# Discussing the issue and impact of debt trapping

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Czech Fiscal Council

# Outline

1. „Good“ and „bad“ debt?
2. Debt as an opportunity
3. Debt as a threat
4. No debt without deficits
5. Economic theory and the level of debt
6. Public finances in Czechia
7. Public finances in the EU
8. Role of the Czech Fiscal Council





# 1. „GOOD” AND „BAD” DEBT?

# „Good" debt (government)



**Good debt:** increases future income and productivity

- **investment in infrastructure** (roads, railways, energy) ⇒ higher economic activity, GDP growth (government)
- **investment in education and human capital** ⇒ higher economic productivity
- **investment in civic infrastructure** (government, municipality)
- **digitalisation and greater efficiency of public administration** ⇒ lower future expenditure
- **countercyclical fiscal policy** ⇒ supports the economy when it is weak… and cools it when it overheats

The magic word:
**„MULTIPLIER"**
(What effect does 1 CZK of government spending have on GDP?)



**Good debt** is borrowed at a "reasonable interest rate" and is sustainable in the long run (its benefits exceed its costs).

**Buzzword „INVESTMENT":** What is and isn't an investment?

# „Bad" debt (government)



**Bad debt:** places a disproportionate future burden on the government or municipality

- **financing current consumption with no future benefit** (government, municipality) ⇒ blanket, untargeted payments
- **persistently high structural deficits** ⇒ systematic spending beyond revenues (government)
- **inefficient public investment** („overpriced projects")
- **politically motivated expenditure with no return**
- **increasing mandatory expenditure** (expenditure arising from legislation) **without funding** (government)




**Bad debt** does not raise the economy's potential or future tax revenues; it increases debt without a corresponding benefit and creates pressure for future tax increases or spending cuts.

# What should we do if we become overindebted?

**What TO DO if we become overindebted (generally)?**

- **(1) cut non-essential expenditure**
- **(2) increase income/revenues**

  Both can be difficult and painful, whether for an individual, household, company, municipality or government!



**What NOT TO DO, if we become overindebted?**

- **do not "play dead" or "bury your head in the sand":** procrastination does not help ⇒ it is better to face the truth immediately, reach an agreement with the bank/creditor and learn from mistakes
- talk to the bank and address the situation (reduce instalments by extending the debt maturity, request a temporary payment holiday, etc.)
- the financial institution (bank) also has an interest in your repaying the debt…
- Government: here it is more complicated…Let's take a closer look at this!





# 2. DEBT AS AN OPPORTUNITY

# Would we be better off without debt? Not always:

## Household:

- saving enough to buy a property would be much harder without a mortgage loan, if possible at all (house prices may rise faster than wages and salaries)



## Company:

- without credit (debt), economic development would be visibly slower, mainly because of lower investment



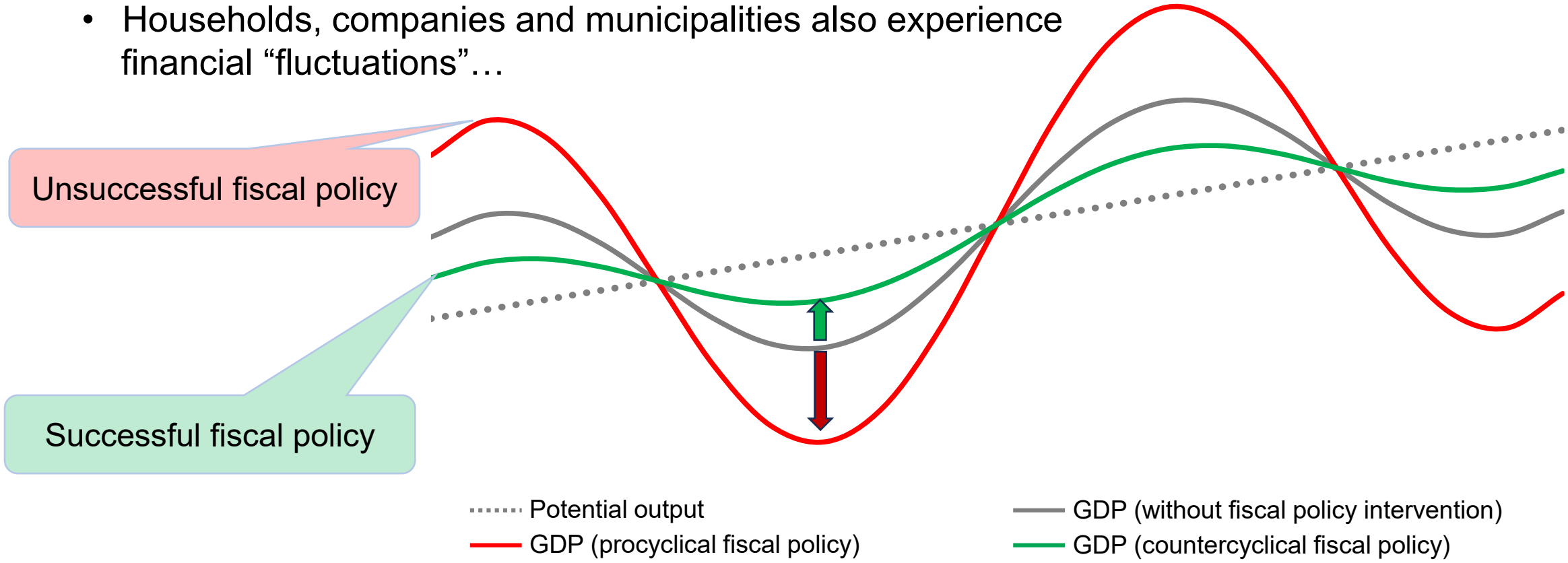
## Government:

- economic downturns and crises would be deeper (the government could not act countercyclically)
- capital markets (primary and secondary) would be missing
- public investment in education, research and infrastructure would be lower, reducing the country's growth potential



# Would we be better off without debt? Not always…

- Economic fluctuations are unavoidable in a market economy
- Expectations (positive and negative) are a major driver
- Households, companies and municipalities also experience financial “fluctuations”…





# 3. DEBT AS A THREAT

# Debt as a snowball…

**Household:**

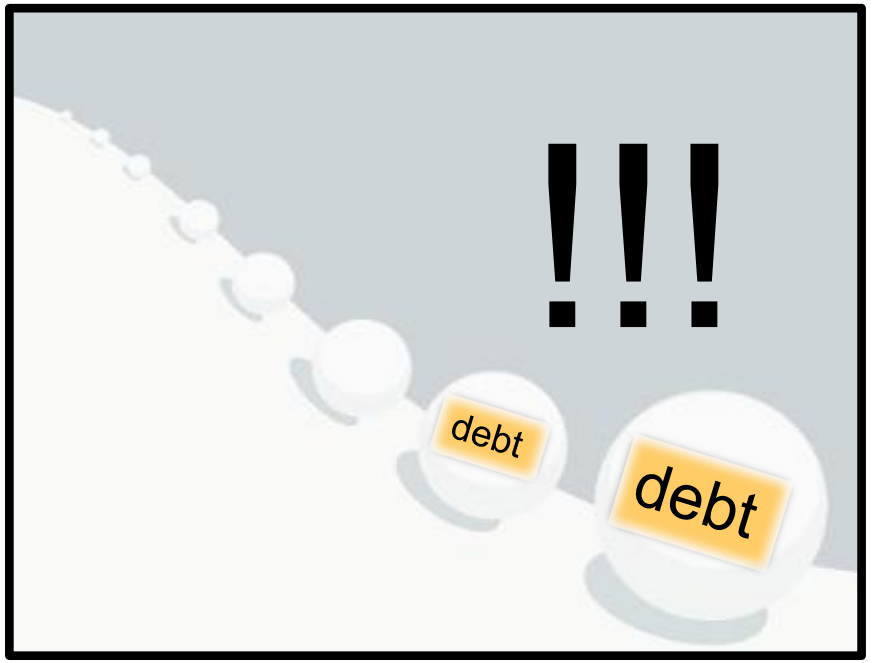
- **return < interest rate = a problem** (a rental property does not earn enough to cover repayments) ⇒ taking on more debt is not the solution

**Company:**

- **return < interest rate = a problem** (the company does not generate the expected profit) ⇒ taking on more debt is not the solution

**Government:**

- **interest rate (cost) > GDP growth = a problem** ⇒ debt snowballs




- **inflation** reduces the real value of debt
- a rise in **interest rates** increases debt
- not having cash on time (**low liquidity**) can increase debt
- **financial leverage** increases risk (debt default)

# Each country can „carry” a different level of debt… We do not know exactly how much



Debt of around 150% of GDP = loss of confidence, political instability

Debt of around 90% of GDP = signs of weaker economic growth

Debt of around 60% of GDP = breach of the Maastricht criterion

Debt brake (Czechia: 55% of GDP)

Debt of 40–50% of GDP (generally a relatively safe zone)

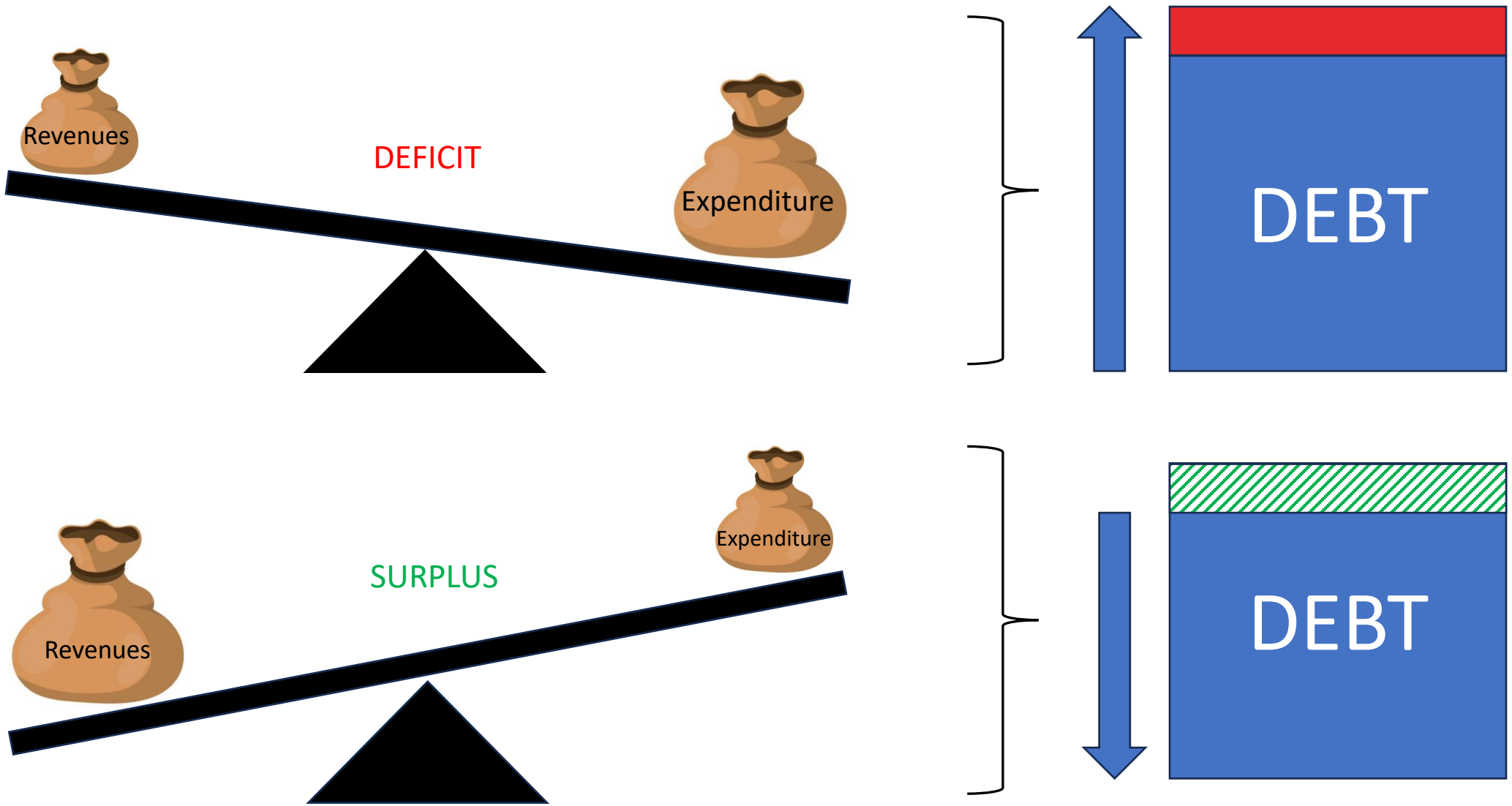
Debt below 40% of GDP (a safe debt level)

# 4. NO DEBT WITHOUT DEFICITS

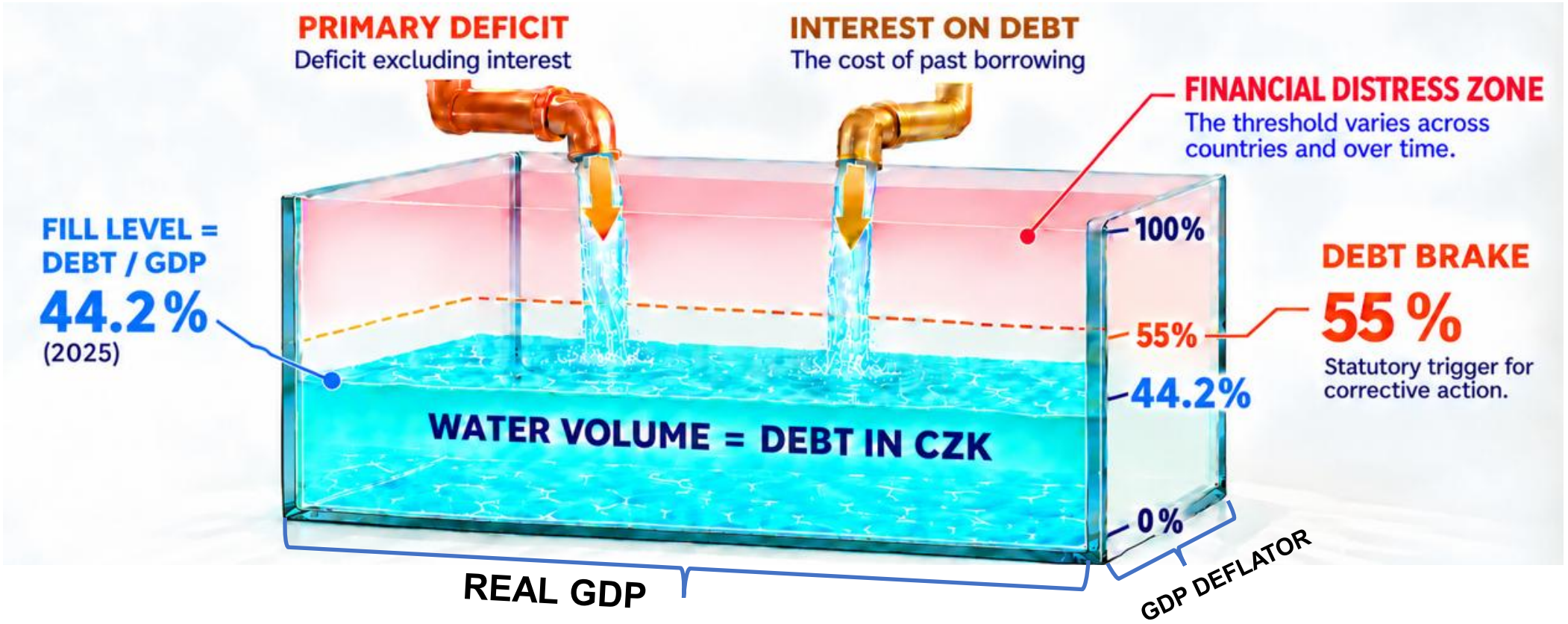
**Example 1:**
**Water tank**

**Example 2:**
**The Novák family**

# Relationship between the deficit and debt



# WATER TANK: Relationship between the deficit and debt

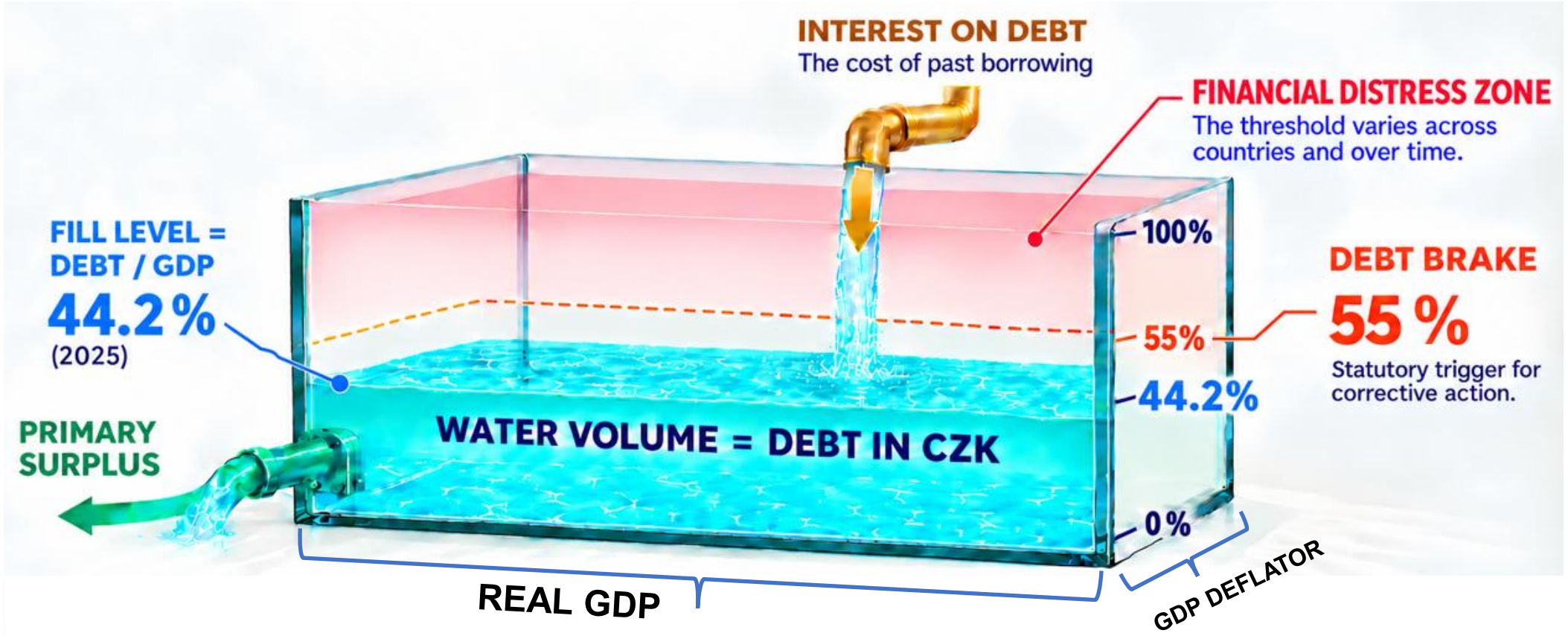



**The tank's volume represents the NOMINAL GDP (in CZK) as the product of the REAL GDP (the longer edge of the tank's base) and the GDP deflator (the shorter edge of the tank's base).**

Note: Let us consider the height of the tank to be unity. Changes in the real GDP or the GDP deflator then determine the total volume of the tank — that is, the volume of nominal GDP.

Is it better to reduce the debt by **increasing real GDP** or through **higher inflation**?

# WATER TANK: Relationship between the surplus and debt

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Is it better to reduce the debt by **increasing real GDP** or through **higher inflation**?

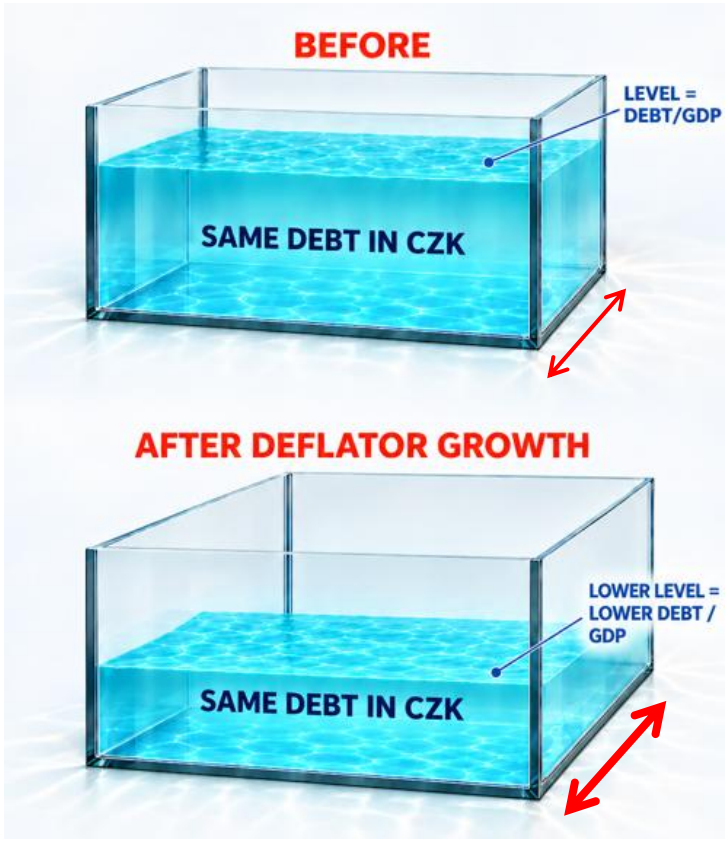
# WATER TANK: Debt reduction through nominal GDP growth

## (1) as a result of growth in real GDP




The real GDP grew (the longer edge of the base became even longer), whilst price trends remained unchanged.

## (2) as a result of rising prices




Prices level/GDP deflator increased (the shorter edge of the base became longer), whilst the real GDP remained unchanged.

# WATER TANK: The size of the debt matters!





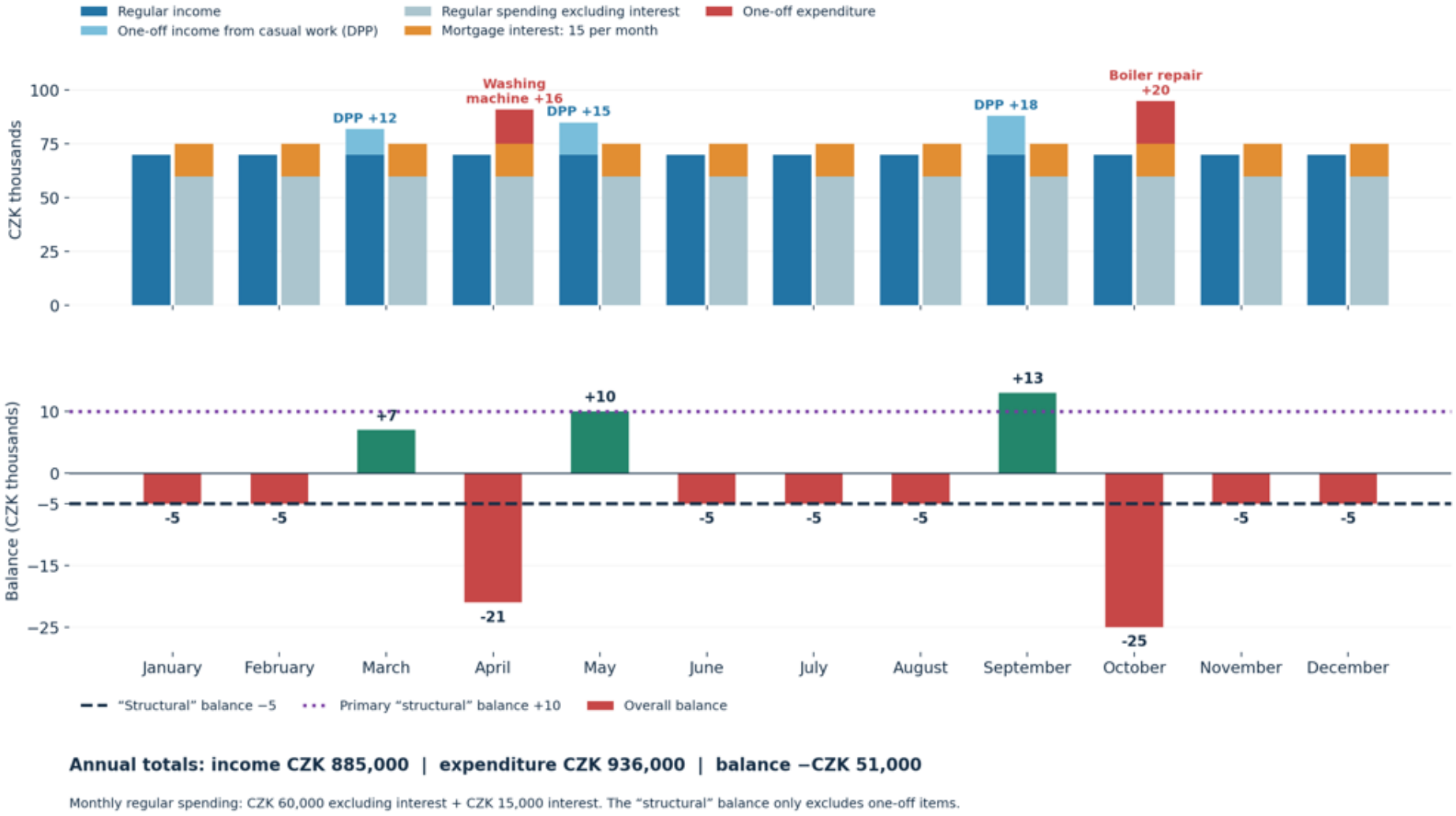


The economy is much better placed to fulfil the functions of public finance (allocation, stabilisation and redistribution) and has the fiscal scope to address unexpected fluctuations, crises or other challenges (defence, an ageing population, renewable energy sources).

The economy must be „running at full speed“ to ensure that economic growth can cover the current costs associated with high levels of debt. The economic cycle will eventually lead to a slowdown, and it is therefore essential to consolidate public finances in this situation.

# The NOVÁK family: a year of recurring deficits



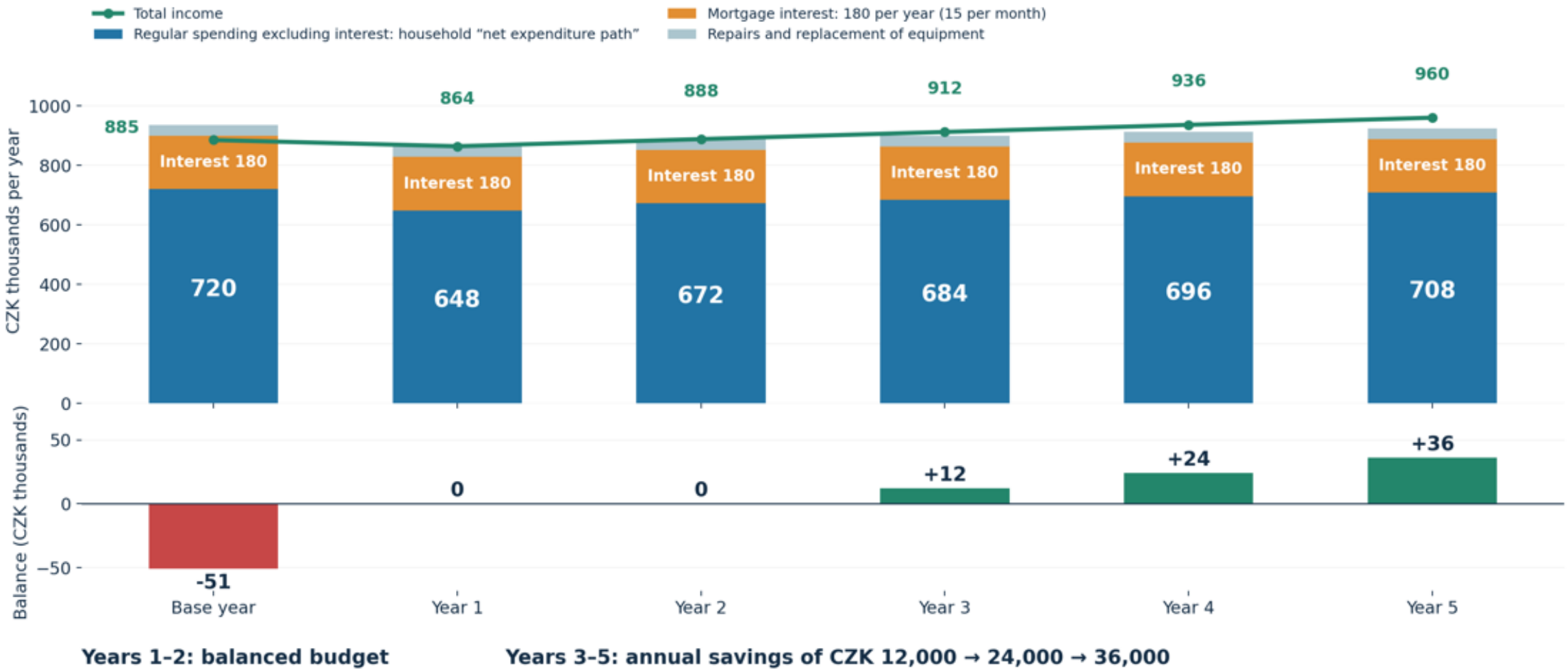



**Annual totals: income CZK 885,000 | expenditure CZK 936,000 | balance −CZK 51,000**

Monthly regular spending: CZK 60,000 excluding interest + CZK 15,000 interest. The "structural" balance only excludes one-off items.

Note: This illustration has been created solely for educational purposes, with the aim of explaining economic concepts relating to public finance to the wider economic public.

# The NOVÁK family: expenditure path from deficit to surplus

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# 5. ECONOMIC THEORY AND THE LEVEL OF DEBT

# More investment today, more consumption tomorrow?

## (1)

The government should always run a balanced budget or a surplus.



**Do not borrow!**

## (2)

The government may borrow in “bad” times if it repays debt in “good” times.



**Cycle stabilisation**

## (3)

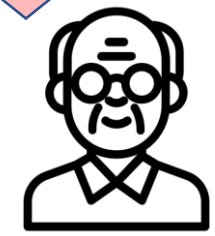
The government may borrow even in good times, but only to finance investment.



**Golden rule**

## (4)

The government may borrow even in good times because the future will be even better.



**Intergenerational fairness**

## (5)

The government cannot go bankrupt; it can always repay its debts with newly created money. It only needs to watch inflation.



**Manage the economy, not the budget**

Fiscally „conservative“

Fiscally „progressive“

# More investment today, more consumption tomorrow?

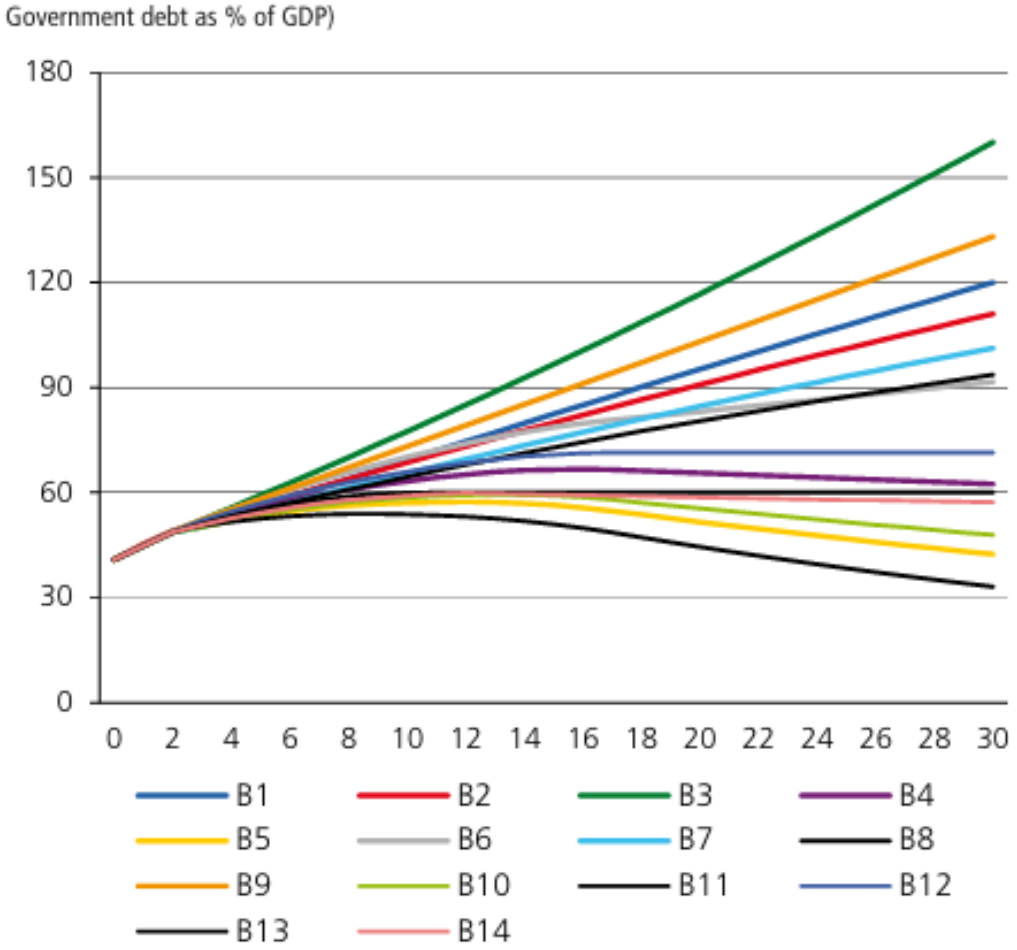
| Approach to debt | Debt rule | Deficit rule |
|---|---|---|
| **(1) Do not borrow!** | Debt reduction strategy | Budget balance > 0 |
| **(2) Cycle stabilisation** (e.g. Germany) | | Structural balance > 0 |
| **(3) Golden rule** (e.g. United Kingdom) | Debt/GDP < 40% | Capital expenditure > structural budget deficit |
| **(4) Debt for anything** (e.g. EU, to this day) | Debt/GDP < 60% | Deficit < 3% of GDP, with exceptions during crises (e.g. Covid) |
| **(5) Manage the economy, not the budget!** (hopefully nobody!) | Inflation < 2%, regardless of debt | No rule |

# A creeping imbalance can become a major problem!

$$B_t = (1 + r_t)B_{t-1} - (T_t - E_t)$$

$$\underbrace{\frac{B_t}{Y_t} - \frac{B_{t-1}}{Y_{t-1}}}_{\text{Change in debt}} = \underbrace{\underbrace{(r_t - g_t)}_{\text{r–g differential}} \frac{B_{t-1}}{Y_{t-1}}}_{\text{Interest-cost effect}} - \underbrace{\frac{T_t - E_t}{Y_t}}_{\text{Primary balance}}$$

# Nominal debt paths given different assumptions about economic growth, interest rates and primary balance

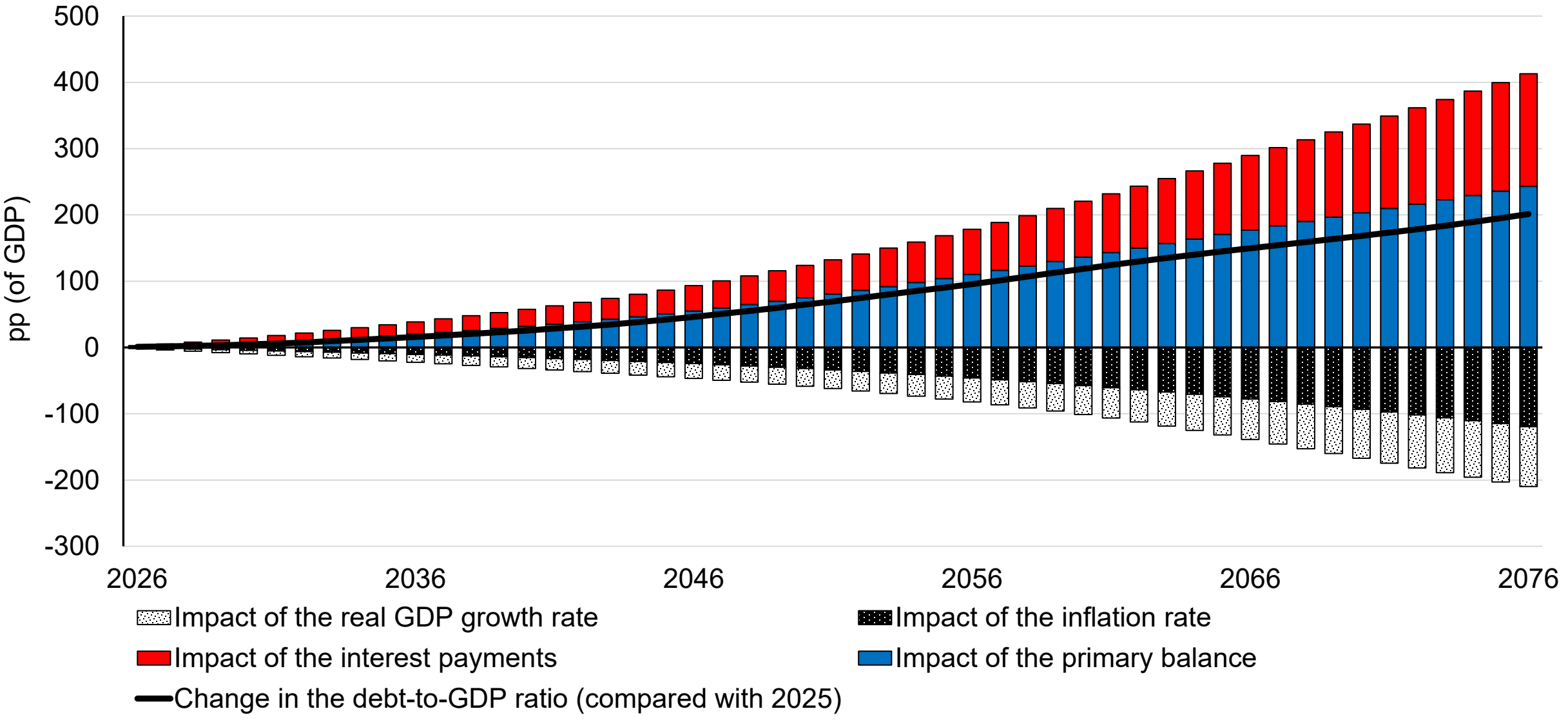



(%)

| Debt trajectory | GDP growth (g) | Real interest rate (r) | Primary balance (PB) |
|---|---|---|---|
| B1 | **2** | 1.5 | deficit 3 % GDP |
| B2 | **2** | 1 | deficit 3 % GDP |
| B3 | **2** | 3 | deficit 3 % GDP |
| B4 | **2** | 1.5 | consolidation (after 17 years PB=0) |
| B5 | **2** | 1 | consolidation (after 17 years PB=0) |
| B6 | **2** | 3 | consolidation (after 17 years PB=0) |
| B7 | **3** | 1.5 | deficit 3 % GDP |
| B8 | **3** | 1 | deficit 3 % GDP |
| B9 | **3** | 3 | deficit 3 % GDP |
| B10 | **3** | 1.5 | consolidation (after 17 years PB=0) |
| B11 | **3** | 1 | consolidation (after 17 years PB=0) |
| B12 | **3** | 3 | consolidation (after 17 years PB=0) |
| B13 | **2** | 2 | consolidation (after 17 years PB=0) |
| B14 | **2.5** | 0.5 | consolidation (after 11 years PB=-1%) |

Source: Komárková, Dingová and Komárek (2013).

# Debt dynamics (baseline scenario)



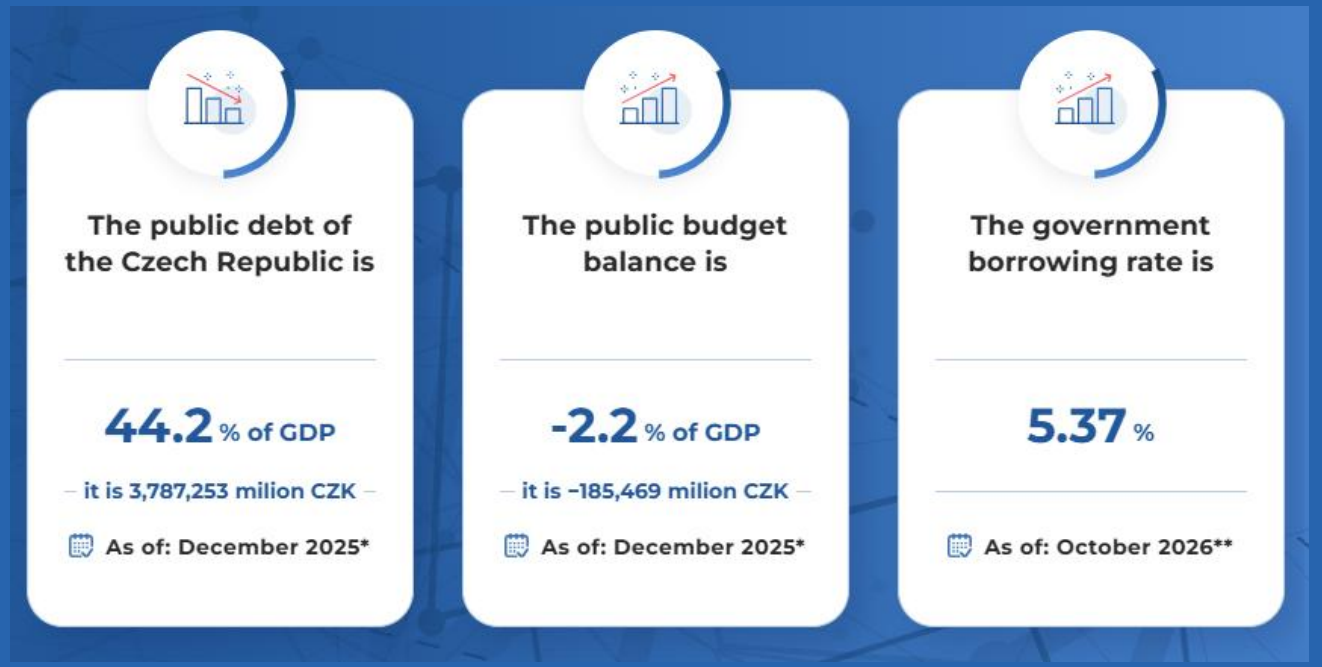

Source: CSO (2026); CFC chart.

# Relationship between the deficit and debt

- **Debt is a long-term burden on a country!**
- An excessive deficit can be corrected much faster than excessive debt
- There is no universal “red line” for debt, but several general patterns often apply:
  - the stronger and more developed the economy, the higher the level of “stable” debt it may sustain
  - countries issuing a reserve currency tend to enjoy greater confidence and higher debt capacity
  - be wary of foreign-currency debt (devaluation increases the value of the debt in the national currency):
  - a higher share of debt held by residents supports greater debt sustainability, as do an appropriate maturity structure and interest-rate structure
  - $r < g \Rightarrow$ condition for debt sustainability
  - Please note: even relatively fiscally responsible governments tend to run up deficits (a phenomenon known as „deficit bias“)



# 6. PUBLIC FINANCES IN CZECHIA



# What makes up PUBLIC FINANCES in Czechia?

**S.1311: Central government**

State budget, state funds (e.g. State Environmental Fund, State Fund for Transport Infrastructure), state-funded organisations (university hospitals, public universities, public research institutions, Czech Television, Railway Administration, National Development Bank, Czech Export Bank, EGAP, „PGRLF“, etc.)

**S.1313: Local government**

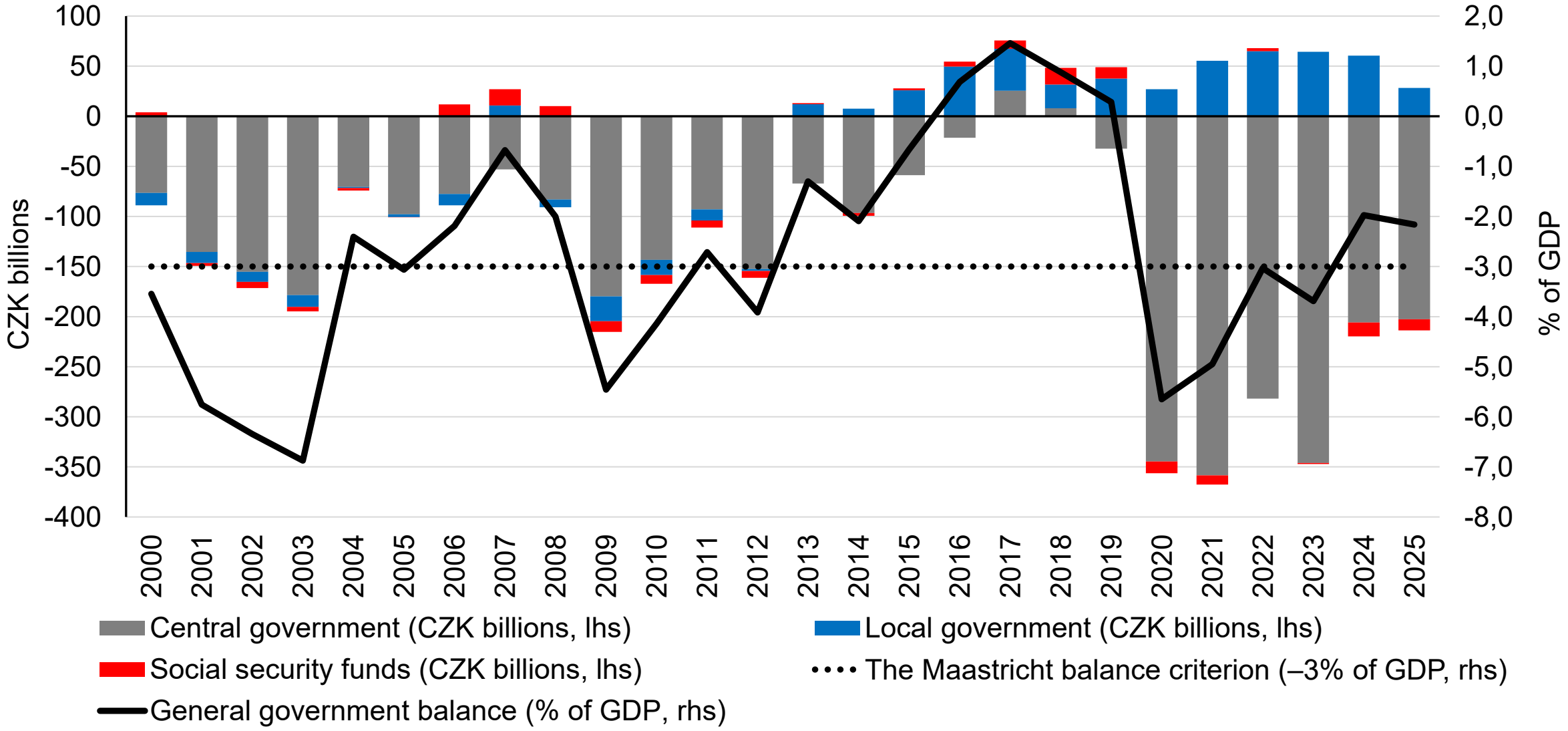
Municipal and regional budgets, contributory organisations of municipalities and regions (primary and secondary schools, hospitals, libraries)

**S.1314: Social security funds**

Health insurance funds' budgets

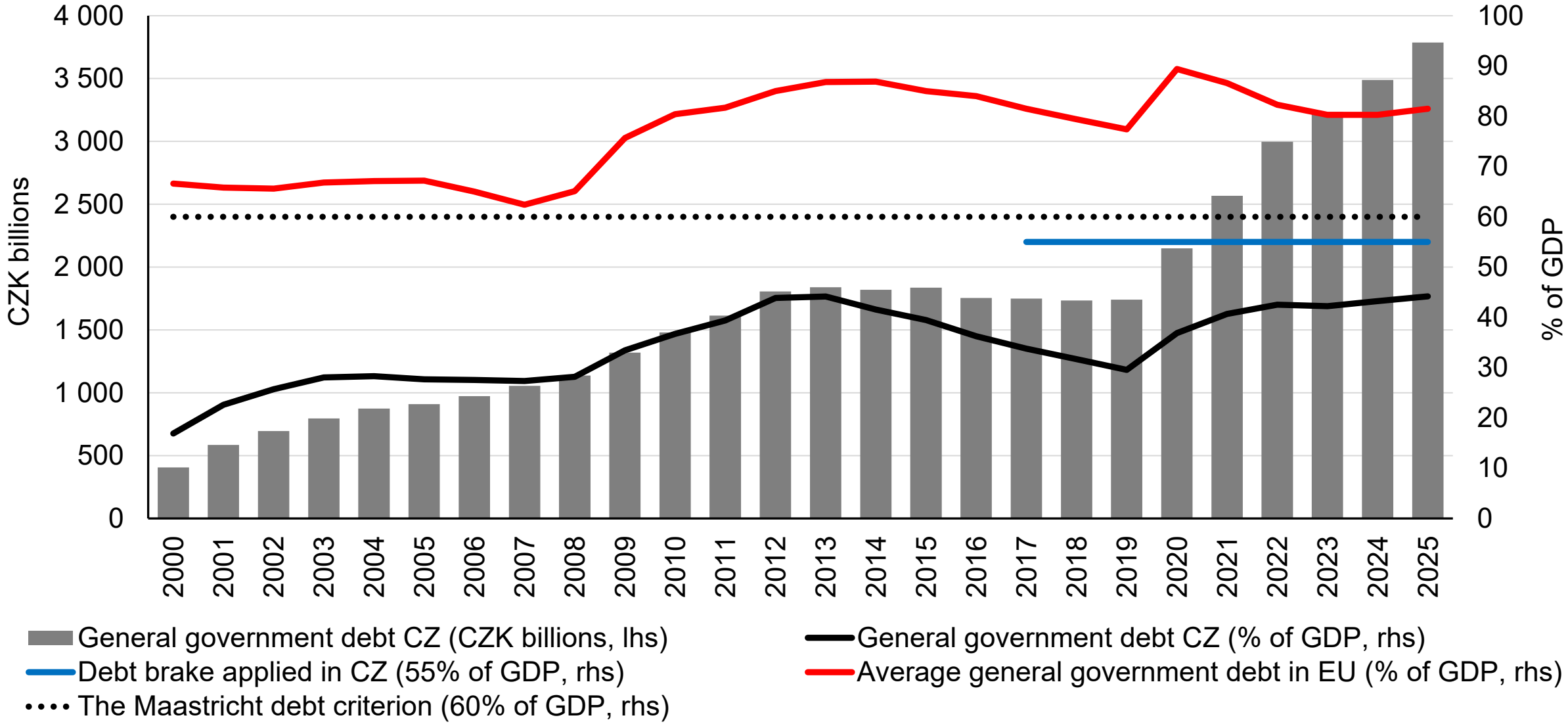
**S.13 GENERAL GOVERNMENT SECTOR**

# Breakdown of the general government balance (Czechia)




Source: CSO (2026); CFC chart.

# Trends in the debt-to-GDP ratio in Czechia and the EU




Source: CSO (2026); CFC chart.

# 7. PUBLIC FINANCES IN THE EU

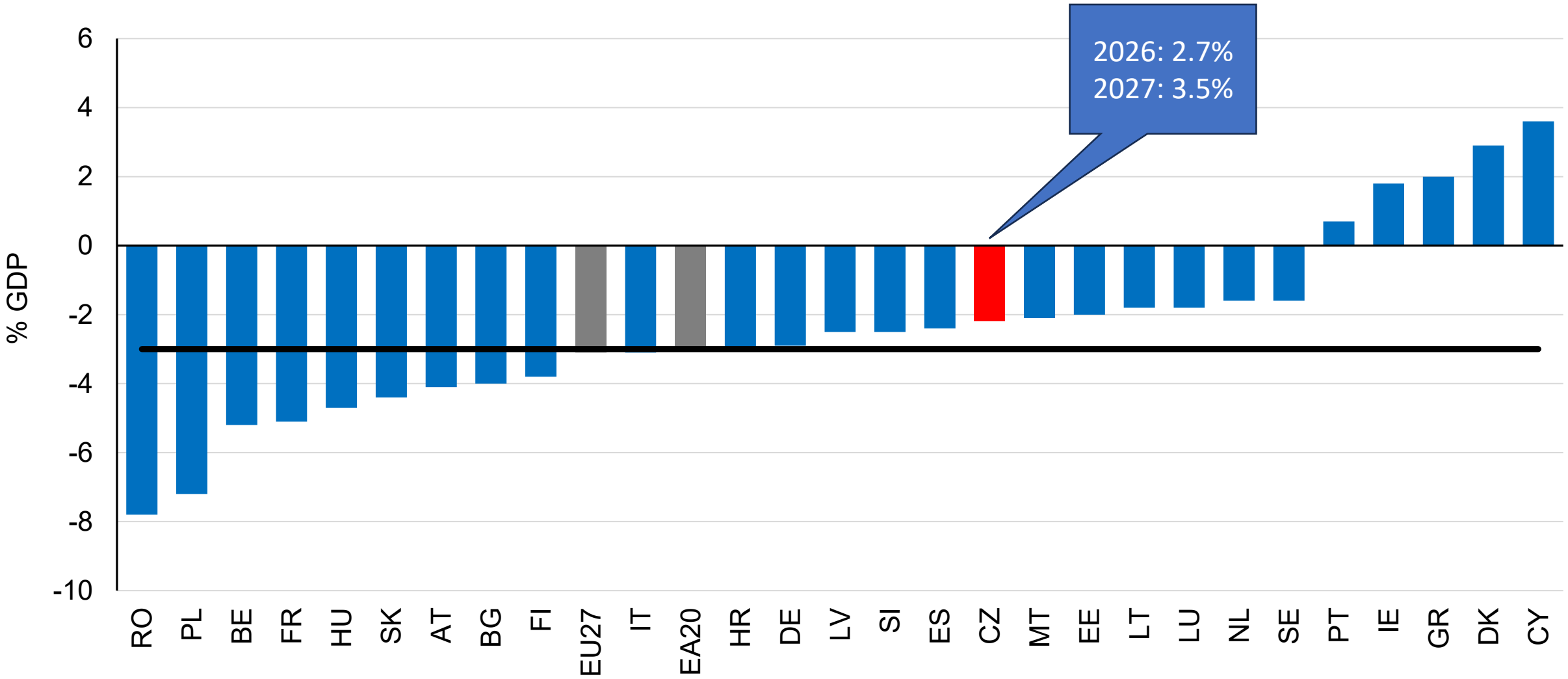
# Euro adoption: Maastricht criteria




**Deficit criterion:** the annual general government deficit must not exceed 3% of GDP (2025: 2.2%)

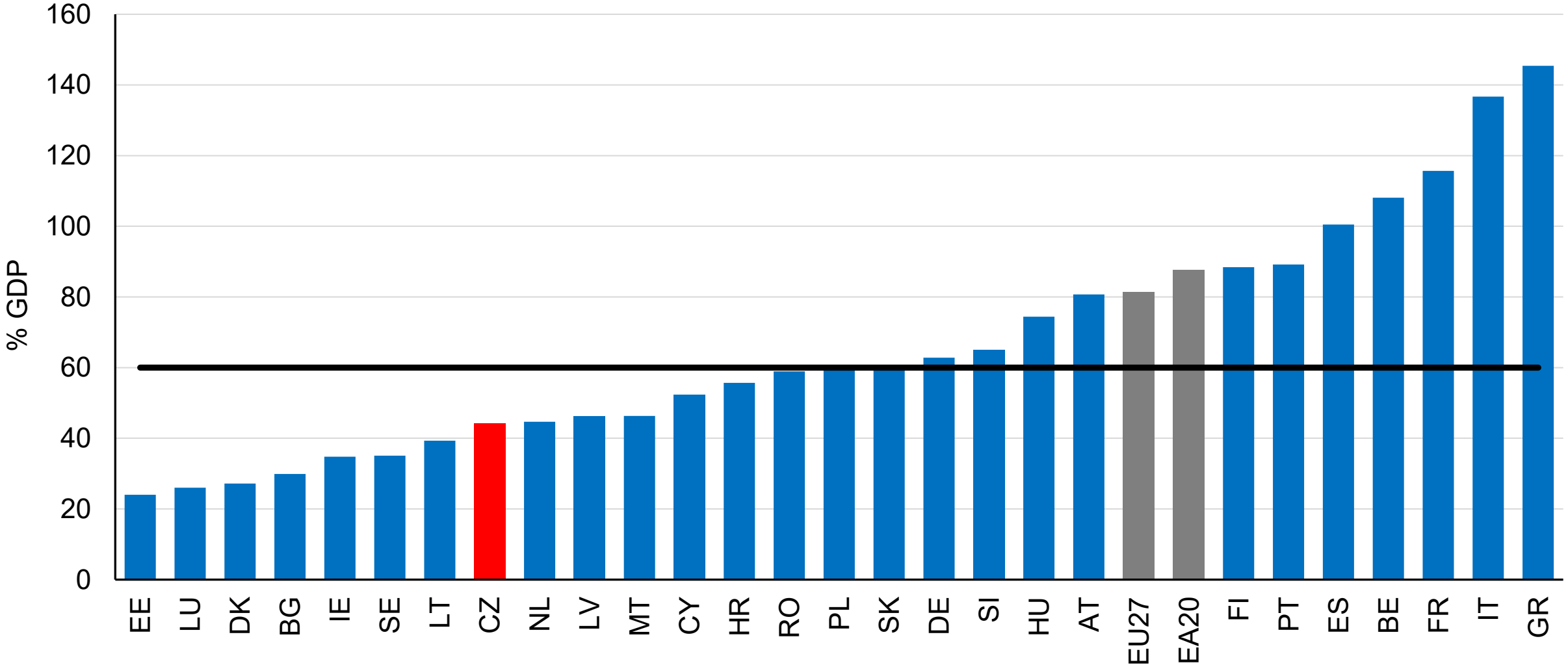
**Debt criterion:** general government debt must not exceed 60% of GDP, or it must be declining sufficiently towards that threshold (2025: 44.2%)

# Balance of the general government sector in EU countries (2025)




Source Eurostat (2026); chart CFC..
Note: EA20 = euro area countries without Bulgaria

# General government debt in EU countries (2025)

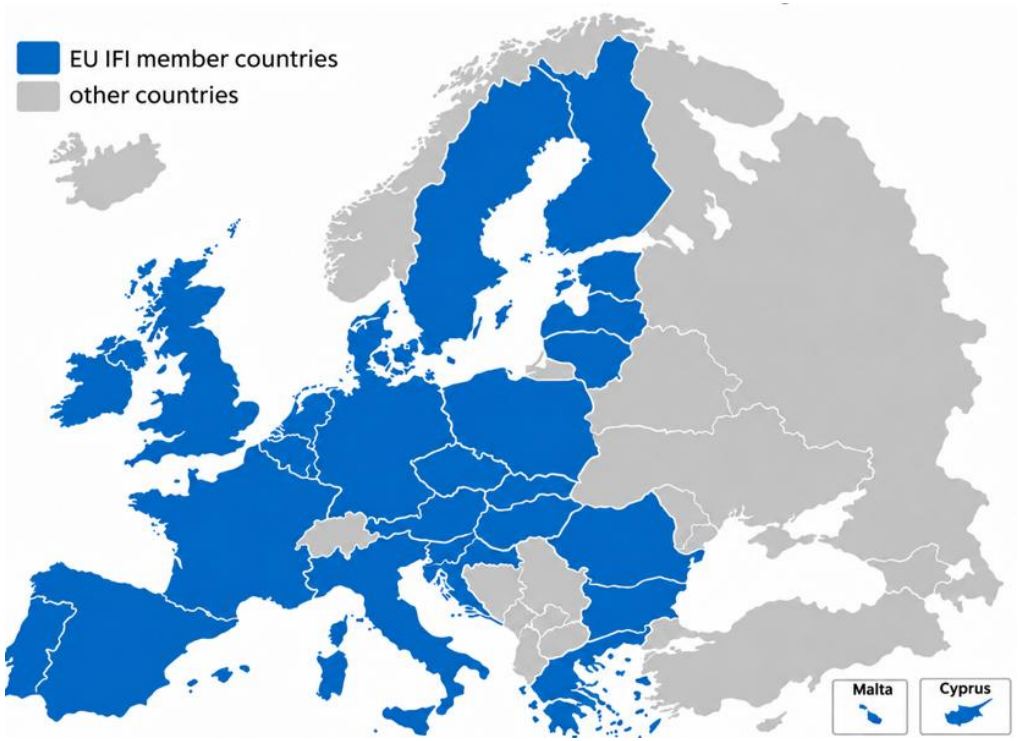



Source Eurostat (2026); chart CFC..
Note: EA20 = euro area countries without Bulgaria

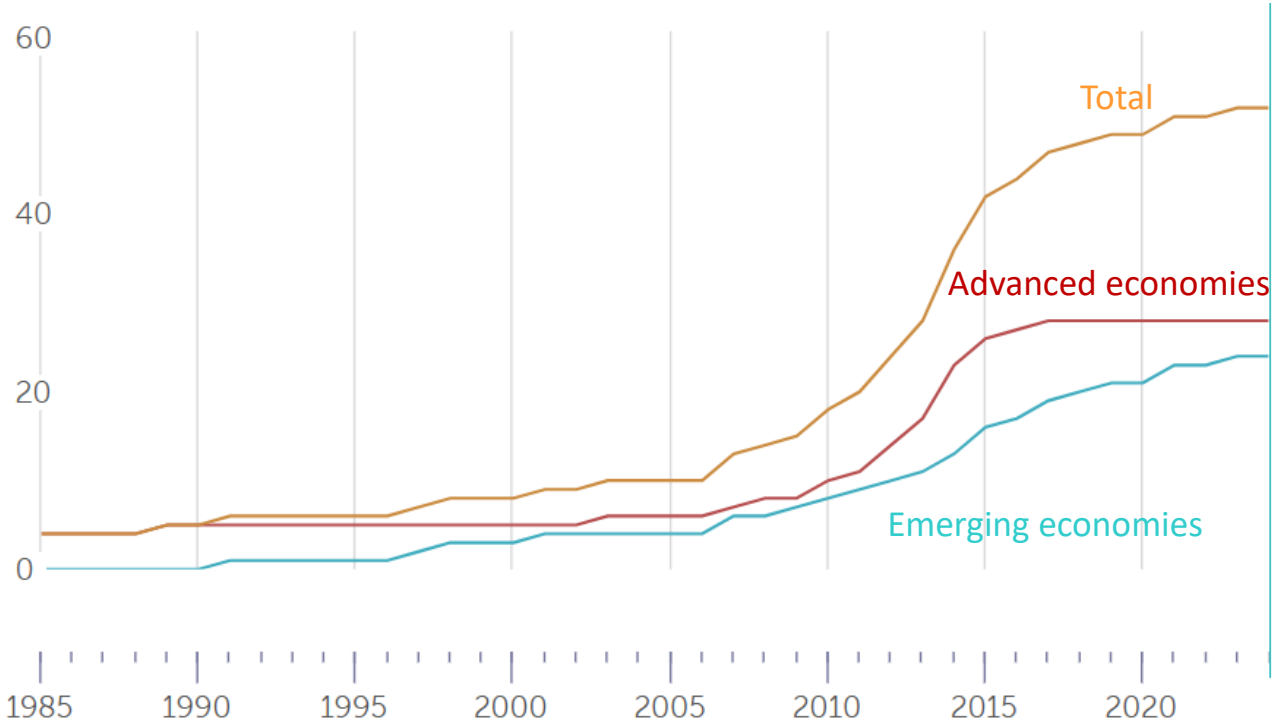
# 8. ROLE OF THE CZECH FISCAL COUNCIL

# Independent fiscal institutions established across the EU

**Fiscal councils in Europe**
(number of countries)




**Fiscal councils worldwide**
(number of countries)



# The role of the Czech Fiscal Council IS:

The Czech Fiscal Council is an independent body that **monitors, assesses and explains the state of public finances to help ensure that Czechia does not become indebted in an unsustainable way.** In particular, the Council carries out:

## 1. Assessment of the long-term sustainability of public finances

- The Council regularly assesses whether public finances (central government, municipalities, regions and other institutions) are sustainable in the long term

## 2. Monitoring compliance with fiscal rules

- **Debt brake:** 55% of GDP
- **Primary structural balance of public finances,** net expenditure path (Act No. 23/2017 Coll., Fiscal-Structural Plan of the Czech Republic for 2027–2030 period)
- **Rules for local and regional governments:** debt should not exceed 60% of average revenues over the previous four years

## 3. Issuing opinions and reports

- Report on the long-term sustainability of public finances
- Opinions on the draft state budget, developments in the general government sector and the setting of fiscal and budgetary policy
- Regular fiscal-policy analyses

# The role of the Czech Fiscal Council **IS NOT:**

The Czech Fiscal Council should not **decide, politicise or implement policy**, but only **independently and professionally assess the state of public finances and highlight risks to their development**. The Council:

## 1. It does not decide fiscal policy

- The Council is neither the government nor the Ministry of Finance

## 2. It does not replace democratic politics

- Fiscal policy is the outcome of political decision-making arising from elections

## 3. It must not be politically involved

- Independence is its main asset; it must not support specific political parties or a government it “favours”

# References: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# Thank you for your attention…




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# Glossary of Terms

| State budget (cash basis) | General government (accrual basis) |
|---|---|
| **Balance** = revenue − expenditure | **Balance** = revenue − expenditure<br>[Maastricht deficit criterion: ≤ 3% of GDP] |
| **Primary balance** = balance – interest expenditure | **Primary balance** = balance – interest expenditure |
| | **Cyclically adjusted balance** = balance at potential output (including one-off and temporary measures) |
| | **Cyclically adjusted primary balance** = cyclically adjusted balance – interest expenditure |
| | **Structural balance** = cyclically adjusted balance − the impact of one-off and temporary measures |
| | **Structural primary balance** = structural balance – interest expenditure |

The main difference between the accrual-based and cash-based balances of the state budget lies in **the point at which revenue and expenditure are recorded**. Whilst the cash-based balance tracks the actual movement of money in accounts, the accrual-based balance records economic events at the time they actually occurred, regardless of when payment is made.
It is also necessary to distinguish between transactions involving EU funds and those that do not.