OPINION OF THE CZECH FISCAL COUNCIL

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Concerning the development of public sector finances and the set-up of fiscal and budgetary policy

Pursuant to Act No. 23/2017 Coll., on Budgetary Responsibility Rules, Section 21 (2) (a), the Czech Fiscal Council monitors the development of public sector finance. Within the framework of that work, it also strives to identify risks and threats that may have an adverse impact on public budget stability in the short-term, medium-term, and long-term. Since September 2018, the Czech Fiscal Council regularly, i.e., quarterly, informs the public of its conclusions.

Basic economic situation

In Q2 of this year, the Czech economy noted a year-on-year increase by 2.7%, which is, in principle, in accordance with the expectations of the Ministry of Finance. Growth was predominantly driven by services and, in terms of demand, by household and government consumption. Investment demand, however, slowed significantly, attended by weakened dynamism of imports. In spite of the relatively weak growth of imports, net imports noted a positive contribution to overall GDP growth, of 1.1 p.p. The employment market is still marked by a surplus of available jobs over the number of the unemployed, which continues to put significant pressure on wage growth, the rate of which was above 7% in the first half. In the long-term, the growth of unit wage costs as compared to labour productivity contributes to inflation growth, which has been near 3% for several months now, i.e., at the top of the CNB target band.

As for future developments, there is a rather high level of uncertainty, not only among economists, but also among company representatives. The Ministry of Finance expects Czech GDP to increase by 2.4% for this year as a whole, and the country's economy should add 2.2% in 2020. At the same time, however, downward risks prevail, which arise, above all, from the situation abroad, and the materialisation of which is not factored in by the present prediction. A hard exit of the United Kingdom from the EU or a further escalation of trade wars between the US and China would have an adverse impact on the small open Czech economy, both directly, in terms of a drop in imports, and indirectly, due to the worsened economic situation of the country's foreign trading partners. The most important of those partners, Germany, has been balancing on the verge of a technical recession already. Furthermore, there is a threat that tariff increases by more countries will affect the European Union as a whole, which would go to further deepen the indirect impact on the Czech Republic. In terms of domestic risks, the situation on the labour market is the most evident, as wage growth is faster than the rate of labour productivity growth, which may over time weaken price-competitiveness of Czech companies abroad.

Public sector finances and the set-up of fiscal and budgetary policy for upcoming years

The slower rate of GDP growth compared to previous years is naturally also manifested in public budget income. At the end of August, the state budget posted a deficit of CZK 15.9 bn, net of EU funds, which is CZK 10.5 bn. more than in previous year. Furthermore, certain tax income is growing slower than planned (e.g., VAT). It can therefore not be assumed that the state budget balance for the entire year would be significantly better than the planned CZK – 40 bn. If the deceleration in the growth of tax income continues in the months to come, it may even threaten the achievement of the planned deficit. The CFC believes that, in that case, the government should respond, for example, by restricted drawing of operating expenses, i.e., to try not to exceed the forty-billion deficit.

Data for the second quarter do not yet point to further significant slowing of the economic development of the Czech Republic, even though increasing foreign risks must be taken into account. If they do not materialise and the economy continues to develop in accordance with the prediction of the Ministry of Finance of the Czech Republic, the CFC thinks it will not be necessary to perform a more significant stimulation of the economy by fiscal policy for the time being. One of the reasons is the present situation on the employment market, where there is not a great number of job applicants with the requisite qualifications, and also the inflation rate at the top band of the CNB inflation target. Any fiscal impulse would therefore be manifest in the GDP growth rate only marginally and would, rather, result in yet greater disbalance on the labour market. Fiscal policy should therefore be of a neutral nature at this point.

As concerns the government budget proposal for 2020, the CFC believes that its deficit should not go beyond the 40 billion crowns announced earlier. From the point of view of long-term economic growth, investment expenses should continue to gradually grow, in order that the infrastructure gap between the Czech Republic and old EU Member States be closed.

The CFC does, however, understand that foreign developments involve significant risks whose potential materialisation would have an adverse impact on the Czech economy, in particular in the sphere of industrial production. The CFC believes that the government should preventatively prepare for this possibility, by drawing up a set of possible measures to stimulate the country's economy, should the need arise. These measures should meet several criteria. Above all, their potential implementation should be relatively fast and they should be directed at enhancing demand in those sectors that are labour-force-intensive and are, at the same time, able to absorb it with the structure that would result in the case of lay-offs in the export-oriented industry.

Furthermore, the CFC believes that pension system reform should be undertaken within the foreseeable future, as it is the most important risk in terms of long-term sustainability of public finance[1]. Not addressing the problem also has an impact on the determination of the medium-term budget objective (MTO)[2] and hence on how much room the government has for fiscal stimulation of the economy, should it be required. Since 2020, the MTO for the Czech Republic was tightened at -0.75% GDP, which is a stricter value than that defined by the Czech Act on Budgetary Responsibility Rules (-1%GDP). One of the reasons behind this is the imposition a limit on the retirement age, at 65 years.

The CFC believes that a suitable basis for modifications of the system are the data presented in the "Report on the situation in the pension system of the Czech Republic…"[3] and that the purpose of Section 4a of Act No. 582/1991 Coll., on organisation and execution of social security, should be respected. Retirement age should be set such that each generation spends one-quarter of its life on pension. The CFC considers it appropriate to adhere to this mechanism, as it makes the system transparent, foreseeable, and also fairer for individual generations. It is, however, evident that the

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[1] See CFC (2019): Report on Long-term Sustainability of Public Finance.

[2] The MTO sets the limit of the structural deficit of the public institutions sector.

[3] MLSA (2019): Report on the situation in the pension system of the Czech Republic and its expected development, with a view to the demographic situation of the Czech Republic and the expected population and economic development.

lengthening of retirement age must be accompanied by mechanisms and resources that will allow for earlier retirement of those persons who are performing physically demanding jobs.

A failure to re-evaluate the retirement age and maintenance of the status quo increases the likelihood of a further tightening of the MTO, from the present −0.75% to −0.5% of GDP (presently, the calculation value relevant for its determination is −0.53%). This modification of the MTO would, given the present assumptions about structural balance development in upcoming years,[4] mean that all manoeuvring room for fiscal policy would be consumed.

[4] In the Convergence Programme of April 2019, the value of the structural balance of the public sector for 2020-2022 is expected at -0.5% GDP.