The Czech Fiscal Council

Report on Compliance with the Rules of Budgetary Responsibility for the Year 2019

October 2020

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Introduction

This year's edition of the annual Report on Compliance with the Rules of Budgetary Responsibility (the "Report") was written a time when adverse economic developments had revealed the full importance of having fiscal rules in place. However, it will not be possible to fully assess compliance with the rules during the COVID-19 pandemic until next year. The following pages therefore offer a look back at 2019, when the Czech economy had already slowed but few could truly have known what 2020 held in store.

Assessing compliance with the fiscal rules and preparing the Report, which is subsequently submitted to the Chamber of Deputies of the Parliament of the Czech Republic, is one of the main statutory duties of the Czech Fiscal Council (CFC). This year's Report is the third of its kind to be issued during the existence of the CFC, and, in terms of the statutory view of compliance/non-compliance with the fiscal rules, evaluates the information relating to 2019 only. As context, however, it makes an excursion into the period before 2019 and takes a look at current and expected future events.

The Report is divided into five sections. Section 1 describes the evolution of general government[1] finances to date. Section 2 evaluates compliance with the debt rule, i.e. the rule applying to the general government debt level. Section 3 examines compliance with the expenditure rule, i.e. the rule for deriving the state budget and state funds expenditure framework and determining total general government expenditure. This section also looks at information on legislative changes made in 2020 relaxing the rules of budgetary responsibility for 2021–2027.

The relatively high sensitivity of compliance with the expenditure rule to the accuracy of the estimate of potential output was confirmed in the course of 2020. The information on compliance/non-compliance with the rule can be distorted if the estimate is not accurate enough. The estimates of potential output and the structural deficit, and, in turn, the view of compliance with the expenditure rule, change significantly in the event of a shock to the economy. The CFC therefore established intensive communication with the Ministry of Finance of the Czech Republic to jointly eliminate these weaknesses in the quantification of compliance with one of the two main rules of budgetary responsibility. The outcome is a revised expenditure framework determination methodology, which the Ministry of Finance used in its September macroeconomic forecast.

Section 4 of the Report examines compliance with the rules of budget responsibility by territorial self-governing units. New stress tests of municipalities have been created to test the resilience of territorial self-governing units to economic shocks. These stress tests will feature in all future issues of the Report as well. Those in the current Report respond primarily to changes and challenges associated with the coronavirus crisis.

The new section 5 compares compliance with the fiscal rules in the Czech Republic with that in the rest of the EU. This part of the Report describes the historical roots of the fiscal rules and how they were gradually adapted in order to fulfil the underlying objective of keeping public finances sustainable in the long term. This new section also provides a wider and more comprehensive view of public finances in the Czech Republic over the last two decades by comparison with the usually available analyses.

[1] The central term we use in the text is "general government" (S.13 in ESA 2010). In ESA 2010, "general government" is subdivided into "central government" (S.1311), "state government" (S.1312), "local government" (S.1313; see section 4 of this Report) and "social security funds" (S.1314).

1 General government finances

The Czech economy continued to boom in 2019, although the pace of growth was lower than in previous years (annual real GDP growth stood at 2.3%, as against 3.2% in 2018 and a full 5.2% in 2017). This growth was driven by household consumption and also by investment activity. However, the favourable economic situation was reflected only partially in general government finances, as the sector's balance worsened in 2018 and 2019 as a result of expansionary fiscal policy. The surplus therefore fell gradually from 1.5% of GDP in 2017 to 0.3% in 2019. The high GDP growth and surpluses caused a continued decline in the general government debt ratio to 30.2% of GDP in 2019.

It is clear that public budgets will switch to sizeable deficits in 2020 owing to the sharp deterioration in the Czech Republic's economic condition caused by the COVID-19 pandemic. This switch will be due both to a decline in tax and insurance premium revenues resulting from the economic downturn and to discretionary measures taken to stabilise economic agents affected by the pandemic and stimulate aggregate demand. Given its knowledge of the scale of the discretionary measures at the end of September 2020, and given an expected economic contraction of 6.6%, the CFC assumes that the total general government deficit will be 6.2% of GDP and the structural deficit 2.6% of GDP this year. Similar figures are presented in the Macroeconomic Forecast issued by the Czech Ministry of Finance (MF CR) in September 2020.[2] If, however, the economy is hit hard by a second wave of the pandemic in autumn 2020, the results will be even more unfavourable.

The situation in future years will be strongly affected by the uncertain economic outlook and by a significant relaxation of the fiscal rules. The latter occurred in spring 2020 with the adoption of an amendment to Act No. 23/2017 Coll., on the Rules of Budgetary Responsibility (the "Act"), significantly revising the rules for determining total general government expenditure and deriving the state budget and state funds expenditure framework. The main change to the Act consists in an increase in the maximum permissible structural deficit for 2021–2027 from 1% to 4% of GDP. The cap on the structural deficit will be 4% in 2021 and will be reduced by at least 0.5 pp a year in the following years, i.e. the maximum allowable structural deficit should be 3.5% of GDP for 2022, 3.0% for 2023 (see the dashed red line in Chart 2) and so on, so that it reaches 1% of GDP in 2027 (i.e. the figure given in the original version of the Act).

2 The debt rule

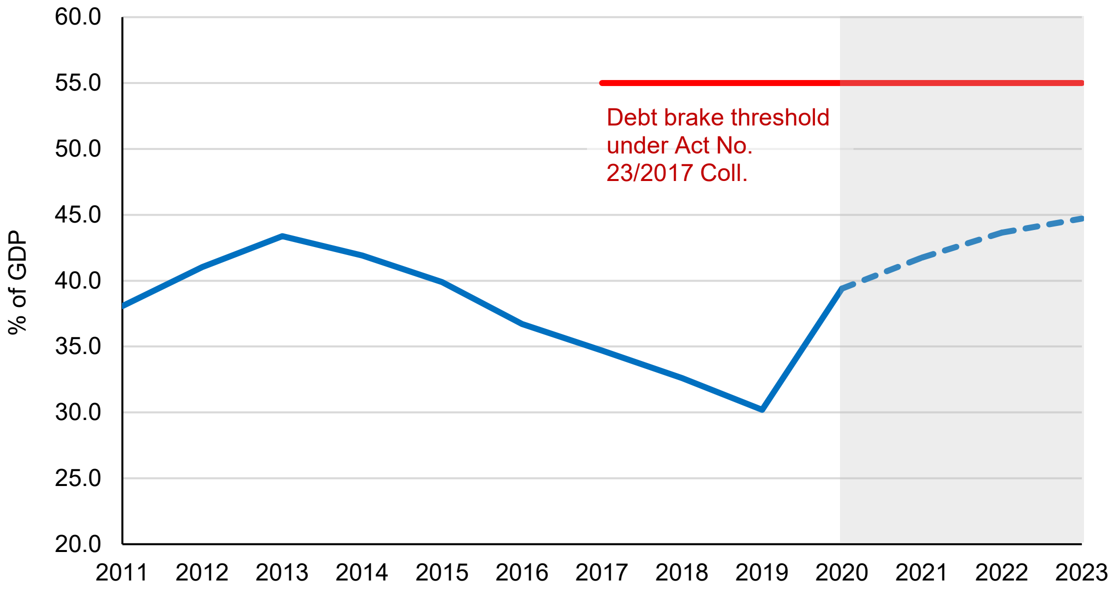
The debt rule is defined in Sections 13–16 of the Act on the Rules of Budgetary Responsibility. The subject of monitoring is the level of general government debt minus the state debt financing reserve, expressed as a percentage of GDP. If the debt defined in this way exceeds 55% of GDP (the "debt brake threshold"), the measures set out in Section 14 will be activated (exemptions are given in Section 15). If the debt exceeds 60% of GDP, the government will propose measures leading to a decrease of this level pursuant to Section 16 of the Act.

The value of the debt rule indicator for 2019 was announced at 30.79% of GDP in a CFC communication of 9 April 2020, based on data provided by the Czech Statistical Office and the Czech Ministry of Finance.

The nominal GDP figure was later increased in a revision of the national accounts, causing the level of general government debt minus the state debt financing reserve to decrease to 30.2% of GDP. This update, however, did not in any way change the fact that neither of the above reference values defined in the Act were exceeded.

[2] MF CR: Macroeconomic Forecast of the Czech Republic (September 2020).

Chart 1 General government debt minus the state debt financing reserve



Source: MF CR: Draft State Final Accounts of the Czech Republic for 2014, section E. State Debt Management Report; MF CR: Convergence Programme of the Czech Republic (2017–2020), MF CR: Macroeconomic Forecast of the Czech Republic (September 2020), CNB: Government Financial Statistics; CFC calculations.
Note: CFC projection for 2020. CFC projection assuming full use of the relaxed structural balance limits for 2021–2023.

Chart 1 shows the evolution of this indicator between 2011 and 2023; the figures for 2021–2023 are a projection of what would occur if full use were made of the fiscal policy room gained by the relaxation of the cap on the structural balance. It is clear from the chart that although the general government debt-to-GDP ratio will continue to increase (approximately to the 2012 and 2013 levels), it will not reach the 55% threshold. The growth in the debt will of course be lower if the government does not use all the available room.

Conclusion: The CFC states that the reference values of the general government debt indicator defined in Section 14 and Section 16 of the Act were not exceeded in 2019.

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

The state budget for 2019 and the budgets of other relevant general government entities were prepared during 2018. In April 2018, the Ministry of Finance set the total general government expenditure for 2019 at CZK 2,291.4 billion and the state budget and state funds expenditure framework (including the EU) for 2019 at CZK 1,496.0 billion.[3] During the preparation of the state budget, the state budget and state funds expenditure framework was revised to CZK 1,583 billion in September 2018 (mainly because of an increase in expected tax revenue), in accordance with Section 8 of Act No. 218/2000 Coll., on Budgetary Rules. The total approved level of state budget and state funds expenditure was CZK 1,542 billion, approximately 2.6% lower than the revised framework. The procedure for determining total general government expenditure and deriving the state budget and state funds expenditure framework was followed in the process of approval of the state budget and state funds expenditure level.

The planned state budget expenditure was increased by CZK 30.5 billion during the budget period, owing mainly to financing of projects under EU operational programmes. There was also an additional originally unbudgeted outgoing of CZK 18.6 billion from the General Treasury Management chapter to state financial assets on a special pension insurance reserves account connected with the pension insurance system surplus recorded in 2018. Unlike in the previous year, the overall state budget balance was not significantly affected by the take-up of claims arising from unconsumed expenditure, since the take-up thereof of CZK 78.9 billion was offset in 2019 by the non-

[3] MF CR: General Government Budgetary Strategy of the Czech Republic for 2019–2021 (2018).

take-up of a similar amount of planned expenditure, so the value of claims arising from unconsumed expenditure was almost unchanged compared with the previous year.[4]

Actual general government expenditure totalled CZK 2,375 billion and actual state budget and state funds expenditure CZK 1,593 billion in 2019. This is CZK 10 billion more than the figure in the revised framework. However, this excess spending did not put compliance with the cap on the structural balance at risk, as it was caused by spending with a zero impact on the accrual budget balance (the transfer of the pension account surplus is a transaction inside the general government sector; the increase in spending on EU projects is offset by an increase in revenues).

Table 1 Key expenditure rule indicators and the figures actually recorded in 2019 (CZK billions)

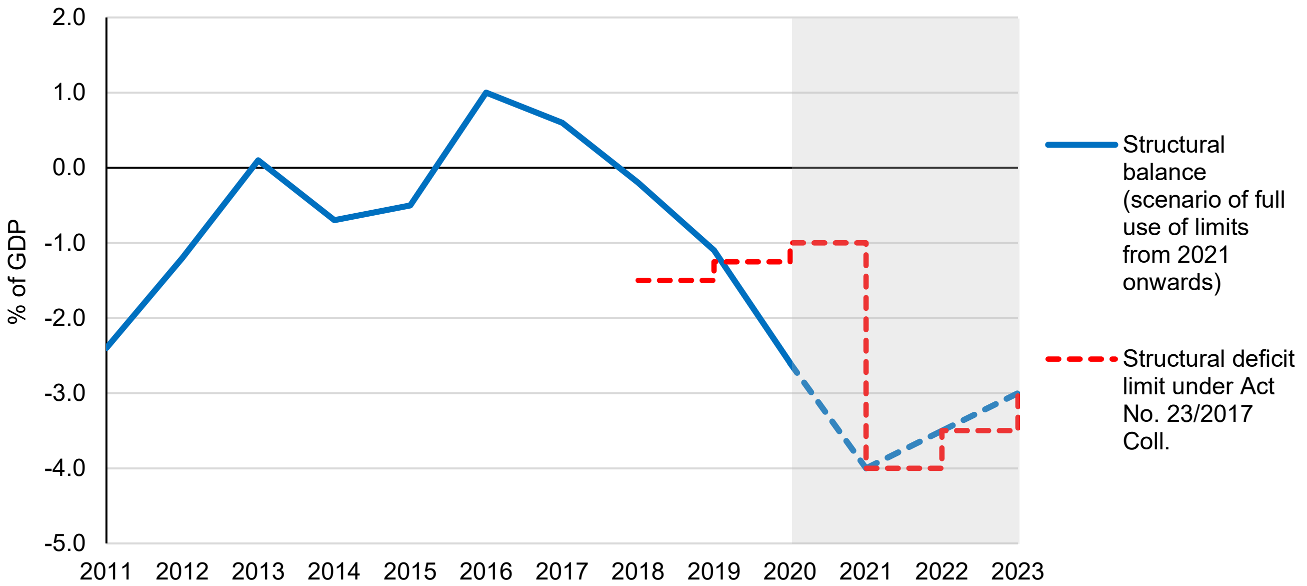
	Budgetary strategy (April 2018)	Draft state budget (September 2018)	Approved state budget (December 2018)	Actual figure (October 2020)
General government expenditure	2,291			2,375
SB and SFs expenditure framework, including EU	1,496	1,583		
SB			1,505	1,552
SFs			132	143
Transfers from SB to SFs			95	102
SB and SFs, total			1,542	1,593
GDP at current prices	5,596	5,589		5,749
Structural balance (% of GDP)		0.3		–1.1
Output gap (% of potential output)		1.9		3.7

Source: MF CR: General Government Budgetary Strategy of the Czech Republic for 2019–2021 (2018); MF CR: Medium-term Outlook for the State Budget of the Czech Republic for 2020 and 2021 (2018); MF CR: State Treasury Monitor (2020); MF CR: Treasury Performance for January–December 2019 (2020), MF CR: Macroeconomic Forecast of the Czech Republic (September 2020); CZSO: National Accounts Database (2020); CFC calculations.
Note: SB = state budget, SFs = state funds.

The aim of setting the state budget and state funds expenditure framework under the Act is to prevent the cap on the structural deficit from being exceeded. From the perspective of compliance with this rule, we therefore need to assess not only whether the derivation procedure was followed, but also whether the cap on the structural deficit was exceeded. In 2019, the general government structural balance was –1.1% of GDP, meaning that the purpose of the rule was fulfilled, as the Act set the limit for 2019 at –1.25% of GDP. Despite this formal compliance with the rule, however, the structural balance worsened significantly. In addition to fiscal policy easing, this was due to a revision of the estimate of the output gap.[5]

[4] Claims arising from unconsumed expenditure amounted to CZK 131.1 billion as of 1 January 2019 and CZK 130.1 billion as of 1 January 2020. See MF CR: Draft State Final Accounts of the Czech Republic for 2019 – C. Report on the State Budget Results (2020).
[5] See, for example, Box 2.1 Volatility of output gap estimates, in CFC (2020): Report on the Long-Term Sustainability of Public Finances.

Chart 2 The general government structural balance



Source: MF CR: Macroeconomic Forecast of the Czech Republic (September 2020); MF CR: General Government Budgetary Strategy of the Czech Republic for 2021–2023 (2020); CFC calculations.
Note: CFC projection for 2020–2023.

Chart 2 shows the evolution of the general government structural balance between 2011 and 2019. For 2020 the CFC estimate is given, and for 2021–2023 the chart shows the values of the structural balance in the scenario where full use is made of the relaxed limits for this period.

Conclusion: The CFC states that the procedure for determining total general government expenditure and deriving the state budget and state funds expenditure framework was followed in the process of approval of the state budget and state funds expenditure level for 2019. The actual general government finance result for 2019 corresponded to a structural deficit of 1.1% of GDP. This means the limit applicable for 2019 (–1.25% of GDP) was not exceeded.

4 Local and regional government finances

Pursuant to the Constitution of the Czech Republic, territorial self-governing units are municipalities and regions. Section 17 of the Act defines a special budgetary responsibility rule for the finances of municipalities and regions. That rule involves monitoring a debt criterion and, where it is exceeded, monitoring the rate of decrease of the debt. Territorial self-governing units also establish many 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 section first presents the overall financial results of the local government subsector and then evaluates the frequency and seriousness of violations of the fiscal rule.

4.1 Local government finances 2015–2019

The local government subsector[6] has reported budget surpluses in the last five years and has thus contributed to better financial results of the overall general government sector each year. In 2019, the total revenue of the subsector was CZK 710.5 billion, up CZK 51.4 billion on the previous year. Local government revenue accounted for 29.8% of total general government revenue and local government expenditure for 28.5% of total general government expenditure. The local government surplus rose by CZK 12.4 billion year on year to CZK 36 billion in 2019, amounting to 0.6% of GDP. Table 2 contains the relevant figures.

[6] 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.

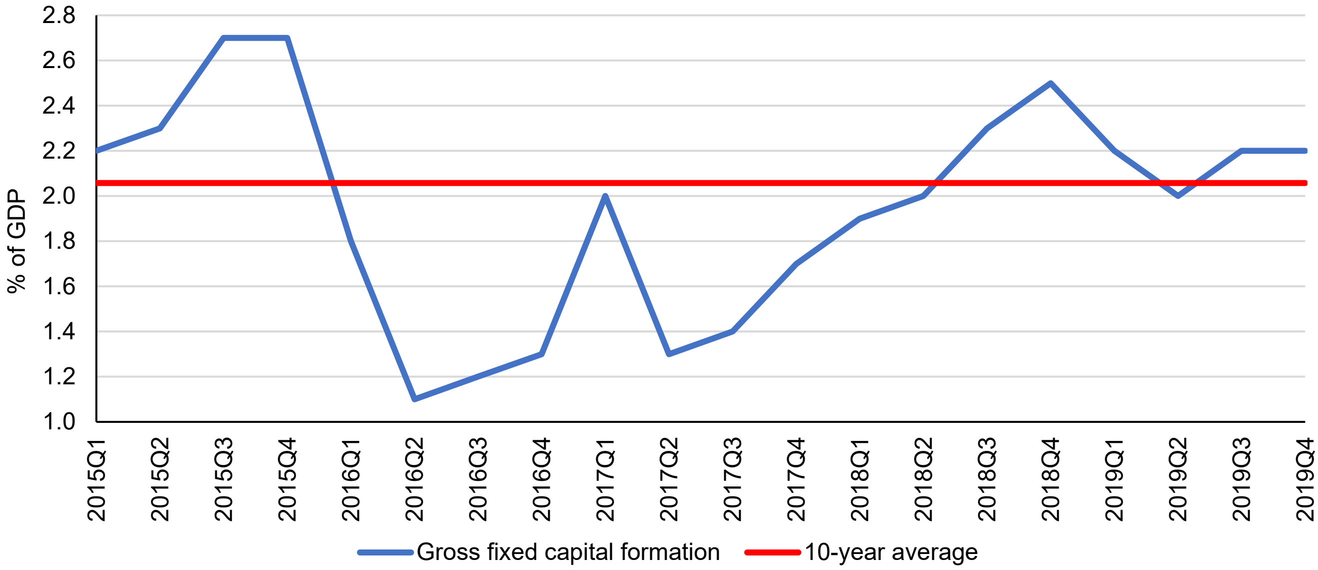
Table 2 Local government finances in the Czech Republic 2015–2019

	2015		2016		2017		2018		2019	
	CZK bn	% of GDP	CZK bn	% of GDP	CZK bn	% of GDP	CZK bn	% of GDP	CZK bn	% of GDP
Revenue	551.7	11.8	543.9	11.4	589.9	11.7	659.1	12.4	710.5	12.6
Expenditure	525.8	11.3	494.2	10.4	548.0	10.9	635.5	11.9	674.5	11.9
Balance	26.0	0.6	49.7	1.0	41.9	0.8	23.6	0.4	36.0	0.6

Source: CZSO (July 2020); CFC calculations.

The local government surpluses were due above all to higher tax revenue stemming from both an ongoing change in the income structure of GDP (a rising share of compensation of employees in GDP) and the cyclical position of the economy (a positive output gap). A change to the budgetary designation of taxes applicable from 1 January 2017 also contributed to the rise in revenue. Budgets were also affected in 2019 by a year on year decrease in investment activity, which was roughly at the 10-year average for 2010–2019 (see Chart 3).[7]

Chart 3 Local government investment in the Czech Republic 2015–2019



Source: Eurostat (July 2020); CFC calculations.

Local government surpluses usually go hand-in-hand with a downward trend in the subsector's relative debt, as is evident from Table 3. By comparison with the previous year, however, local government debt was almost unchanged at CZK 84.2 billion in 2019, accounting for less than 5% of total general government debt.

Table 3 Local government debt in the Czech Republic 2015–2019

	2015	2016	2017	2018	2019
Debt (CZK billions)	110.7	89.5	84.9	84.0	84.2
% of total general government debt	6.0	5.1	4.9	4.8	4.8

Source: CZSO (April 2020); CFC calculations.

Conclusion: The finances of territorial self-governing units (and organisations 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 stabilising general government finances for quite some time now. The level of debt of territorial self-governing units is also very low and, as a whole, does not represent a significant risk factor in terms of growth in general government debt. The investment activity of territorial self-governing units decreased slightly in 2019, stabilising close to the 2010–2019 average.

[7] Gross fixed capital formation by the local government subsector rose gradually from 1.4% of GDP in 2016 to 2.2% of GDP in 2019.

4.2 The budgetary responsibility rule for territorial self-governing units and compliance therewith in 2019

Section 17 of the Act sets the following rule for territorial self-governing units:

a) A territorial self-governing unit shall manage its finances in the interests of maintaining sound and sustainable public finances such that its debt[8] at the balance-sheet date does not exceed 60% of its average annual revenues[9] over the last four budget years (hereinafter referred to as the "debt criterion").
b) Should the debt of a territorial self-governing unit at the balance-sheet date exceed 60% of its average annual revenues over the last four budget years, the territorial self-governing unit 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 referred to as the "debt reduction rule").

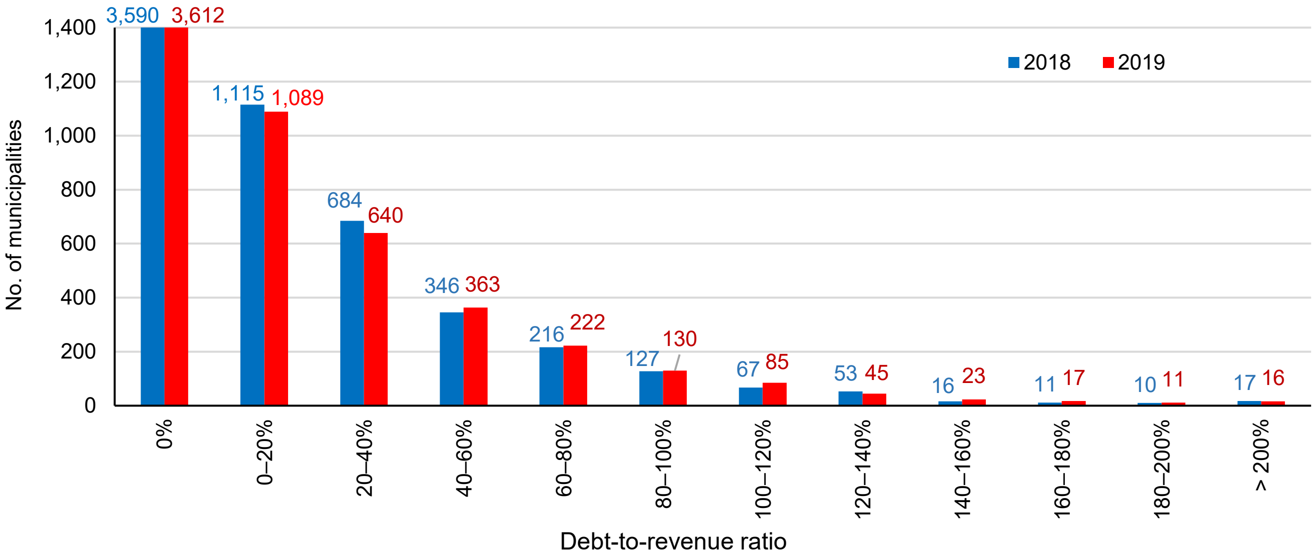
The Ministry of Finance monitors the finances of territorial self-governing units on the basis of financial data and accounting records submitted by municipalities. In 2019, this monitoring covered 6,266 territorial self-governing units of the Czech Republic, i.e. 6,253 municipalities,[10] including the City of Prague, and 13 regions.

Three of the total of 517 municipalities whose debt as at 31 December 2018 was higher than 60% of their average revenues over the last four years were not compliant with the obligation to reduce their debt in 2019 by at least 5% of the difference between the amount of their debt and 60% of their average revenues over the last four budget years. However, all of these municipalities took remedial action when called upon to do so by the Ministry of Finance, so the Ministry did not have to suspend the transfer of their shares in tax revenue.

Indebtedness in relation to the debt indicator

The budgetary responsibility rule indicator (i.e. the ratio of debt to average revenues over the last four years) was above 60% as of 31 December 2019 for 549 of the total of 6,253 municipalities (i.e. for 8.78% of all municipalities). A total of 637,230 people, i.e. just under 5.96% of the Czech population, live in these municipalities (in 2018, 5.6% of the population were living in municipalities exceeding the indicator).[11] Figures are also available in Chart 4.

Chart 4 Numbers of municipalities in ranges according to the percentage level of the budgetary responsibility rule indicator, 2018 versus 2019



Source: MF CR (2019): Information on the Monitoring of Territorial self-governing units' Finances for 2018; MF CR (2020): Information on the Monitoring of Territorial self-governing units' Finances for 2019; CFC calculations.

[8] For the purposes of the Act, the debt of a territorial self-governing unit means the value of outstanding liabilities arising from bonds issued, credit, loans and returnable financial assistance received, guarantees honoured and bills of exchange issued.
[9] For the purposes of the Act, the revenues of a territorial self-governing unit mean the sum of all monies received into its budget during the budget year, consolidated in accordance with another legal regulation.
[10] The municipality of Staré Hutě in the Zlín region is excluded from monitoring due to failure to submit financial statements to the Central State Accounting Information System.
[11] Only 135,325 people live in municipalities where the budgetary responsibility rule indicator exceeds 100% (197, i.e. 3.15% of municipalities). This represents only 1.27% of the Czech population (in 2018 the figure was 109,558 people, i.e. 1.03% of the Czech population).

The total debt of municipalities in 2019 was CZK 63.8 billion, i.e. CZK 1.3 billion more than in 2018. The combined debt of municipalities exceeding the limit of 60% of average revenues was CZK 3.8 billion, i.e. CZK 0.2 billion more than in 2018. The average debt of municipalities was 16.1% (15.7% in 2018). A total of 3,612 municipalities, i.e. 58% of the total, were entirely free of debt.[12] Twenty-two fewer municipalities were debt-free in 2018.[13] The number of municipalities whose budgetary responsibility rule indicator exceeded 200% decreased from 17 to 16.

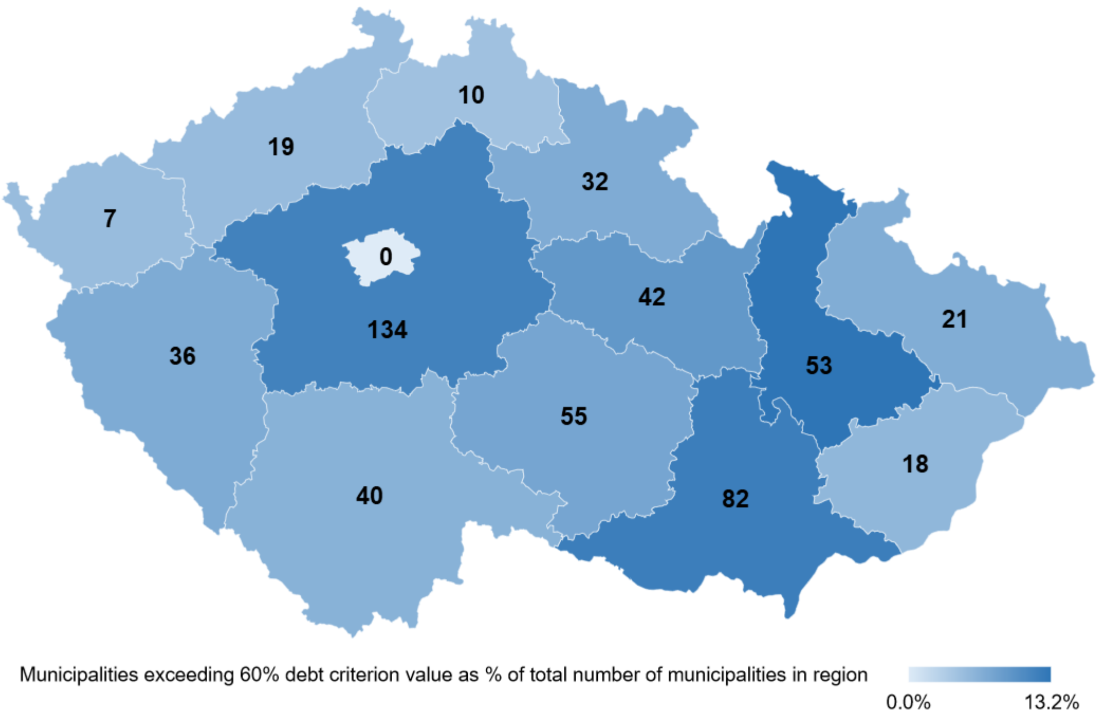
Table 4 Number of municipalities exceeding the 60% debt criterion value of the budget responsibility rule

No. of inhabitants of municipality	No. of municipalities		No. of municipalities exceeding 60% debt criterion value		% of municipalities exceeding 60% debt criterion value	
	2018	2019	2018	2019	2018	2019
1–100	447	438	18	24	4.03	5.48
101–200	987	993	71	75	7.19	7.55
201–500	1,990	1,987	193	184	9.70	9.26
501–1,000	1,377	1,364	124	140	9.01	10.26
1,001–2,000	753	769	71	80	9.43	10.40
2,001 or more	698	702	40	46	5.73	6.55
Total	6,252	6,253	517	549	8.27	8.78

Source: MF CR (2019): Information on the Monitoring of Territorial self-governing units' Finances for 2018; MF CR (2020): Information on the Monitoring of Territorial self-governing units' Finances for 2019; CFC calculations.

Table 4 shows that in 2019, municipalities with 501–1,000 and 1,001–2,000 inhabitants most often exceeded the debt criterion, whereas in 2018 it had been smaller municipalities with 201–500 inhabitants.

Chart 5 Number of municipalities exceeding the 60% debt criterion value of the budget responsibility rule



Source: MF CR (2020): Information on the Monitoring of Territorial self-governing units' Finances for 2019; CFC calculations.

[12] MF CR (2020): Information on the Monitoring of Territorial self-governing units' Finances for 2019.
[13] MF CR (2019): Information on the Monitoring of Territorial self-governing units' Finances for 2018.

Chart 5 shows that the largest number of municipalities in absolute terms exceeding the debt criterion of the budgetary responsibility rule lie in Central Bohemia, 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 are located in the Olomouc region (13.2% of municipalities). South Moravia and Central Bohemia also recorded more than 10% of municipalities exceeding the debt criterion of the budgetary responsibility rule (12.2% and 11.7% respectively). The best performers in this respect were municipalities in the Liberec region (4.7%).

Besides the budgetary responsibility rule set by the Act, the Ministry of Finance monitors another two indicators in the case of municipalities. These indicators, for which the Ministry sets recommended levels, are the ratio of loans and advances to total assets, and total liquidity. The Ministry considers them to be important because, unlike the budgetary responsibility rule, they contain information about the assets and overall liabilities of municipalities and regions. Although these indicators are not directly related to the Act, the CFC decided to take them into account as well, since they provide a fuller picture of the finances of municipalities and regions.

The Ministry of Finance recommends that the ratio of loans and advances to total assets, which expresses the share of assets covered by third-party finances, be no higher than 25% in the case of municipalities and regions. A total of 139 territorial self-governing units (TSUs) – 132 municipalities (2.11% of all municipalities) and seven regions – exceeded this level in 2019, a year on year increase of 33 TSUs. In all, 99 of the municipalities exceeding the debt criterion of the budgetary responsibility rule are not compliant with the required ratio of loans and advances to total assets, i.e. 18% of the municipalities exceeding the debt criterion, or 1.58% of all municipalities. The municipalities exceeding both criteria are home to 0.55% of the population of the Czech Republic. The municipalities of Turovice and Prameny report the highest ratios of loans and advances to total assets (658% and 260% respectively).[14]

The total liquidity indicator, which expresses the ratio of current assets to short-term liabilities, indicates to what extent a municipality is able to fulfil its short-term obligations. The Ministry of Finance recommends that this ratio lie in the range ⟨0;1⟩. A total of 104 municipalities (i.e. 1.66%) are not compliant with this recommendation. This represents a year on year decrease of 21 municipalities.

In 2019, the category of TSUs that exceed the limits on all three monitored indicators simultaneously and are therefore classified by the Ministry of Finance as TSUs with a high level of financial risk, contained six municipalities (i.e. 0.10% of all municipalities). This represents a year on year decline of four municipalities. The total number of people living in these municipalities is 2,395, or 0.022% of the total Czech population (in 2018 the figure was 6,103). The municipalities concerned are Naloučany and Ocmanice in the Vysočina region, Olešnice and Čestice in the Hradec Králové region, Doubek in the Central Bohemia region and Pnětluky in the Ústí nad Labem region. The limits on the monitored indicators were exceeded mainly due to the implementation of investment projects financed primarily from returnable resources (loans). The municipalities concerned often have only low immediately available financial reserves and their finances may therefore be exposed to the following risks:

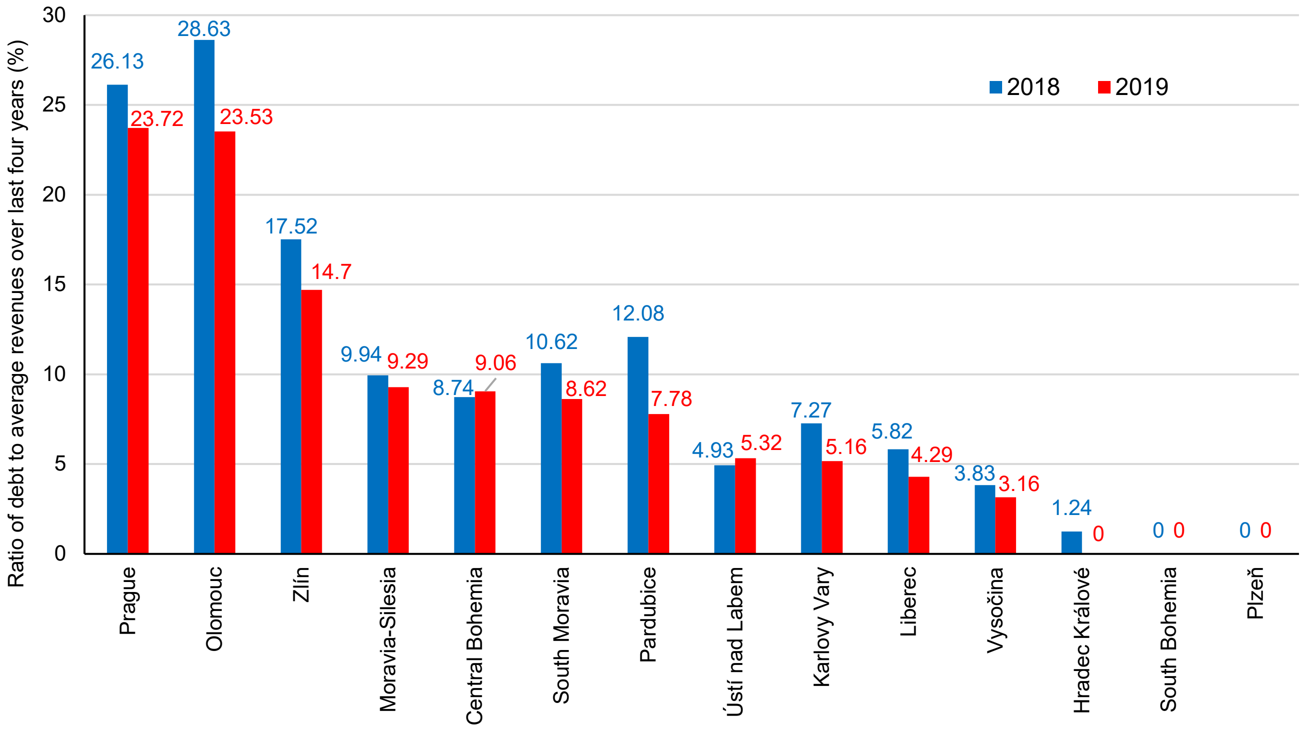
a) insufficient funds for the management and repair of tangible fixed assets,
b) the need to cover suddenly arising expenditures,
c) non-compliance with the conditions of subsidies provided/promised (including ensuring the sustainability of the project for the required period).

Aside from the municipalities that exceed the limits on all three indicators mentioned above, the municipalities of Prameny and Turovice are also facing serious financial problems. They do not exceed the limits on all three monitored indicators simultaneously, but they do report the highest ratios of loans and advances to total assets of all the municipalities in the Czech Republic.

At the level of regions, the debt criterion of the budgetary responsibility rule is fulfilled by a comfortable margin. The City of Prague[15] and the Olomouc region have reported the highest ratios of debt to average revenues over the last four years. By contrast, the regions of South Bohemia, Plzeň and Hradec Králové had absolutely no debt in 2019.[16] Compared to 2018, most regions reported a drop in the ratio of debt to average revenues over the last four years. Slight increases were recorded only by the regions of Ústí nad Labem (0.39 pp) and Central Bohemia (0.32 pp). The figures are shown in Chart 6.

[14] A ratio of loans and advances to total assets in excess of 100% means that the municipality reports negative equity.
[15] Prague is accorded the status and powers of both a municipality and a region – see Act No. 131/2000 Coll., on the City of Prague.
[16] See MF CR (2020): Information on the Monitoring of Territorial self-governing units' Finances for 2019.

Chart 6 Regions by debt-to-average revenue ratio over the last four years; in %, 2018 versus 2019



Source: MF CR (2019): Information on the Monitoring of Territorial self-governing units' Finances for 2018; MF CR (2020): Information on the Monitoring of Territorial self-governing units' Finances for 2019; CFC calculations.

Conclusion: As of 31 December 2019, a total of 549 municipalities and no regions exceeded the debt criterion defined in Section 17(1) of the Act. In 2019, a total of three municipalities were non-compliant with the obligation to reduce their debt by the statutorily defined minimum level. However, all of them took remedial action within the stipulated deadline, so there was no need to suspend the transfer of their shares in tax revenue.

Box 1 Stress test of municipalities 2020

In order to quantify the impact of the coronavirus crisis on the debt of territorial self-governing units, the Office of the Czech Fiscal Council (OCFC) drew up a projection estimating the financial situation of municipalities and regions at the end of 2020. The methodology is based on the realistic variant of the projection described in the publication "Impacts of the Coronavirus Crisis on Territorial Self-Governing Units' Finances in 2020".[17]

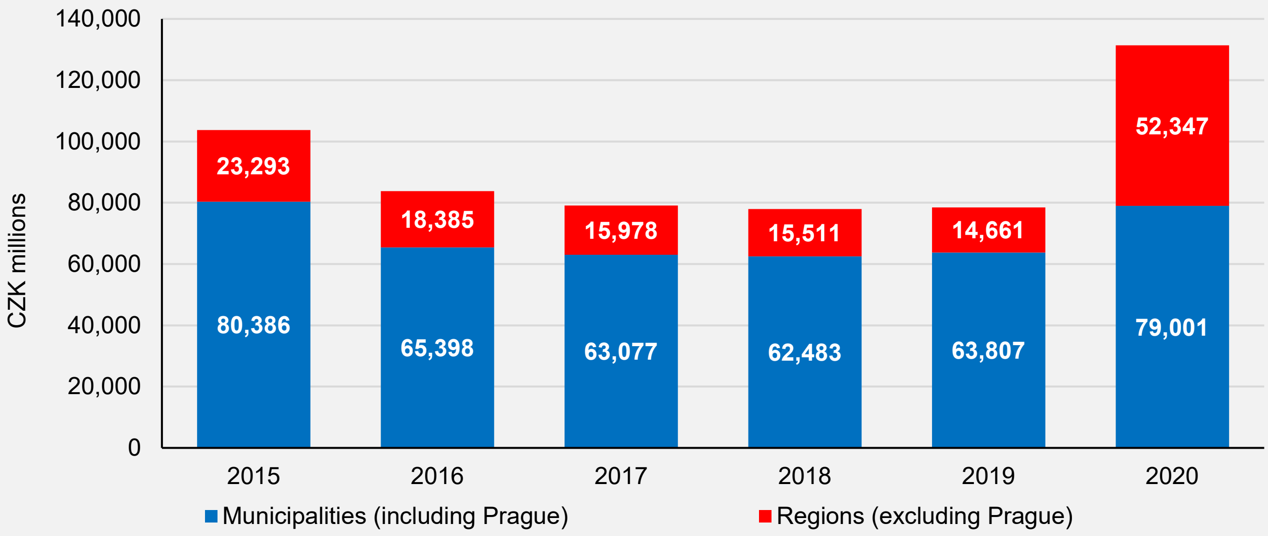
The realistic variant of this study assumes that territorial self-governing units (TSUs) will use a combination of funding sources to make up their revenue shortfalls. Based on the OCFC's model assumption, we assume that municipalities will maintain their bank account balances at a minimum of 20% of their planned expenditure for 2020 and will use only the portion of their savings exceeding this level to finance the deficits they incur. In other words, in the first phase of covering their revenue shortfalls, TSUs will use their savings until they are left with 20% of the planned expenditure for 2020 on their bank accounts.[18] To cover the remainder of their revenue shortfalls, they will again make use of debt financing where necessary. We therefore implicitly assume that municipalities with savings below 20% of their planned expenditure for 2020 will finance their deficits solely with debt.

Chart B1 plots the overall debt of TSUs between 2015 and 2019 along with the CFC projection for 2020. In the latter, we expect municipalities' total debt to rise by approximately 20% year on year in 2020, nearing the 2015 level. Excluding the compensatory bonus paid to municipalities for the tax revenue shortfall, their total debt could

[17] Kalabiška R., Morda P. (2020): Dopady koronavirové krize na hospodaření územních samosprávných celků v roce 2020. CFC Information Study.
[18] The overall figures are CZK 115.6 billion (i.e. 58.3%) from municipalities' savings and CZK 45 billion (i.e. 44%) from regions' savings.

reach CZK 88 billion in 2020.[19] In the case of regions, we estimate a significant year on year rise in overall debt. This is due primarily to regions' high planned spending for 2020, which totals CZK 386.5 billion, as against CZK 313.4 billion in 2019. However, for the reasons discussed in section 1 of Kalabiška and Morda (2020), we expect the actual expenditure to be lower. The CFC projection also estimates the increase in the debt indicator value for all 13 regions (with the exception of the City of Prague). No region will get very near to the 60% debt criterion limit. We therefore focus below solely on analysing the debt indicator of municipalities in more detail.

Chart B1 Debt of territorial self-governing units (CZK millions)



Source: State Treasury: Central State Accounting Information System (2020), CFC calculations
Note: * CFC projection for 2020.

Table B1 shows that, according to the realistic variant of the projection, the number of municipalities exceeding the 60% debt rule limit will increase to 660 in 2020. Only in the category of 200 or fewer inhabitants will the number of municipalities exceeding the debt criterion decrease, according to the projection.[20] By contrast, in the case of large municipalities with more than 2,000 residents, the number of municipalities exceeding the debt rule will more than double. We can therefore conclude that the revenue shortfall will have a bigger impact on larger municipalities, mainly because they generally have a lower savings ratio to cover the shortfall.

Table B1 Number of municipalities exceeding the 60% debt criterion value by number of inhabitants

No. of inhabitants of municipality	No. of municipalities exceeding 60% debt criterion value				% of municipalities exceeding 60% debt criterion value			
	2017	2018	2019	2020	2017	2018	2019	2020
1–100	14	18	24	16	3.13	4.03	5.48	3.65
101–200	65	71	75	57	6.53	7.21	7.55	5.84
201–500	182	193	184	195	9.14	9.71	9.26	9.76
501–1,000	113	124	140	183	8.24	9.01	10.26	13.46
1,001–2,000	57	71	80	113	7.62	9.42	10.40	14.56
2,001 and more	25	40	46	96	3.60	5.73	6.55	13.60
Total	456	517	549	660	7.30	8.27	8.78	10.55

Source: State Treasury: Central State Accounting Information System (2020), CFC calculations
Note: * Projection for 2020.

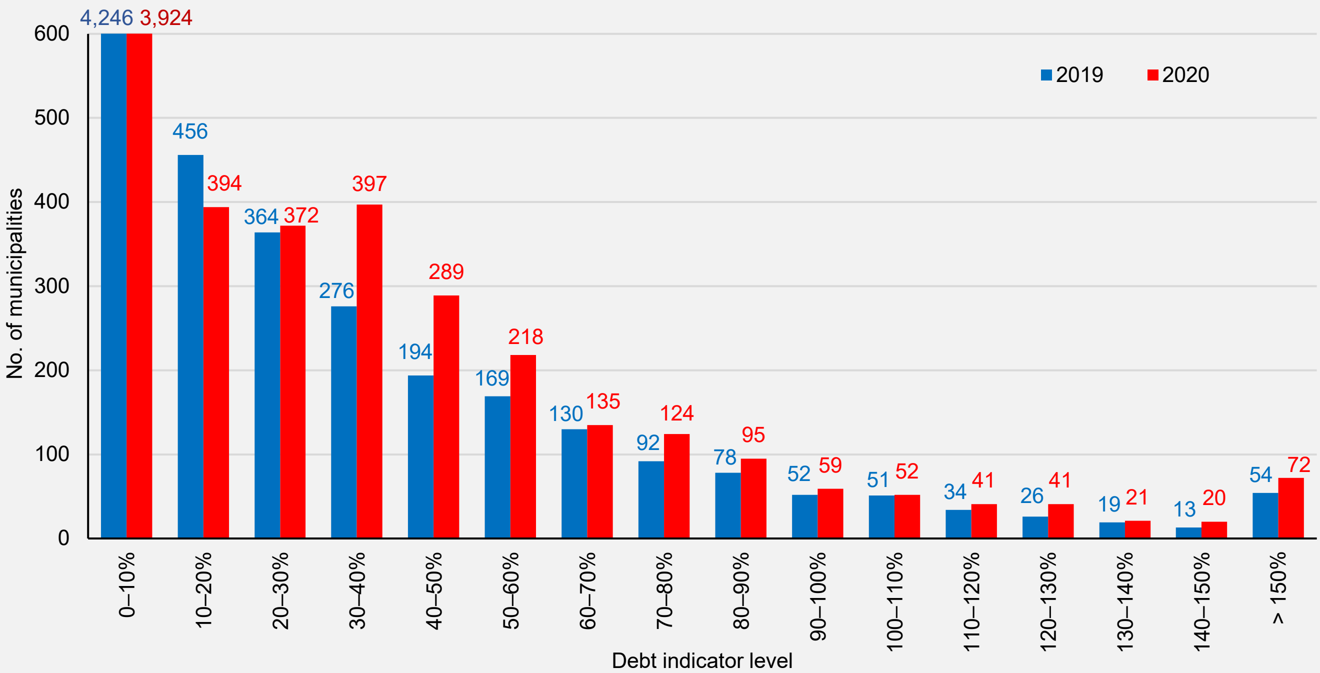
The largest number of municipalities that will, according to the projection, exceed the 60% debt rule limit are located in Central Bohemia (131, i.e. 11.5% of the municipalities in the region). Three regions will be worse off in percentage terms – Moravia-Silesia (19%), Olomouc (16.5%) and South Moravia (14.6%). These four regions are

[19] A one-off contribution of CZK 1,250 per inhabitant was provided to municipalities under an amendment to Act No. 159/2020 Coll., on the Compensatory Bonus in Relation to Crisis Measures Connected with the Occurrence of the SARS CoV-2 Coronavirus, which took effect on 7 August 2020. The aim of the contribution is to compensate municipalities for the fall in tax revenue connected with the payment of state assistance to the self-employed and owners of small limited liability companies.
[20] A municipality exceeding the debt criterion may reduce its debt indicator below 60% if its savings are sufficient to cover its revenue shortfall and simultaneously to reduce its existing debt.

therefore home to the majority of the municipalities whose debt exceeds 60% of revenue. By contrast, Karlovy Vary registers only four municipalities exceeding the debt criterion. Four regional capitals also figure among the municipalities whose debt-to-average revenue ratio will exceed 60%, according to the projection.

Chart B2 shows the number of municipalities by debt indicator value in the realistic variant of the projection. It estimates a decrease in the number of municipalities with a debt-to-revenue ratio of less than 20% from 4,702 last year to 4,318 this year. A total of 384 municipalities will therefore migrate into a higher debt indicator category, according to the projection. In the categories of municipalities that will exceed 60%, we project a rise of 111 municipalities from 549 last year to 660 this year (i.e. an increase of 20.2%). The largest rise (30.2%) can be seen in the categories of municipalities with debt indicator values of between 40% and 60%. The number of municipalities whose budgetary responsibility rule indicator will exceed 200% will go up from 16 last year to 24 this year, according to the projection.

Chart B2 Number of municipalities by debt indicator level



Source: State Treasury: Central State Accounting Information System (2020), CFC calculations.
Note: * Projection for 2020.

Conclusion: The CFC projection indicates that the debt of territorial self-governing units will increase in 2020. The number of municipalities exceeding the 60% budgetary responsibility rule limit will rise by 111 to 660 (approximately 10% of all municipalities). Municipalities with more than 2,000 inhabitants and municipalities in the Moravia-Silesia region are most at risk.

5 Compliance with the fiscal rules in the Czech Republic and in other countries – a comparison

The role of the fiscal rules is to keep public finances on a path that is sustainable in the long run. The EU fiscal rules form part of the Stability and Growth Pact (SGP) and have been ratified by all the Member States. A Europe-wide consensus is vital because the state of public finances in one country has impacts on the rest given the countries' strong interconnectedness through numerous trade and financial channels.

The late 1990s saw the introduction of a basic fiscal rules. One demanded capping the general government deficit at 3% of GDP. Another fiscal rule requires government debt to be kept below 60% of GDP, or, if it exceeds that level, to be at least approaching it at a satisfactory pace.

However, reality showed that the original rules did not sufficiently reflect the stabilisation role of fiscal policy, as countries were able to comply with the rules even when fiscal policy was excessively expansionary during booms. Non-compliance then automatically followed during recessions. The rules therefore displayed a procyclical compliance/non-compliance structure. For this reason, the SGP was reformed and expanded to include a structural balance rule and an expenditure rule.

So, after a 20-year search for suitable fiscal rules, the SGP now contains four fiscal rules:

a) **debt rule**[21] – a country is compliant with this rule if (i) the debt-to-GDP ratio does not exceed 60% of GDP or if (ii) this reference value is exceeded but the debt-to-GDP ratio has been declining by at least 1/20 on average over the past three years;

b) **deficit rule** – a country is compliant with this rule if (i) the total general government deficit is less than or equal to 3% of GDP or if (ii) this 3% reference value is exceeded but the deviation remains small (no more than 0.5% of GDP) and is limited to one year;

c) **structural balance rule** – a country is compliant with this rule if (i) the general government structural balance is at or above the Medium-Term Objective (MTO[22]) or if (ii) the MTO has not yet been reached, but the annual positive change in the structural balance is greater than 0.5% of GDP;

d) **expenditure rule** – a country is compliant with this rule if (i) the annual rate of growth of real adjusted general government expenditure[23] is at or below the 10-year average of the nominal rate of potential output growth minus the convergence margin.

The Czech Republic's rate of compliance with the fiscal sustainability rules in 1998–2019 was approximately two thirds, the average score for the EU[24] (Larch and Santacroce, 2020). However, the rates of compliance with the various fiscal rules in the Czech Republic differ. The Czech Republic was compliant with the debt rule over the entire period under review, but was compliant with the deficit rule in only 59% of fiscal periods, i.e. in 13 periods. The above rules get a great deal of media attention, and compliance/non-compliance with them is discussed quite often. By contrast, the structural deficit and expenditure rules are not such a frequent subject of public debate, even though it is they that form the core of the stabilisation function of fiscal policy.

The current relatively low level of general government debt should be assessed in the context of the preceding fiscal periods. The tradition of fiscal policy discipline in the Czech Republic dates back to the First Czechoslovak Republic (1918–1938).[25] The other three rules refer primarily to current economic policy and are less strongly linked to the fiscal responsibility of past years.

The rate of compliance with the structural balance rule is 59%. Even in years when the Czech Republic fulfilled this rule, it was only just compliant (with the exception of 2004).

The rate of compliance with the expenditure rule in the Czech Republic is the lowest of all the rules (50%). Again, we can say that even in times of above-average economic growth, compliance with this rule has been at the lower bound. The rate of compliance with the expenditure rule has thus been similar to that in euro area countries.

The following charts show the deviations from the limit defined by each rule. However, the rules should be interpreted not as recommended limits or objectives, but only as a minimum basis for long-term public finance sustainability. Put simply, a positive deviation can be interpreted as meaning that the Czech Republic/euro area countries complied with the fiscal rule. The distance above zero formed the margin of compliance with the rule. A negative deviation conversely means that the Czech Republic/euro area countries did not comply with the rule. Non-compliance with the rules (or only narrow compliance solely in times of economic growth) can lead to a substantial rise in total public sector debt. That, in turn, can lead to public finance non-sustainability due to an increase in the costs of servicing the growing debt and to adverse demographic change. Furthermore, the high openness of the Czech economy means that this could occur in a relatively short period of time.

[21] The debt rule in this section refers to the SGP debt rule and is thus not identical to the rule set out in Sections 13–16 of the Act and discussed in section 2 of this Report. The same applies to the other rules given in section 5 of this Report.

[22] The MTO can differ from country to country depending, for example, on their level of debt or on the extent of population ageing. For the MTO calculation method, see, for example, Box 2.1 Calculation of the Medium-Term Budgetary Objective for the Czech Republic, in CFC (2019): Report on the Long-Term Sustainability of Public Finances.

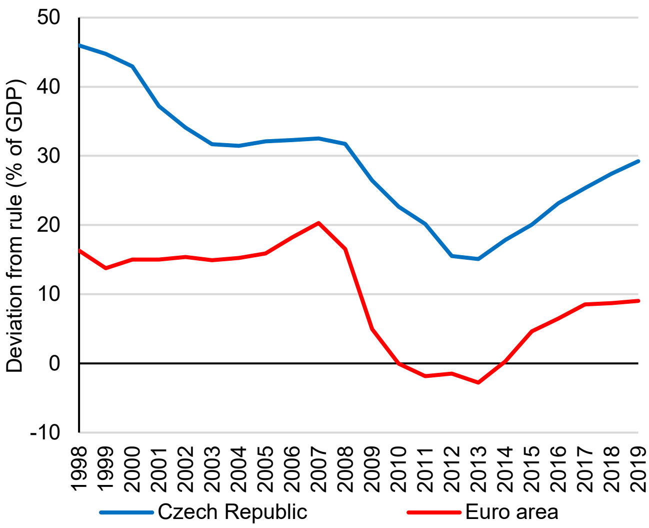
[23] Real adjusted general government expenditure is government expenditure net of gross fixed capital formation, investment volatility, interest expenditure, transfers from the EU (current international cooperation and investment subsidies), unemployment benefits and discretionary revenue measures.

[24] The rules were not all binding over the entire period but nevertheless offer interesting information on individual governments' fiscal discipline.

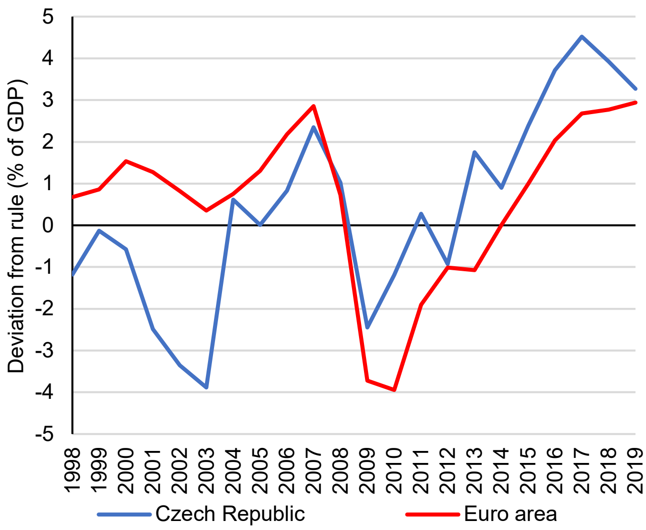
[25] The following countries besides the Czech Republic were compliant with the debt rule over the entire period under review: Bulgaria, Denmark, Estonia, Latvia, Lithuania, Luxembourg, Poland, Romania, Slovakia and Sweden. The countries compliant with this rule either have relatively high rates of taxation, such as Denmark and Sweden, or are new EU Member States. Luxembourg is a very specific case due to its size and the structure of its economy.

Chart 7 Compliance with the fiscal rules

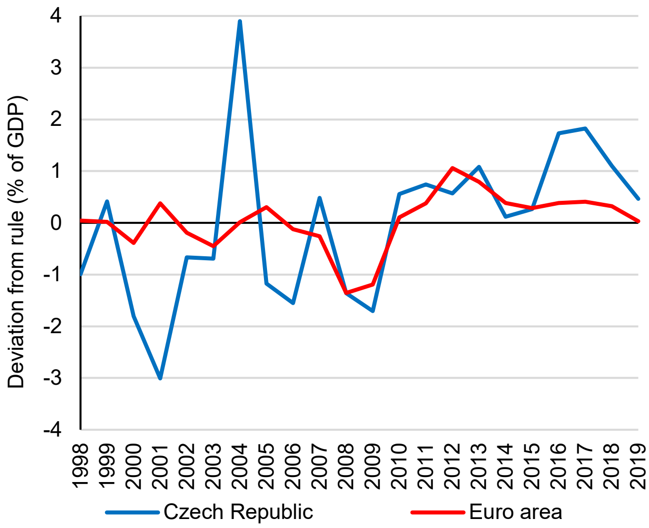
a) Debt rule[a]



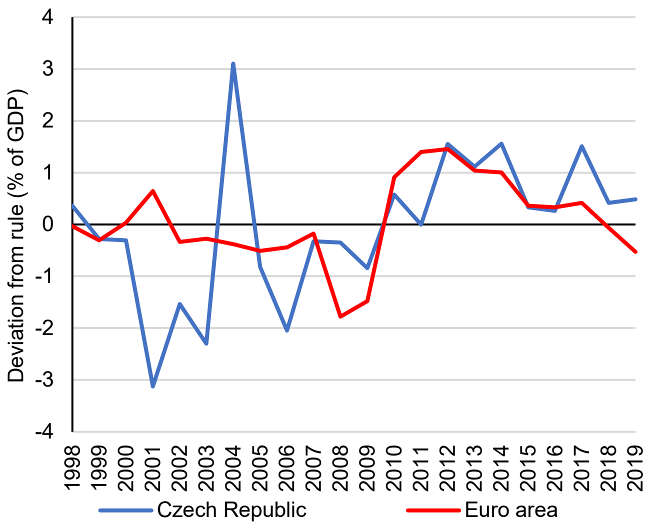
b) Deficit rule



c) Structural balance rule[b]



d) Expenditure rule



Source: Larch, M., Santacroce, S. (2020). Numerical compliance with EU fiscal rules: The compliance database of the Secretariat of the European Fiscal Board. May 2020.[26]

Note: Put simply, a value above zero can be interpreted as meaning that the Czech Republic/euro area countries complied with the fiscal rule. For the debt rule, it is thus the difference between the reference value of the rule and the actual debt-to-GDP ratio, and for the other rules it is the difference between the actual balance/expenditure and the reference value of the rule.

[a] For countries with debt below 60% of GDP, the reference value of the debt rule is set at 60%. For countries with debt in excess of 60% of GDP, the debt rule takes into account the required decrease in the debt. Its value is thus equal to the value of the debt last year minus 1/20 of the difference between this value and 60%.

[b] For the structural deficit rule, a positive sign means that the country is above its Medium-Term Objective (MTO), or its fiscal effort (i.e. the change in the structural balance) is above 0.5% of GDP.

[26] Available at: https://ec.europa.eu/info/files/efb-compliance-tracker-dataset_en.

Summary

The Czech Fiscal Council states that in 2019:

a) the general government debt rule (Section 14 and Section 16 of the Act) was complied with,
b) the procedure for determining total general government expenditure and deriving the state budget and state funds expenditure framework was followed,
c) the general government structural balance for 2019 did not exceed the limit (–1.25% of GDP) arising from the procedure for deriving the state budget and state funds expenditure framework,
d) a total of 549 municipalities exceeded the 60% limit on territorial self-governing unit debt (Section 17(a) of the Act),
e) a total of three municipalities were non-compliant with the obligation to reduce their debt in 2019 by the set minimum level, but all of them took remedial action within the stipulated deadline,
f) the Ministry of Finance did not have to suspend the transfer of any territorial self-governing unit´s share in tax revenue.

Furthermore, the Czech Fiscal Council states that even though the rules of budgetary responsibility were complied with in 2019, the expected structural balance worsened significantly from the originally planned surplus of 0.3% of GDP to a deficit of 1.1% of GDP. In addition to fiscal policy easing, this was due to a revision of the estimate of the output gap. Government fiscal policy therefore appears to have been significantly procyclical in 2019, reducing the fiscal room to react in subsequent years.

The cap on the structural balance was relaxed significantly in spring 2020 with the adoption of an amendment to the Act revising the rule for determining total general government expenditure and deriving the state budget and state funds expenditure framework. If full use is made of the extra room provided by the amendment, the government debt-to-GDP ratio will continue to increase to approximately the 2012 and 2013 levels, but the threshold of 55% of GDP will not be reached in the near future.

Local government finances again contributed to stabilising general government finances in 2019. However, they will worsen in 2020 as a result of the coronavirus crisis and the related revenue shortfall. If territorial self-governing units spend their budgeted expenditures in full, according to the CFC projection, municipalities' total debt will rise by approximately 20% year on year in 2020, nearing the 2015 level. The number of municipalities exceeding the 60% debt criterion limit would also increase by around 20%. The deterioration would occur mainly in large municipalities. The debt of regions would also rise substantially, but no region would get very close to the 60% debt criterion limit.

In the case of territorial self-governing units, the Czech Fiscal Council also points out that there is still no systemic mechanism making it possible to resolve the situation of the most seriously indebted municipalities, which have long been in a hopeless position. The current preventive measures defined in the Act do not address pre-existing insolvency. The level of services provided to the inhabitants of the municipalities concerned has thus been greatly reduced. Given the above, the Czech Fiscal Council is of the opinion that such a mechanism should be created.