The Czech Fiscal Council

# Office of the Czech Fiscal Council

# CZECH FISCAL COUNCIL

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**OPINION**

**of the Czech Fiscal Council**

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**on general government finances and fiscal and budgetary policy**

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

**Initial economic situation**

In the second quarter gross domestic product (GDP) increased by 0.6% (y-o-y) and by 0.3% (q-o-q). The value of q-o-q GDP growth (+0.3%) was mainly given by government consumption (+0.3 pp), fixed investment (+0.5 pp) and lower inventory formation (–0.6 pp). All the main demand components of domestic product contributed to the 0.6% annual growth: household consumption (+1.2 pp), government consumption (+0.8 pp), gross fixed capital formation (+0.4 pp) and net exports of goods and services (+0.3 pp). Only the changes in inventories were negative (–2.1 pp). Gross value added (hereinafter "GVA") rose by 0.1% y-o-y and 0.5% q-o-q in the second quarter. GVA in the manufacturing sector fell for the second consecutive quarter (–1.7% q-o-q) and was mainly driven by the financial and insurance activities (+3.4% q-o-q) and trade, transportation, accommodation and food service activities (+2.3% q-o-q).

In Q2, average wage rose by 6.5% y-o-y (3.9% y-o-y in real terms). However, as in Q1, median wage grew more slowly, this time by 5.8% y-o-y. The highest nominal y-o-y growth in average wage occurred in the health and social care sector (+11.1%). The seasonally adjusted unemployment rate was 2.7% in July, 0.2 pp lower to previous July, with 2.3% for men and 3.2% for women. The unemployment rate has shown no trend since last July, with only small fluctuations. In terms of price level growth, the divergence between prices of goods and prices of services remains evident. The annual inflation rate in July was 2.2%, with prices of goods rising by 0.6% y-o-y and prices of services by 4.9%. In Q2, services sales increased by 2.5% y-o-y in real terms and by 0.4% q-o-q, with increases in all sub-sectors of the services activities.

The German economy experienced a very bad second quarter, being the only major world economy to contracted q-o-q (–0.1%). However, the structure of this contraction looks even more unfavourable, as investment activity (–2.2%) and household consumption (–0.2%) weakened sharply, and the decline was only tempered by growth in government consumption (+1.0%) and inventory formation (+0.4%). Developments in Germany probably influenced the August Business cycle surveys in the Czech Republic, which point to a further decline in consumer and business confidence in the economy. In industry, the assessment of current demand remained extremely pessimistic and in services there was a deterioration not only in the assessment of demand over the last quarter but also in the expected demand for the coming quarter.

**General government finances and fiscal policy settings for the coming years**

The situation of public finances in the Czech Republic has been characterised by a concentration of imbalances at the level of the State budget, which recorded a deficit of almost CZK 176 bn at the end of August; after adjusting for revenues and expenditures related to EU projects, the deficit was almost CZK 12 billion higher. State budget revenues grew by 2% y-o-y, dominated by tax revenues and social security contributions. Personal income tax showed high dynamics, with the annual growth[1] exceeding 13% (general government level). This is not only a consequence of the dynamics of nominal wage growth, but also the effect of the gradual reduction of the size of tax credits plays a role. A different situation can be observed for corporate income tax, where relatively large repayments of advance payments have been made, which is related to the decline in corporate profitability in 2023 compared to the record year of 2022[2]. Selective consumption tax revenues show high growth (almost 10% y-o-y), driven by the return of the tax rate on fuel to its previous level and the increase in the tax rate on tobacco products, in addition to the growth in household consumption. In the case of VAT, the y-o-y growth is 4.6% (general government level), driven by the growth in household consumption expenditure.

On the revenue side of the State budget, the budgeted revenues from the sale of EU ETS can be once again expected to be unfulfilled, as the assumed revenue calculated with a very high prices and did not calculate the levy to the market reserve, which is always decided in the middle of the year, and which was applied this year. The expected shortfall is expected to be around CZK 25 billion but should be compensated by higher than originally budgeted revenue from the windfall tax, hereinafter also "WFT", (current estimates of windfall tax revenues are around CZK 36 bn[3], while the approved budget assumed CZK 17 billion). No major risks are yet apparent on the expenditure side of the State budget. Total State budget expenditure stood at 65.7% of the full-year budget at the end of August, 1 percentage point below the aliquot. Thus, the current state of the State budget does not yet indicate a risk of a significant overshooting of the approved balance. However, the outcome may be affected, for example, by the extent to which claims from unspent expenditure are included.[4]

The other parts of the general government sector are evolving much differently than the State budget. Health insurers reported a deficit of slightly more than CZK 2.5 billion in cash terms at the end of July, thus heading towards a slightly deficit balance for the full year. In contrast, local government units continue to generate significant surpluses. At the end of June, the cash surplus reached CZK 82.7 billion, equivalent to more than 1% of expected GDP this year. The CFC does not consider such high surpluses to be macroeconomically rational. The funds are being accumulated in the bank accounts of local government units and there is no long-term indication they will be used to boost investment activity. The CFC also considers problematic that the local government units are not making sufficient use of the possibility of depositing surplus liquidity in Treasury account, even when they can obtain very favourable valuations for doing so[5]. This leads to a suboptimal situation where government bonds must be placed on the financial market to finance the State budget deficit, while another part of the public sector deposits macroeconomically significant funds in commercial banks. On the basis of the above, the CFC considers that such high surpluses are not macroeconomically appropriate and recommends that a discussion be considered on adjusting the budget determination in favour of the State budget.

The indicators characterising the state of public finances underwent some changes in June this year, in connection with the revision of the national accounts data. This led to an increase in the value of nominal GDP, which logically affected the ratio indicators in a positive direction. This concerns especially the

[1] The annual growth rates of individual taxes in the State budget may differ from the general government data due to changes in the coefficients used to determine taxes in the budget since 1 January.
[2] Such high reimbursements are likely to lead to a revision of the general government balance for 2023 from the current value of -3.5% of GDP to -3.8% of GDP in the autumn.
[3] See Opinion of the Ministry of Finance on the continuation of Windfall tax in 2025.
[4] Claims on unspent expenditure are funds that were allocated to individual chapters in previous budgets and which have not been spent. In simple terms, they can be used to indicate that the amount by which the State budget expenditure may exceed the amount of expenditure approved in the current year's budget.
[5] The current rate of interest-replacing transactions is set at 4,3 % p.a. for a three-month term deposit.

debt to GDP ratio, which has been reduced from 44.0% of GDP to 42.4% of GDP for 2023. However, these adjustments do not change the trends in the Czech public finances, which are characterised by a structural imbalance slightly above 2% of GDP and a steady, albeit decelerating, trend in the growth of the debt ratio.

At the end of August, the Ministry of Finance submitted to the Government the draft of the State budget for 2025. Since some adjustments can be expected during the September deliberations, we will comment here only on the basic parameters. The proposed deficit of CZK 230 billion corresponds to the adjusted expenditure framework, which was derived based on a maximum possible structural deficit of 2.25% of GDP. In terms of the fiscal policy settings, it can be stated that the proposed budget will have roughly neutral effects on economic growth dynamics, as the structural deficit will stagnate slightly above 2% of GDP. On the expenditure side, there are no major changes in the intensity of individual agendas and thus no reduction in the number of jobs financed by the State budget. The CFC points out that reducing the resources for the remuneration of government sector employees is not a sustainable solution in the long term without reducing the number of positions. The CFC also notes that the current version of the Budgetary Responsibility Rules Act foresees a maximum structural balance of –1.75% of GDP for 2026, which will require continued consolidation efforts. In terms of transparency of the budgetary process, the CFC welcomes the fact that the 2025 budget does not longer involve deficit of the State Transport Infrastructure Fund, which the CFC has criticised in the past. This will make public budgets clearer and more transparent again.

The question of the legitimacy and justification of the continuation of the windfall tax for the following year has been raised again in the context of the preparation of next year's State budget, even though under the current legal order this tax is a tax that the state is entitled to levy in 2025. The CFC has previously commented on the logic and design of this tax in its public communications, so the CFC position can only be reiterated. For the CFC, the main purpose of this specific and temporary type of taxation was to secure extra revenues from those who have received windfall profits from the energy and price crisis of 2022–2023 and to redistribute them to those who have received windfall costs and losses from the same crisis, i.e. primarily households and the non-financial sector. The idea was that the costs of the energy crisis should not be passed on to the public debt of the Czech Republic, which would have happened without this tax. In this logic, the CFC presented calculations comparing the key items (extraordinary revenues of the general government sector and the extraordinary costs of the same sector for energy interventions and market stabilisation) in the first half of 2024 and stated that most likely these items will be in balance during or at the end of 2024. One of the integral items of extraordinary revenues was the part of the CEZ dividend paid in 2023, namely the part paid to shareholders more than the normal so-called payout ratio.

The logic of the calculation of costs and revenues was also discussed with the Ministry of Finance in the spring. On behalf of the CFC, it is obvious that this calculation cannot strictly follow the methodology of the so-called one-off and transitional operations according to the established joint methodology of the Ministry of Finance and the CFC without further adherence, as this standard methodology is never able to cover and consider all aspects of extraordinary crises. The calculations will always be ad hoc in ad hoc cases. Therefore, in its calculations, the CFC has assumed from the outset that the part of the CEZ dividend paid in 2023 that is higher than the "normal" or "usual" dividend is clearly of an extraordinary, non-repeatable nature, which corresponds exactly to the nature of the 2022–2023 crisis and the nature of the market in which CEZ operates. This extraordinary nature has been perceived as such by the market, the public and the authorities.[6]

[6] Extraordinary expenditures related to the energy crisis were also incurred by the government in 2024 (additional payments for energy price caps) and in 2022 (e.g. the energy saving tariff), while the Czech Republic, unlike other EU countries, did not apply the WFT retroactively to 2022. As a result, some costs were incurred before the introduction of the WFT and some continued in 2024, when the energy crisis had already passed.