

Office of the Czech Fiscal Council

CZECH FISCAL COUNCIL

OPINION

of the Czech Fiscal Council

Number 2/2021

of 3 June 2021

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, on a quarterly basis, has informed the public about its conclusions.

Macroeconomic background

Refined estimate of GDP released by Czech Statistical Office (CZSO) confirmed a 2.1% year-on-year decline in GDP in Q1 2021. The dominant factor in GDP development was household consumption, which fell by 6.1% year on year. In particular, consumption of goods with medium-term durability and expenditures on services weakened; the decline can be naturally attributed to epidemiological restrictions.

Investment demand expressed as gross fixed capital formation dropped by 3.6% year-on-year. Quarter-on-quarter, however, investments recovered by 1.6%. This positive signal was also matched by the significant rise in inventories and an acceleration of import dynamics.

Imports noted a rise by 5.6% in the first quarter, exports increased by 4.3%. Whereas the exports of goods maintained their high year-on-year growth of 7.9%, the export of services fell by 13.5%, which again was a consequence of restrictive measures. Foreign trade made an overall positive contribution of 0.4 p.p. to GDP development.

The continued recovery of exports corresponds mainly to good industrial performance. Gross value added in the manufacturing industry in the first quarter of 2021 grew by 3% year on year. Furthermore, the current business cycle survey has shown positive results.. Not only industrial companies, but also entrepreneurs in the service sector, have perceive the situation more favourably than a year ago. In line therewith, the number of businesses planning layoffs has been declining, and consumer fears of joblessness have also decreased. On the contrary, the concerns about inflation have been persisting. This is entirely founded, given that in April, the year-on-year growth in consumer prices reached 3.1%, crossing the upper limit of the Central Bank's target range. The share of unemployed persons fell to 4.1% in April, and according to the MLSA statistics available, there are still more vacancies in the economy (343,000) than the number of available jobseekers (280,000). The imbalance on the labour market will thus continue to create inflationary pressures.

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

The public sector balance in the first five months of 2021 continued to be adversely affected by restrictive measures adopted in connection with the COVID-19 epidemic and by the significant decline in personal income tax collection, as a result of the abandonment of super-gross salary taxation and an increase in the basic taxpayer credit. At the end of May, the government budget deficit reached CZK 255 bn (excluding the impact of transactions with the EU, a full CZK 262 bn), which amounts to 51% of the deficit approved for the entire year. The dynamics of the widening deficit should decrease in the coming months, as support programmes will be scaled back as a result of the improving epidemic situation. An acceleration in the collection of certain taxes may also be expected due to the recovery of economic growth. The present government budget deficit is more a reflection of excessive fiscal expansion, as it is predominantly of a structural nature¹. One-off measures clearly linked to the COVID-19 epidemic (in particular, the compensation bonus, the Antivirus and COVID programmes) only contributed CZK 60 bn to the deficit.

The Ministry of Finance assumes that public budgets will close this year with a deficit of 8.8% of GDP², which is 2.6% of GDP more than in the crisis year of 2020. This also means a deterioration of the structural balance by 3.8% of GDP and an increase in the debt quota by approximately 6.7% of GDP. No significant improvement can, however, be expected in the coming years. For 2022, the Ministry of Finance is proposing a state budget deficit of CZK 390 bn., and for the following two years, it is planning on deficits of CZK 370 and 343 bn, respectively³. Assuming a slight surplus or balance in other parts of public budgets (local budgets, health insurance companies, etc.), this will result in a year-on-year improvement of the structural balance of 0.5% of GDP, i.e., only the minimum extent required by the current version of the Act on Budgetary Responsibility Rules.

The CFC, however, considers that rate inadequate, with a view to the expected recovery and high debt quota growth rate (see below). Furthermore, additional tax and spending measures are being adopted and proposed, which further increase the existing structural imbalance. One example is the planned increase in child benefits, with an impact of CZK 4.5 bn, and the increase of the tax credit for the second and third child in personal income tax, which will result in a shortfall of CZK 2.1 bn in public budgets⁴, which has not been planned for in the proposed state budget framework for 2022. Furthermore, the plan for a higher-than-statutorily-mandated valorisation of pensions must be mentioned, with a negative impact on the structural balance of 0.2% of GDP. In the present public budget situation, the CFC considers such steps irresponsible, in particular if they are not accompanied by adequate adjustments on the revenue or spending sides.

The expected high deficits in 2021 and 2022 and the insufficiently ambitious consolidation in the following years will result in a dynamic increase in the share of public sector debt in GDP. The CFC's calculations show that the debt brake, which is set at 55% of GDP, will likely be reached as early as in 2024. This would result in the application of the measures set out in the Act on Budgetary Responsibility Rules⁵, which would significantly limit the possibility for active use of the stabilisation

¹ MF ČR expects that in 2021, the structural balance will reach -6.5% of GDP in 2021. MF ČR (2021): Macroeconomic Prediction of the Czech Republic - April 2021, p. 12.

² MF ČR (2021): Macroeconomic Prediction of the Czech Republic - April 2021, p. 12.

³ MF ČR (2021): Preparation of the 2022 state budget of the Czech Republic and medium-term outlook for 2023 and 2024.

⁴ Law proposal Act No. 117/1995 Coll., on state social support, as amended, and Act No. 586/1992 Coll., on income tax, as amended; Senate publication No. 99. The forecasts of fiscal consequences have been calculated by the CFS.

⁵ See Section 14 of Act No. 23/2017 Coll., on budgetary responsibility rules.

function of public finance and would complicate the operations of many organisations in the public sector. Furthermore, a potential negative reaction of financial markets cannot be underestimated, given that some rating agencies are already drawing attention to the absence of a sufficiently ambitious consolidation strategy⁶. Hence, it is clear that, if the reaching of the debt brake limit is to be prevented, consolidation efforts must be stepped up significantly from the envisaged 0.5% of GDP per year.

The fact that the fiscal policy easing expansion in the Czech Republic is too massive is clear from an international comparison, as well. In its current economic outlook⁷, the International Monetary Fund predicts that only 6 EU countries will widen their deficits in 2021 compared to the previous year. The Czech Republic is one of those, and the magnitude of the deterioration of its balance (1.8 p.p.) will be the second highest, next to Estonia. For 2022, a lower public finance deficit than in 2020 is expected for all EU countries, with the exception of the Czech Republic and Estonia. In 2023, the outlook of Czech public finance balance, of -5.6% of GDP, represents the second highest deficit in the EU27 (after Romania with -6.2% of GDP). The Czech Republic will maintain that rank in 2024 to 2026, as well. According to an International Monetary Fund projection, the high deficits mentioned above will also result in the Czech debt quota being 24.8 p.p. higher than in 2019. A higher increase in debt ratios is expected only in Estonia (32.4 p.p.) and Romania (27.7 p.p.). It is evident from the above that fiscal expansion and debt growth dynamics in the Czech Republic are highly above-average in an international context.

A fact that can be considered at least a partly positive development is that the possibility of faster consolidation has already been mentioned in official government documents, especially the Convergence Programme. At least an alternative scenario⁸ admits to the need to increase the tax burden by CZK 50 bn. Unlike the original commitment to reduce personal income tax only temporarily, however, it proposes increasing taxes on consumption, taxing global corporations, and revising tax expenditures⁹. The fiscal potential of taxation on global corporations and reduction of tax expenditures is, however, limited (see below), which is why it can be expected that a greater emphasis will be put on taxes on consumption. However, their increase usually has regressive effects and may result in price increases, which in turn, through the necessitated indexation in social transfers (in particular, pension insurance benefits) increases the importance of mandatory expenditures in public budgets and the positive effects on the public sector balance is partially erased.

In terms of the revision (or, more precisely) restriction, of tax expenditures, the CFC points out that the effect is nothing but an increase in the tax burden. In effect, the reduction in various tax exemptions, deductions from the tax base, tax credits, and other design elements increases the average tax rate, either in general or for specific groups of taxpayers. Furthermore, it must be noted that even though at first glance, the extent of tax expenditures in public budgets is considerable, but for the most part, they are elements that fulfil important social and incentive functions. The Ministry of Finance estimates that in 2018, the value of tax expenditures on the three most important taxes

⁶ https://www.moody.com/research/Moody-affirms-the-Czech-Republics-Aa3-ratings-and-maintains-stable--PR_439412

⁷ For more details, see Zamrazilová E., Morda P. (2021): Střednědobý výhled českých veřejných financí v mezinárodním srovnání (*Medium-term outlook for Czech public finance in an international comparison*).

⁸ MF ČR (2021): Convergence programme of the Czech Republic – April 2021, p. 16.

⁹ A tax expenditure is a tax relief granted to a group of individuals or for a specific activity, by means of a reduction in tax liability instead of a direct expenditure. This relief is provided through diverse tax design elements, in particular tax exemptions, deductions from the tax base, tax credits, and reduced rates. The term “reduction of tax exemptions” is sometimes used in the context of tax expenditure reduction.

(both income taxes and value-added tax) amounted to CZK 520 bn¹⁰, of which nearly CZK 300 bn was attributable to pension tax exemptions and social tax credits (for taxpayer, for children, etc.) for personal income tax, CZK 134 bn on VAT exemptions for selected deliveries (e.g., lease of real properties), and CZK 57 bn for the existence of reduced VAT rates. It is therefore clear that the room for reducing tax expenditures that would not affect the majority of the population (whether in the form of a reduction of disposable income or in the form of price increases) is limited and certainly cannot ensure that the entire consolidation need is met through it.

Based on the above, the CFC remains of the view that a credible consolidation strategy must be drawn up to prevent a collision with the debt brake and that the consolidation effort in 2022 and 2023 must be higher than the announced 0.5% of GDP. Adjustments of tax and spending policies must be taken up in the drafting of the 2022 budget, as their postponement would result in the need of a higher consolidation in subsequent years, which could have a significant adverse impact on the rate of economic growth. The total consolidation that will need to be undertaken in order to return to the level of 1% structural deficit¹¹ currently amounts to 5.5% of GDP. It is evident that consolidation on such a scale cannot be implemented solely through public spending reductions and a not insignificant increase of the tax burden will have to be undertaken, whether in the form of higher tax rates or by adjusting other tax design elements.

¹⁰ MF ČR (2020): Quantification of tax relief in the Czech Republic for 2018.

¹¹ See Section 10 of Act No. 23/2017 Coll., on budgetary responsibility rules.