The Czech
Fiscal Council

REPORT ON COMPLIANCE WITH THE RULES OF BUDGETARY RESPONSIBILITY FOR 2022

September 2023
Czech Fiscal Council

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Office of the Czech Fiscal Council

Holečkova 31, 150 00 Prague 5

Phone: +420 277 771 010

E-mail: podatelna@unrr.cz

Web: www.rozpoctovarada.cz/en/

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Introduction

In 2022, Czech public finances were dominantly affected by a surge in inflation. The post-Covid recovery in many countries of the World, including the Czech Republic, brought with it increased private sector demand which, however, ran up against a stagnant supply of producers and retailers, fuelling a rise in the inflation rate. The invasion of Ukraine by Russian troops in February 2022 – in addition to the incalculable loss of human health and life – was another factor contributing to the rise in the inflation rate due to, among other things, the significant increase in the price of energy, fuel and food. The Czech fiscal policy response to the war conflict in terms of humanitarian and military aid spending was justified and did not have a major impact on the sustainability of public finances. However, the same cannot be said of some other actions of the government in the context of compensation of domestic actors related to energy market interventions or other measures.

Compared to the pandemic years of 2020 and 2021, the general government sector has achieved better economic results, but the effects of the earlier loose fiscal policy and measures taken during the pandemic are also affecting public finances now and will continue to be felt in the years to come. The reverberations of the fiscal policy response to COVID-19 are visible, among other things, in the general government structural deficit which was around 2.8% of GDP in 2022[1]. It reflects actions taken during the pandemic, which ultimately have a more lasting impact on the structure of public revenues and expenditures than the pandemic itself. The change in the structure of public revenue and expenditure, together with one-off and temporary measures to support the economy, also contributed to the rise in inflationary pressures.

On the one hand, it is appropriate that the government has often reacted and is reacting with temporary, not permanent, support for the affected entities and is trying to cover the temporary expenses with extraordinary revenues (e.g. the so-called levy on excessive income or the so-called windfall tax, applied from 2023). However, it should be noted that the design and parametric setting of these temporary measures contribute to increasing uncertainty in the general government sector's economic results.

On the other hand, the high inflation rate also brought changes with long-term implications for public finances. These include, in particular, three extraordinary pension indexations which will mean increased costs in the coming years, as well as the introduction of so-called indexations for other items of public expenditure. These indexations are then difficult to abolish or reduce, which again does not contribute to the long-term sustainability of public finances.

Currently, the so-called consolidation package presented in May 2023, which should help stabilise public finances, is also widely discussed. However, the list and parameters of all the envisaged changes and their impact in their definitive approved form were not known at the time of writing. Nevertheless, the current efforts to consolidate public finances can be positively appreciated. It is again clear that the setting of the parameters of the consolidation package will affect not only the current but also the future economic development of the general government sector.

This Report on Compliance with the Rules of Budgetary Responsibility (the Report on Compliance with the Rules) contains an assessment of compliance with the fiscal rules in 2022. The preparation of this Report on Compliance with the Rules is one of the main tasks of the Czech Fiscal Council (CFC) set out by Act No. 23/2017 Coll., on the Rules of Budgetary Responsibility, as amended (the Act). Although the Report on Compliance with the Rules only considers facts relating to 2022, it also examines the period before that year. Unlike in previous years, this Report on Compliance with the Rules does not focus on expected developments in the following years. The reason is that at the time of drafting of the Report on Compliance with the Rules (early September 2023), the basic parameters of the state budget for 2024 had not yet been finally approved. The preparation of the budget for this year and the outlook for 2024 and 2025 was thus burdened with a significant degree of uncertainty.

[1] The calculation of the structural balance was based on the total general government balance according to the CSZO (2023): Notification of General Government Deficit and Debt - 2022 (First notification, Data Notified by Eurostat) published on 21 April 2023. The cyclical component of the balance and one-off and other temporary measures were taken from the MF CR (August 2023): Macroeconomic Forecast of the Czech Republic. This August macro-forecast indicates a total general government balance of –3.2% of GDP (compared to –3.6% of GDP in the first notifications). The improvement of the balance of CZK 31.2 billion is due to higher corporate income tax revenue for 2022 than was considered by the Czech Statistical Office (CZSO) during the first notifications in April 2023. The updated figure on the total general government balance for 2022 will be published by the CZSO as part of the so-called second notifications in October 2023.

1 General government finances

In 2022, gross domestic product (GDP) grew by 2.4% year-on-year in real terms, exceeding its pre-pandemic value (in 2019, GDP at constant prices was CZK 5,304 billion, in 2022 it reached CZK 5,313 billion).[2] Gross capital formation (1.7 percentage points) and the net exports (0.9 percentage points) were the main contributors to the growth in product. Government final consumption expenditure contributed only marginally to growth (0.1 pp). Final consumption expenditure of households contributed in the opposite direction (–0.3 pp), reflecting a decline in their real incomes. The economy was slightly above its potential over the economic cycle, with an output gap of 0.2% of potential output. The general government deficit reached CZK 247.5 billion, i.e. 3.6% of GDP.[3] The structural balance reached –2.8% of GDP.[4] The debt-to-GDP ratio increased by 2.1 pp year-on-year to 44.2% of GDP.

For 2023, the Ministry of Finance of the Czech Republic (MF CR) expects[5] an annual decline in real GDP of 0.2% and an output gap of –0.6% (of potential output). The general government sector is expected to end with a deficit of 3.6% of GDP and the structural balance is estimated by the MF CR at –2.3% of GDP. The general government debt-to-GDP ratio is expected to rise by 0.5 pp to 44.7% of GDP. The low increase in the debt ratio is mainly due to continued high growth in price level: in 2023, the average consumer price inflation rate is expected to be 10.9% and the GDP deflator 9.0%. The high inflation environment is putting considerable pressure on the introduction of so-called indexation in public finances (see Box 1). At the same time, the significant increase in the price level contributes to a generally difficult-to-quantify public and private sector response which is reflected, among other things, in the high degree of uncertainty associated with the forecast (not only) for 2023.

Box 1 Indexation in public finances

Automatic indexation means that the selected parameter of spending or tax policy (its level or growth rate) is linked to a certain economic indicator and adjusted annually for its development. The following significant expenditure blocks will be indexed in the Czech public finances from 2024:[6]

- pension benefits (according to the rate of inflation and the rate of growth of real wages),
- payments for state insured persons (according to the inflation rate and the growth rate of real wages),
- defence spending (% of GDP),
- teachers' salaries in regional education (% of the national average wage).

However, in professional and political discussion there are proposals for further expansion of automatic indexation: e.g. for the level of subsistence minimum, social discounts on personal income tax or parental allowance.

The main argument for the use of automatic indexation is that it allows economic agents (benefit recipients, taxpayers, etc.) to anchor their expectations and makes public finances transparent and more predictable.

However, any indexation means that the government autonomously increases certain groups of expenditure each year, which greatly limits its room for manoeuvre. The government is thus effectively deciding on an ever-smaller range of public expenditure (e.g. in the Czech Republic, the sum of the most fiscally important items subject to automatic indexation from 2024 – pensions, payments for the state insured persons, military spending and teachers' salaries – represents almost 50% of the state budget expenditure). Fiscal policy is turning into an automaton determined by the application of the relevant formulas which certainly do not guarantee its counter-cyclicality and sustainability.

Another consequence of the above-mentioned institution is that it may lead to autonomous changes in the structure of public finances or other unintended effects. For example, if wages and salaries as a share of GDP are rising (as was the case in the pre-COVID-19 period in the Czech Republic), the consequence is that expenditure on wage-indexed items grows faster than the GDP growth rate. This creates pressure for a worsening of the

[2] MF CR (August 2023): Macroeconomic Forecast of the Czech Republic.
[3] The balance figures are based on the CZSO (2023): Notification of General Government Deficit and Debt - 2022 (First Notification, Data Notified by Eurostat), published on 21 April 2023. The MF CR in its August macro forecast reports a total balance of CZK –216 billion, i.e. –3.2% of GDP. The improvement of CZK 31.2 billion compared to the first notifications is due to higher corporate income tax revenue than was known during the first notifications. However, these better economic results have not yet been notified by Eurostat (this may happen during the second notifications, the results of which will be published by the Czech Statistical Office in October 2023), therefore we present the original figures in the text.
[4] The cyclical component of the balance and one-off and other temporary operations are based on the MF CR (August 2023): Macroeconomic Forecast of the Czech Republic. The general government balance is taken from the Czech Statistical Office (CZSO) according to the first notifications, see footnote above.
[5] MF CR (August 2023): Macroeconomic Forecast of the Czech Republic.
[6] As can be seen from the above list of expenditure blocks, the inflation rate is an important economic indicator to which expenditure or tax policies can be linked as part of indexation. A more comprehensive view of the impact of inflation on public finances is presented in Box 1.1 of the CFC (2023): Report on the Long-Term Sustainability of Public Finances.

structural balance. In the case of pension benefits, their indexation at least at the rate of inflation led to a sharp increase in the average replacement rate and an increase in the share of expenditure on these benefits in GDP in 2022 and 2023 (in the case of high inflation and falling real wages).[7]

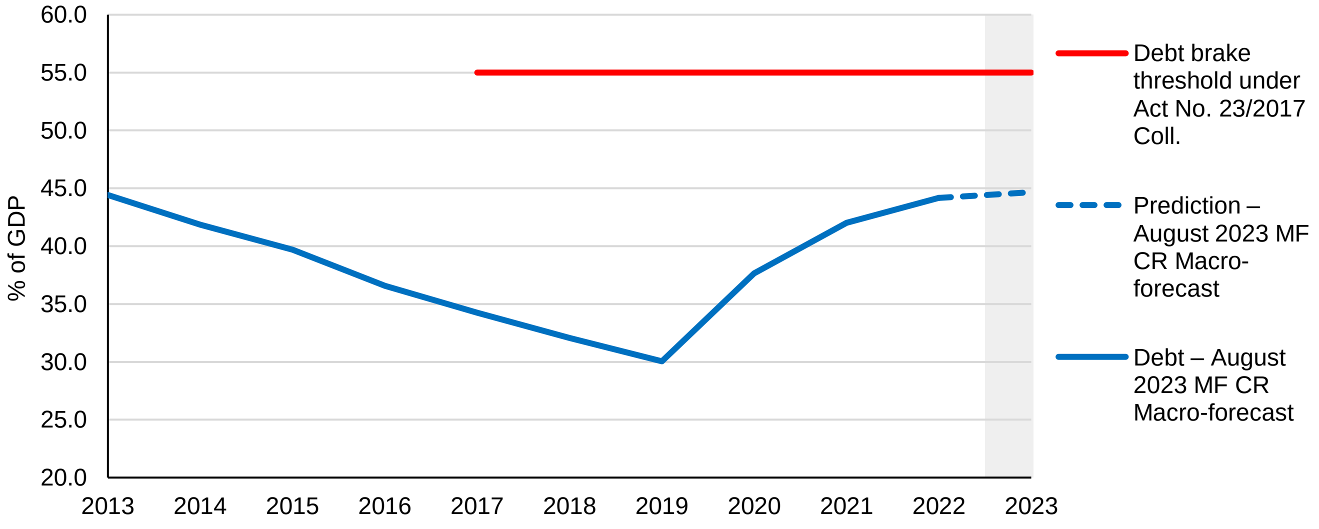
If major expenditure blocks are subject to automatic increases, this makes it difficult for the government to adjust the budget in accordance with its preferences. Any significant change entails the need to amend the relevant act that sets the given indexation formula. However, those affected may then feel 'cheated' as they are deprived of something to which until now they were automatically entitled. This is, after all, why indexation is created in the first place. Its purpose is to make the increase in indexed expenditure more difficult to change and easier to predict in advance. It is far more acceptable if the government does not simply proceed to increase a particular item and uses the space gained to boost spending in the area of its current priorities (or to reduce the deficit).

2 The debt rule

The debt rule is defined in Sections 13 to 16 of the Act. Section 13 of the Act stipulates that the general government debt (net of the cash reserve in financing the public debt) as a percentage of GDP is monitored. If the ratio exceeds 55% of GDP (the so-called "debt brake threshold"), the measures set out in Section 14 of the Act are applied. These measures would lead to reduction in the active use of fiscal policy to stabilise economic developments over the economic cycle and would restrict the activity of many general government organisations. In addition, a breach of the debt brake threshold would signal to the financial markets the deterioration of the Czech public finances, with a consequent possible demand for an increased risk premium, which would contribute to growth in debt. Section 16 of the Act states that if the debt-to-GDP ratio exceeds the 60% of GDP threshold, the government will propose measures to reduce this level.[8]

In its communication of 20 April 2023[9], based on the data of the Czech Statistical Office (CZSO) and the MF CR, the CFC announced the value of the debt rule indicator as of 31 December 2022 at 44.1% of GDP. Owing to a revision of the national accounts, the nominal GDP figure for 2022 was reduced (from CZK 6,795 billion to CZK 6,786 billion), which caused the general government debt ratio (minus the state debt financing reserve) to increase to 44.2% of GDP (see Chart 1). However, the increase in the ratio did not cause the thresholds set by the Act and mentioned in the previous paragraph to be exceeded.

Chart 1 General government debt minus the state debt financing reserve



Source: MF CR (August 2023): Macroeconomic Forecast of the Czech Republic; CFC calculations.

Conclusion: The CFC states that the reference values of the general government debt indicator defined in Sections 14 and Section 16 of the Act were not exceeded in 2022.

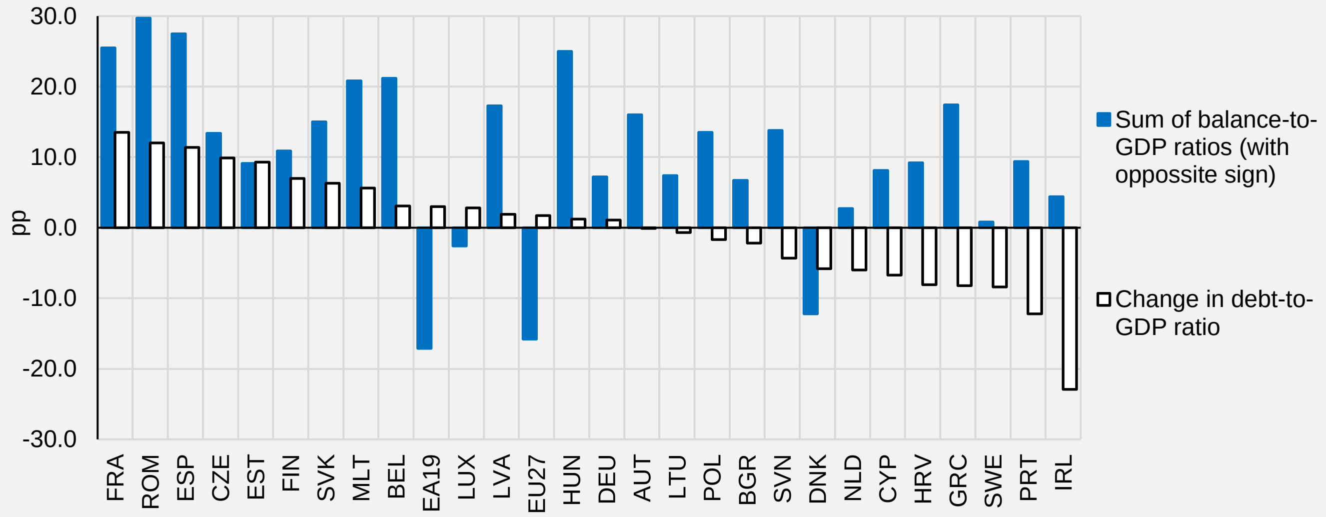
[7] See CFC (2023): Report on the Long-Term Sustainability of Public Finances, in particular subsection 3.1 and Box 3.1.
[8] The exact specifics of these measures are contained in Article 2(1a) of Council Regulation (EC) No 1467/1997. Above all, the measures define the minimum rate of reduction of the debt-to-GDP ratio towards the 60 % threshold if it is exceeded.
[9] Czech Fiscal Council Communication No. 117/2023 Coll., on the level of general government debt minus the state debt financing reserve.

Box 2 provides a more detailed breakdown of the change in the general government debt ratio of the Czech Republic and other EU countries over the period 2018–2022. Box 3 then focuses on the specifics and impacts of the loan (under the so-called Recovery and Resilience Facility) from the European Commission for the Czech public finances.

Box 2 Distribution of the change in EU countries' debt between 2018 and 2022

The ratio of the general government balance and debt-to-GDP is one of the most closely watched economic indicators. If we consider that the balance is a "flow" indicator and the debt a "stock" indicator, then it would be intuitive to assume that the sum of balances over a certain period yields the change in debt over that period. However, Chart B2.1 showing the sum of the balance-to-GDP ratios and the change in the debt-to-GDP ratio over the period 2018-2022 rather refutes this assumption. For some EU economies, the sum of balances is higher than the change in the debt ratio would imply over the given period (France, Romania, Spain and, for example, the Czech Republic), and the reverse situation, i.e. the sum of balances is smaller than the absolute change in debt, is the case in Sweden, Portugal, Ireland etc.

Chart B2.1 Sum of balance-to-GDP ratios versus change in debt-to-GDP ratios over the period 2018–2022



Source: AMECO (2023); CFC calculations.
Note: Italy was excluded from analysis due to inconsistent data.

How can this discrepancy be explained? We have already presented the basic debt dynamics equation which captures the main factors influencing the change in the debt-to-GDP ratio over time (primary balance, implicit interest rate and nominal GDP growth) in the earlier 2019 and 2020 Report on the Long-Term Sustainability of Public Finances (see Boxes 2.2 and 2.3). If we extend and modify this equation, we can capture the following factors affecting the change in the debt-to-GDP ratio: the primary balance, the implicit interest rate, “transition” between balance and debt (so-called stock-flow adjustment (SFA)), the growth rate of real GDP and the inflation rate. Chart B2.2 shows the impact of these factors on the change in the debt ratio between the years 2018 and 2022.

The impact of the primary balance-to-GDP ratio on the development of the debt-to-GDP ratio is relatively straight-forward. Other things being equal, a surplus primary balance reduces debt and a deficit primary balance increases debt. The primary balance had a negative effect on debt in most EU economies, with large deficits – especially during the COVID-19 pandemic and in some economies also during 2022 (due to geopolitical tensions and high price increases with a subsequent general government response) – increasing public debt. For some economies, such as Denmark, Portugal or Luxembourg, the opposite phenomenon was observed over the given period, with the primary balance contributing to a reduction in the debt-to-GDP ratio.

The impact of the implicit interest rate on the dynamics of the debt-to-GDP ratio can also be deducted, at least in a basic understanding of the problem. In general, under normal market conditions, interest costs should rise with increasing debt, inter alia because of the higher risk premium requirements of debt security holders. The environment of higher interest rates in which EU countries find themselves after a fragile post-covid economic recovery also contributes – other things being equal – to higher interest costs on debt servicing.[10]

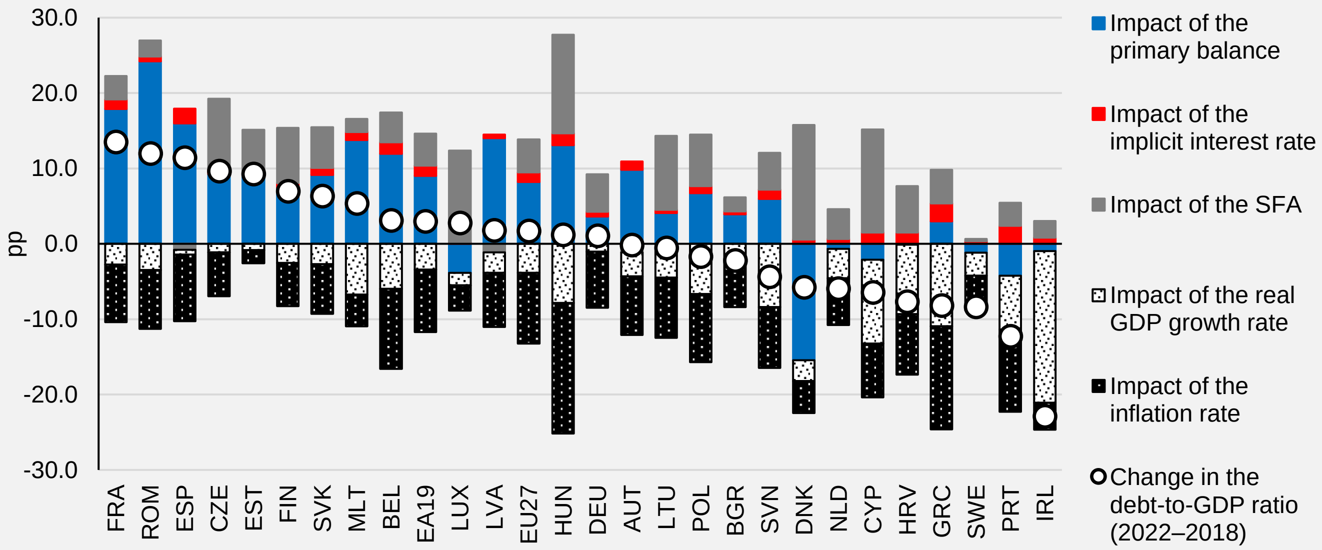
The magnitude of the impact of the SFA on the debt-to-GDP ratio is difficult to estimate in advance. The SFA has three main components: a) net acquisition of financial assets, b) methodological adjustments, c) statistical discrepancy.[11]

The net acquisition of financial assets usually plays an important role in the SFA. Over the observed 2018–2022 period, there was a significant increase in this item in the covid years (mainly 2020, to a lesser extent 2021) when many EU countries issued debt securities without immediately using the funds raised for public expenditure, with a consequent impact on the general government balance. Instead, the funds raised increased the liquidity available to governments for possible future use in those uncertain times. In addition, EU countries also benefited from favourable financing conditions during the pandemic (compare e.g. the current situation on the financial markets).

Unlike the net acquisition of financial assets item, the other two components of the SFA (methodological adjustments and statistical discrepancies) are generally less significant.

The growth rate of nominal GDP can be "split" into two parts: real GDP growth and the inflation rate (captured by the GDP deflator). Real GDP growth helps to reduce the debt-to-GDP ratio, see for example the significant reduction in the debt ratio in Ireland. The inflation rate, as might be intuitively apparent from Chart B2.2, reduces the debt ratio (see, for example, Hungary or Greece). However, the impact of inflation on public finances may not be so straightforward and not always positive. It depends, among other things, on the response of economic agents and the government. For example, consumption may be reduced due to a decrease in real incomes, resulting in lower consumption tax collections. Higher inflation rates may also put pressure on the introduction of indexation on other items of public expenditure. These aspects are further discussed in Box 1.1 of the Report on the Long-Term Sustainability of Public Finances (2023) or Box 1 of this Report on Compliance with the Rules.

Chart B2.2 Factors influencing the change in the debt-to-GDP ratio over the period 2018–2022



Source: AMECO (2023); CFC calculations.
Note: the sum of the individual factors affecting the debt-to-GDP ratio may not be exactly the same as the difference between the debt ratio at the end and the beginning of the reference period because of the approximation of the calculation of the individual factors and the accuracy of the data used.

In the case of the Czech Republic, the dominant factor in the change in the debt ratio over the 2018–2022 period was the primary balance. In 2018 and 2019, the balance was positive and therefore helped reduce the debt ratio. In 2020–2022, on the other hand, it was negative and thus increased the debt ratio. Interest costs have consistently contributed to the increase in the debt ratio, only the strength of their effect has varied – their effect was weaker in the low interest rate environment during the pandemic and stronger in the high interest rate environment in 2022. The "transition" between the balance and debt, i.e. the SFA, also increased the debt ratio throughout the

[10] We abstract here from a number of other factors affecting the implicit interest rate. More detailed information is provided, for example, by CFC (2023): the Report on the Long-Term Sustainability of Public Finances; Morda (2022): Development of the Czech Republic's state debt; Tománková (2020): The Impact of General Government Debt on the Government Bond Yield Rate.
[11] For the EU countries, Eurostat (2022) offers a summary of SFA statistics including comments, e.g.: Eurostat (2022): Stock-flow adjustment for the Member States, the euro area and the EU, for the period 2018-2021 (as reported in the April 2022 EDP notification).

period under review. This was mainly the net acquisition of financial assets between the years 2020 and 2022.[12] Real GDP growth reduced the debt ratio throughout the period, except in 2020, when there was a year-on-year decline in real GDP. The increase in the price level reduced the debt ratio throughout the period, but most strongly in 2022, when inflationary pressures escalated in the Czech Republic.

Box 3 Recovery and Resilience Facility (RRF) loan

As part of the June "Update of the National Recovery Plan", the government expressed interest in a loan from the European Commission worth CZK 137 billion to be drawn down in 2024–2026. In August 2023, however, the final amount of the loan was reduced, therefore its amount will be CZK 19.4 billion. The CFC appreciates this step, as it has been pointing out from the beginning that from the point of view of the general government deficit and debt, it is completely irrelevant whether the government raises funds through the issue of government bonds, borrowing or using other debt instruments. However, borrowing under the RRF entails the obligation to fulfil a number of conditions (in particular, the so-called targets and milestones). Therefore, it is not a financial resource that the government can dispose of as freely as if it had raised it through the issuance of its own bonds. Although it can be assumed that the interest rate will be slightly lower than in the case of a bond issue, the exact interest rate is not known at this point in time, i.e. at the time of the conclusion of the contract. Its design[13] allows only an estimate of the interest rate, but the final interest rate will always be communicated to the Member State a few days before the drawdown of the individual tranches. In addition to the exchange rate risk, another risk of the loan is the ambitious deadline by which all financed projects must be implemented and also notified by the European Commission. That is the end of 2026. Failure to meet the conditions would deepen the debt, but with the difference that without the existence of the RRF, the projects at national level in question might never have been initiated. The loan is divided into two parts, a loan part and a grant part. The funds under the loan part (CZK 9.9 billion) will be further "re-lent" by the central government to municipalities, regions and private entities. These are mainly programmes of the Ministry of Regional Development of the Czech Republic related to housing (e.g. soft loans). The grant part (CZK 9.5 billion) will be directly allocated to selected subsidy titles approved by the European Commission. In the case of the Czech Republic, this concerns in particular the chapter of the Ministry of the Interior of the Czech Republic, specifically the area of cyber security.

3 The rule for determining total general government expenditure and deriving the state budget and state funds expenditure framework

Section 10a(2) of the Act states that the MF CR will not apply the General Government Budgetary Strategy in 2021 for the purpose of determining the total expenditure of the general government and the expenditure frameworks of the state budget and state funds for 2022. According to this provision, the structural balance for 2021 forecasted by the MF CR in September 2021 at the latest, increased by 0.5 pp, will be used in 2021 for the purpose of determining the total expenditure of the general government for 2022. According to the August 2021 Macroeconomic Forecast of the Czech Republic by the MF CR, from which the 2022 limit was eventually derived, the structural deficit for 2021 was forecast at 6.1% of GDP, and therefore the limit for 2022 was set at 5.6% of GDP.

According to the draft act on the state budget for 2022 and the medium-term outlook for 2023 and 2024 of September 2021[14], which was based mainly on the August macroeconomic forecast of the MF CR[15], the general government expenditure was to amount to CZK 2,874.8 billion and the expenditure framework of the state budget and state funds (including the EU) to CZK 1,972.0 billion, see Table 1. The state budget deficit was estimated at CZK 376.6 billion. According to the MF CR[16], the method used to derive the expenditure frameworks was the same as that set out in the budget strategies.

However, this draft act on the state budget was not approved by the Chamber of Deputies of the Parliament of the Czech Republic until the beginning of the 2022 budget period. Thus, the government emerging from the autumn 2021 elections operated in a budget provisional environment from 1 January to 18 March 2022.[17] This meant

[12] See CFC (2023): Report on the Long-Term Sustainability of Public Finances (2023), subchapter 1.1 for the situation in the Czech Republic in 2022.
[13] See: European Commission Implementing Decision (EU) 2021/1095 of 2 July 2021.
[14] MF CR (2021): Draft Act on the State Budget of the Czech Republic for 2022 including Budget Documentation, MF (2021): Medium-term Outlook of the State Budget of the Czech Republic for 2023 and 2024.
[15] MF CR (August 2021): Macroeconomic Forecast of the Czech Republic.
[16] MF CR (2021): Draft Acton the State Budget of the Czech Republic for 2022 including Budget Documentation - Report on the Draft Act of the State Budget of the Czech Republic for 2022.
[17] See Section 9 of Act No. 218/2000 Coll., on Budget Rules and on Amendments to Certain Related Acts (Budget Rules), as amended.

that the state budget chapters could draw a maximum of one-twelfth of the total expenditure per month according to the 2021 State Budget Act (i.e. CZK 157.1 billion), extra-budgetary resources could not be used, and claims arising from unconsumed expenditure could not be used.[18]

The provisional budget was terminated by the entry into force of Act No. 57/2022 Coll., on the State Budget of the Czech Republic for 2022. The Report on the Draft Act of the State Budget of the Czech Republic for 2022[19] was based on the January macroeconomic forecast by MF CR[20]. Compared to the original budget draft from autumn 2021, there were changes between the August (2021) and January (2022) macroeconomic forecast of the MF CR, which, according to the provisions of Article 8, paragraph 2 of Act No. 218/2000 Coll., allow to update the originally established parameters of the expenditure framework or the state budget. The expenditure framework for 2022 was increased from CZK 1,972 billion to CZK 2,055 billion (Table 1). The main contributors to this increase were the change in cash revenues of the state budget and state funds (CZK 63.2 billion, i.e. higher tax revenues and social insurance contributions) and the change in the estimate of revenues from EU funds and financial mechanisms (CZK 12 billion). The approved draft act on the state budget expected a balance of CZK –280 billion.

Table 1 Key expenditure rule indicators and the figures actually recorded in 2022 (CZK billions unless stated otherwise)

	(1) Budgetary strategy*	(2) Draft state budget (September 2021)	(3) Approved state budget (March 2022)	(4) Amendment to the state budget (November 2022)	(5) Actual figure (August 2023)**
General government expenditure		2,875			3,030
SB and SFs expenditure framework, including the EU		1,972	2,055		
SB		1,928	1,893	2,053	1,985
SFs				206	193
Transfers from SB to SF				150	157
SB and SFs, total				2,109	2,020
GDP at current prices		6,431	6,617		6,786
Structural balance (% of GDP)		–5.6	–3.1		–2.8
Output gap (% of potential output)		1.8	–0.4		0.2

Source: MF CR(2021): Draft Act on the State Budget of the Czech Republic for 2022 including Budget Documentation, MF CR (2022): Draft Act on the State Budget of the Czech Republic for 2022 including Budget Documentation, Act No. 57/2022 Coll., Act No. 344/2022 Coll., MF CR (2023): Draft State Final Accounts of the Czech Republic for 2022, Workbook C - Report on the State Budget Results, MF CR (2023): State Treasury Monitor, MF CR (2023): Treasury Performance for January-December 2022, MF CR (August, 2023): Macroeconomic Forecast of the Czech Republic, CZSO (2023): National Accounts Database; CFC calculations.
Note: SB = state budget, SFs = state funds. The totals in the table may be subject to inaccuracies due to rounding. *General Government Budgetary Strategy was not published. **The calculation of the structural balance was based on the total general government balance according to the CZSO (2023): Notification of the General Government Deficit and Debt - 2022 (First Notification, Data Notified by Eurostat) published on 21 April 2023. The cyclical component of the balance and one-off and other temporary measures were taken from the MF CR (August 2023): Macroeconomic Forecast of the Czech Republic. Charts 2 and 3 (see below) show the figures of the structural balance and other components of the overall balance for 2022 and 2023 according to the MF CR (August 2023).

Major events in the course of 2022, including the war conflict in Ukraine with subsequent public expenditures of a humanitarian and military nature and the high rise in energy, fuel and food prices with the prompt response of the general government, have triggered the need to amend the Act on the State Budget[21] for 2022. The budget amendment was approved by the Chamber of Deputies despite the President's veto and brought the increase in state budget expenditure to CZK 2,053 billion (Table 1). The amended state budget balance was expected to reach CZK –375 billion. State budget revenues increased under the amendment primarily due to higher estimates of tax revenues and dividend income, mainly from CEZ, a.s. Expenditures increased mainly due to reasons related

[18] See also CFC Commentary (2022): Cleaning up public finances is worth a short-term provisional budget.
[19] MF CR (2022): Draft Act on the State Budget of the Czech Republic for 2022 including Budget Documentation.
[20] MF CR (January 2022): Macroeconomic Forecast of the Czech Republic.
[21] Act No. 344/2022 Coll., amending Act No. 57/2022 Coll., on the State Budget of the Czech Republic for 2022 (effective from 19 November 2022).

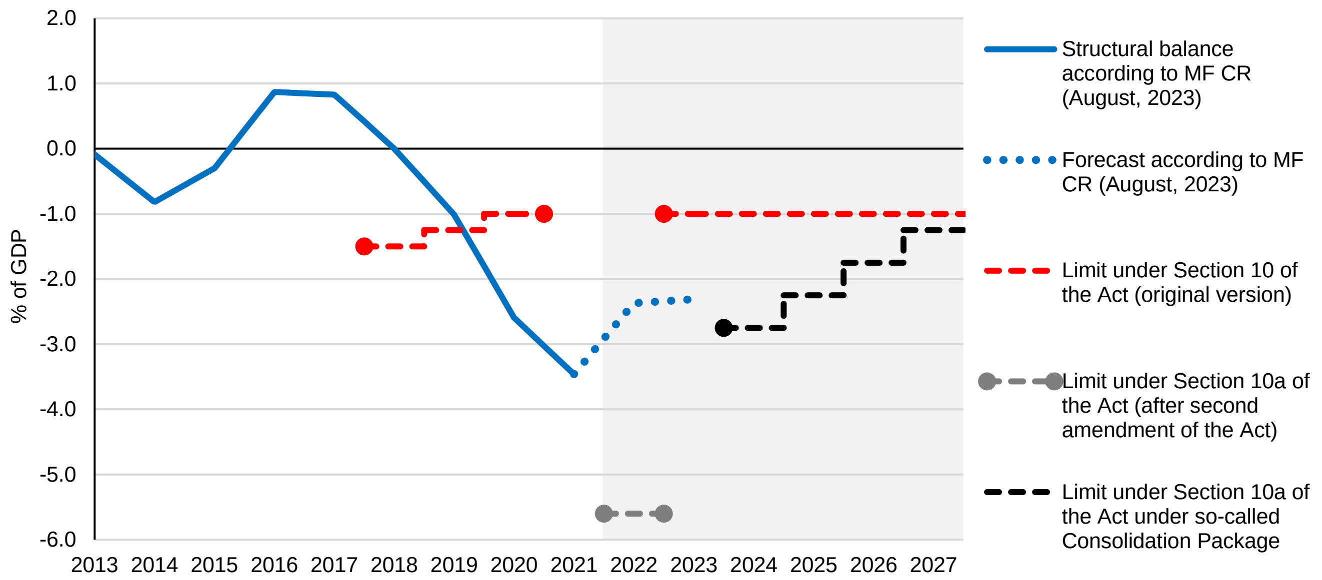
to the war conflict, compensations caused by rapid price increases and the second extraordinary indexation of pensions.[22]

Claims arising from unconsumed expenditure at the beginning of 2022 amounted to CZK 162.8 billion. During 2022, CZK 128.9 billion in claims arising from unconsumed expenditure were employed in the budgets or terminated. CZK 90.5 billion was actually drawn down (CZK 38.4 billion underspent). The balance of claims arising from unconsumed expenditures at the end of 2022 was CZK 71.4 billion. As of 1 January 2023, the claims amounted to CZK 210.1 billion. This high figure reflects the low involvement of entitlements in the 2022 budget and the low uptake of the claims. This reflects the impact of the budget provisioning in early 2022, when the claims could not be used.

Actual general government expenditure totalled CZK 3,030 billion and actual the state budget and state funds expenditure CZK 2,020 billion in 2022 (see Table 1). This is around CZK 35 billion less than the figure in the revised framework.

The reason for setting the state budget and state funds expenditure framework under the Act is to prevent the defined structural deficit limit from being exceeded.[23] When assessing compliance with this rule, it is therefore necessary to monitor not only the procedure used to derive the expenditure framework, but also whether the limit on the general government structural balance was exceeded. Although the limit has not been exceeded, this fact cannot be seen as a result consistent with the long-term sustainability of public finances. The rule was not breached in 2022 only because the second amendment of the Act derived this limit from the very loose expectations of the MF CR regarding the structural balance (see information from the first paragraph of this chapter and Chart 2 – grey dashed line).

Chart 2 The general government structural balance



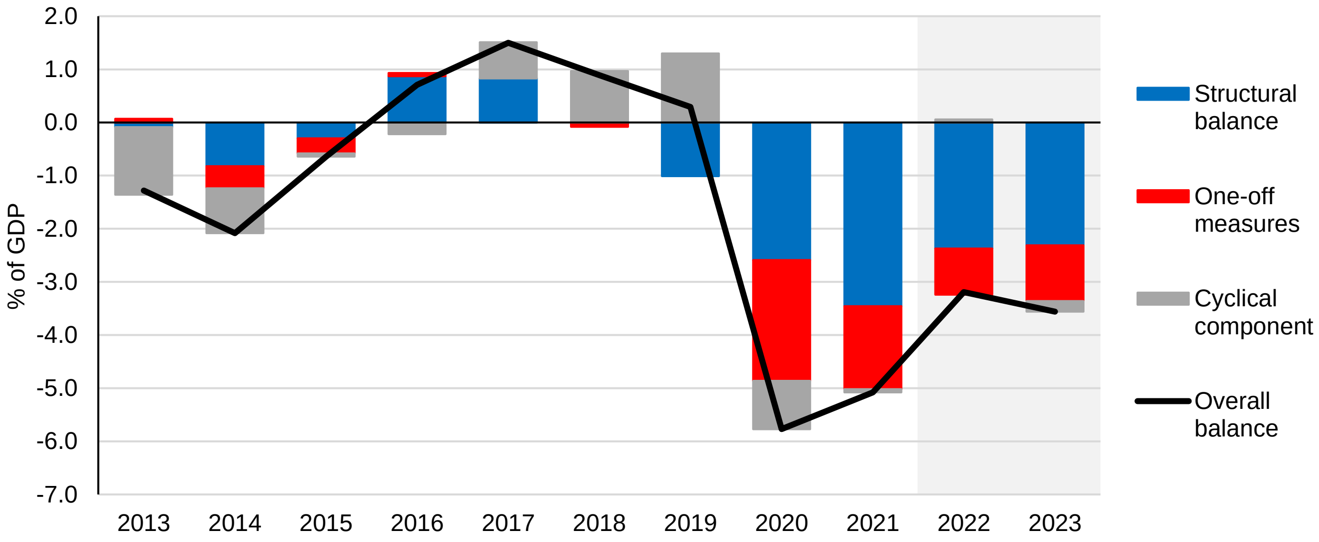
Source: MF CR (August 2023): the Macroeconomic Forecast of the Czech Republic, Act (various versions), Bill on the Consolidation of Public Budgets; CFC calculations.
Note: The structural balance for 2022 is derived from the general government balance of –3.2% of GDP according to the MF CR (August 2023). This updated figure of the 2022 balance has not yet been published by the CZSO as part of the so-called second notifications (October 2023). Therefore, we consider the structural balance for 2022 presented in Charts 2 and 3 as a prediction, and in the text of the Report on Compliance with the Rules we present the total sector balance for 2022 at –3.6% of GDP (according to the first notifications of April 2023), or the structural balance derived from it according to the adjustments presented in the note under Table 1.

Chart 3 provides the breakdown of the overall general government balance. It shows that the dominant part of the deficits from 2020 onwards is not made up of one-off and temporary measures taken in the context of a pandemic

[22] MF CR (2023): Draft State Final Accounts of the Czech Republic for 2022, Workbook C - Report on the State Budget Results.
[23] The limit for 2021 was not set by the amendments to the Act and is therefore not shown in Chart 2. The red dashed line shows the balance limit under the current version of the Act. For a different interpretation of the Act according to the MF CR and the CFC, see CFC (2022): Report on the Long-Term Sustainability of Public Finances, Box 2.1. The black dashed line indicated the lowest allowed value of the balance according to the amendment to the Act proposed as part of the consolidation package ("Bill on the Consolidation of Public Budgets“, for detailed information see: https://www.psp.cz/sqw/text/tiskt.sqw?O=9&CT=488&CT1=0, available in Czech only).This proposal explicitly sets limits on structural balances for the years 2024–2027 in the new version of Section 10a of the Act.

(mainly 2020 and 2021), the geopolitical situation or in the context of mitigating the impact of high price increases (2022 and 2023), but rather a permanent change in the level of revenue and expenditure reflected in a high structural deficit.

Chart 3 Decomposition of the overall general government balance



Source: MF CR (August 2023): the Macroeconomic Forecast of the Czech Republic; CFC calculations.

Conclusion: The CFC states that the procedure for determining the total general government expenditure and deriving the state budget and state funds expenditure framework for 2022 was followed, although the General Government Budgetary Strategy was not used for its derivation. However, the second amendment to the Act set a very relaxed limit for 2022, so meeting it did not require significant fiscal effort. At the same time, the second amendment of the Act, through the provision of Section 11b, abolished the application of the corrective part for 2022.

Box 4 The budget process in the Czech Republic and its problems

The basic prerequisite for the proper functioning of the public finance system in the Czech Republic and the fulfilment of its functions is not only compliance with all the requirements set out in legislation, but also the implementation of the principles of good practice in the budget process. Long-term stability of the legal environment and compliance with all relevant deadlines are also important. While these processes have been gradually cultivated since the entry of Czech Republic into the EU, the last few years we have witnessed rather the opposite process.

The most important part of the system of public budgets is undoubtedly the state budget[24], the draft of which is discussed in the Chamber of Deputies of the Parliament of the Czech Republic and once approved, takes the form of an act. The act itself defines three basic parameters - the size of revenue, expenditure and the balance.

In terms of content, it should be emphasised that the approved budget represents a mandate for the government to use public funds in the structure defined by the individual binding indicators. Its discussion and approval by the legislature is therefore a kind of ex-ante examination. However, in addition to the size and structure of public expenditure, legislators should also consider the macroeconomic context. In particular, the extent to which this expenditure is covered by public revenue and the impact on debt levels of the chosen coverage.

Unlike public expenditure, the amount of which is fixed once approved, the extent of public revenue is only an estimate, as its amount is derived from expected macroeconomic developments, which may not subsequently be met.

[24] For more information on the budget process, see the CFC (2023) website: All about public finance – State budget: budget process.

In order for the legislature's consideration of the state budget to be meaningful, it is necessary to ensure that the data presented is relevant and transparent. This should ensure respect for **the principles of realism and completeness**.

The principle of realism on the revenue side assumes that the draft budget includes only those revenues that are certain (legislatively based) and for which there is no proposal for their reduction in the legislative process by the government majority. Therefore, it is necessary to take a different approach to the situation when an increase and when, on the contrary, a decrease in taxes is foreseen when approving the budget. While the approval of tax cuts is almost certain, tax increases are likely to face efforts to moderate them. Therefore, the expected additional revenue may not materialise.

On the expenditure side, the principles of realism and completeness assume that the budget includes all public expenditure which, at the time of budget preparation, is clear that it will have to be spent. There should also be no shifting of the deficit to parafiscal units[25] to visually reduce the figure of the government budget deficit.

Over the past few years, we have unfortunately witnessed violations of the above principles. The main examples are:

- **Failure to respect the principle of budget realism by including uncertain revenues** – e.g. the state budget for 2020 included expected revenues from the so-called digital tax, which was never introduced. The 2023 budget envisaged the possibility of using the so-called Modernisation Fund for current expenditure, although this was not possible under the acts in force.
- **Failure to respect the principle of budget realism by including revenues that the government intends to reduce** – the budget for 2021 did not take into account the drastic reduction in personal income tax (abolition of super gross wage taxation), which made the approved deficit unreliable.
- **Reducing the transparency of public finances** – an attempt to shift the deficit to parafiscal units, an example of which is the approval of the significant deficit of the State Fund for Transport Infrastructure for 2023.
- **Failure to comply with the deadlines and procedures set out in the relevant legal norms** – e.g. in 2023 the Budgetary Strategy was not submitted by the deadline set by the Act.
- **Inconsistencies in budget materials** - The Budgetary Strategy and the Convergence Programme, which is part of the Budgetary Strategy according to the Act, usually work with different figures of the structural balance.
- **Changes to the parameters of the fiscal rules according to current needs** – the double amendment of the Act in 2020, which led to a drastic loosening of the structural balance rule.

The above shows that Czech public finances lack the necessary legal stability and the willingness to comply with formal and informal rules. As a result, fiscal policy is becoming less transparent and less comprehensible, with negative effects on the stability, manageability and sustainability of public finances.

4 Local and regional government finances

Local and regional authorities are, according to the Constitution of the Czech Republic, municipalities and regions for whose finances the Act defines a special budgetary responsibility rule in Section 17. Within the framework of this rule, the criterion of the amount of debt is monitored and, in case of its exceeding, the rate of its reduction. Local and regional authorities also establish a large number of other organisations (mostly in the form of entities partly subsidised from public budgets), the finances of which affect the overall results of the general government sector. This chapter first presents the overall performance of the local government subsector and then evaluates the frequency and significance of fiscal rule breaches.

4.1 Local government finances 2019–2022

The local government subsector[26] has reported budget surpluses in the last four years. This has contributed to the improved performance of the overall general government sector each year. In 2022, the total revenue of this sub-sector was CZK 906.4 billion, an increase of CZK 64.7 billion compared to the previous year. Local government revenue accounted for 32.6% of total general government revenue. Expenditure accounted for 28.2% of

[25] These are institutions whose finances are visually separate from the state budget, but whose deficits and liabilities directly affect the deficits and liabilities of the public finances as a whole.

[26] The local government subsector is part of the general government sector in the ESA 2010 methodology. It consists of local government units and organisations directly accountable to them, i.e. all organisations having a local sphere of competence and financed out of local budgets.

total general government expenditure. The surplus of the local government subsector declined slightly by CZK 3 billion year-on-year to CZK 52.8 billion in 2022, reaching 0.8% of GDP. Table 2 contains the relevant data.

Table 2 Local government finances in the Czech Republic 2019–2022

	2019		2020		2021		2022	
	billion CZK	% of GDP	billion CZK	% of GDP	CZK billion	% of GDP	billion CZK	% of GDP
Revenue	717.6	12.4	768.0	13.5	841.7	13.8	906.4	13.3
Expenditure	680.0	11.7	741.7	13.0	785.9	12.9	853.6	12.6
Balance	37.6	0.6	26.3	0.5	55.8	0.9	52.8	0.8

Source: CZSO (July 2023); CFC calculations.
Note: the totals in the table may be subject to inaccuracies due to rounding.

The downward trend in the share of local government debt in total general government debt generally corresponds to the local governments surplus. In 2022, the debt of the local government subsector was CZK 88.8 billion (about 1.3% of GDP), representing only 3.0% of total general government debt (see Table 3).

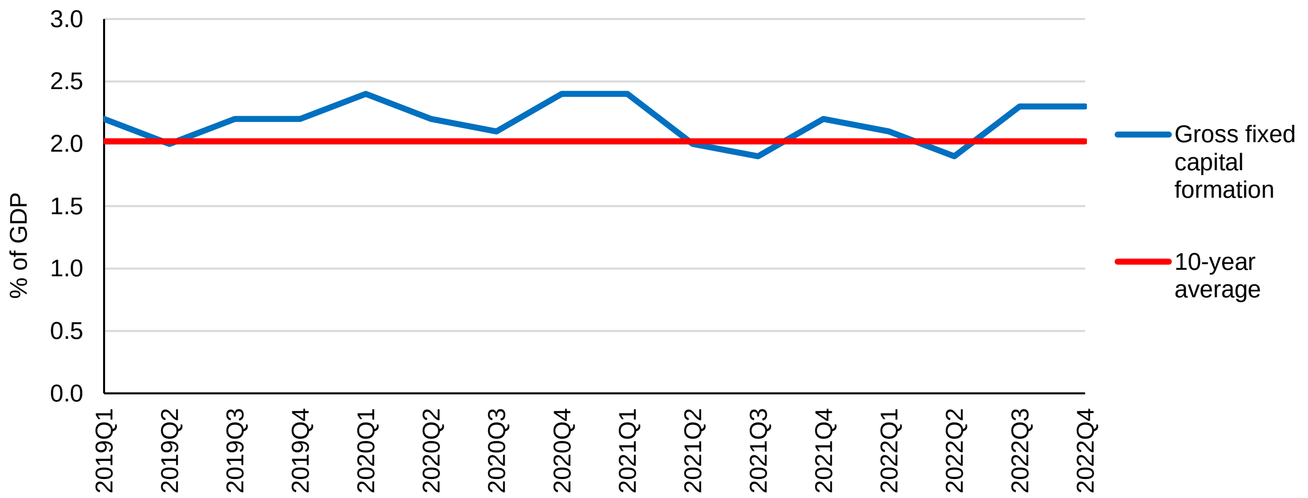
Table 3 Local government debt in the Czech Republic 2019–2022

	2019	2020	2021	2022
Debt (billion CZK)	84.4	87.3	87.0	88.8
Debt-to-GDP ratio (%)	1.5	1.5	1.4	1.3
Share of total general government debt (%)	4.9	4.1	3.4	3.0

Source: CZSO (July 2023); CFC calculations.

In 2022, the local government subsector recorded a slight increase in investment activity, corresponding to approximately CZK 146 billion, see Chart 4.

Chart 4 Local government investment in the Czech Republic 2019–2022



Source: Eurostat (July 2023); CFC calculations.

Conclusion: The finances of local and regional authorities (and organisations accounted to them) does not pose significant risks to the overall financial results of the general government sector. On the contrary, they have been contributing to stabilising general government finances for quite some time now. Also, the level of debt of local and regional authorities is also very low and, as a whole, thus does not represent a significant risk factor in terms of growth of general government debt.

4.2 The budgetary responsibility rule for local and regional authorities and compliance therewith in 2022

Section 17 of the Act provides the following rule for local and regional authorities:

a) A local or regional authority shall manage its finances in the interest of maintaining sound and sustainable public finances such that its debt[27] at the balance-sheet date does not exceed 60% of its average annual revenue[28] over the last 4 budget years (hereinafter the "debt criterion").
b) Should the debt of a local or regional authority at the balance-sheet date exceed 60% of its average annual revenues over the last 4 budget years, the local or regional authority shall reduce it in the following calendar year by at least 5% of the difference between the amount of its debt and 60% of its average revenues over the last four budget years (hereinafter the "debt reduction rule").

MF CR monitors the management of local and regional authorities on the basis of financial data and accounting records submitted by municipalities. For the year 2022, the monitoring covered 6,265 local and regional authorities of the Czech Republic, i.e. 6,252 municipalities[29] including the City of Prague, and 13 regions.

Of the 578 municipalities whose debt exceeded 60% of their average revenue over the previous four years as of 31 December 2021, a total of 10 municipalities were not compliant with the debt reduction rule in 2022. In three cases, this was an omission that was corrected and the 2022 minimum instalment was sent after a call from the MF CR. In one case, the implementation of even the minimum instalment would have paralysed the municipality's functioning due to its extreme debt burden and therefore the MF CR did not proceed with sanctions. In six other cases, the instalment was not made due to the setting of the repayment schedule for loans or borrowings granted by commercial banks or the State Environmental Fund of the Czech Republic. The implementation of extraordinary repayments was either not possible (loan in the drawdown phase) or would have been too costly. Also in these cases, the MF CR did not proceed to suspend the transfer of part of the tax revenue, arguing that there was no risk of unsustainable financial situation and that extraordinary instalments, due to their costliness, would be contrary to the principle of economy (see Section 2(2) of the Act).

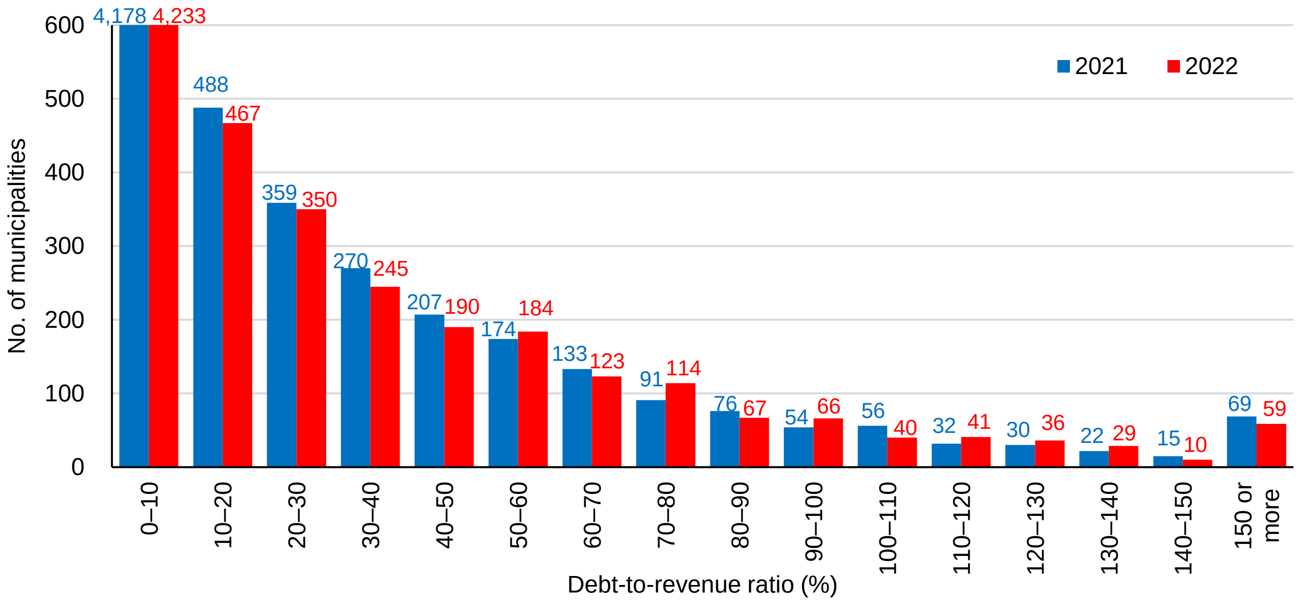
The CFC points out that although the above procedure is logical and understandable, it is not entirely clear from the wording of Act No. 23/2017 Coll., on the Rules of Budgetary Responsibility, as amended, and Act No. 243/2000 Coll., on the Budgetary Determination of Taxes, as amended, whether it can be consistently applied in this way. In this case, the CFC lacks unambiguous criteria for the MF CR decision-making in the above-mentioned situations, where there is a conflict between the implementation of the rule of budgetary responsibility and the principle of economy. In view of the need to provide the local and regional authorities with a clear and predictable environment, the CFC considers that either the relevant legal norms should be amended or at least a clear methodology for assessing the above cases should be developed and published. At the same time, as a precautionary measure, the local and regional authorities should be informed to carefully analyse the repayment terms and conditions when negotiating loans and borrowings and do not come into conflict with the debt reduction rule because of them.

Indebtedness in relation to the debt indicator

The budgetary responsibility rule indicator (i.e. the percentage ratio of debt to average revenue over the last four years) was above 60% for 585 municipalities out of 6,254 (i.e. 9.4% of all municipalities) as of 31 December 2022. This is a year-on-year increase of 7 municipalities. These municipalities have 434,740 inhabitants, i.e. approximately 4.1% of the Czech population (in 2021, approximately 4% of the Czech population lived in municipalities exceeding the indicator).[30] The data are also available in Chart 5.

[27] For the purposes of the Act, the debt of a local or regional authority shall be understood as the value of outstanding liabilities arising from issued bonds, credit, loans and returnable financial assistance received, guarantees honoured and bills of exchange issued.
[28] For the purposes of the Act, the revenues of a local and regional authority mean the sum of all monies received into its budget during the budget year, consolidated in accordance with another legal regulation.
[29] The municipalities Bohuslavice and Želechovice nad Dřevnicí are not included in the monitoring because their financial statements have not been submitted to the Central State Accounting Information System.
[30] The total of 129,488 people live in municipalities where the budgetary responsibility rule indicator exceeds 100% (215, i.e. 3.4% of municipalities). This represents approximately 1.23% of the Czech population (in 2021 it was 122,561 people, i.e. 1.17% of the Czech population).

Chart 5 Numbers of municipalities in ranges according to the percentage level of the budgetary responsibility rule indicator, 2021 versus 2022



Source: MF CR (2022): Information on the Monitoring of Local and Regional Authorities' Finances for 2021, MF CR (2023) Information on the Monitoring of the Local and Regional Authorities' Finances for 2022; CFC calculations.

The total debt of municipalities in 2022 was CZK 65.8 billion, i.e. CZK 2 billion more than in 2021. The average debt of municipalities was 16.7% (17.1% in 2021). 3,691 municipalities, i.e. 59% of all municipalities, were entirely free of debt, 133 more than in 2021. The number of municipalities whose budgetary responsibility rule indicator exceeded 200% decreased from 24 to 19.[31]

Table 4 Number of municipalities exceeding the 60% debt criterion of the budget responsibility rule

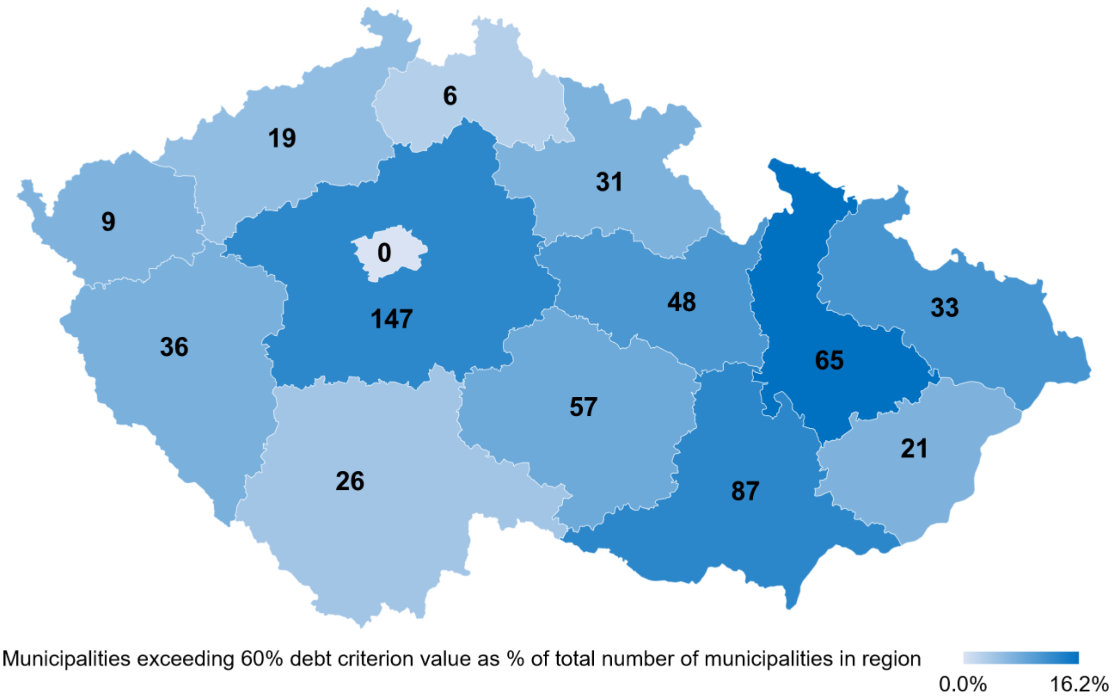
No. of inhabitants of municipality	No. of municipalities		No. of municipalities exceeding 60% debt criterion value		% of municipalities exceeding 60% debt criterion value (%)	
	2021	2022	2021	2022	2021	2022
1–100	436	414	16	9	3.7	2.2
101–200	983	985	75	65	7.6	6.6
201–500	1,990	1,998	220	232	11.1	11.6
501–1,000	1,370	1,370	165	173	12.0	12.6
1,001–2,000	772	776	69	73	8.9	9.4
2,001 or more	703	711	33	33	4.7	4.6
Total	6,254	6,254	578	585	9.2	9.4

Source: MF CR (2022): Information on the Monitoring of the Local and Regional Authorities' Finances for 2021, MF CR (2023): Information on the Monitoring of the Local and regional Authorities' Finances for 2022; CFC calculations.

Table 4 shows that municipalities with 201–500 and 501–1,000 inhabitants were the most often exceed the debt criterion of the budgetary responsibility rule in 2022. Compared to 2021, the proportion of municipalities with fewer than 200 residents exceeding the debt criterion decreased. The largest municipality exceeding the debt criterion in 2022 was the town of Lysá nad Labem with 9,732 inhabitants. Its debt to average revenue ratio almost doubled year-on-year to 79.8%. Among the regional cities, Olomouc had the highest debt-to-revenue ratio in 2022 (54.1%). Jihlava was in this regard the best-performing regional capital with a debt-to-revenue ratio of just 5.1% in 2022. By contrast, besides Olomouc, Liberec is also close to the 60% debt-to-revenue threshold, with a 50.4% debt-to-revenue ratio in 2022.

[31] MF CR (2023): Information on the Monitoring of Local and Regional Authorities' Finances for 2022.

Chart 6 Number of municipalities exceeding the 60% debt criterion of the budget responsibility rule



Source: MF CR (2023): Information on the Monitoring of the Local and Regional Authorities' Finances for 2022; CFC calculations.

Chart 6 shows that the largest number of municipalities in absolute terms exceeding the debt criterion of the budgetary responsibility rule is in the Central Bohemia Region, which also has the largest number of municipalities of all regions. Thus, the largest percentage of municipalities exceeding the debt criterion of the budgetary responsibility rule is in the Olomouc region (16.2% of municipalities). In addition, the South Moravian Region (12.9%), the Central Bohemia Region (12.8%), the Moravian-Silesian Region (11%) and the Pardubice Region (10.6%) recorded more than 10% of municipalities exceeding the debt criterion of the budgetary responsibility rule. The best performing municipalities in this respect are in the Liberec Region (2.8%) and the South Bohemia Region (4.2%).

In addition to the rule of budgetary responsibility set out in the Act, the MF CR monitors two other indicators for municipalities, for which it sets their recommended level. These are the ratio of loans and advances to total assets and the total liquidity indicator. These indicators are considered important by the MF CR because, unlike the budgetary responsibility rule, they contain information about the assets and overall liabilities of municipalities and regions. Despite the fact that these indicators are not directly related to the Act, the CFC decided to take them into account as they illustrate the context of the municipalities' and regions' finances.

According to the recommendation of the MF CR, the ratio of loans and advances to total assets, which expresses the proportion of assets covered by third-party finances, should not exceed 25% for municipalities and regions. In 2022, a total of 285 local and regional authorities exceeded this threshold, including 284 municipalities (4.5% of all municipalities) and one region (Olomouc Region). This is a year-on-year increase of 95 local and regional authorities. In all, 191 municipalities exceeding the debt criterion of the budgetary responsibility rule are not compliant with the required ratio of loans and advances to total assets, i.e. 32.6% of municipalities exceeding the debt criterion, or 3.1% of all municipalities. 1.1% of the Czech population lives in municipalities exceeding both criteria. The highest values of the indicator of the ratio of loans and advances resources to total assets were reported by the municipalities of Turovice (696%) and Prameny (294.6%). No other municipality exceeded the threshold of 100% of the ratio of loans and advances resources to total assets.[32]

The total liquidity ratio, which express the ratio of current assets to short-term liabilities, indicates how well a municipality is able to meet its short-term obligations. The MF CR recommends that its value should lie between

[32] If the ratio of loans and advances to total assets exceeds 100%, it means that the municipality has negative equity.

0 and 1. A total of 70 (i.e. 1.1%) municipalities do not comply with this recommendation, a year-on-year decrease of two municipalities.

In 2022, 12 municipalities (compared to five in 2021) were included in the category of local and regional authorities that showed exceeding the threshold values of all three monitored indicators simultaneously and were thus classified by the MF CR as local and regional authorities with a high level of financial risk.

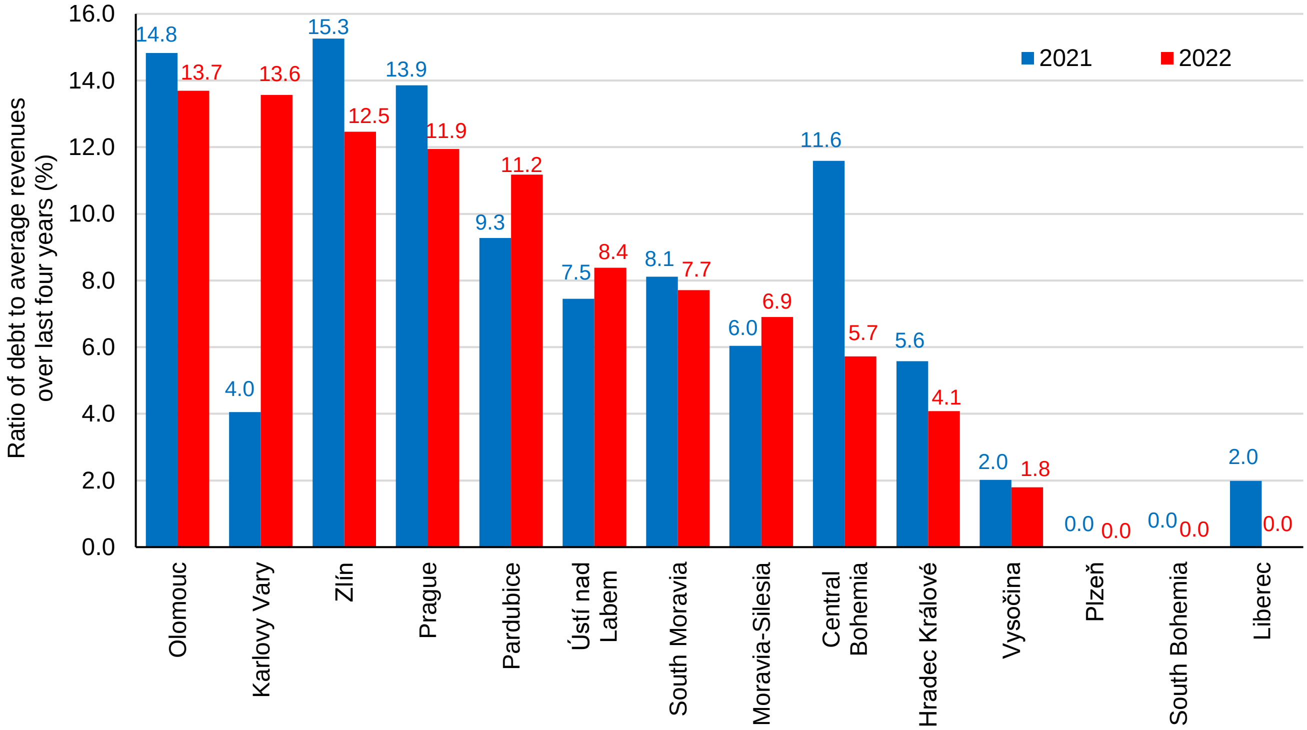
The total number of people living in these municipalities is 4,939, which is less than 0.05% of the total population of the Czech Republic (in 2021 it was 1,925 inhabitants). The main reason for exceeding the monitored indicators was the deferral of loan repayment in accordance with repayment schedules. The municipalities concerned often have only low immediately available financial reserves and their finances may therefore be exposed to these risks:

a) insufficient funds for the management and repair of tangible fixed assets,
b) the need to cover sudden expenditure needs,
c) non-compliance with the conditions of the subsidy received/promised (including ensuring the sustainability of the project for the required period).

Aside from the municipalities exceeding the limits of all three of the indicators mentioned above, the municipalities of Prameny and Turovice, which do not exceed the limits of all three monitored indicators at the same time, are also facing serious economic problems.

At the regional level, the debt criterion of the budgetary responsibility rule is fulfilled by a comfortable margin. The Olomouc Region has the highest debt-to-average revenues ratio over the last four years (13.7%), followed by the Karlovy Vary Region (13.6%) and the Zlín Region (12.5%). By contrast, the South Bohemia, Plzeň and Liberec Regions are completely debt-free in 2022.[33] Compared to 2021, eight regions reported a drop in the debt-to-average revenues ratio over the last four years. The Karlovy Vary Region recorded the largest increase (from 4% in 2021 to 13.6% in 2022). The total regional debt in 2022 was CZK 17.8 billion. The data are presented in Chart 7.

Chart 7 Regions by debt-to-average revenue ratio over the last four years, 2021 versus 2022



Source: MF CR (2022): Information on the Monitoring of Local and Regional Authorities' Finances for 2021, MF CR (2023): Information on the Monitoring of the Local and Regional Authorities' Finances for 2022; CFC calculations.
Note: The calculations in the chart may be subject to inaccuracies due to rounding.

[33] See MF CR (2023): Information on the Monitoring of the Local and Regional Authorities' Finances in 2022.

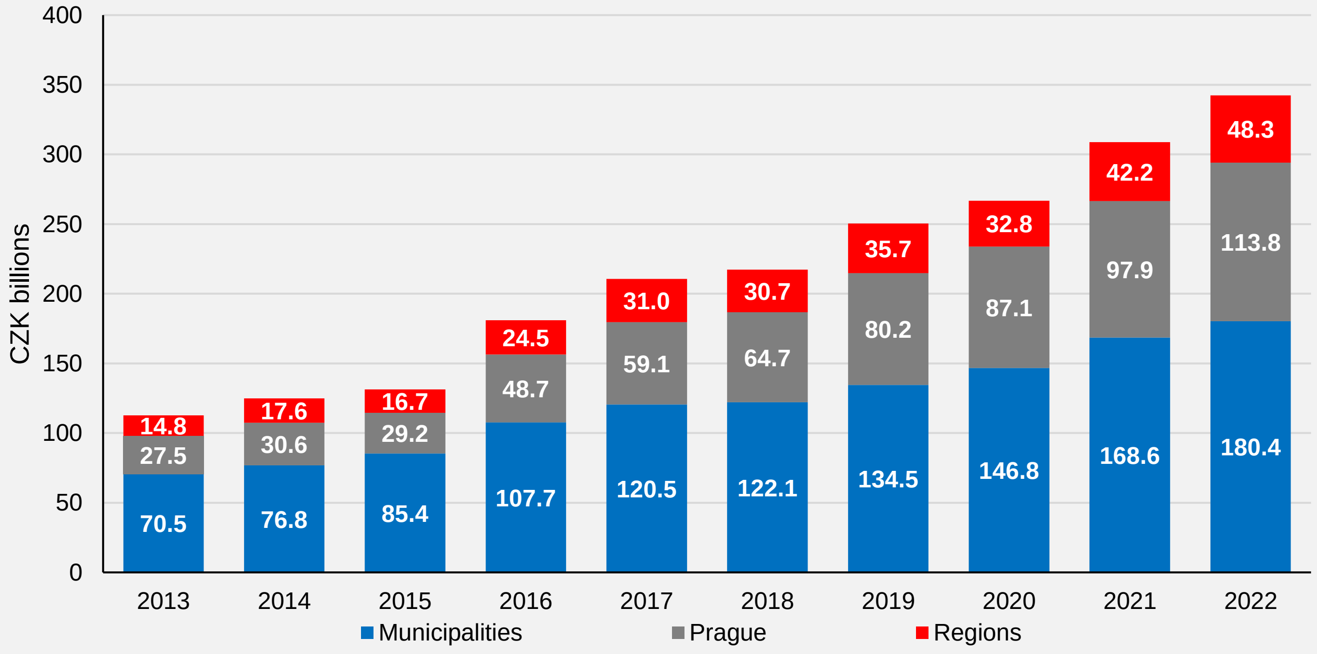
Conclusion: As of 31 December, 2022, a total of 585 municipalities and no regions exceeded the debt criterion defined in Section 17(1) of the Act. In 2022, a total of 10 municipalities failed their obligation to reduce their debt by the minimum level defined by the Act. However, the Ministry of Finance of the Czech Republic did not suspend the transfer of part of tax revenues in any case. In this context, the CFC draws attention to the lack of clarity of the legislation and the conflict between certain principles contained in the relevant legal norms. The CFC believes that it would be appropriate to clarify the situation either by amending the relevant provisions or at least by elaborating and publishing a clear methodology for assessing the above cases by the Ministry of Finance of the Czech Republic, which would create a predictable environment for the local and regional authorities' finances in the Czech Republic.

Box 5 Municipalities and regions' finances in the period 2013–2022

Over the last 10 years, the total savings[34] of municipalities and regions have more than tripled from CZK 97.2 billion as of 31 December 2012 to CZK 342.4 billion as of 31 December 2022. The fastest growth over this period has been in savings of the City of Prague (by approximately 319.1%), followed by regions (by 284.8%) and other municipalities (by 213.5%). The data are presented in Chart B5.1.

Table B5.1 shows the distribution of savings among regions and municipalities according to their size by the end of 2022. The largest amount of savings among all municipalities is held by the City of Prague, which is included in the group of municipalities with 1,000,001 inhabitants or more. Specifically, this amounts to CZK 113.8 billion, which represents approximately 38.7% of the savings of all municipalities and almost a third of the savings of all local and regional authorities, although only about 12.1% of the population of the Czech Republic lives in Prague. In per capita terms, Prague has savings of approximately CZK 89 thousand per inhabitant. This is partly due to the dual competence of the City of Prague as a municipality and a region at the same time. For other larger municipalities, the relative amount of savings is significantly lower. The indicator again increases with decreasing population. The smallest municipalities (with less than 100 inhabitants) have savings of more than CZK 60 thousand per inhabitant. On the other hand, regions have on average several times lower savings per capita than municipalities.

Chart B5.1 Savings of local and regional authorities units in 2013–2022



Source: MF CR: State Treasury (2023), CFC calculations.

[34] By savings we mean balances on bank accounts, i.e. synthetic accounts 068, 231, 236, 241, 244 and 245. The total financial assets of local and regional authorities (including securities, equity holdings and other financial accounts) reached CZK 542.9 billion in 2022.

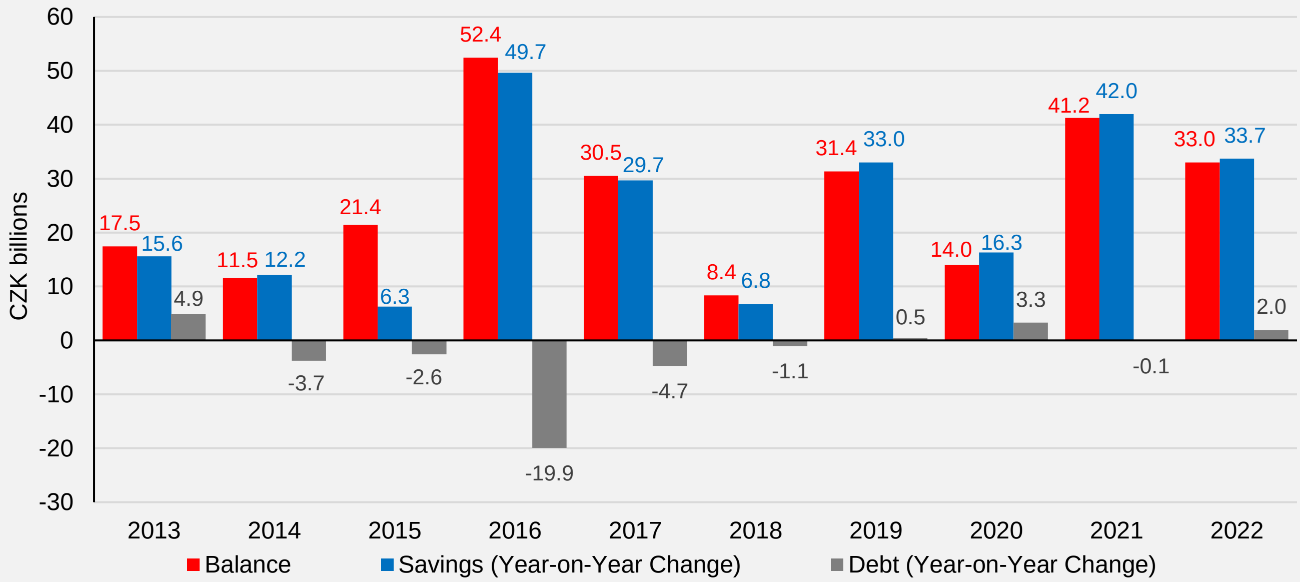
Table B5.1 Savings of local and regional authorities as of 31 December 2022

Population	No. of municipalities	Population	Savings (CZK billions)	Savings per capita (CZK)
0–100	414	29,673	1.8	60,260
101–200	985	145,828	6.5	44,746
201–500	1,998	658,216	21.2	32,252
501–1,000	1,370	970,631	25.6	26,354
1,001–2,000	776	1,079,260	24.7	22,931
2,001–5,000	443	1,335,338	23.2	17,351
5,001–10,000	141	972,138	14.8	15,185
10,001–20,000	67	942,529	14.2	15,096
20,001–50,000	43	1,283,658	17.6	13,675
50,001–100,000	12	893,089	12.9	14,451
100,001–1,000,000	4	930,941	17.9	19,220
1,000,001 or more	1	1,275,406	113.8	89,210
Municipalities	6,254	10,516,707	294.2	27,971
Regions	13	9,241,301	48.3	5,225
Total	6,267	10,516,707	342.4	32,562

Source: MF CR: State Treasury (2023), CFC calculations.

Chart B5.2 shows that the growth in savings since 2016 has approximately copied the balance of the local and regional authorities' budget outcome. This reached a cumulative total of CZK 210.9 billion over these seven years, resulting in an increase in savings of CZK 211.2 billion. Over the same period, the debt was reduced by only CZK 20.1 billion and since 2019, when the overall local and regional authorities' budget outcome reached CZK 119.6 billion cumulatively, the debt has even increased slightly.

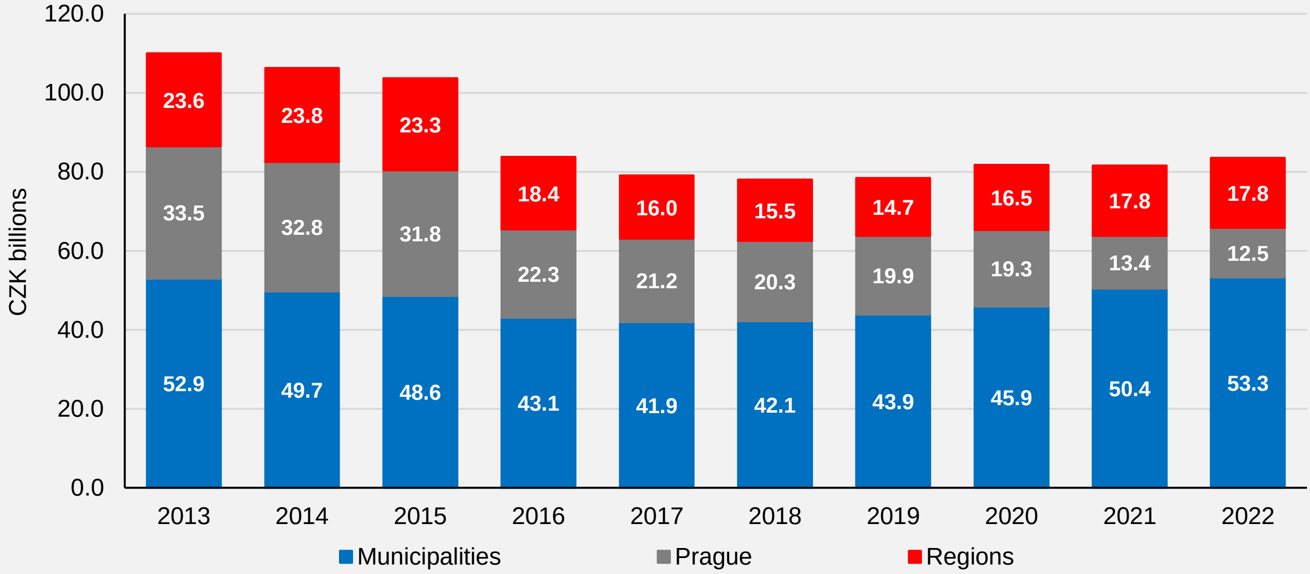
Chart B5.2 Comparison of the balance, year-on-year change in savings and year-on-year change in debt of local and regional authorities in 2013–2022



Source: MF CR: State Treasury (2023); CFC calculations.

Chart B5.3 shows the distribution of debt of local and regional authorities between 2013 and 2022. Since 2016, when the most significant repayments took place, we could observe a significant decrease in the debt of the City of Prague and a contradictory increase in the debt of other municipalities by about CZK 10 billion, despite the budget surpluses (cumulatively CZK 63.8 billion in 2017–2022). Similar to the total debt of the local and regional authorities, the debt of the regions has changed only slightly since 2016.

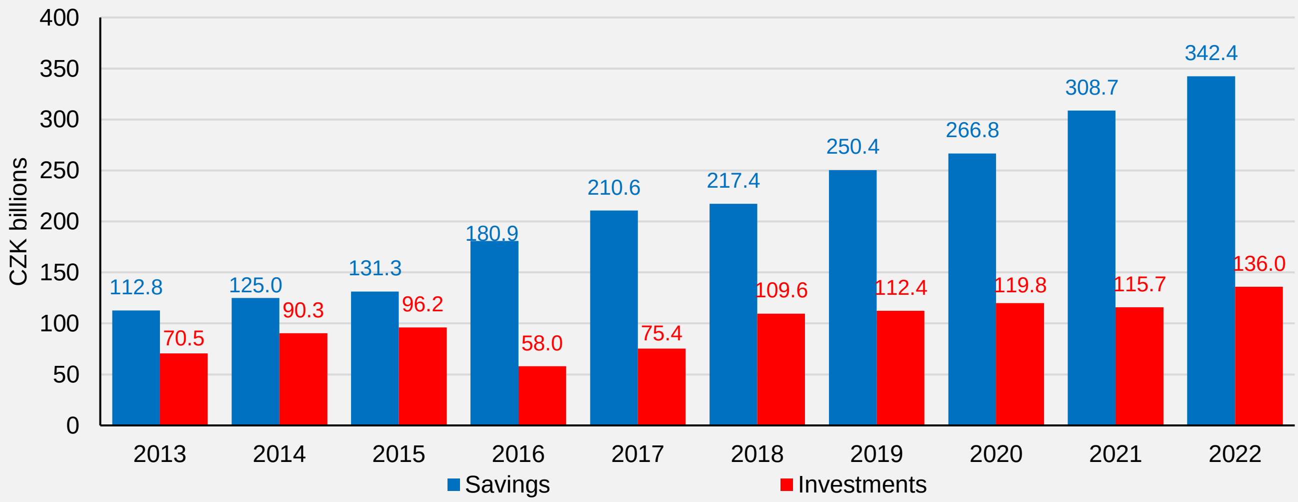
Chart B5.3 Debt of local and regional authorities in 2013–2022



Source: MF CR: State Treasury; CFC calculations.

In addition to the ability to repay debts, surplus budgets and the associated growth in savings also mean the ability to use these funds to make investments or other expenditures. Chart B5.4 shows the evolution of the total savings in the bank accounts and investments[35] of the local and regional authorities. While local and regional authorities' savings have grown by over 250% over the last 10 years, investments have only grown by 92.9% and have been stagnant since 2018. In 2022, municipalities and regions have invested just under 40% of their savings, and this share is trending downwards. In contrast to savings, investments are distributed evenly among municipalities of different sizes.

Chart B5.4 Comparison of savings and investments of local and regional authorities in 2013–2022

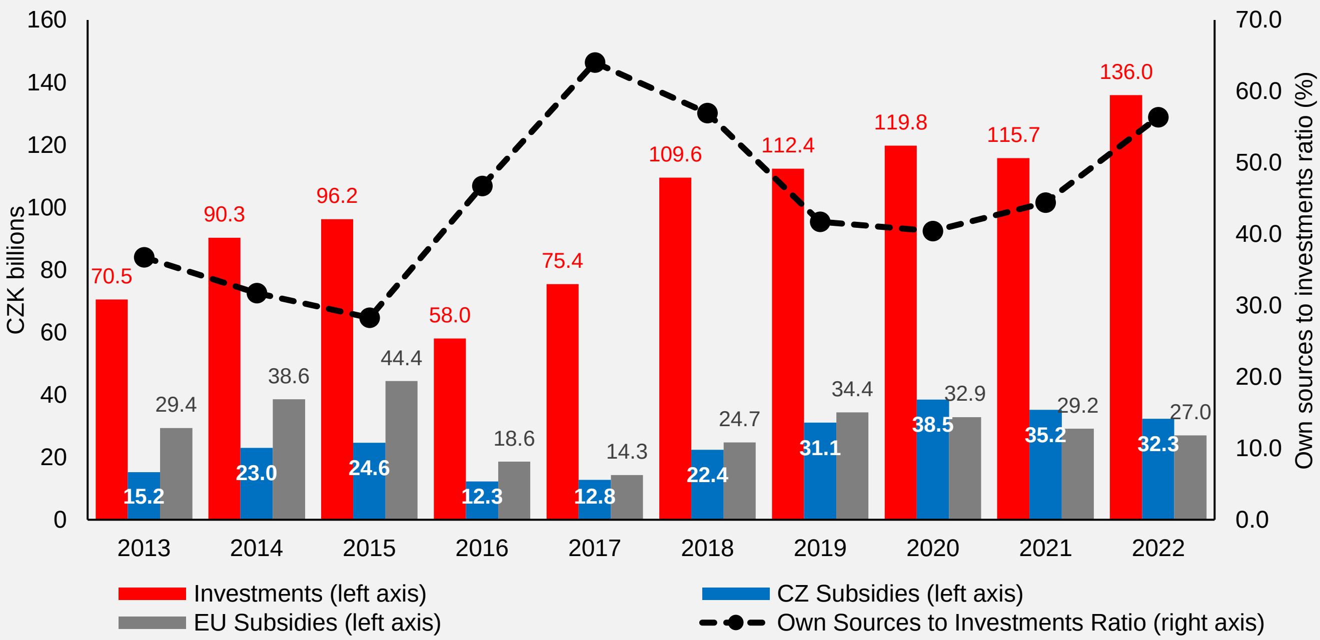


Source: MF CR: State Treasury; CFC calculations.

[35] By investment we mean the grouping of items 61 - capital purchases and related expenditure and the sub-grouping of items 635 - capital transfers to organisations in form of entities partly subsidised from public budgets and similar organisations.

As interesting as the total volume of regional investments is the structure of their financing. In Chart B5.5 we can see that both the total volume of investments (from CZK 115.7 billion to CZK 136 billion) and the share of own resources invested by the local and regional authorities have increased compared to 2021. In 2022, the total investments of municipalities and regions were covered by approximately 56.4% (CZK 76.7 billion) of their own resources, 23.8% (CZK 32.3 billion) by investment transfers received from the central government and 19.9% (CZK 27 billion) by EU investment transfers. Of the EU instruments, the most significant were the Integrated Regional Operational Programme 2014+ (CZK 10.1 billion) and the Integrated Regional Operational Programme 2014+ (CZK 10.1 billion). CZK), OP Environment 2014+ (CZK 3.6 billion), OP Jan Amos Komenský (CZK 2.7 billion), National Recovery Plan (CZK 2.5 billion), OP Research, Development and Education 2014+ (CZK 2 billion), OP Employment 2014+ (CZK 1.5 billion), OP Prague - Growth Pole of the Czech Republic 2014+ (CZK 1.3 billion) and others (CZK 3.9 billion in total). In 2016, local and regional authorities invested only CZK 27.1 billion from its own resources and another CZK 30.9 billion from transfers received. Between 2019 and 2021, total investment stagnated around CZK 115 billion and the share of own resources in investment was around 40%. Thus, there was a slight nominal growth in local and regional authorities investment activity in 2022.

Chart B5.5 Received subsidies and investments of local and regional authorities in 2013–2022



Source: MF CR: State Treasury; CFC calculations.

Conclusion: Despite the budget surpluses, the trend of accumulating savings in the bank accounts of the local and regional authorities continues, where the funds are losing their real value due to high inflation. Therefore, the budget surpluses of local and regional authorities do not promise a higher rate of implementation of regional investments or repayment of their liabilities.

Summary

The Czech Fiscal Council states that in 2022:

a) the general government debt rule (Sections 14 and 16 of the Act) was complied with,

b) the procedure for determining total general government expenditure and deriving the state budget and state funds expenditure framework was followed, although the General Government Budgetary Strategy was not used for the derivation,

c) the general government structural balance for 2022 did not exceed the value derived on the basis of the amended version of the Act (Section 10a),

d) 585 municipalities exceeded the 60% limit on local or regional authority debt (Section 17(a) of the Act),

e) ten municipalities were non-compliant with the obligation to reduce their debt by the minimum level in 2022, some of them by omission, some of them as a result of high debt levels or possible uneconomic implementation of extraordinary repayments of loans and borrowings,

f) the Ministry of Finance of the Czech Republic did not suspend the transfer of any local or regional authority's share in tax revenue.

In 2022, the statutory rules were complied with, but largely only because they had been repeatedly modified over the previous years, systematically towards softer or less binding rules. The Czech Fiscal Council states that the year 2022 has reaffirmed the urgency of adherence to sound budgeting principles and the need for general respect for the rules of budgetary responsibility and the necessary sequence of steps required by the legislation that lead to the establishment of a credible and responsible budgetary framework and then the budget itself in the public finance system. Arbitrary softening of the rules, their repeated and rapid adjustments and often non-standard applications lead to an erosion of their clarity over a long period of time and thus to a decline in the willingness to comply with these rules and thus to keep the whole public finances within the limits of long-term sustainability. In the years of fiscal consolidation after 2022, this general pattern has proven even more true.