Czech Republic

2020 budget to focus on social measures, kick the can down the road

- **We consider projections realistic, even slightly on pessimist side**
- **General government surplus target is at 0.4% of GDP, probably to be missed**
- **Finance ministry to extend VAT reimbursement period which will cover a big part of spending splurge**
- **Social contribution intake is like underestimated, but there is downside risk for excise taxes**
- **Central government budget continues to bet on social expenses, public sector wage hikes and infrastructure spending**
- **EU funds' absorption to keep improving, given that bar is still rather low**
- **Overall risk is smaller than we expected, we expect a modest surplus barring a major crisis**

The 2020 budget bill is the fruit of political compromise between ANO and the CSSD, as ANO got a less responsible budget than it would like, while the CSSD didn't achieve all of its social spending goals. It comes at a sensitive time, when external uncertainty could turn economic activity around, particularly under a threat of a hard Brexit and a trade war with the United States. Under such premise, the finance ministry has tried to do what it can to tie the cash balance next year (through extending the VAT reimbursement period from 30 to 45 days), but it is only kicking the can down the road. We expect that the 2021 budget will be the real challenge, especially after it will take effect during an election year, as the next general election is due in the autumn of 2021.

Macroeconomic framework

On a positive note, the finance ministry has remained prudent with its macroeconomic scenario, expecting GDP growth at 2.4% in 2019 and 2.2% in 2020. It puts the forecast on the pessimist side, when compared to available forecasts, as the average projection for GDP growth next year is currently at 2.5%. We generally see no major issue with the scenario, as it continues to bet on strong domestic demand and only a slight external surplus (net exports are expected to contribute by 0.2pps to GDP growth). In fact, we believe that the finance ministry is playing it safe, as it is very conservative on long-term interest rates and relatively conservative on wage growth. With the current acute shortages in labour supply, we believe labour cost pressure will remain strong next year, thus pushing wage growth upwards.

The only likely weakness may be the euro area growth projection, where the GDP should accelerate its growth from 1.1% in 2019 to 1.4% in 2020. It could have a negative impact on net exports, but we doubt that there will be a considerable deviation from the baseline scenario. It will probably compensate for conservative projections on government consumption, for instance, where growth is seen as easing when compared to 2019. On a positive note, investment is likely to retain its pace, though slower than in 2018, helped by much higher public capital expenditure.

Table 1. Macroeconomic framework

Indicator	Measure	2019	2020	2021	2022
GDP	CZK bn	5,627	5,880	6,127	6,381
GDP	**% y/y**	**2.4**	**2.2**	**2.2**	**2.1**

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Private consumption	% y/y	2.6	2.4	2.4	2.1
Government consumption	% y/y	2.4	1.9	1.9	1.9
Gross fixed capital formation	% y/y	2.5	2.4	2.3	2.6
Net exports	contribution, pps	0.4	0.2	0.1	0.1
Inventories	contribution, pps	-0.3	0	0	0
GDP deflator	% y/y	3.1	2.2	1.9	2
CPI inflation	% y/y	2.7	2.4	1.9	1.8
Employment	% y/y	0.7	0.3	0.1	0
Unemployment rate	%	2.2	2.3	2.4	2.5
Wages	% y/y	7.4	5.9	5.5	5
Current account balance	% of GDP	0.6	0.8	0.9	1
EUR/CZK		25.6	25.2	24.7	24.2
Long-term interest rates	%	1.6	1.5	1.7	1.9
Brent crude oil	USD/barrel	64	60	59	59
Euro area GDP	% y/y	1.1	1.4	1.6	1.7

Source: Ministry of Finance

General government targets

The 2020 general government budget is planned at a slight surplus, at 0.4% of GDP, slightly higher than this year's 0.3% of GDP. Interestingly, the finance ministry projects a slight structural surplus, which we are not so convinced about, but we do agree that the structural balance is likely to remain close to being neutral. We do agree that government debt will keep falling, especially in an environment where low interest rates are anticipated. Besides, we believe that the finance ministry remains conservative with the social insurance fund, which will probably report a better performance than planned, given low unemployment and still growing wages.

The tax burden is expected to increase slightly, up by 0.4pps for taxes only and by another 0.3pps for policies related to social and health insurance. The effect is not surprising, given that the government intends to increase excise taxes on alcohol and tobacco, as well as introduce a new tax on digital sales for large multinational companies (mostly GAFA). The increase is not considerable and the Czech Republic's tax burden remains below that of most OECD peers, though it will hardly be the leader in the EU in terms of low taxation.

Table 2. General government, % of GDP

	2018	2019	2020	2021	2022
Budget balance	**0.9**	**0.3**	**0.4**	**-0.1**	**-0.4**
Structural balance	0.4	-0.1	0.2	-0.2	-0.4
Government debt	**32.6**	**31.3**	**30.7**	**30.2**	**29.7**
Tax burden, %					
taxes only	19.6	19.6	20	19.8	19.8
social and health insurance included	35	35.2	35.9	35.8	35.8

Source: Ministry of Finance

Fiscal policy changes

The government was active in fiscal policy adjustments this year, and there will be a number of changes that will impact the 2020 budget. The finance ministry has done its best to try to balance political demands, and it has found a short-term solution that will have an impact on the cash balance only in 2020. We refer to a decision to increase **the period for VAT reimbursement** from 30 to 45 days, which is estimated to bring in an additional CZK

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16.2bn. It is a one-off measure and the finance ministry is simply kicking the can down the road. Yet, it will cover most of the additional spending demands that were included in the 2020 budget, along with already planned measures to strengthen the revenue side.

The biggest measures on the revenue side are undoubtedly the planned **hike of excise tax on tobacco and alcohol**, as well as the **removal of a tax break on technical provisions** under the Insurance Act. Smaller measures include the introduction of the third and fourth stage of the electronic registration of sales (EET) system, as well as the new digital sales tax, which will be levied on online advertising revenue at 7% on firms with global revenue at least at EUR 750mn (so mainly GAFA, but probably not European tech firms). The latter effects will be mostly negated by the planned move of certain goods and services to the super reduced VAT rate (10%), such as central heating, water & sewerage, catering, draft beer, etc. Overall, most of the measures are relatively small in scope, dwarfed by the extension of the VAT reimbursement period and the excise tax hike.

On the spending side, social measures will carry the big load of additional spending. The heavy hitter is **the increase of public sector wages**, which are going to cost CZK 8.2bn for teachers (their wages will rise by 10%) and CZK 5bn for everyone else (a lump sum increase of CZK 1,500/month). The finance ministry projects an average increase of wages in the public sector by 6.6%, but these increase those for people in education, where even non-teaching staff will get a 10% raise, as the government will remove the lowest pay grade for civil servants. The other big measure is **the 36% hike of parental allowance**, which is going to cost CZK 8.6bn. We remind that parental allowance is a lump sum in the Czech Republic, which can be used for a period up to 4 years. Finally, **pensions will increase by a lump sum of CZK 900/month**, a measure that is going to cost CZK 5.4bn. This impact is somewhat arguable, because pensions would increase anyway, though by a lesser amount, but we assume that the figure given by the labour ministry incorporates most of the bigger hike.

We didn't really explore the change in maintenance spending, mostly because it won't increase that much (by 4.2% in 2020, compared to 3.9% in 2019). Some of the increase is the result of political bargaining, but its overall impact turns out to be much smaller than implied during the 2020 budget talks between ANO and the CSSD.

Table 3. Fiscal policy impact (major effects only)

Item	CZK bn	Reason
VAT	16.2	Longer VAT reimbursement period - from 30 to 45 days (cash effect only in 2020)
VAT	-2.8	Moving certain services (heating, water & sewerage, catering) to super reduced rate (10%)
VAT	1.1	Third and fourth stage of electronic registration of sales (EET) system
Excise tax	8.6	10% hike of taxes on tobacco (CZK 7.7bn) and 13% hike of taxes on alcohol (CZK 0.9bn)
Corporate income tax	3.8	Removal of tax break on technical provisions under Insurance Act
Capital gains tax	-1.2	Tax break on dividends paid by government-owned companies
Digital sales tax	2.1	New tax on online advertising revenue, at 7%, levied on firms with annual revenue above EUR 750mn
Parental allowance	-8.6	Increase of allowance by 36%
Teachers' wages	-8.2	Increase by 10%
Civil servants' wages, excl. teachers	-5	A lump sum increase by CZK 1,500/month to base wages
Pensions	-5.4	Increase by CZK 900/month. Effect is overestimated, as pensions would still increase, though by less

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Note: Only changes not related to economic cycle

Source: Ministry of Finance

Central government budget

As in previous years, the central government budget puts an emphasis on social spending. On the revenue side, social contribution collection is going to remain the primary revenue source, which we believe is accurate, given low unemployment and robust wage growth. The finance ministry has put higher absorption of EU funding, which we see as relatively realistic, given that issues with operational programmes are gradually being removed (though not fast enough). We believe personal income tax revenue is underestimated, as it has been the case in 2018 and 2019. Finally, VAT and excise tax revenue will receive a major bump, but the VAT collection improvement will be only temporary, due to slower reimbursement on the government's side. We see some downside risks for excise tax collection, as there are independent reviews worrying that contraband of tobacco products may increase due to the higher tax rate.

Spending structure is not set to change a lot from this year, as social expenses and transfers will still represent 73% of total spending. Non-discretionary expenses will increase by 7%, which is a slower rate than the planned rise in headline spending (at 7.5%). Capital expenses will continue to grow at a fast pace, up by 19.5%, though the big spike was this year, when capital spending is planned to rise by 35%. The big increase in transfers is mostly due to central government policies, like the teacher wage hike (which is contained in the transfers' increase), as well as the pension hike (which is included in transfers to the state pension fund). On a positive note, there will be once again interest savings next year, even if only at CZK 2.7bn (interest expenses will fall by 5.8%). We see some room for additional savings here, as we believe the finance ministry is conservative in its interest rate forecast.

On the finance side, the shift towards long-term domestic borrowing will continue next year, as the bulk of financing needs will be covered through domestic debt issuance. It means that the odds for new Eurobonds are low, though if borrowing terms are favourable, the finance ministry could take advantage. Generally, there will be a retreat from short-term borrowing, with a planned net decrease in short-term debt in 2020.

Table 4. Central government budget, CZK bn

	2019	2020	Change	% y/y
REVENUES	**1,465.30**	**1,578.10**	**112.8**	**7.70%**
Tax revenues	1,325.30	1,405.00	79.7	6.00%
Taxes, o/w:	768.9	818.6	49.7	6.50%
VAT	297.9	319.7	21.8	7.30%
Excise tax	155.3	165.7	10.4	6.70%
Corporate income tax	124.4	127.6	3.2	2.60%
Personal income tax	146.2	155.1	8.9	6.10%
Social security contributions	556.4	586.4	30	5.40%
Non-tax and capital revenues, transfers	140	173.1	33.1	23.60%
o/w: EU funds and financial programmes	92.5	110.1	17.7	19.10%
EXPENDITURE	**1,505.30**	**1,618.10**	**112.8**	**7.50%**
Current expenses	1,383.00	1,471.90	88.9	6.40%
Social expenditure	601.9	651.7	49.8	8.30%
Personnel	142.4	149.3	6.9	4.80%
Interest	46.5	43.8	-2.7	-5.80%
Other non-investment expenses	95.2	99.2	4	4.20%
Transfers	497	527.9	30.9	6.20%

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Capital expenses	122.3	146.2	23.9	19.50%
Memo				
Non-discretionary expenses	825	883.1	58.1	7.00%
Transfers to EU and financial programmes	93.9	111.5	17.6	18.70%
BALANCE	**-40**	**-40**	**0**	**0.00%**
w/o EU and financial programmes	-40	-40	0	0.00%
FINANCING	**40**	**40**	**0**	**0.00%**
Domestic	44.6	40.6	-4	-8.90%
short-term	25	-2.6	-27.7	n/m
long-term	19.6	43.3	23.7	121.20%
Foreign	-4.6	-0.6	4	-86.30%
short-term	-39	-13.9	25.1	-64.30%
long-term	34.4	13.3	-21.1	-61.40%

Source: Ministry of Finance

EU-related flows

Planning remains cautious, as the finance ministry is being conservative about the capacity of EU funds' absorption next year. We included a revised estimate for 2019, based on absorption until the end of July and projection until the end of the year, which shows that the initial estimates in the 2019 budget law on EU funding may be exceeded by close to 50%. We believe the same can happen in 2020, given that EU funds' absorption this year has been nothing spectacular. Still, given the big issues with EU programmes in 2018, it is a vast improvement. We should point out that this won't necessarily mean a big increase in national co-financing, only in funding received from the EU budget.

We should also note that there will be no longer a strong base effect as this year, since EU funds' absorption is expected to be at a similar rate. Low absorption in 2018 led to visibly lower co-financing, thus saving a lot of planned spending. About 60% of this year's deterioration in the state government budget comes from more EU-funded projects being approved, but this won't repeat in 2020.

Table 5. EU and other financial programmes, CZK bn

	2019 plan			**2019 projection***			**2020 plan**		
	Co-financing	EU	Total	Co-financing	EU	Total	Co-financing	EU	Total
Operational programmes, 2014-2020	4.9	59.4	64.3	6.1	100.4	106.5	4.4	76	80.4
CAP, 2014-2020	5.7	31.4	37.2	6.7	31.3	38	5.6	30.8	36.3
Other programmes, 2007-2020	0.2	1.4	1.5	0.2	0.8	1	0.2	0.3	0.5
EU	**10.8**	**92.2**	**103**	**12.9**	**132.6**	**145.5**	**10.1**	**107.1**	**117.2**
Financial programmes	0.1	0.3	0.4	0	0	0	0.2	0.6	0.7
Total	**10.9**	**92.5**	**103.3**	**12.9**	**132.6**	**145.5**	**10.3**	**107.6**	**117.9**

Note: * Based on absorption in January-July

Source: Ministry of Finance

Conclusion

The 2020 budget has fewer risks than we originally expected, but it doesn't mean risks are non-existent. The biggest threat is external developments, as a faster slowdown of activity in the euro area will inevitably have an impact on the domestic economy and on fiscal performance. There are downside risks about excise taxes, as they

might not bring the desired revenue, and possibly some upside risks on the spending side, primarily related to the wage bill. We consider the latter not very big, however, as the wage bill itself doesn't have such a big impact.

We are more optimistic about the general government budget, as even if external demand falls sharply, we believe there will be a certain lag in the domestic labour market responding. Our argument is that there are already acute labour shortages, so initially there will be less stress on the labour market, rather than explosion of unemployment. In turn, it will provide some safety cushion for budget revenue, even if tax collection falls short of targets. Besides, we expect better fiscal discipline at local government level, which will be helped by generous transfers from the central government.

Therefore, we allow for some deterioration in the general government balance, but we expect that it will still end the year with a small surplus, in the vicinity of 0.1-0.2% of GDP. In any scenario outside a new global crisis, we expect there will be a primary surplus at general government level and a continued reduction of government debt.

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