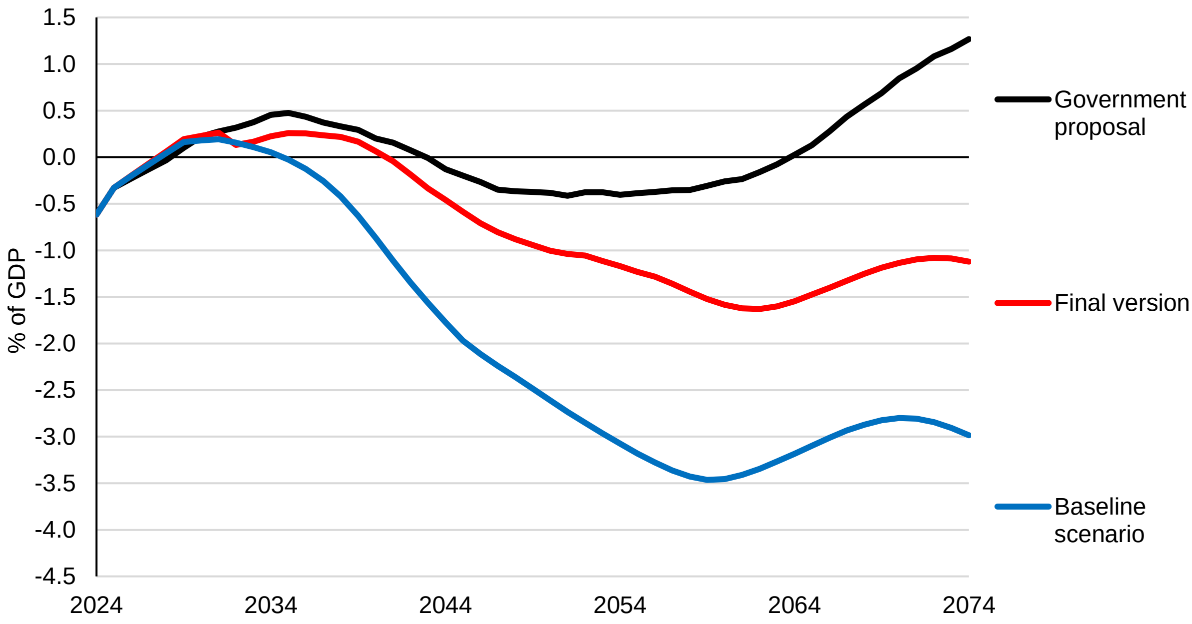
[4] See Opinion of the CFC No. 5/2024 https://www.rozpoctovarada.cz/en/publications/opinion-of-the-cfc-no-5-2024-on-general-government-finances-and-fiscal-and-budgetary-policy/

compared to the pension system setting after the so-called “small pension reform” (i.e. after adjusting the regular indexation of pensions and setting stricter conditions for early retirement pensions).

Therefore, the reformed Czech pensions system (see chart) in the times of the deepest deficit (the turn of the 2050s and 2060s) should fall into a deficit of a maximum of 1.7% of GDP (red curve), while the baseline scenario (without the impact of the “great pension reform”) implied a pension system deficit of around 3.5% of GDP in the same period (blue curve). At the same time, the CFC adds that if the government's original proposal for a "great pension reform" (which was even more ambitious) had been approved, the pension deficit would have been below 0.5% of GDP in the most unfavourable period (black curve).

The improvement in the projection of the pension system deficit compared to last year was also positively affected by a change in the demographic projection (especially the assumption of higher net migration) and the aforementioned “small pension reform”. Overall, the reform changes account for roughly three-quarters of the improvement in the projection of pension system deficits in 2050–2060, with the remainder attribute to more favourable assumptions about the demographic situation and related macroeconomic developments.

Chart – Projections of pension system balances under different variants of the “great pension reform”



Source: CFC calculations.