The Czech Fiscal Council

REPORT ON COMPLIANCE WITH THE RULES OF BUDGETARY RESPONSIBILITY FOR 2023

September 2024

Czech Fiscal Council

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Introduction

In 2023, public finances were affected by gradual decline in inflation. In the same year, a so-called consolidation package was introduced to help put public finances back on a long-term sustainable trajectory.

Given the current low inflation rate and the consolidation efforts, it appears that public finances will return to balance almost immediately and will be on a long-term sustainable path. However, the correction will take time and the positive steps taken need to be sustained and not lose intensity. Among the imaginary burdens that will make it difficult to implement these positive changes are the decisions taken by fiscal policymakers in response to the temporary negative shocks that have hit (not only) the Czech economy in recent years. The “legacy” of the COVID-19 pandemic is, first and foremost, the abolition of the super gross wage tax, which led to a significant decline in general government revenues even in the post-pandemic period. The wave of inflation of 2021–2023 brought with it, among other things, the further introduction of so-called indexations, which will continue to have a negative impact on structural balance of the general government sector in the following years. Such developments are then reflected in an increase in the general government debt, which entails rising interest payment costs. And interest payments are a mandatory (compulsory) item in general government budgets that weigh on the general government deficit. Breaking out of this imaginary spiral is neither trivial nor a short-term affair given the structural changes made earlier in the general government expenditure and revenue.

The present Report on Compliance with the Rules of Budgetary Responsibility (“the Report on Compliance with the Rules”) provides an assessment of compliance with the fiscal rules for 2023. 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”). Strict adherence to clearly defined and stable fiscal rules should significantly contribute to the equilibrium and long-term sustainability of public finances.

The first chapter of this Report on Compliance with the Rules briefly presents the performance of the general government in 2023 and the outlook for 2024.The second chapter focuses on one of the three Czech fiscal rules, namely the debt rule, which monitors the general government debt-to-GDP ratio. The Czech public finances are in compliance with this rule, and in 2023 the debt ratio has decreased by 0.1 percentage point compared to the previous year. However, this decrease is largely virtual. The problem of the increase in the debt ratio was “masked” by the high growth of nominal gross domestic product (“GDP”) during the wave of inflation in 2021–2023 and, in addition, by the revisions to the national accounts introduced by the Czech Statistical Office (“CZSO”) in June 2024, which retroactively increased nominal GDP.

The third chapter focuses on another fiscal rule, the so-called expenditure rule, also called the structural balance rule because it monitors compliance with the limit of this balance. The rule was complied with in 2021 and 2022, but only formally and not effectively. In fact, the double amendment of the Act during the COVID-19 pandemic considerably relaxed this rule, allowing the implementation of an expansionary fiscal policy. At the same time, the second amendment to the Act introduced ambiguity into the interpretation of the 2023 limit of the rule, which led to a disagreement between the CFC and the Ministry of Finance of the Czech Republic (“MF CR”) on the applied level of the rule limit. In 2023, the rule – according to the CFC's interpretation of the then applicable version of the Act – was no longer fulfilled. The breach of the limit reflected, among other things, the “legacy” presented above, which had permeated the structure of general government expenditure and revenue, resulting in long-standing high structural deficits. The interpretation difficulties were only resolved by the amendment of the Act included in the aforementioned consolidation package.

The fourth chapter deals with the last national fiscal rule, which concerns local government units (i.e. regions and municipalities). This rule sets a limit on the debt ratio of regions and municipalities and a return to this limit if it is exceeded. Of the 6,262 units that provided data to the MF CR, 565 exceeded the debt indicator, mainly smaller municipalities. It may seem that this is a marginal issue, but here again – as in last year's Report on Compliance with the Rules – the systematic problem described in the text of chapter four occurred in the case of a small number of municipalities that did not comply with the requirement to reduce the debt ratio due to the deferral of loan repayments (borrowings) according to the applicable repayment schedule. In the last edition of the Report on Compliance with the Rules, the CFC called for a systematic solution to this problem, but so far – given the recurrence of the same situation – to no avail.

The full text of the Report on Compliance with the Rules is supplemented by four boxes on topical issues. The first box focuses on the change in the general government balance in 2023 as part of the so-called first notifications taking place in spring 2024. The second box presents the new fiscal rules at the level of the European Union, the wording of which was intensively worked on during 2023 and reached so far its final form in 2024. The third box presents the impact of the changes in the budgetary determination of taxes on municipalities and regions that were part of the consolidation package. The last box deals with inefficient financial management at the level of municipalities and regions, which, even in an environment of high inflation, accumulate their surpluses mostly in current accounts with low interest rates. This fourth box thus puts into perspective hasty conclusions about the desirability of keeping surpluses as liquid as possible. Decisions on the allocation of these funds should be taken by local governments in the broader context of the needs of municipalities and regions (e.g. for investment activity).

1 General government finances

In 2023, real GDP declined by 0.1% y-o-y.[1] In terms of the individual components of GDP calculated using the expenditure method, gross capital formation fell by 6.5% y-o-y, although gross fixed capital formation grew, entities reduced their accumulated inventories and valuables. Household final consumption expenditure declined by 2.8% compared to 2022, while imports of goods and services also decreased by 0.9% y-o-y. Exports of goods and services (2.7%) and general government final consumption expenditure (3.5%) changed in the opposite direction y-o-y. The Czech economy operated below its potential in 2023, with a negative output gap of 1.2% of potential output. The general government sector recorded a deficit of CZK 268 billion (3.5% of GDP[2]) and the structural deficit reached 2.3% of GDP. The general government debt-to-GDP ratio fell by 0.1 pp y-o-y to 42.4% of GDP. The ratio was also reduced by the revision of the national accounts, which led, inter alia, to an increase in nominal GDP in 2023 and only a slight increase in general government debt in monetary units.

For 2024, the MF CR forecasts[3] annual real GDP growth of 1.1% and an output gap of –2.1% of GDP. The general government balance is expected to be –2.5% and the structural balance –2.1% of GDP. The general government debt ratio is expected to increase by 1.3 percentage points to 43.7% of GDP. The increase in the debt ratio, despite the lower general government balance compared to the previous year, is partly due to the expected moderate dynamics of price level growth in 2024 compared to 2021–2023.

2 The debt rule

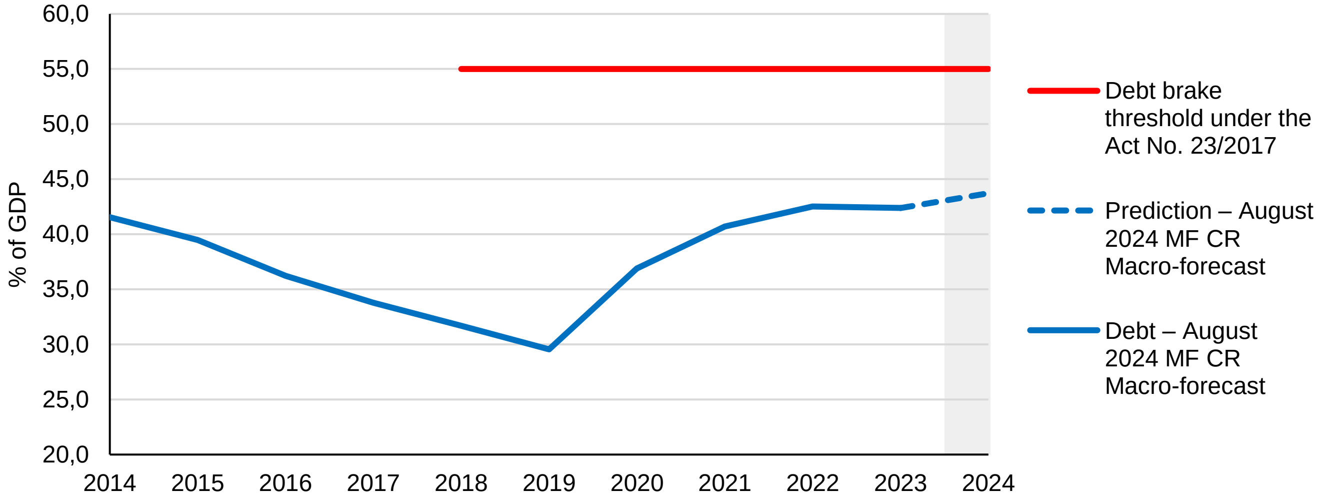
Sections 13 to 16 of the Act define the so-called debt rule.[4] According to Section 13 of the Act, the general government debt (minus the state debt financing reserve) is monitored as a percentage of GDP. If the ratio thus defined exceeds the 55% threshold (the so-called “debt brake threshold”, see Chart 1), the measures specified in the Act are applied in accordance with Section 14. These measures would reduce the possibility of using fiscal policy to stabilise economic developments over the economic cycle and would restrict the activities of many general government organisations. In addition, an increase in the debt ratio above the threshold set by the Act could send a negative signal to financial markets about the deterioration of public finances, which could materialise in the form of an increased risk premium demanded by investors, which would – other things being equal – lead to a further increase in debt. Section 16 of the Act states that if the debt-to-GDP ratio exceeds the 60% threshold, the government will propose measures to reduce this level.[5]

In its communication of 11 April 2024[6], based on CZSO and MF CR data, the CFC announced the value of the debt rule indicator as of 31 December 2023 at 43.96% of GDP. Based on the revision of the national accounts, there was a slight increase of general government debt (by CZK 17 million) and also a noticeable increase in the nominal GDP figure for 2023, which caused a decrease of the general government debt ratio (minus the state debt finance reserve) to 42.38% GDP. Therefore, the change in the ratio did not cause the debt rule threshold set by the Act to be exceed (see the paragraph above and Chart 1).

Conclusion: The CFC states that the thresholds for the general government debt indicator defined in Sections 14 and 16 of the Act were not exceeded in 2023.

[1] MF CR (August 2024): Macroeconomic Forecast of the Czech Republic.
[2] In its August macroeconomic forecast, the MF CR reports an overall balance of the general government sector of CZK –292 billion (–3.8% of GDP). However, these data have not yet been notified by Eurostat as part of the so-called second notifications, so we present the data confirmed by Eurostat as part of the so-called first notifications. However, the figures shown reflect changes due to revisions in the national accounts (https://csu.gov.cz/produkty/vysledky-mimoradne-revize-narodnich-uctu, available in Czech only).
[3] MF CR (August 2024): Macroeconomic Forecast of the Czech Republic.
[4] The CFC’s interpretation of the debt rule under the Act is presented in the CFC (2024): Výroční zpráva za rok 2023 [Annual Report 2023, available in Czech only], see subsection 3.4. The issue of the general government debt is addressed in the educational material CFC (2024): Průvodce světem veřejného dluhu [Guide to the World of General Government Debt, available in Czech only].
[5] The exact specifics of these measures are contained in Article 2(2) of Council Regulation (EC) No. 1467/1997. In particular, the measures define the minimum rate of decrease of the debt-to-GDP ratio to the reference value of 60% when the ratio exceeds the reference value.
[6] Sdělení Národní rozpočtové rady č. 100/2024 Sb., o výši dluhu sektoru veřejných institucí po odečtení rezervy peněžních prostředků při financování státního dluhu. [Czech Fiscal Council Communication No. 100/2024 Coll., on the Level of General Government Minus the State Debt Financing Reserve, available in Czech only].

Chart 1 General government debt minus the state debt financing reserve



Source: MF CR (August 2024): Macroeconomic Forecast of the Czech Republic; CFC calculations.

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

The state budget for 2023 and the budgets of other relevant general government entities were prepared during 2022. A key element of the budget preparation is the General Government Budgetary Strategy ("Strategy") published in April 2022, which sets out the expenditure framework for the state budget and state funds. However, during the preparation of the 2023 budget, the CFC had a different view on the maximum structural deficit figure to be included in the framework calculations. The MF CR have set the maximum structural deficit limit for 2023 at 5.1% of GDP (see Table 1, column 1). However, the CFC did not consider this to be a correct application of the Act. This is because the second amendment to the Act set the structural balance limit only for 2022 and did not explicitly set the structural balance limit for 2023 and subsequent years. Thus, according to the CFC, the Section 10 setting the structural balance limit at –1% of GDP should have been applied in 2023 (see Table 1, column 3 and the black dashed line in Chart 2).[7] The above-mentioned interpretative discrepancy was resolved for the following years by the third amendment to the Act (implemented by Act No. 349/2023 Coll.) under the so-called consolidation package, which explicitly sets the limit for 2024 at –2.75% of GDP and tightens this limit by 0.5% of GDP each year thereafter until the 1% threshold for the structural deficit-to-GDP ratio is reached (see green dashed line in Chart 2).

According to its interpretation of the Act after its second amendment[8], the MF CR derived the total general government expenditure at CZK 3,225 billion and the expenditure framework of the state budget and state funds (including the EU) at CZK 2,191 billion in the Strategy. The better-than-expected development of general government finances and the government's intensified consolidation efforts resulted in a stricter total general government expenditure (CZK 3,196 billion) and expenditure framework (CZK 2,162 billion), also in contrast to the interpretation of the Act chosen by the MF CR,[9] see Table 1 and columns 1 and 2.

As mentioned above, after the second amendment[10], the CFC interpreted the Act differently, resulting in different values for general government expenditure (CZK 2,933 billion) and the expenditure framework (CZK 1,898 billion), see Table 1, column 3.

[7] See Box 2.1 Report on the Long-Term Sustainability of Public Finances 2022 for more details.
[8] The second amendment to the Act was made by Act No. 609/2020 Coll., amending some laws in tax area and some other laws. This amendment modified, among other things, the Section 10a of the Act, where paragraph 2 of this Section explicitly stipulated that in 2021 the MF CR will use the balance for 2021, which it forecasts no later than September 2021, increased by 0.5 pp. In August 2021, the MF CR predicted in its macroeconomic forecast a structural balance for 2021 of –6.1% of GDP. Thus, a balance of –5.6% of GDP was taken into account in the derivation of this rule for 2022 (see Chart 2, black dashed line) and for 2023, in the MF CR interpretation of the Act after its second amendment, a balance of –5.1% of GDP.
[9] The MF CR took into account a structural balance of –4.7% of GDP (and not –5.1% of GDP as specified in the Act according to the interpretation of the MF CR) for the determination of total expenditure or the expenditure framework for 2023.
[10] See, among other things, Box 2.1 in the Report on the Long-Term Sustainability of Public Finances 2022.

According to the draft act on the state budget for 2023 of September 2022[11], which was based mainly on the August macroeconomic forecast of the MF CR[12], the expenditure framework was to amount to CZK 2,361 billion. According to the CFC's interpretation, it should have been CZK 2,089 billion, see columns 4 and 5 in Table 1. The increase in the expenditure framework compared to the Strategy was in accordance with the Section 8 paragraph 2 of Act No. 218/2000 Coll., on Budgetary Rules and on Amendments to Certain Related Acts (Budgetary Rules), as amended.[13] The draft act set the state budget deficit at CZK 295 billion.

According to Act No. 449/2022 Coll., on the State Budget of the Czech Republic for 2023, the state budget expenditure was set at CZK 2,223 billion, state budget and state funds expenditure at CZK 2,321 billion, see column 6 in Table 1.

Claims arising from unconsumed expenditure at the beginning of 2023 amounted to CZK 210.1 billion. During the year, CZK 167.3 billion of claims arising from unconsumed expenditure was employed in the budgets or terminated. CZK 125.7 billion was actually drawn down. As of 1 January 2024, claims arising from unconsumed expenditure amounted to CZK 212 billion.

Table 1 Key indicators of the expenditure rule and actual figures recorded in 2023 (CZK billions unless stated otherwise)

	(1) Budgetary strategy (May 2022); interpretation of the Act after the second amendment according to the MF CR	(2) Budgetary strategy (May 2022); pursuit of faster consolida-tion (beyond the Act)	(3) Expenditure and expenditure framework; interpretation of the Act after second amendment (according to the CFC)	(4) Draft state budget (September 2022) – modified expenditure framework	(5) Modified expenditure framework; interpretation of the Act after second amendment (according to the CFC)	(6) Approved state budget (November 2022)	(7) Actual figure (August 2024)*
General government expenditure	3,225	3,196	2,933				3,332
SB and SFs expenditure frame-work, including the EU	2,191	2,162	1,898	2,361	2,089		
SB						2,223	2,203
SFs						234	217
Transfers from SB to SFs						136	138
SB and SFs, total						2,321	2,282
GDP at current prices	7,135	7,135	7,135	7,356	7,356	7,356	7,619
Structural balance (% of GDP)	-5.1	-4.7	-1.0	-3.1	-1.0	-3.1	-2.3
Output gap (% of potential out-put)	-0.5	-0.5	-0.5	-0.4	-0.4	-0.4	-1.2

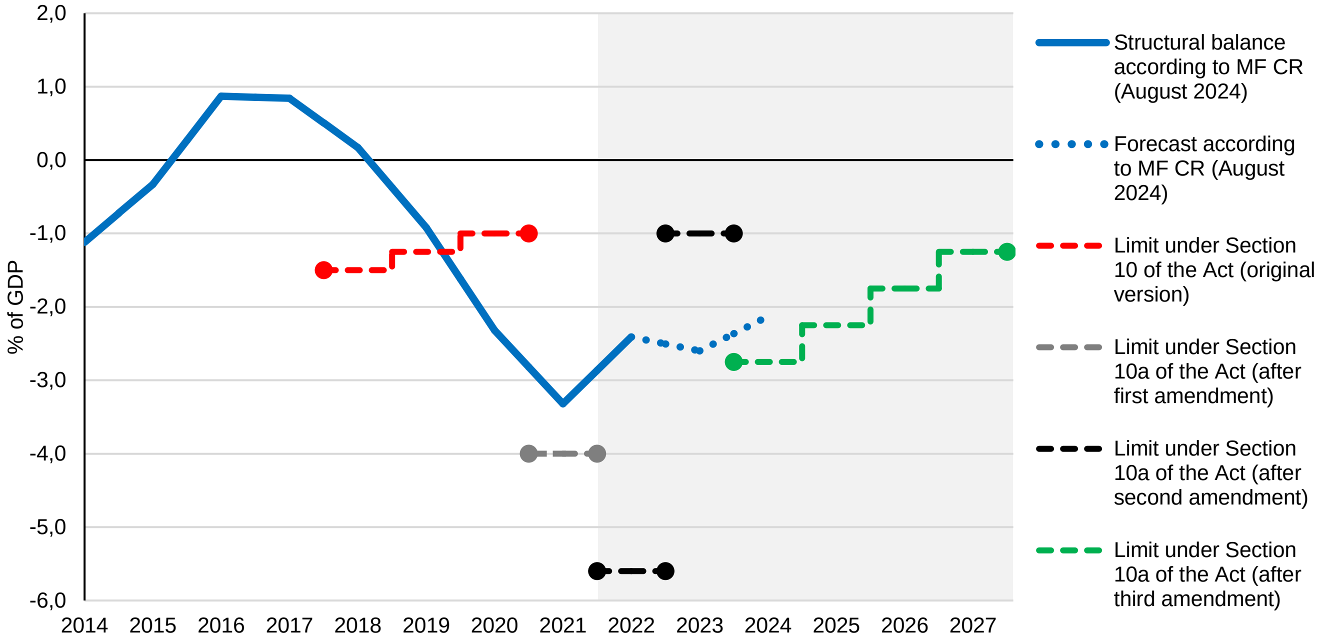
Source: MF CR (2022): General Government Budgetary Strategy of the Czech Republic for 2023–2025, MF CR (2022): Draft Act on the State Budget of the Czech Republic for 2023, including budget documentation, Act No. 449/2022 Coll, MF CR (2024): Draft State Closing Account of the Czech Republic for 2023, Workbook C - Report on the Results of the State Budget, MF CR (2024): State Treasury Monitor, MF CR (2024): Treasury Performance for January–December 2023, MF CR (August, 2024): Macroeconomic Forecast of the Czech Republic, CZSO (2024): National Accounts Database; CFC calculations.
Note: SR = state budget, SFs = state funds. The totals in the table may be subject to inaccuracies due to rounding. *The calculation of the structural balance was based on the total general government balance according to the CZSO (2024): Notification of the General Government Deficit and Debt – 2023 (First notification, data notified by Eurostat) published on 22 April 2024. The cyclical component of the balance and one-off and other temporary measures were taken from the MF CR (August 2024): Macroeconomic Forecast of the Czech Republic. Charts 2 and 3 (see below) show the value of the structural balance and other components of the overall balance for 2023 and 2024 according to the MF CR (August 2024).

The reason for setting the expenditure framework for the state budget and state funds in accordance with the Act is to prevent the defined structural deficit limit from being exceeded. Therefore, when assessing this rule, it is essential to monitor not only the process of deriving the expenditure framework but also the level of the general government structural balance and whether the structural balance limit set by the Act was exceeded. Looking at

[11] MF CR (2022): Draft Act on the State Budget of the Czech Republic for 2023, including budget documentation.
[12] MF CR (August 2022): Macroeconomic Forecast of the Czech Republic.
[13] On the revenue side, there were changes increasing the expenditure framework by CZK 98.8 billion (including a change in Modernisation Fund revenues, higher dividends and revenues from the auctions of emission allowances) and on the expenditure side, there were changes increasing the expenditure framework by CZK 100 billion (the effect of one-off measures related to support for entities in the context of high energy prices). More on the MF CR (2022): Report on the Draft Act on the State Budget of the Czech Republic for 2023.

column 7 of Table 1 and Chart 2 it is clear that the maximum structural deficit has been exceeded by about 1.3% of GDP (about CZK 99 billion) according to the CFC interpretation.[14]

Chart 2 The general government structural balance



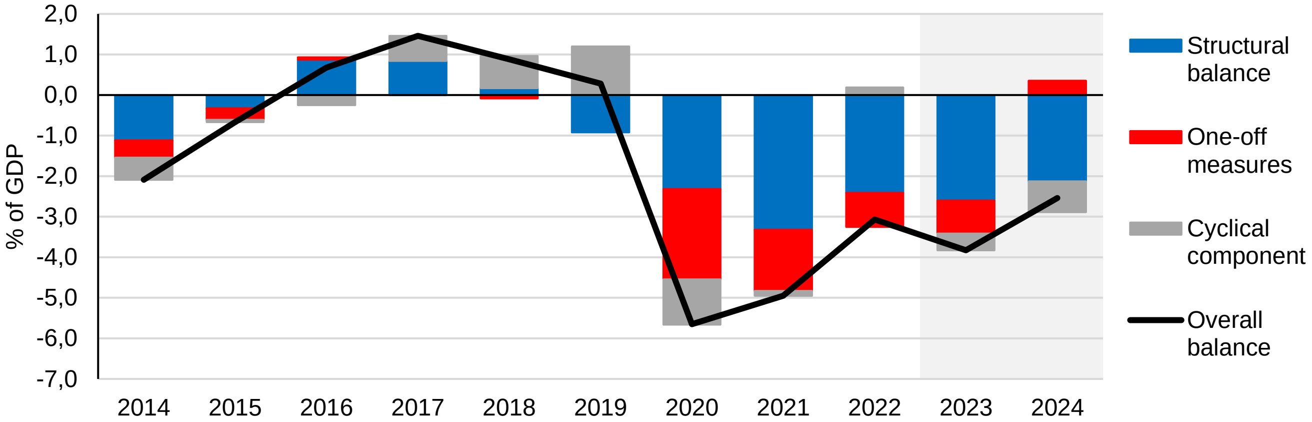
Source: MF CR (April 2024): Macroeconomic Forecast of the Czech Republic, the Act (various versions); CFC calculations.
Note: The first amendment to the Act (implemented by Act No. 207/2020 Coll.) set the limit of the structural balance for 2021 at –4.0% of GDP (see grey dashed line), with a subsequent annual improvement of at least 0.5% of GDP in 2022–2027 (the trajectory for this period is not shown in Chart 2 for clarity). The structural balance for 2023 is derived from the general government balance –3.8% of GDP according to the MF CR (August 2024). This updated value of the balance for 2023 has not been published yet by the CZSO as part of the so-called second notifications (October 2024). Therefore, we consider the structural balance for 2023 presented in Charts 2 and 3 as a forecast and in the text of the Report on Compliance with the Rules we present the total general government balance for 2023 at –3.5% of GDP (according to the first notifications of April 2024), or the structural balance derived from it according to the adjustments presented in the note under Table 1.

The decomposition of the overall general government balance is shown in Chart 3. The chart shows **that the structural component of the balance has a significant and persistent impact on the overall general government balance from 2020 onwards**. This suggests that it takes many years for structural changes in the composition of general government expenditure and revenue to take effect, leading to a reduction in the high structural deficit and thus contributing to a more stable evolution of general government finances. This contrasts with the relatively flexible use of one-off and temporary measures, which do not achieve the hysteresis (“inertia”) as changes in the composition of revenue and expenditure reflected in the structural balance, see the use of one-off and temporary measures during the pandemic crisis (2020–2021) and the energy crisis linked to geopolitical uncertainty (2022–2023).

If fiscal policy does not intensify its consolidation efforts, then the inertial structural deficit may become a significant obstacle to meeting the expenditure rule in the years ahead (see also Chart 2 and the tightening of the rule limit under the third amendment to the Act in 2024–2027).

[14] The calculation includes nominal GDP for 2023 given in the MF CR (August 2024): Macroeconomic Forecast of the Czech Republic. These are therefore data after revision of the national accounts data of the Czech Republic.

Chart 3 Decomposition of the general government balance



Source: MF CR (August 2024): Macroeconomic Forecast of the Czech Republic; CFC calculations.

Conclusion: The CFC states that the *technical procedure* for determining the total general government expenditure and deriving the state budget and state funds expenditure framework for 2023 was followed. However, the CFC states that a stricter value of the maximum structural deficit (max. 1 % of GDP) should have been applied according to the version of the Act in force at the time. In the opinion of the CFC, the structural deficit rule was thus not respected. At the same time, however, it should be noted that, thanks to the government's consolidation efforts, the actual expenditure of the state budget and state funds was approximately CZK 79 billion lower than the government's updated expenditure framework in the state budget documentation for 2023. It should be also noted that the trajectory of the reduction of the structural deficit from 2024 onwards, explicitly set out in the Act and approved as part of the so-called consolidation package, should prevent differences in interpretation in the application of the Act in the future.

Another peculiarity of 2023 was the change in the general government balance made as a part of the so-called first notifications at the request of Eurostat. A more detailed description of the events leading to this revision is given in Box 1 below.

Box 1 Reasons for the change in the 2023 total general government balance in the first notifications: the super-dividend issue

In spring 2024, the Czech Statistical Office (CZSO) sent Eurostat data on the performance of the general government for 2023[15], according to which the general government deficit for 2023 reached 3.3% of GDP and debt 44.0% of GDP. However, after Eurostat notified the data, the deficit for 2023 was lowered to 3.7% of GDP and debt remained at the same level.[16,17] The main reason for this change is the methodological differences in the national accounting system[18] in the recording of *dividends* and *super-dividends*, with a consequent different impact on the general government finances.

[15] https://csu.gov.cz/rychle-informace/notification-of-government-deficit-and-debt-2023-first-notification-data-sent-to-eurostat.
[16] https://csu.gov.cz/rychle-informace/notification-of-government-deficit-and-debt-2023-first-notification-data-notified-by-eurostat.
[17] After the first notifications, the general government balance for 2023 changed from CZK –240 billion (–3.3% of GDP) to CZK –268 billion. The revision of the national accounts published by the CZSO at the end of June 2024 changed, among other things, the GDP figure for 2023 (see https://csu.gov.cz/produkty/vysledky-mimoradne-revize-narodnich-uctu, available in Czech only). Although the value of the general government balance remained almost unchanged (there was an increase of CZK 10 million), the balance-to-GDP ratio changed to –3.5% of GDP due to the increased nominal GDP for 2023. In its August macroeconomic forecast, the MF CR quotes the value of the sector balance as CZK –292 billion and –3,8% GDP. The deterioration of the balance for 2023 in the amount of CZK 23.2 billion compared to the figures reported by the CZSO after the revision of the national accounts is due to lower corporate income tax revenues and the levy on electricity producers' excess revenues. However, the value of the balance reported in the August MF CR material has not yet been notified. The CZSO will publish the values of the general government balance as part of the so-called second notifications in October 2024. Therefore, in the text we work with the data on the general government balance (and its sub-sectors) published by the CZSO, which were confirmed by Eurostat as part of the first notifications, see CZSO (2024): Public database, General government deficit/surplus, debt position and related data [accessed on 23 August 2024]. General government debt was only marginally affected by the revisions (there was an increase of CZK 17 million for 2023), but the debt ratio fell by about 1.6 pp to 42.4% of GDP in 2023 due to higher nominal GDP.
[18] See, for example, EU (2023): Manual on Government Deficit and Debt - Implementation of ESA 2010 (2022 edition); EU (2013): European System of Accounts (ESA 2010) and other updated manuals at https://ec.europa.eu/eurostat/web/esa-2010/overview; CZSO (2015): European System of Accounts ESA 2010.

The general government balance is the difference between total revenue and total expenditure. According to the CZSO methodological note[19] which explains the change in the reported balance, there is a decrease in government revenue in 2023, specifically in the item *property income received*. This item includes interest, dividends, profit shares, etc. However, it does not include the so-called super dividends. In order to assess whether a dividend is a (“standard”, “ordinary”) dividend or a super-dividend, a *super-dividend test* is applied.

A corporation has funds available to distribute dividends to its shareholders in the form of *distributable income*[20]. The usual situation is that in the previous year (e.g. 2022), the corporation reaches a certain amount of distributable income, and the following year (e.g. 2023) those funds can be used to pay dividends. If the super-dividend test shows that the total amount of dividends declared exceeds the ratio of dividends to distributable income that has been common in the recent past[21], then the portion of dividends significantly[22] in excess of that ratio is referred to as the super-dividend[23]. The super-dividend, from a general government sector national accounts perspective, is recorded in the financial account[24] as the withdrawal of owners' *share and other equity*[25] from the corporation.

The reason for the deterioration of the balance from –3.3% of GDP to –3.7% of GDP in the first notifications was precisely the "reclassification" of part of dividends to super dividends in a corporation (co-)owned by the general government. The change was due to a different perception of this issue by Eurostat. Specifically, it concerned the recording of the results of trading in derivatives. The (co-)owned government corporation, whose name could not be mentioned in the CSZO methodological note due to confidentiality obligations and protection of confidential statistical data, also used commodity derivates[26] to "hedge" the pre-determined purchase or sale price of certain commodities in the future. It then sold these commodities to its clients. According to the information received from the corporation, CSZO also included the results of trading in commodity derivatives in its distributable income, thereby increasing that income, which could be distributed as dividends. However, Eurostat considered the main objective of derivatives transactions to be to trade on commodity price movements without the need to physically buy or sell commodities. Eurostat therefore did not include these trading results in the distributable income of the corporation, which reduced the distributable income, and a part of the dividends had to be treated – given the results of the super-dividend test – as a so-called super-dividend.[27]

Although this change increased the general government deficit as part of the first notifications, the debt-to-GDP ratio for 2023 remained unchanged.[28] This is because debt[29] consists only of currency issued, deposits received, debt securities issued, and loans received. Thus, the reduction (withdrawal) of the financial account item share and other equity due to the payment of the super-dividend does not change the debt ratio. However, this operation is reflected in the stock-flow adjustment (SFA) item, which captures the difference between the change in the amount of debt and the general government balance for the period. Thus, within the SFA portion of *net acquisition of financial assets*, there is a reduction in the share and other equity item in 2023.[30]

[19] Again, see https://csu.gov.cz/rychle-informace/notification-of-government-deficit-and-debt-2023-first-notification-data-notified-by-eurostat.
[20] Distributable income is equal to *entrepreneurial income* plus the *balance of current transfers* (i.e. all current transfers receivable minus all current transfers payable) minus the *adjustment for the change in pension entitlements*. Entrepreneurial income is referred to in corporate accounting as *operating surplus before distributions and income taxes*.
[21] The explicit definition of the time period is not mentioned in the relevant passages of the manuals used.
[22] An explicit determination of "excess" is not provided in the relevant passages of the manuals used.
[23] Super-dividends are funded from accumulated reserves or from the sale of assets. If they were included in the item of property income received, they would 'artificially' increase the revenue of the general government, although the reality, i.e. the economic performance of the (co-)owned government corporations in the period in question, would not correspond to this. At the same time, this increase in the general government balance could not be permanent because of the limited amount of reserves and assets of the (co-)owned corporation.
[24] The financial account is one of the *accumulation accounts* in the sequence of national accounts, which, among other things, record changes in the volume and valuation of the individual components of the assets and liabilities of the sectors of the national economy.
[25] Shares and other equity consist of all transactions in shares and other equity that are financial assets which represent property rights on corporations or quasi-corporations.
[26] From an economic point of view, derivatives are instruments derived from other (so-called basic, underlying) instruments, e.g. a commodity or a financial instrument, etc. Derivatives are futures in nature, i.e. the details of the derivative contract (including e.g. the future price of the underlying instrument) are negotiated "today", but settlement of the derivative contract will only occur at a precisely specified time in the future. The reasons for negotiating a derivative contract may include speculation, arbitrage or hedging.
[27] The CZSO also argued that the corporation in question had not experienced a decline in accumulated reserves or a sale of assets and therefore it was not a super-dividend.
[28] However, the general government debt and its ratio to GDP have been changed as part of revisions to the national accounts, see text earlier.
[29] General government debt means debt published under notifications, i.e. in accordance with Council Regulation (EC) N°479/2009, as amended by EU Commission Regulation No. 220/2014. This concept includes in debt the items that are listed in the text of this box. According to a different concept under ESA 2010, debt consists of a broader concept of liabilities. See e.g. EU (2023): Manual on Government Deficit and Debt - Implementation of ESA 2010 (2022 edition).
[30] Detailed values of the changes can be obtained by comparing Excel spreadsheets on the CZSO website - see Table 3A sent to Eurostat (https://csu.gov.cz/rychle-informace/notification-of-government-deficit-and-debt-2023-first-notification-data-sent-to-eurostat) versus Table 3A with adjusted data according to Eurostat notifications (https://csu.gov.cz/rychle-informace/notification-of-government-deficit-and-debt-2023-first-notification-data-notified-by-eurostat).

Box 2 New European fiscal rules

New European fiscal rules were adopted at the end of April this year. While the basic rules setting the benchmark for general government debt at 60% of GDP and the general government deficit at 3% of GDP remain unchanged, the new fiscal rules aim to better reflect the diversity of fiscal positions, public debt and economic challenges across Member States. They also put more emphasis on addressing medium and long-term challenges.

The cornerstones of the new fiscal rules are the so-called National Medium-Term Fiscal-Structural Plans (hereinafter "National Plans"), which Member States draw up for a period of four or five years, based on the regular length of the Member State's legislature. The National Plans link fiscal policy, structural reforms and investment in each Member State and, to some extent, replace the convergence and stability programmes issued so far. In addition to providing information on priority public investments and reforms, broader reforms and investments (including in relation to common EU priorities), the National Plans also set out the fiscal – or net expenditure – path. Member States will submit these National Plans for the first time in autumn 2024.

The only indicator tracked are so-called net expenditure, i.e. government expenditure net of interest expenditure, discretionary revenue measures, expenditure on Union programmes fully matched by revenue from EU funds, national expenditure on co-financing of programmes funded by EU, cyclical elements of unemployment benefit expenditure, and one-offs and other temporary measures.

The net expenditure path should cover a minimum period of four years. However, this so-called adjustment period can be extended, up to three years, if supported by a set of reforms and investments meeting the criteria set out in the regulation[31].

Member States with a general government debt exceeding 60% of GDP or a general government deficit exceeding 3% of GDP will be granted a so-called reference trajectory by the European Commission[32]. This serves more or less as a basis for the elaboration of the net expenditure path and should ensure the following:

a) the projected general government debt-to-GDP ratio needs to be on a plausibly downward path without further budgetary measures, or remain at prudent levels below 60% of GDP over the medium-term,
b) the projected general government deficit is brought below 3% of GDP and, in the absence of further budgetary measures, is kept below 3% of GDP over the medium-term,
c) there is no postponement of the fiscal adjustment effort (i.e. the fiscal adjustment effort is linear as a rule and at least proportional to the overall effort over the entire fiscal adjustment period),
d) in case of opening of an excessive deficit procedure due to an excessive deficit, the minimum annual structural adjustment is 0.5% of GDP.

At the same time, the reference trajectory shall ensure so-called debt sustainability and deficit resilience safeguards.

The debt sustainability safeguard specifies a minimum annual reduction in the projected general government debt-to-GDP ratio. Member States with general government debt above 60% of GDP but below 90% of GDP must reduce their debt-to-GDP ratio by at least 0.5 pp of GDP per year on average. Member States with general government debt above 90% of GDP must reduce the debt-to-GDP ratio by at least 1 pp of GDP per year on average.

The deficit resilience safeguard should create a fiscal buffer against adverse shocks. Thus, the fiscal adjustment should continue until the structural deficit (i.e. the cyclically adjusted general government deficit net of one-offs and other temporary measures) is 1.5% of GDP relative to the 3% of GDP deficit benchmark.

Other Member States (i.e. Member States that do not exceed either of the benchmarks) can ask the European Commission for so-called technical information. These include the primary structural balance (i.e. the structural balance net of interest expenditure) needed to keep the general government deficit below the reference value in the medium and long term without further budgetary measures. At the same time, they are consistent with a deficit resilience safeguard.

The National Plans, including the net expenditure path, are submitted by the Member States to the European Commission and the Council of the European Union ("the Council of the EU"), which assesses the plans. If the national plan meets the requirements set out therein, the Council of the EU adopts a recommendation setting the

[31] Regulation (EU) 2024/1263 of the European Parliament and of the Council of 29 April 2024 on effective economic policy coordination and multilateral budgetary surveillance and repealing Council Regulation (EC) No. 1466/97.
[32] The reference trajectory was provided to 17 Member States this year: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Hungary, Italy, Malta, Poland, Portugal, Romania, Slovakia, Slovenia, Spain.

net expenditure path (or a set of reform and investment commitments which underpin an extension of the adjustment period).

The control account is used to monitor compliance with the net expenditure path set by the Council of the EU. It tracks any deviations of observed net expenditure from the established path. At the same time, each Member State submits the so-called annual progress report, which contains information not only on the implementation of the net expenditure path, but also on the implementation of reforms and investments.

Deviations from the net expenditure path are not recorded in the control account only if one of the escape clauses has been activated. The general escape clause may be activated in the event of a severe economic downturn in the euro area or in the Union as a whole. However, the general escape clause can only be activated for one year, which may be extended. The national escape clause may be activated if exceptional circumstances beyond the control of a Member State have a significant impact on its public finances. The national escape clause must also be time-limited and is renewable. However, both types of escape clauses must not endanger the sustainability of public finances in the medium term.

During the preparation of the new fiscal rules, the role of independent fiscal institutions ("IFIs") was widely discussed. In the final version of the rules, the advisory role of the IFIs has been maintained with the aim of gradually building up their capacity. The IFI will only assess the consistency of the actual budgetary outcomes reported in the annual progress report or analyse the factors that led to the deviation from the net expenditure path if requested by the Member State concerned. The assessment of the macroeconomic forecast and the macroeconomic assumptions for the determination of the net expenditure path by an independent fiscal institution will only be carried out at the request of the government until May 2032. Thereafter, IFIs should issue these opinions provided that they have built up sufficient capacity.

The so-called corrective arm of the rules and the Excessive Deficit Procedure ("EDP") have also changed. While the EDP for breaches of the deficit benchmark remains unchanged, the initiation of the EDP for breaches of the general government debt benchmark takes into account the new national plans and the net expenditure path. In the event that a Member State exceeds the government debt benchmark (i.e. 60% of GDP), the budget position is not close to balance or in surplus and deviations from the established net expenditure path in the control account exceed 0.3 pp of GDP per year or 0.6 pp of GDP cumulatively, an EDP may be opened. However, so-called relevant factors such as the degree of debt challenges or an increase in government investment in defence are also taken into account.

Once an EDP has been initiated, the Member State must take effective action and implement the so-called corrective net expenditure path. This should meet a minimum annual structural adjustment of 0.5% of GDP in the years when the general government deficit is expected to exceed the 3% of GDP reference value[33] in case an EDP has been initiated for non-compliance with the deficit criterion.

The amount of fines that the Council of the EU can impose for non-compliance with notices by a Member State has also been adjusted. The new maximum amount is 0.05% of GDP, payable every six months until the Council of the EU decides that the Member State has taken effective action.

[33] For a transitional period until 2027, the European Commission may adjust the minimum structural adjustment to take into account the increase in interest payments when determining the corrective path, provided that the Member State explains how it will ensure the delivery of reforms and investments.

4 Local and regional government finances

According to the Constitution of the Czech Republic, local and regional authorities are 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 partially 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 violation of the fiscal rule.

4.1 Local government finances 2020–2023

The local government subsector[34] has reported budget surpluses the last four years. This has contributed to better financial results of the overall general government sector each year. In 2023, the total revenue of this subsector was CZK 987.7 billion, an increase of CZK 81.4 billion compared to the previous year. Local government revenue accounted for 32.2% of total general government revenue. Local government expenditure accounted for 27.5% of total general government expenditure. The surplus of the local government subsector increased slightly by CZK 5.2 billion year-on-year to CZK 70.3 billion in 2023, reaching 0.9% of GDP. The relevant data are presented in Table 2.

Table 2 Local government finances in the Czech Republic 2020–2023

	2020		2021		2022		2023	
	CZK bn	% of GDP	CZK bn	% of GDP	CZK bn	% of GDP	CZK bn	% of GDP
Revenue	747.6	12.8	818.7	13.0	906.3	12.9	987.7	13.0
Expenditure	720.5	12.4	763.3	12.1	841.2	11.9	917.4	12.0
Balance	27.0	0.5	55.5	0.9	65.1	0.9	70.3	0.9

Source: CZSO (July 2024); CFC calculations.

The downward trend in the share of local government debt in total general government debt generally corresponds to the local government surpluses. However, this was not the case in recent years and the debt of the local government subsector was in the range of CZK 85–90 billion despite surpluses, as shown in Table 3. In 2023, the debt of the local government subsector amounted to CZK 85.4 billion (approximately 1.1% of GDP), representing 2.6% of total general government debt.

Table 3 Local government debt in the Czech Republic 2020–2023

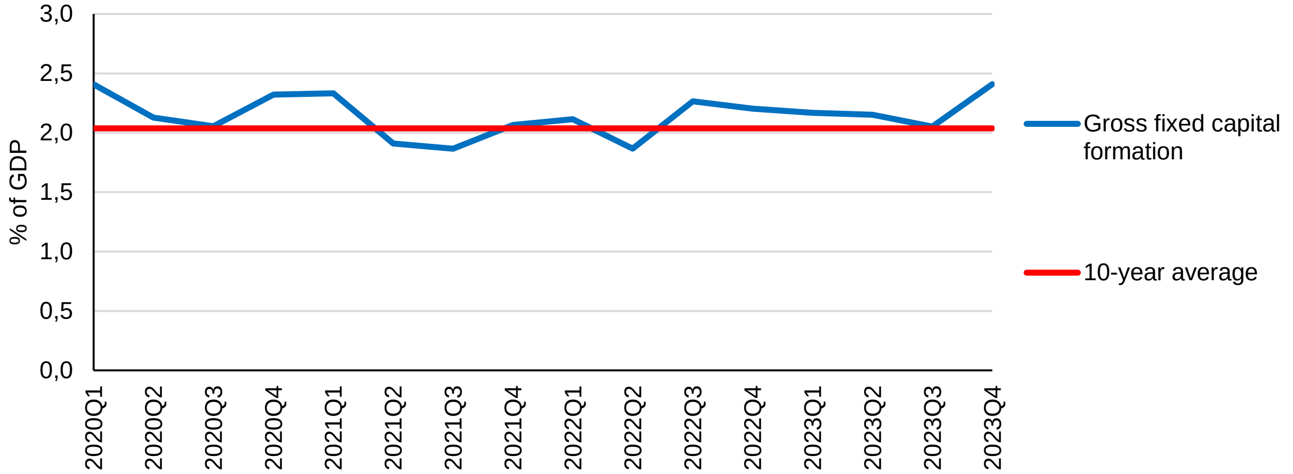
	2020	2021	2022	2023
Debt (CZK billions)	87.1	87.0	89.1	85.4
Ratio to GDP (%)	1.5	1.4	1.3	1.1
% of total general government debt	4.1	3.4	3.0	2.6

Source: CZSO (July 2024), Eurostat (July 2024); CFC calculations.

In 2023, the local government subsector recorded an increase in investment activity by CZK 18.3 billion. Thus, investment in 2023 reached approximately CZK 167.4 billion, which is CZK 50.3 billion higher than the 10-year average for 2014-2023 (see Chart 4).[35]

[34] Under the ESA 2010 methodology, the local government subsector is a part of the general government sector. 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.
[35] Gross fixed capital formation of the local government subsector gradually increased from 1.3% of GDP in 2016 to 2.3% of GDP in 2023.

Chart 4 Local government investment in the Czech Republic 2020–2023



Source: CZSO (July 2024); CFC calculations.

Conclusion: The finances of local and regional authorities (and organisation accountable to them) do not pose significant risks to the overall financial results of the general government sector. On the contrary, they have been contributing to stabilise general government finances for quite some time. The 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 the growth in general government debt. The investment activity of local and regional authorities increased to around 2.2% of GDP in 2023, slightly above the 10-year average.

BOX 3 Impact of changes in the budgetary determination of taxes on the tax revenues of the local and regional authorities in 2024

The total revenue of the local and regional authorities from the budgetary determination of taxes in 2023 amounted to CZK 422.2 billion, of which almost half is a revenue from value added tax (CZK 201.5 billion; 47.7%), followed by more than a quarter from corporate income tax (CZK 122 billion; 47.7%). The smallest share comes from the income from the real estate tax (CZK 12.5 billion; 3%), which is exclusively a revenue of municipalities. A similar ratio can be observed for the recipients of these tax revenues. More than half is received by municipalities other than Prague (CZK 225.1 billion; 53.3%), about a quarter by regions (CZK 106.2 billion; 25.1%) and about a fifth by the City of Prague (CZK 91 billion; 21.6%), see Table B3.1.

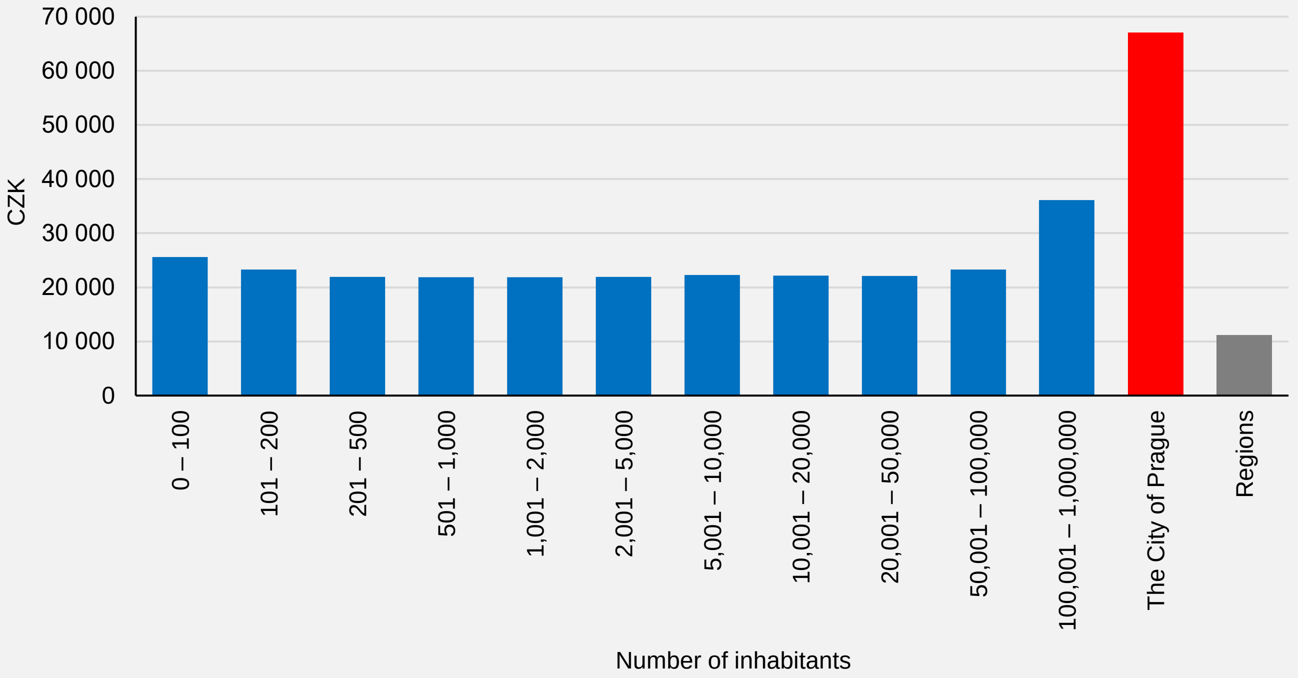
Table B3.1 Revenues of the local and regional authorities from the budgetary determination of taxes in 2023

Territorial unit	Number of territorial units	Number of inhabitants	VAT revenues	Personal Income Tax revenues	Corporate Income Tax revenues	Real Estate Tax revenues	Total	Total per capita
The City of Prague	1	1,357,326	44.1	18.9	26.5	1.5	91.0	67,021
Municipalities	6,253	9,470,203	103.8	45.1	65.1	11.0	225.1	23,768
Regions	13	9,470,203	53.6	22.2	30.4	0.0	106.2	11,209
Total	6,267	10,827,529	201.5	86.2	122.0	12.5	422.2	38,994

Source: MF CR State Treasury (August 2024); CFC calculations.
Note: VAT = value added tax.

While the revenues of the regions from the budgetary determination of taxes amount to approximately CZK 11,209 per capita, this figure is significantly higher for municipalities, where the average is about CZK 29,190, of which CZK 67,021 for the City of Prague and CZK 23,768 for other municipalities. However, large municipalities with more than 100,000 inhabitants are significantly above this average, with revenues from the budgetary determination of taxes amounting to CZK 36,142 per inhabitant. This tax revenue indicator is also slightly higher for the smallest municipalities with less than 100 inhabitants (CZK 25,595), see Chart B3.1.

Chart B3.1 Municipal and regional revenues per capita from the budgetary determination of taxes in 2023



Source: MF CR State Treasury (August 2024); CFC calculations.

During 2023, as part of the consolidation package, the government approved, among other things, a change in the budgetary determination of taxes[36], which reduces the share of municipalities and regions in the national collection of value added tax, personal income tax and corporate income tax, and a change in the real estate tax act, which is expected to have a positive impact on municipalities and regions. The specific changes are shown in Table B3.2.

Table B3.2 Changes in the budgetary determination of taxes in 2024 (%)

	Recipient	2023	2024
Value Added Tax	Regions	9.78	9.76
	Municipalities	25.84	24.92
	State Budget	64.38	65.32
Personal Income Tax (by withholding tax at special tax rate; from self-employment)	Regions	9.78	9.76
	Municipalities	25.84	24.92
	State Budget	64.38	65.32
Personal Income Tax (from a dependent employment)	Regions	9.78	9.76
	Municipalities	27.34	26.42
	State Budget	62.88	63.82
Corporate Income Tax	Regions	9.78	9.76
	Municipalities	25.84	24.92
	State Budget	64.38	65.32
Real Estate Tax	Municipalities	100.00	100.00

Source: Financial Administration (2024); CFC.
Note: from 2025, the share of the regions in shared taxes will change from 9.76% to 9.95%, see Parliamentary Print 701 (amendment to the Act on the Budgetary Determination of Taxes).

On the basis of these changes, and using the 2024 budgets of individual municipalities, we have estimated the tax revenue of the local and regional authorities in 2024. Table B3.3 shows that the effect of the increase in total tax collections in aggregate will exceed the reduction in the share of the municipalities and regions. Thus, in 2024,

[36] The change in the budgetary determination of taxes adopted as part of the consolidation package applies to the years 2024 and 2025. However, in this box, we focus only on 2024, as the 2025 budget used to estimate tax revenues is not available at the time of writing this Report on Compliance with the Rules.

we project the revenues of the local and regional authorities from the budgetary determination of taxes at CZK 438.8 billion, i.e. CZK 16.6 billion (approximately 3.9%) more than in 2023. We project the largest increase in revenues from the value added tax (CZK 7 billion), followed by revenues from the real estate tax (CZK 6.8 billion) and the corporate income tax (CZK 3.3 billion). On the other hand, revenues from personal income tax decreased slightly (CZK –0.5 billion).

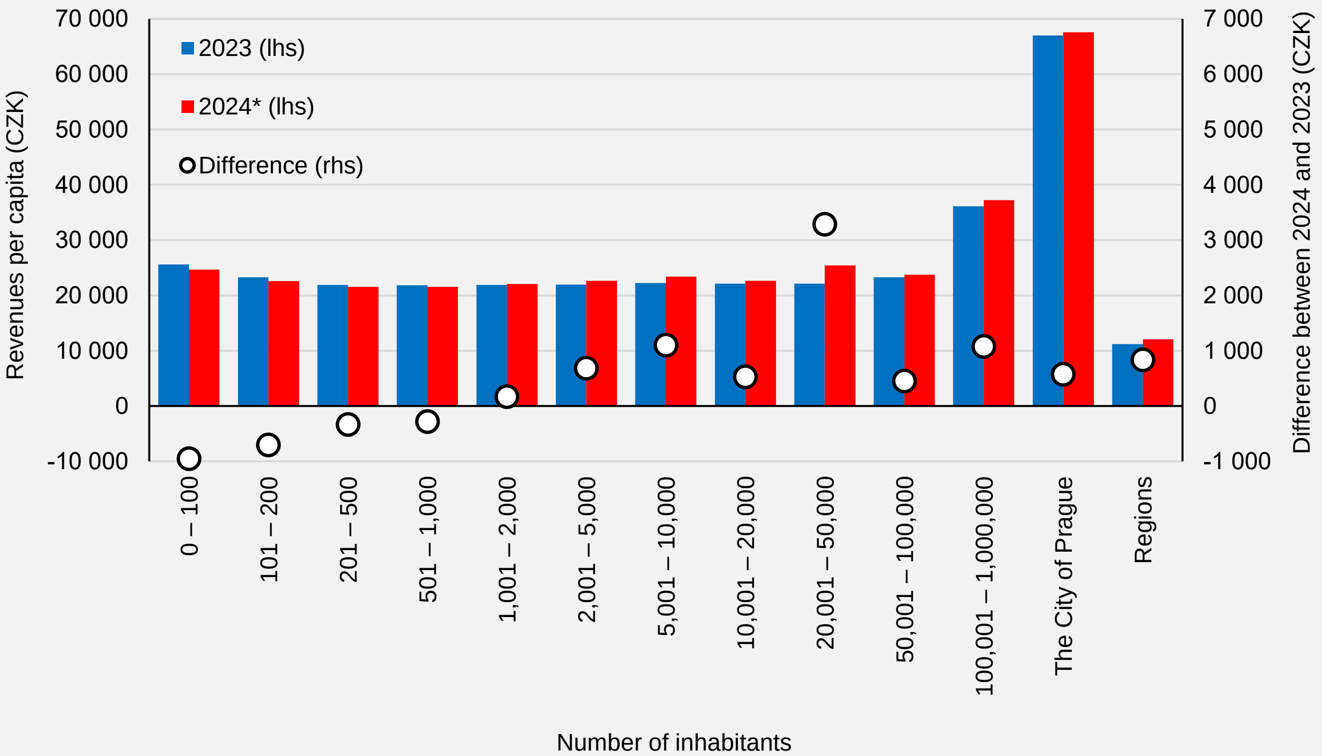
Table B3.3 Municipal and regional revenues from the budgetary determination of taxes in 2020–2024 (CZK billion)

	2020	2021	2022	2023	2024*
Value Added Tax	138.5	162.7	189.1	201.5	208.5
Personal Income Tax	77.6	63.9	71.3	86.2	85.7
Corporate Income Tax	57.3	79.8	91.3	122.0	125.4
Real Estate Tax	11.6	11.9	12.4	12.5	19.2
Total	284.9	318.3	364.0	422.2	438.8

Source: MF CR State Treasury (August 2024); CFC calculations.
Note: *estimated by the CFC.

Chart B3.2 shows that the change in the budgetary determination of taxes in 2024 will have an asymmetric impact on individual municipalities, depending on their size. While the revenues of small municipalities with fewer than 1,000 residents based on the budgetary determination of taxes will be lower in 2024 than in the previous year, our analysis shows that larger municipalities and regions will be better off on average by the same amount. Of these, all regions (by a total of CZK 7.9 billion) and municipalities with populations between 20,000 and 50,000 (by a total of CZK 4.2 billion) will improve the most. In nominal terms, the highest year-on-year increase in revenues from the budgetary determination of taxes in our analysis was recorded by the City of Prague (CZK 780.8 million more than in 2023), while the biggest drop in revenues from the budgetary determination of taxes was recorded by Náchod (CZK 63.9 million less than in 2023). A total of 3,054 municipalities (48.8% of all municipalities) will achieve higher revenues from the budgetary determination of taxes in 2024 than in 2023.

Chart B3.2 Municipal and regional revenues per capita from the budgetary determination of taxes in 2023 and 2024



Source: MF CR State Treasury (August 2024); CFC calculations.
Note: *estimated by the CFC.

4.2 The budgetary responsibility rule for local and regional authorities and compliance therewith in 2023

The Act (Section 17) 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[37] at the balance-sheet date does not exceed 60% of its average annual revenues[38] over the last 4 budget years (the “debt criterion”).
b) Should the debt of a local or regional authority at the balance-sheet day exceed 60% of its average 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”).

The MF CR monitors the finances of local and regional authorities on the basis of financial data and accounting records submitted by the municipalities. In 2023, 6,262 local and regional authorities of the Czech Republic were included in the monitoring, i.e. 6,249 municipalities[39] including the City of Prague and 13 regions.

Of the 585 municipalities whose debt as of 31 December 2022 was higher than 60% of their average revenue over the previous four years, a total of eight municipalities were not compliant with the debt reduction rule.[40] The reason for the non-compliance during 2023 was the deferral of loan repayments, which were set out in a repayment schedule. In none of the cases did the MF CR decide to suspend the transfer of tax revenues to the respective municipalities, arguing that there was no risk of unsustainable financial situation and that extraordinary repayments would be contrary to the principle of economy due to their costliness (see the provisions of Section 2(2) of the Act).

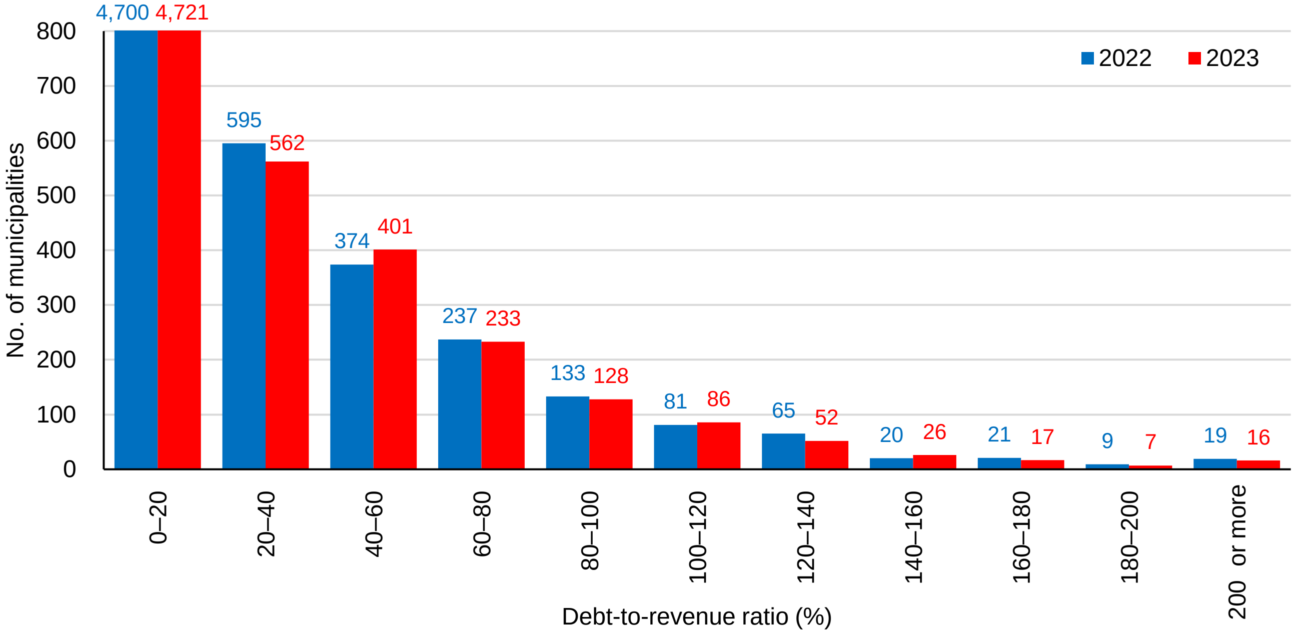
The CFC points out that although the above procedure is logical and understandable, it is not entirely clear from the wording of Act No. 23/2017 Coll., on the Rules of Budgetary Responsibility, as amended, and Act No. 243/2000 Coll., on the Budgetary Determination of Taxes, as amended, whether it can be consistently applied in this way. In this case, the CFC lacks clear criteria for the decision-making of the MF CR in the above-mentioned situations where there is a conflict between the implementation of the rule of budgetary responsibility and the principle of economy. Given the need to create a clear and predictable environment for the local and regional authorities, 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, so as not to come into conflict with the debt reduction rule.

Indebtedness in relation to debt ratio

The budgetary responsibility rule indicator (i.e. the percentage ratio of debt to average revenue over the last four years) was above 60% as of 31 December 2023 for 565 municipalities out of 6,249 municipalities (i.e. 9% of all municipalities). This is a decrease of 20 municipalities compared to the previous year. These municipalities have 528,752 inhabitants, i.e. approximately 4.9% of the Czech population (in 2022, approximately 4.1% of the Czech population lived in municipalities exceeding the indicator).[41] The figures are also available in Chart 5.

[37] For the purposes of the Act, the debt of a local or regional authority means the value of outstanding liabilities arising from bonds issued, credit, loans and returnable financial assistance received, guarantees honoured and bills of exchange issued, and, from 2023, public and private legal relationships with a maturity of more than one year, except for liabilities arising from transfers and liabilities not intended to defer debt repayment (synthetic account 459). Thus, due to the change in the Act, the year-on-year comparison may be misleading.
[38] 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.
[39] The towns of Vejprty, Výsluní, Trmice and the municipalities of Bohuslavice and Hnačov are not included in the monitoring due to the failure to submit financial statements to the Central State Accounting Information System.
[40] Four of these eight municipalities have loans for the construction of sewerage and wastewater treatment plants, which involve subsidies from the State Environmental Fund of the Czech Republic in the total amount of CZK 138.7 million in 2023. The municipalities concerned are Svojetín, Hnojník, Cheznovice and Mutějovice.
[41] The total of 123,909 people live in municipalities where the budgetary responsibility rule indicator exceeds 100% (204 municipalities, i.e. 3.3% of the total). This represents approximately 1.14% of the Czech population (in 2022 the figure was 129,488 people, i.e. 1.23% of the Czech population).

Chart 5 Number of municipalities in ranges according to the percentage level of the budgetary responsibility rule indicator, 2022 versus 2023



Source: MF CR (2023): Information on the Monitoring of Local and Regional Authorities' Finances for 2022, MF CR (2024): Information on the Monitoring of Local and Regional Authorities' Finances for 2023; CFC calculations.

The total debt of municipalities in 2023 was CZK 62.8 billion, i.e. CZK 3 billion less than in 2022. The average debt of municipalities was 16.5% (16.7% in 2022). A total of 3,168 municipalities, i.e. 50.7% of all municipalities, were entirely free of debt, 521 fewer than in 2022. The number of municipalities whose fiscal budgetary responsibility rule indicator exceeded 200% decreased from 19 to 16.[42]

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

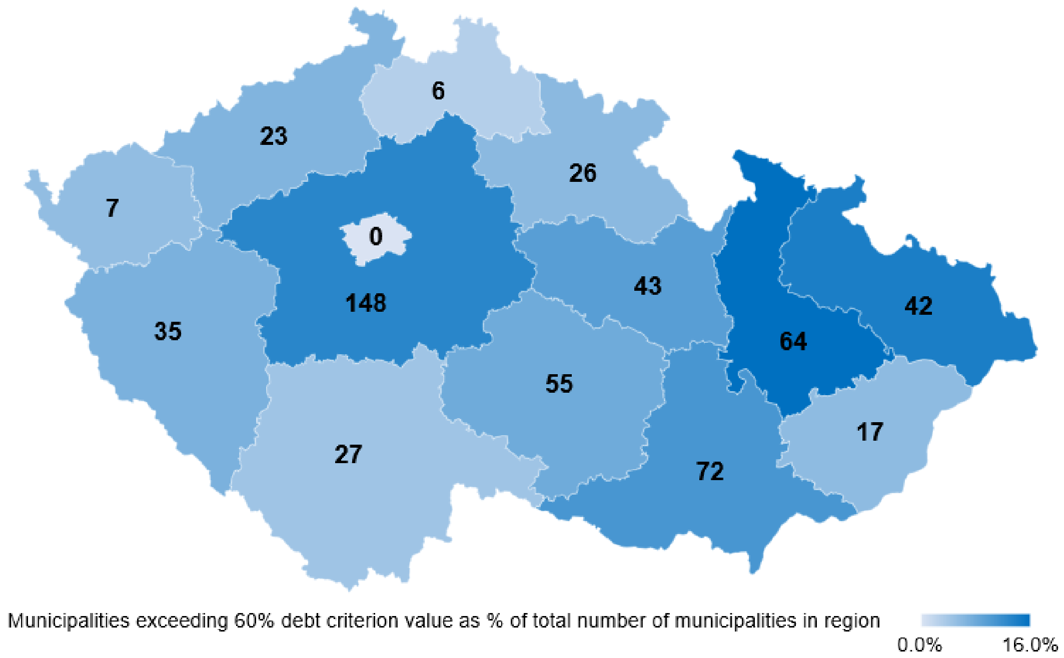
No. of inhabitants of municipality	No. of municipalities		No. of municipalities exceeding 60% debt criterion value		% of municipalities exceeding 60% debt criterion value (%)	
	2022	2023	2022	2023	2022	2023
1 – 100	414	397	9	11	2.2	2.8
101 – 200	985	969	65	65	6.6	6.7
201 – 500	1,998	1,988	232	203	11.6	10.2
501 – 1,000	1,370	1,380	173	166	12.6	12.0
1,001 – 2,000	776	793	73	84	9.4	10.5
2,001 or more	711	727	33	37	4.6	5.1
Total	6,254	6,254	585	565	9.4	9.0

Source: MF CR (2023): Information on the Monitoring of Local and Regional Authorities' Finances for 2022, MF CR (2024): Information on the Monitoring of Local and Regional Authorities' Finances for 2023; CFC calculations.

Table 4 shows that municipalities with 501 – 1,000 inhabitants were most likely to exceed the debt criterion of the budgetary responsibility rule in 2023. Compared to 2022, the share of municipalities with 201–500 inhabitants exceeding the debt criterion decreased. The largest municipality exceeding the debt criterion in 2022 was the statutory city of Kladno with 68,436 inhabitants. Its debt-to-revenue ratio increased year-on-year from 53.2% in 2022 to 63% in 2023. Among regional cities, Olomouc had the highest debt-to-revenue ratio in 2023 (51.1%). The best-performing regional capital in this regard is Jihlava, whose ratio of debt to average revenues was just 3.5% in 2023.

[42] MF CR (2024): Information on the Monitoring of Local and Regional Authorities' Finances for 2023.

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



Source: MF CR (2024): Information on the Monitoring of Local and Regional Authorities' Finances for 2023; CFC calculations.

Chart 6 shows that the largest number of municipalities in absolute terms exceeding the debt criterion of the budgetary responsibility rule lie in the Central Bohemian Region, which, however, also has the largest number of municipalities of all the regions. The largest percentage of municipalities exceeding the debt criterion of the budgetary responsibility rule is in the Olomouc Region (16% of municipalities). Furthermore, the Moravian-Silesian Region (14%), the Central Bohemian Region (12.9%) and the South Moravian Region (10.7%) recorded more than 10% of municipalities exceeding the debt criterion of the budgetary responsibility rule. The best performing municipalities in this respect are those in the Liberec Region (2.8%) and the South Bohemian Region (4.3%).

In addition to the rule of budgetary responsibility set out in the Act, the MF CR monitors two other indicators for municipalities, for which the MF CR sets its 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 budget responsibility rule, they contain information on the assets and total liabilities of municipalities and regions. Despite the fact that these indicators are not directly related to the Act, the CFC has decided to take them into account as they provide the context of the finances of municipalities and regions.

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% in the case of municipalities and regions. In 2023, a total of 263 local and regional authorities exceeded this threshold, including 262 municipalities (4.2% of all municipalities) and one region (Olomouc Region). This is a decrease of 22 local and regional authorities compared with the previous year. In all, 163 municipalities, i.e. 28.8% of the municipalities exceeding the debt criterion of the budgetary responsibility, or 2.6% of all municipalities, are not compliant with the requirement of the ratio of loans and advances to total assets. Municipalities exceeding both criteria have 104,796 inhabitants (i.e. 1% of the total population of the Czech Republic). The highest values of the ratio of loans and advances to total assets are reported by the municipalities of Turovice (601.5%) and Prameny (266.9%). No other municipality exceeded the threshold of 100% of the ratio.[43]

The total liquidity indicator, which expresses the ratio of current assets to short-term liabilities, shows to what extent a municipality is able to meet its short-term obligations. The MF CR recommends that this ratio should be between 0 and 1. A total of 65 (i.e. 1%) municipalities do not comply with this recommendation, a decrease of 5 municipalities compared to the previous year.

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

In 2023, 10 municipalities (the same number as in 2022) were included in the category of local and regional authorities that exceeded the limits of all three monitored indicators simultaneously and were therefore assessed 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 3,964, which is less than 0.04% of the total population of the Czech Republic (4,939 inhabitants in 2022). The reason for exceeding the monitored indicators was mainly the deferral of loan repayment in accordance with the repayment schedules. The municipalities concerned often have only low immediately available financial reserves and their finances may be exposed to following risks:

a) Liquidity risk – the municipality cannot meet its debts as they fall due or cannot finance its assets,

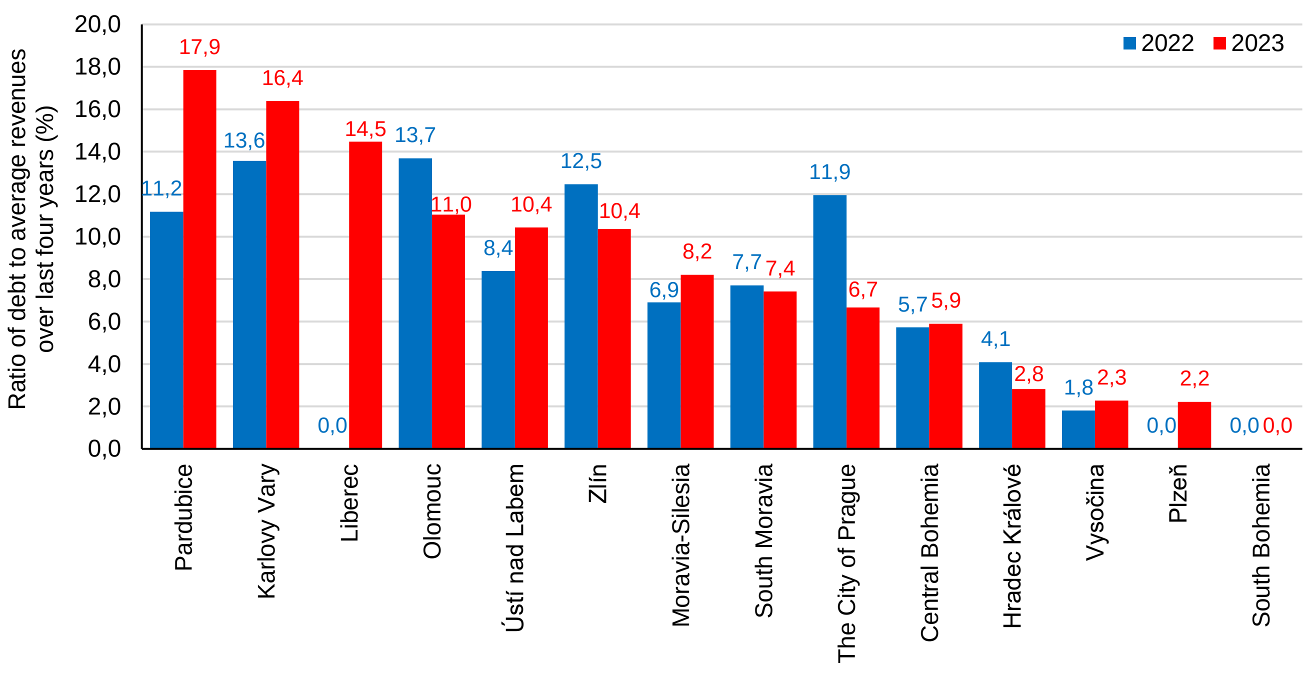
b) Legislative risk – failure to comply with the requirements under the specific conditions of the subsidy received, EU regulations, laws, regulations and standards of general validity, the fulfilment of which is required for the payment of the relevant subsidy amount by the municipality in accordance with the provisions of the legal act,

c) Credit risk – the risk of default or non-repayment of the loan taken by the municipality.

In addition to the municipalities exceeding the limits of all three indicators mentioned above, the municipalities of Prameny and Turovice, which do not exceed the threshold values of all three monitored indicators at the same time but they do report the highest ratios of loans and advances to total assets of all municipalities, are also facing serious economic problems. The main reason for their problematic financing is failed investment projects.

At the level of regions, the debt criterion of the budgetary responsibility rule is met with a margin. The Karlovy Vary Region (16.4%) has the highest ratio of debt to average revenue over the last four years, followed by the Liberec Region (14.5%), the Olomouc Region (11%), the Ústí nad Labem Region (10.4%) and the Zlín Region (10.4%). By contrast, the South Bohemian Region was free of debt in 2023.[44] Compared with 2022, five regions have seen their debt to average revenue ratios over the last four years fall. However, the largest increase, due to a change in the method of calculating debt, was recorded by the Liberec Region, which had a debt to revenue ratio of 14.5% in 2023. The total amount of regional debt in 2023 was CZK 21.9 billion, an increase of CZK 4.2 billion compared to the previous year. The figures are shown in Chart 7.[45]

Chart 7 Regions by debt-to-average revenues ratio over the last four years, 2022 versus 2023



Source: MF CR (2023): Information on the Monitoring of the Local and Regional Authorities' Finances for 2022, MF CR (2024) Information on the Monitoring of the Local and Regional Authorities' Finances for 2023; CFC calculations.
Note: The calculations in the chart may be subject to inaccuracies due to rounding.

[44] See MF CR (2024): Information on the Monitoring of the Local and Regional Authorities' Finances for 2023.
[45] The calculations in the chart may be subject to inaccuracies due to rounding.

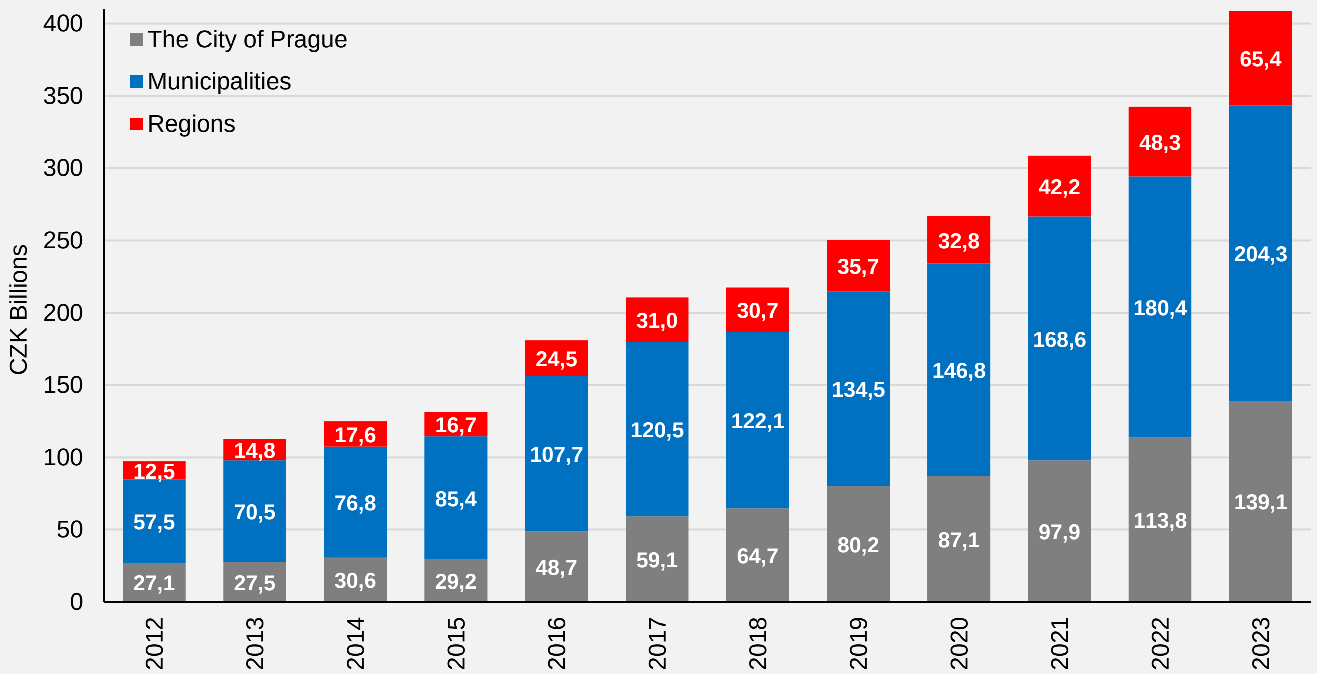
Conclusion: As of 31 December 2023, a total of 565 municipalities and no regions exceeded the debt criterion defined in Section 17(1) of the Act. In 2023, a total of eight municipalities were not compliant with their obligation to reduce their debt by the minimum level defined in the Act. The MF CR did not suspend the transfer of the share of tax revenues for any local or regional authority.

Box 4 Accumulation of financial funds of local and regional authorities and their low interest rate

In this box, we discuss the accumulation of financial funds of local and regional authorities and their interest. As of 31 December 2023, municipalities and regions had CZK 408.8 billion deposited in their bank accounts[46] (municipalities CZK 343.4 billion – of which CZK 139.1 billion the City of Prague and regions CZK 65.4 billion). This figure has almost quadrupled over the last 10 years, as significant surpluses have been achieved over the long term. Over the same period, the Harmonised Index of Consumer Prices has only increased by around 51%. This is taxpayers' money, which is thus “lie” in bank accounts unused and its purchasing power is threatened by inflation.

A common argument used by councillors to defend the accumulation of savings is that they need these funds to finance investment projects. If this claim were true, years of accumulating savings would be interspersed with years in which they are used to finance investment. However, the data in Chart B4.2 show that since 2013, municipal and regional savings increments have been regularly positive and roughly match their overall balance of the year, so that only the bare minimum of surpluses are used by local and regional authorities for investments in local infrastructure. Specifically, in the period under review between 2013 and 2023, municipalities and regions achieved a cumulative surplus of CZK 333 billion. Of this amount, CZK 311.5 billion were deposited into bank accounts. This means that only CZK 21.5 billion (approximately 6.5% of the total surplus) was used in other ways than to increase the bank account balance, and in particular to repay loans. As a result, the vast majority of municipal and regional surpluses accumulate in bank accounts where they lose their value, as we show below.

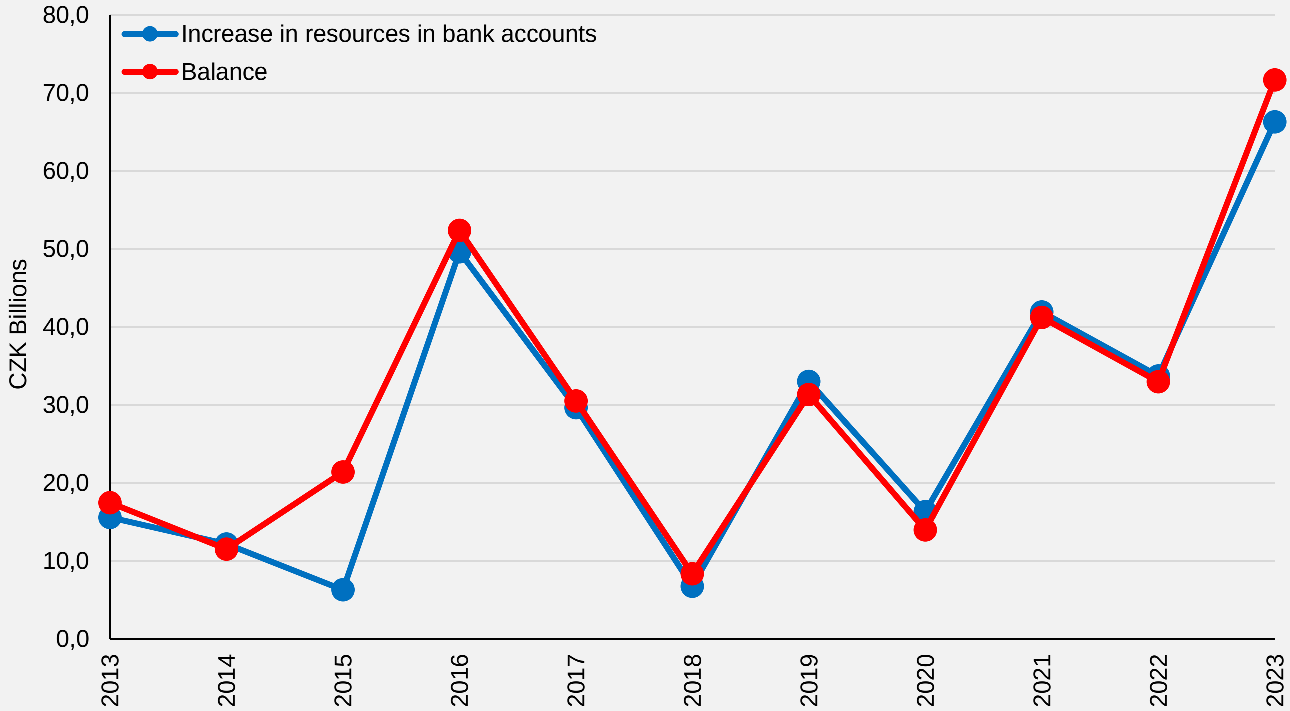
Chart B4.1 Savings of local and regional authorities in 2012–2023



Source: MF CR State Treasury (2024); CFC calculations.

[46] This is a cash implementation of the budget.

Chart B4.2 Comparison of the balance and year-on-year change in savings of local and regional authorities in 2013–2023

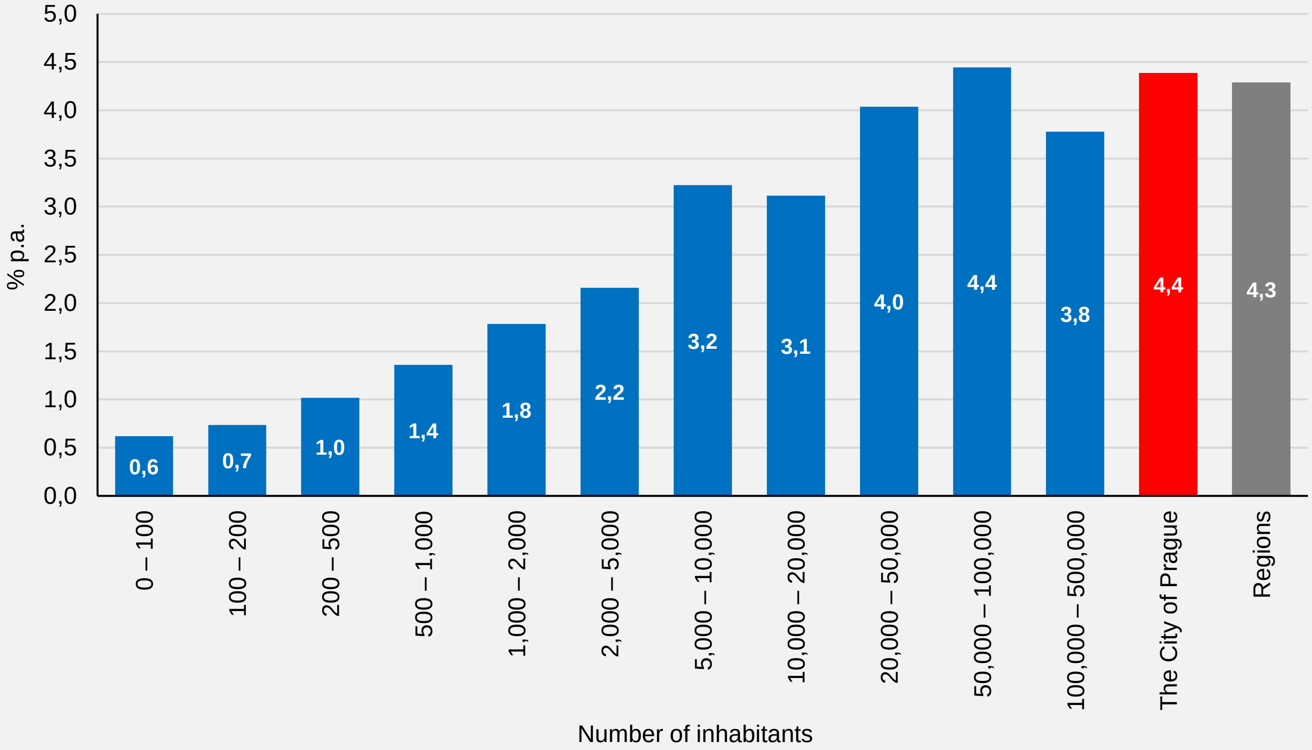


Source: MF CR State Treasury (2024); CFC calculations.

Even more striking than the total amount of savings made by local and regional authorities is the way in which this money is being managed. Of the 462 municipalities and 13 regions that completed a Supporting Analytical Report as of December 31, 2023, a total of 453 municipalities and 12 regions held some portion of their available funds in a Czech National Bank's current account (total of CZK 128.6 billion) and only 6 municipalities held some portion in a Czech National Bank's term account (total of CZK 0.2 billion). These 475 local and regional authorities together had CZK 306.6 billion at their disposal, which is about three quarters of the total bank deposits of all local and regional authorities. However, no interest is paid on current account balances, while the shortest (3-month) term deposit of the Czech National Bank was valued at 5% p.a. during 2023. This rate is determined by the MF CR through so-called cash payment replacing the interest. In the same year, only 175 of local and regional authorities, i.e. 2.8% of 6,267 all local and regional authorities, managed to surpass this threshold, see Chart B4.3. In the hypothetical case that all remaining local and regional authorities would transfer their available resources to the Czech National Bank's term accounts, thereby reaching an effective interest rate[47] of 5% p.a. for the entire calendar year 2023, the total interest revenues of all local and regional authorities for 2023 would increase from CZK 14 billion to CZK 20.3 billion. This corresponds to potential additional revenue of CZK 6.3 billion, of which CZK 0.5 billion for the regions, CZK 0.9 billion for Prague and CZK 4.9 billion for other municipalities. Taking into account average inflation of 10.7% in 2023, the average effective interest rate for municipalities and regions of 3.4% p.a. means a 6.6% annual reduction in their purchasing power, and therefore a decrease of value of their savings.

[47] The effective interest rate is calculated as a ratio of interest revenues (item 2414) to bank account balances (synthetic accounts 068, 231, 236, 241, 244, 245).

Chart B4.3 Effective interest rate of regions and municipalities by number of inhabitants in 2023



Source: MF CR State Treasury (2024); CFC calculations.

The local and regional authorities are still tending to accumulate savings in bank accounts, which are losing their value due to high inflation and low interest rates. This is partly a result of inefficient financial management, especially in the case of smaller municipalities. Such a high accumulation of funds cannot be considered macroeconomically optimal because it is not used for investment activity.

Summary

The Czech Fiscal Council states that in 2023:

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

b) The *technical procedure* for determining total general government expenditure and deriving the expenditure framework of the State budget and State funds for 2023 was followed when deriving the level of expenditure of the State budget and State funds for 2023.

c) A stricter value of the maximum structural deficit (i.e. 1% of GDP instead of 5.1% of GDP, or 4.7% of GDP according to the interpretation of the MF CR) should have been applied when establishing the expenditure framework of the State budget and State funds for 2023 according to the then valid wording of the provisions of Section 10 of the Act.

d) A total of 565 municipalities and no regions exceeded the 60% debt limit of the local or regional debt (provision of Section 17(a) of the Act).

e) In 2023, a total of eight municipalities were non-compliant with the obligation to reduce their debt by the minimum level defined by the Act. The reason for non-compliance was mostly the deferral of loan repayments, as required by the repayment schedule.

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

In 2023, two of the three rules were complied with (in the case of the debt rule for local and regional authorities, with the exception of eight municipalities). In the case of the structural deficit rule, there was non-compliance according to the CFC and its interpretation of the then current version of the Act. However, the amendment of the Act made as a part of the approval of the so-called consolidation package made the maximum limits of structural deficits clear by explicitly stating their values.