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Czech Republic economy briefing:

The Government to Pursue Expansive Fiscal Policy: Prospects & Results

Ladislav Zemánek

China-CEE Institute

Kiadó: Kína-KKE Intézet Nonprofit Kft.

Szerkesztésért felelős személy: Chen Xin

Kiadásért felelős személy: Huang Ping

1052 Budapest Petőfi Sándor utca 11.

+36 1 5858 690

office@china-cee.eu

china-cee.eu

The Government to Pursue Expansive Fiscal Policy: Prospects & Results

This briefing is dedicated to two economic phenomena which have been increasingly momentous in the Czech Republic: (1) a widening salary gap between the state and private sector which is in contradiction to classical economic rules, and (2) rising state debt, also connected with the first question. Inquiring into this problematics, I will show possible solutions of the indebtedness.

The current coronavirus crisis has deepened and revealed even more apparently a salary gap between the state and private sector. Although salaries are usually higher in the private sector in the developed market economies, the opposite is true in the Czech Republic. Paradoxically thus the private business which is more vulnerable to the market risks and multiple uncertainties in comparison with the stable state sector and which, additionally, generates wealthy of the whole society in economic terms, provides lower pay packets at the same time. Suddenly, the traditional correlation between risks and gains (higher risks entailing higher gains and vice versa) does not hold.

Expenditures and deficits

During the first wave of the epidemic in the second quarter of this year, the average monthly gross salary amounted to 40,572 CZK (approximately 1,531 EUR), increasing by 8 per cent compared to the first quarter, in the state sector whereas the private one lagged behind with 36,593 CZK (roughly 1,380 EUR), increasing by slightly more than 2 per cent. The gap is more noticeable if taken the middle value, eliminating extreme values, into consideration. The state salaries added up to 37,547 CZK (1,416 EUR), while the private ones to hardly 30,000 CZK (1,132 EUR). In case it was only a temporary phenomenon, it would not be of greater importance. However, this year´s figures but confirm long-term tendencies, which is warning. An explanation can be sought in different mentalities and attitudes towards management and economic activities. Whilst the state sector is well aware that financial sources are and will be virtually always and in case of need for them, the State is entitled to raise taxes or get into debt, managers in the private companies might bring about bankruptcy if they behave in the same way. In the last months the Government loosened the rules for responsible fiscal policy, thus enabling faster and easier getting into debt, referring to the crisis and the alleged need for higher expenditures. Such a way of thinking has been strengthened by the central banks in many countries, including the Czech Republic, which have decided to pump great amounts of money into national economies through buying (not only) state bonds on a large scale. It deepens indebtedness of the State, and thus the future generations who will be exposed to negative consequences of such squandering, and motivates politicians to further outlays without looking for savings and restructuralisation of both incomes and expenditures.[1]

To put it concretely, the government debt increased to 2.2 trillion CZK (approximately 83 billion EUR), its share on the GDP rising from less than 33 per cent to virtually 40 per cent in the second quarter of this year. Furthermore, by the end of October, the deficit of the state budget amounted to 274 billion CZK (10.3 billion EUR) regardless an increase of 2.6 billion CZK (98 million EUR) in revenues in comparison with the last year´s October.[2] That is due to a sharp soar in expenditures, roughly 45 per cent of which being composed of expenditures on the state employees´ salaries. Only during October itself, the total state deficit increased by 21.3 billion CZK (804 million), i.e. more than 8 per cent. In terms of a structure of the state expenditures in the period of January to October, the biggest share is represented by social benefits (561,4 billion CZK/21,2 billion EUR) whereas solely 121 billion CZK (4,6 billion EUR) were spent on investment. Almost the same amount was spent on salaries. Compared to the previous year, the most considerable increase is observed in the case of the social benefits – from 500,3 billion CZK (18,9 billion EUR) to 561,4 billion CZK (21,2 billion EUR). At the same time, expenditures on investment, which are of the utter importance owing to successful future development and innovative potential of the economy and the country as such, increased by mere 20 billion CZK (754 million EUR). Many experts criticise that under the current difficult circumstances, no economy measures have been prepared by the Government. Moreover, a fast rise in state employees´ salaries continues, even without freezing them to at least solidarise with the rest of society.

[1] I dealt with the problem of indebtedness, fiscal discipline and policy in the May economic briefing: https://china-cee.eu/2020/05/25/czech-republic-economy-briefing-on-a-pathway-towards-a-debt-abyss/.
[2] https://www.mfcr.cz/cs/aktualne/tiskove-zpravy/2020/pokladni-plneni-sr-39853 (in Czech)

State budget for 2021

The pace of indebtedness can lead to a deterioration in the international rating which would further contribute to this negative trajectory because of an inevitable increase in the interest rates available for the Czech State. The recent draft of the 2021 state budget, which was revised several times in the last months, expects a deficit of 320 billion CZK (12 billion EUR).[3] However, it does not reflect a probable significant change in the tax system, which has been a subject of political debates and is planned to take effect at the beginning of 2021, namely the abolition of the so-called super-gross salary, leading to a decrease in the income tax for employees, thus lower tax revenues.[4] The 2021 state budget equals to approximately 1.4 per cent of the GDP, being very expansive without any specification of a way how to consolidate and stabilise the state and public finances in the years to follow. According to economists, the proposed deficit is excessively, disproportionately high. Furthermore, a share of expenditures designated for investment amounts to only 10 per cent. At the same time, expenditures on the state employees´ will increase to 240 billion CZK, i.e. by 5.7 per cent, and the total number of employees will rise by 6,901 to 482,270 people, which equals to roughly 7 per cent of all people in the productive age (18–65 years).

The Government may put forward a higher deficit intentionally in order to avoid a politically unpleasant situation when they would have to ask the Chamber of Deputies to approve further increase during the next year. Nevertheless, many experts warn that the final 2021 deficit can be even higher than the abovementioned figure, reaching 400 billion CZK (15 billion EUR). Moreover, if the super-gross salary is abolished indeed, a negative situation in terms of revenues and state budget balance will be escalated. It is beyond any doubt that the concept of the super-gross salary is intransparent, too complex and confusing, therefore its abolition is a step in the right direction. The problem is that the chosen moment is not favourable and the decision is an isolated measure without a systemic approach and a complex solution of the tax system, an impact assessment and revision of connected aspects being absent. Last but not least, the abolition of the super-gross salary gives preferential treatment to one group of people (employees) to the detriment of another (self-employed persons, entrepreneurs), which can be perceived unfair, all the more if take the aforesaid facts into account.

[3] https://www.mfcr.cz/cs/aktualne/tiskove-zpravy/2020/vlada-schvalila-rozpocet-na-rok-2021-39709 (in Czech)

[4] For more information about the Czech super-gross salary concept and its abolition see at https://home.kpmg/xx/en/home/insights/2020/09/flash-alert-2020-408.html.

Possible scenarios

When deliberating about the Czech state budget and development of its deficits, one should also allow for costs of transition towards the green economy and hardly sustainable pension system. Not by coincidence, the Czech Fiscal Council expects that the state debt will expand to a triple of the GDP by 2070. Generally, the rising indebtedness can be solved by tax rise, issuance of the state bonds or printing money. The two last options, however, stimulates inflation increase, which is high in comparison with other European economies even in the present days. The inflation could be brought down by tax rise in such a case but it would suppress the performance and productivity of the economy. If the rising indebtedness causes inaccessibility to external financing through loans, the overall debt being enormous in the next decades, a scenario of the state bankruptcy can prove to be a favourable solution. Nevertheless, such a way would damage the Czech Republic´s position and reputation substantially.

In order to avoid serious problems in the future, there is another possibility which would help to lower the level of indebtedness – to invest the foreign exchange reserves held by the Czech National Bank.[5] The central bank does not make use of these massive reserves for the monetary policy how demonstrated by the last two serious economic crises in 2008 and 2020 when the CNB did not intervene in favour of the Czech currency´s rate. According to the former advisor to the Vice-Governor of the Czech National Bank Tomáš Havránek, who published an article forcefully called „The last chance of the Czechia without bankruptcy“, investment of the forex reserves could yield 5 per cent yearly amounting to 3.5 per cent of the GDP.[6] In any case, the current Government should mitigate its expansionist fiscal policy and start to cut down expenditures. Unfortunately, it can be hardly expected before the oncoming parliamentary election next year.

[5] Development of the forex reserves available at https://www.cnb.cz/cs/statistika/platebni_bilance_stat/devizove_rezervy/drs_rada.htm (in Czech).
[6] https://archiv.ihned.cz/c1-66842940-posledni-sance-na-cesko-bez-bankrotu (in Czech).