Convergence Programme
Czech Republic

November 2008

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Introduction

As a part of the European Union's multilateral fiscal surveillance and economic policy coordination process, the Czech Republic hereby submits updated Convergence Programme (the "CP").

General government finances during 2007 turned out better than expected: the government balance reached -1.0% of GDP, which represents an improvement of 1.7 percentage points year on year. In 2008 an excessive deficit procedure has been abrogated with the Czech Republic, when the ECOFIN Council stated that the ratio of its general government deficit had been reduced to below the 3% GDP reference value in a credible and sustainable way. The Czech government, nevertheless, is determined not only to maintain deficits well below 3% of GDP, but also to strive for their further reduction. At the same time, it will continue with additional reforms directed to the long-term sustainability of public finances, particularly in the health care and pension systems.

The success of this goal, however, is encumbered by substantial risks. Although the macroeconomic scenario, on the basis of which the CP is created, is— just like in previous years both realistic and conservative— the effects of the financial markets crisis on the global and Czech economies cannot, for the time being, be estimated with much certainty. Under the current state of knowledge (the CP was prepared on the basis of data available as of 1 October), real GDP growth is expected to slow to 4.4% in 2008 and to 3.7% in 2009. After overcoming the consequences of the global crisis, economic growth should accelerate to a rate of 5.2% in 2011.

From the viewpoint of public finances structure, the share of indirect taxes in GDP will continue to increase, while that of direct taxes will continue to fall. The main factor is the increase in the reduced VAT rate from 5% to 9% with effect from 1 January 2008. At the same time, the share of general government expenditures in GDP is decreasing, particularly due to saving measures in the social sphere and moderate growth in government expenditures.

The greatest risk to the long-term sustainability of public finances is expected demographic development, since according to projections the ratio between the number of persons of retirement age and the economically active population should increase in coming years. The government is prepared to confront this problem by pursuing further the already initiated reform of the pension system. Continuing reforms in health care system also should benefit the long-term sustainability of public finances.

The programme was sent to the Czech Parliament for information. The relevant committees pay greater attention to the CP every year and are regularly informed about the assessment of the programme by the European Commission and the ECOFIN Council. They have also been informed about the course and abrogation of the excessive deficit procedure.

The programme was prepared on the basis of Council Regulation (EC) No. 1055/2005, amending Council Regulation (EC) No. 1466/97 on strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies. Moreover, the CP follows principles of the Guidelines on the format and content of Stability and Convergence Programmes adopted by ECOFIN Council on 11 October 2005. The programme is available also on the Ministry of Finance's website: http://www.mfcr.cz.

1 Economic Policy

1.1 Fiscal Policy

Improving the structural parameters of public finances and reducing further the general government deficit continues to be an important priority for the upcoming period. Achieving this target, however, will be complicated by the expected slowdown in the Czech Republic's economic growth, which is related in particular to the cooling of the European and world economies and the crisis in the financial markets. At the same time, the government is committed to continue with reforms that will ensure the long-term sustainability of public finances.

The primary objectives of the government in the fiscal area are:

- Complying with the approved expenditure limits, which should result in achieving a general government deficit of 1.6% in 2009 and 1.5% in 2010. A new fiscal target of -1.2% was approved for 2011, along with its corresponding expenditure limit.
- Lowering tax burden and limiting administrative burden and tax distortion by simplifying the tax system.
- Reducing dynamics of government expenditures in proportion to nominal GDP growth and increasing their effectiveness.
- Continuing to reform the pension and health care systems.

Measures towards reducing the deficit are focused, in particular, on savings on the expenditure side of public budgets, especially in the area of mandatory expenditures, the reduction of which was made possible by the adoption of stabilising measures in 2007. These steps will further increase the effectiveness of the social system and strengthen motivation with respect to economic activity.

On the revenue side, tax burden will be gradually lowered and tax system will be simplified. Reduced personal and corporate taxation along with transparent and business-friendly tax administration are the main factors supporting economic growth. In coming years, growth in tax revenues will decelerate due to a cooling of the Czech economy.

A precondition for successful fiscal consolidation is a thorough implementation of the fiscal targeting regime and upholding the approved medium-term expenditure frameworks.

Reducing the general government structural deficit to 1% of GDP by 2012 continues to be a medium-term budgetary objective.

With regard to the negative fiscal impact of an ageing population, the government is committed to continue with the reforms of the pension and health care systems that were initiated in 2007.

1.2 Monetary Policy

The Czech National Bank (CNB) will continue to conduct monetary policy via the inflation-targeting regime. The inflation target valid since January 2006 is set for annual CPI inflation at a level of 3% with a maximum deviation of one percentage point in either direction. In March 2007, the CNB announced a new inflation target of 2% for annual CPI inflation (with a tolerance band of ± one percentage point), effective from January 2010. In addition, the CNB announced that it would allow a gradual reduction in inflation to the level of the new inflation target far enough in advance so that inflation would be close to the target by the time the targets is effective.

The reduction in the inflation target reflects, in particular, longer-term perspective for inflation targeting in the Czech Republic due to postponing the euro adoption date beyond the originally envisaged horizon of 2010 (see below) and current low-inflationary environment of the Czech economy, exhibited in inflation expectations anchored at low levels. Lower inflation in the Czech Republic in line with the new target further increases the chances of meeting the Maastricht price stability criterion in the future. The CNB continues to view its inflation targets as medium-term in nature, and real inflation may temporarily deviate from them as a result of exogenous shocks. Changes to indirect taxes are one such shock. Monetary policy does not react to first-round effects of such changes and concentrates only on their second-round effects.

The Czech Republic's original Strategy for Eurozone Accession has not been fulfilled, and the originally envisaged date for euro adoption in the Czech Republic of 2009/2010 is no longer realistic. The Czech Republic's Updated Strategy for Eurozone Accession, approved by the Czech government in August 2007, states that the main obstacle to meeting the Maastricht criteria is still the unconsolidated state of public finances. This, along with the low flexibility of the Czech economy, and especially of the labour market, is also a risk to Czech economic performance in the Eurozone and prevents it from reaping the benefits associated with adopting the euro. The euro adoption date will, therefore, be linked to resolving these problematic areas with a fundamental public finance reform and strengthening the flexibility of the Czech economy. In this respect, ERM II entry is still viewed as only a necessary condition for adopting the euro, and hence, the amount of time spent in ERM II should be kept at a minimum. A periodic document "Assessment of the Fulfilment of the Maastricht Convergence Criteria and the Degree of Economic Alignment of the Czech Republic with the Eurozone", jointly prepared by the Ministry of Finance and the CNB and approved by the government at the end of 2007, stated that, to date, insufficient progress had been made toward creating the conditions necessary for adopting the euro to be able to assign a target date for accession to the Eurozone. It recommended that the Czech Republic, for the time being, should not set a target date for accession to the Eurozone. This also implies the recommendation that it should not strive for entry to the ERM II mechanism in 2008.

With the expected waning of inflation pressures associated with the subsidence of one-off expenditure shocks dating from the turn of 2007 to 2008, the economic decline from the peak in the economic cycle, and the impacts of this year's accelerated strengthening in the CZK exchange rate, interest rates can be expected to fall in the very near future and remain roughly stable thereafter.

1.3 Structural Policies

A detailed outline of the priorities and approved measures in the area of structural policies is presented in the Czech Republic's National Reform Programme 2008–2010, which was approved by the government in October 2008. In this section, therefore, we present only a selection of some of the measures.

In March 2008, the government commenced its reform of the research, development and innovation system. The objective of the complete package of measures is to simplify administration, improve the quality of the system, and increase the benefits of research, development and innovation for the Czech economy. Public financial resources for research and development are being gradually increased such that they will represent 1% of GDP by 2010.

Currently under preparation, the "White Book of Tertiary Education" will provide the foundation for tertiary educational system reform. The concept of the reform consists in the elimination of obstacles to access to tertiary education, changes in the structure of the tertiary education, and a change in the financing system. The Czech Strategy for Lifelong Learning was already approved by the government in July 2007. The Czech Republic is currently preparing an Implementation Plan for the Strategy, wherein individual proposals will be elaborated into concrete projects.

The government is also actively engaged in improving the quality of the business environment, in particular by reducing the administrative burden. In April 2008, the "Plan to Reduce the Administrative Burden on Businesses by 2010" was approved. This document establishes binding procedures for reducing the burden by 20% over the period 2005–2010. In July 2008, Czech POINT extended its services for entrepreneurs and an amendment to the Trade Licensing Act entered into effect. This has brought about the abolishment of trade licenses and certificates, abolishment of territorial jurisdiction of trade licensing offices, limiting of the notification duty, introduction of a single unregulated licence, and a complete restructuring of trades. Furthermore, act on E-Government was approved. This covers electronic transactions of select public administration authorities and legal entities, as well as of a secure data exchange system, and it introduces into the legal order authorised conversion of documents. The act will become effective as of July 2009. A comprehensive reform of the tax system is currently being prepared.

Reducing the energy and material demands of the Czech economy is important for increasing its competitiveness and protecting the environment. Starting in January 2008, the Czech Republic launched the first phase of its ecological tax reform by implementing Directive 2003/96/ES. The aim is to shift taxation away from labour and towards products and services, production or consumption of which have negative impacts on the environment while maintaining the principle of revenue neutrality. The Czech Republic also supports renewable sources of energy and the use of combined electricity and heat production by means of redemption prices and contributions toward the price of electricity.

The Schedule for the Construction of Transport Infrastructure 2008–2013 is an initial document for the further expansion of transportation infrastructure, which was approved by the Czech government in September 2007. The main priority is to complete the backbone network of motorways and railway corridors.

Another priority of the government is a flexible labour market. In January 2009, an amendment to the Employment Act entered into effect that significantly revises assistance and benefits for the unemployed and introduces a “green card” for foreign workers. An amendment to the Labour Code is also currently being prepared.

2 Macroeconomic Scenario

The large dispersion of the potential future development of exogenous parameters is markedly increasing the level of uncertainty for the CP's macroeconomic scenario. Although it was drawn up to be realistic and conservative and with an effort to balance potential positive and negative divergence of economic development, given the current state[1] of knowledge it is not possible to estimate either the gravity of global economic problems or the duration, extent and subsequent impacts of the crisis situation on the Czech economy.

2.1 The World Economy and Technical Assumptions[2]

The world economy is passing through a turbulent period of crisis on financial markets, which is significantly complicating the formulation of actual expectations for future global development. At best, the US economy and a number of European economies will stagnate in 2009. Asian economies, especially those of China and India, will continue to grow markedly.

Economic growth in the EU-27 has been slowing since 2006. Considering the development on financial and equity markets as well as the decline in export dynamics, which significantly drive growth in the EU, the bottom of the economic cycle should clearly be reached during 2009. In the subsequent period, a gradual recovery can be expected. The new member states will likely continue to grow at a faster pace than will the old members.

Although the USD price for oil at present has certainly fallen from record levels above USD 140, it will likely remain at a high level even in coming years. The drop in demand in advanced countries will be compensated particularly by consumption growth in Asian economies, which should limit the possibility of a larger price decline.

Table 2.1: Exogenous assumptions of the scenario

		Year 2007	Year 2008	Year 2009	Year 2010	Year 2011
USD/EUR exchange rate	*(annual average)*	1,37	1,49	1,39	1,35	1,35
CZK/EUR exchange rate	*(annual average)*	27,8	24,9	24,7	24,2	23,7
Government bond yield to maturity 10Y		4,28	4,65	4,43	4,26	4,24
PRIBOR 3M		3,09	3,96	3,76	3,71	3,39
GDP EU27	*(real growth in %)*	2,9	1,4	0,9	1,7	2,0
Oil prices	*(Brent, USD/barrel)*	72,7	113	120	115	115

Source: Eurostat, IMF, Ministry of Finance calculations.

The risk to this scenario is the possibility for further deepening of the financial markets crisis, which would lead to a prolonged recession in the US as well as EU economies.

A technical assumption for a stable 1.35 USD/EUR exchange rate from 2010 was chosen. The CZK/EUR exchange rate should appreciate gradually and moderately to 23.50 CZK/EUR in

[1] The CP was prepared on the basis of data available as of 1 October 2008. The development on world financial and commodities markets after that date is not taken into consideration.
[2] For technical reasons, it was not possible to use "common assumptions on the external environment" in preparing the CP. The European Commission forecast from spring, 2008 was, for obvious reasons, already outdated and the definitive assumptions of the autumn forecast were not yet known at the time of preparing the macroeconomic scenario (the start of October 2008). Therefore, the CP was supplemented by a sensitivity analysis for certain macroeconomic indicators based on the exogenous variables in Section 4.

2011, which is consistent with the lead in productivity growth over the Eurozone countries. The assumptions on short-term interest rates were chosen to be consistent with meeting the CNB's inflation target.

2.2 Current Macroeconomic Development

During 2005 to 2007, the Czech economy went through a period of rapid GDP growth, averaging 6.6% annually. A slowing occurred in H1 2008, as expected, and that to 4.9%. Whereas the main source of economic growth in 2006 and 2007 was domestic demand driven by households spending on final consumption and by gross capital formation, the main factor in H1 2008 was foreign trade with a contribution of 3.1 percentage points. In contrast, domestic demand slowed, and that was due to both the effect of decelerating household consumption and the considerable decline in the growth dynamics of gross fixed capital formation. The potential GDP growth rate was 5.2% in H1, driven especially by the high contribution from total factor productivity. The positive output gap, which reached its peak in Q4 2007, is beginning to close and amounted to ca 1.6% in H1.

Chart 2.1: Real GDP
y-o-y growth in %

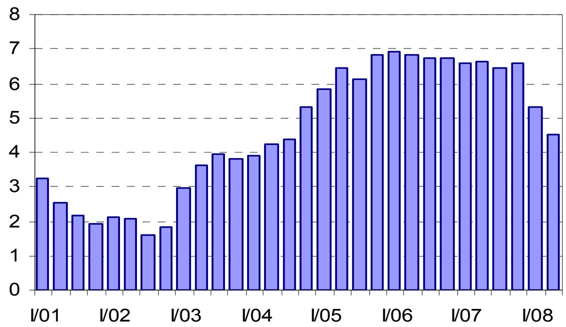
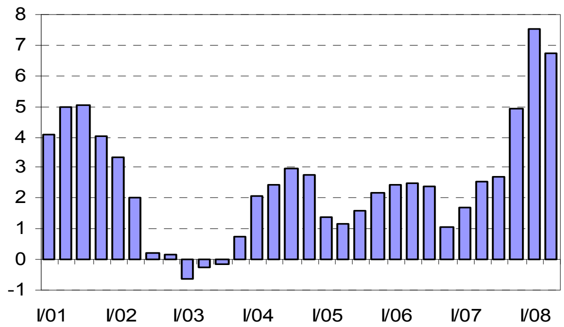


Chart 2.2: Inflation rate (HICP)
y-o-y growth in %



Source: Czech Statistical Office.

The low-inflationary environment that had been typical for the Czech economy in the years of high economic growth receded in Q4 2007. The average inflation rate reached 7.5% and 6.7% (on an HICP basis) in Q1 and Q2, respectively. The main factors behind the high price dynamics are administrative measures, which contributed to year-on-year inflation growth during H1 2008 by more than half, and the high prices of energy and food on world markets.

Due to improvement in the structural characteristics of the labour market and the impact of the cyclical development in the Czech economy, employment has been increasing since Q3 2004 (SNA basis). In Q2 2008, growth in the employment rate reached 1.7%. The positive development on the labour market has also been seen in a drop in the unemployment rate. Since Q1 2004, when the unemployment rate (according to the Labour Force Survey) reached 8.7%, its value has gradually fallen to 4.2% in Q2 2008.

The external economic imbalance, expressed by the current account balance as a proportion of GDP, has been within a sustainable range. In Q2 2008, the current account deficit amounted to 2.5% of GDP. The Czech economy's foreign indebtedness is connected with the high investment activity, which, however, is not reflected in adequate domestic savings. The foreign indebtedness is evident in the deficit income balance in the form of high outflow of wages, interest expenditures, and repatriated or reinvested profits. The negative income balance exceeds the otherwise positive balance of goods and services, which, in contrast, points to the solid performance of foreign trade.

Chart 2.3: Employment (SNA basis)
y-o-y growth in %

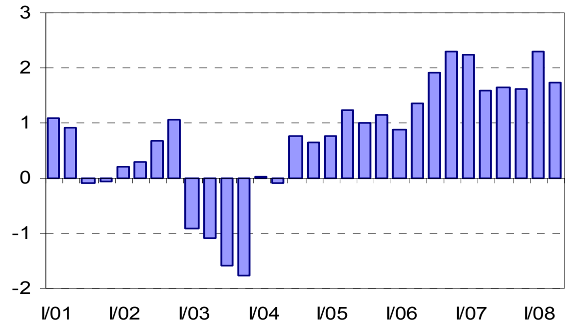
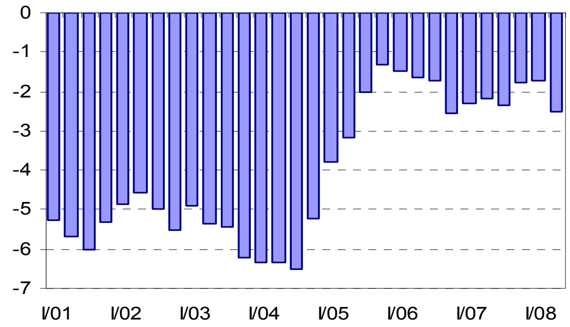


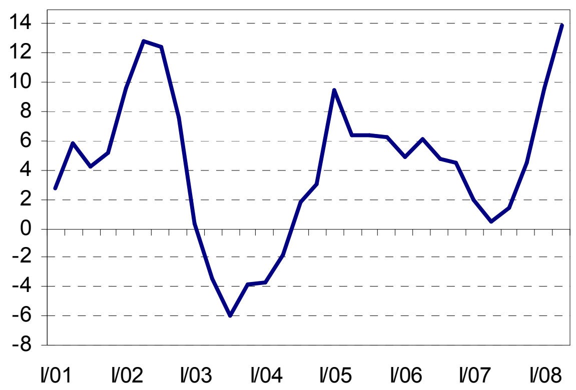
Chart 2.4: Current account/GDP
in %



Source: Czech Statistical Office, Czech National Bank.

As measured by its actual performance and average price level, the Czech economy in the long term will draw near the EU average. A phenomenon associated with this process is the long-term strengthening of the CZK/EUR exchange rate. However, the currency's intense strengthening in H1 2008, which in Q2 reached 13.9% against the euro, did not match the trend. On one hand, the rate appreciation had a positive effect in the form of limiting the projection of rising world energy and food prices into the domestic price level, while, on the other hand, it significantly contributed to the worsening terms of trade. Thus, a solid actual contribution of foreign trade to GDP growth was achieved in H1 at the expense of worsening income conditions. This fact was reflected in the development of the real gross domestic income indicator, the growth of which was considerably lower than the GDP dynamics.

Chart 2.5: CZK/EUR exchange rate
y-o-y appreciation in %



Source: Czech Statistical Office.

One factor behind the intense strengthening of the Czech koruna in H1 2008 could be the shift of available liquidity away from American assets due to the financial crisis in the US. This also can be regarded as the only indirect effect of the continuing financial crisis recorded so far on the Czech economy. In future, we expect further indirect impact on the real economy through lower dynamics of foreign trade in connection with slowing of the world economy.

Direct impacts from unprofitable financial investments abroad and indirect impacts from the banking sphere are expected, but only in a very limited extent.

2.3 The Medium-Term Scenario

Potential GDP and the position within the economic cycle

The current economic growth results from growth in the structural component of GDP with a simultaneous decline in its cyclical component.[3] Increasing economic potential is driven by a high level of addition to total factor productivity.

Chart 2.6: Output gap
in % of potential GDP

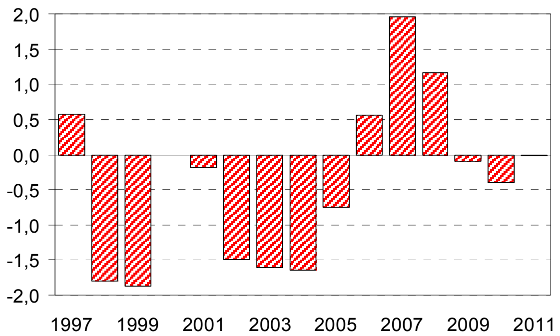
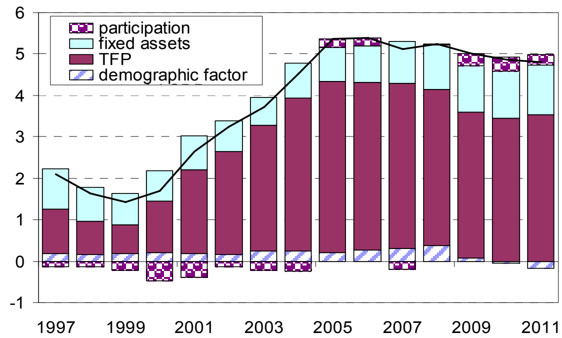


Chart 2.7: Potential GDP growth
contribution to growth in percentage points



Source: Ministry of Finance calculations.

The CP scenario is founded on the assumption that the potential growth rate will be around 5% and with a slight tendency towards deceleration. Total factor productivity will continue to contribute most significantly to its growth, and for the overall period its contribution will be above 3.5 percentage points. The continuing integration into the EU economic structures remains a growth factor. Also significant is the introduction of new technology related to the inflow of foreign direct investment. Total productivity growth also results from the improvement in the economy's institutional parameters and the quality of the business environment.

The contribution of growth in capital stock will be above one percentage point and will, therefore, reflect the high level of investment in the Czech economy. On the contrary, the positive contribution of an increase in the number of persons in their productive years will be gradually reversed. The impact of the participation rate should again become positive due to increased work motivation as a result of structural measures.

We assume that macroeconomic policies will be set in such a way that economic performance will be at the same level as potential GDP by the end of the period.

[3] Calculations of potential GDP and the output gap are currently made using the national methodology, likewise based on the Cobb-Douglas production function. The methodology was described in the 2002 Pre-Accession Economic Programme. The main distinction from the European Commission's method, important for interpreting the results, is the use of the "zero sum of output gaps over time" stipulation.

GDP and the demand side

After the effects of the global crisis have passed, real GDP growth should accelerate to 5.2% by 2011. Domestic demand's contribution to growth (without the change in inventories) should increase from 3.0 percentage points in 2009 to 3.7 percentage points in 2011.

The growth trajectory for potential GDP implies that the process of economic convergence with the neighbouring advanced EU countries will continue. The Czech Republic's economic level (GDP per capita at purchasing power parity) in comparison with the EU-27 will increase by about 8 percentage points against 2007 to ca 90% in 2011.

Chart 2.8: Decomposition of GDP growth
contribution to growth in percentage points

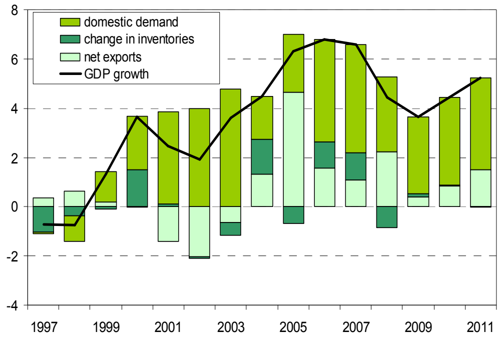
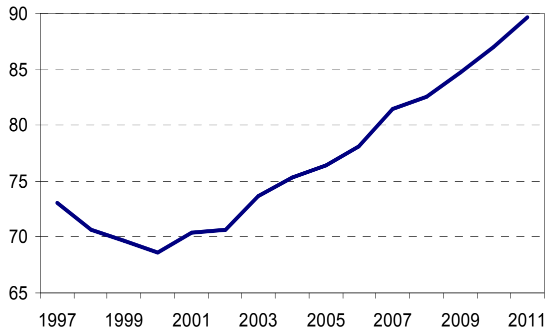


Chart 2.9: GDP per capita
calculated in purchasing power parity, EU-27 = 100



Source: Czech Statistical Office – quarterly national accounts, Eurostat, Ministry of Finance calculations.

Household consumption growth should fall behind the growth rate for economic output, with the exception of 2009 when it should positively reflect disinflation. The increasing risks and debt burden of households will reduce the growth rate in final consumption spending.

Government consumption in future should be flat in real terms. Government institutions are expected to behave thriftily with respect to employment in the general government sector as well as in procuring goods and services. The development of expenditures will be slightly affected by the costs associated with the Czech Republic's EU presidency in 2009.

Table 2.2: Economic growth
CZK billion, increase in %

	ESA code	Year 2007 level[1])	Year 2007 rate of change	Year 2008 rate of change	Year 2009 rate of change	Year 2010 rate of change	Year 2011 rate of change
Real GDP	**B1*g**	3427	6,6	4,4	3,7	4,4	5,2
Nominal GDP	**B1*g**	3551	10,4	6,9	5,8	7,4	7,7
Components of real GDP							
Private consumption expenditure	**P.3**	1660	5,9	3,3	3,9	4,2	4,2
Government consumption expenditure	**P.3**	688	0,5	1,1	0,5	0,0	0,0
Gross fixed capital formation	**P.51**	838	5,8	5,1	4,5	6,2	7,0
Changes in inventories and net acquisition of valuables[2])	**P.52+P.53**	96	2,7	1,6	1,9	1,7	1,7
Exports of goods and services	**P.6**	2822	14,6	11,6	7,1	9,3	10,7
Imports of goods and services	**P.7**	2676	13,8	9,3	7,1	8,8	9,7
Contribution to real GDP growth							
Final domestic demand			4,4	3,0	3,1	3,6	3,7
Change in inventories and net acquisition of valuables	**P.52+P.53**		1,1	-0,9	0,2	0,0	0,0
External balance of goods and services	**B.11**		1,1	2,2	0,4	0,9	1,5

1) Levels 2007 are stated in prices from the previous year.
2) This item expresses change in inventories as a percent of GDP in current prices.

Source: Czech Statistical Office – quarterly national accounts, Ministry of Finance calculations.

Following a temporary slowing of investment activities in 2009, the dynamics should be renewed. We expect a positive impact due to a higher drawdown of resources from the structural funds and the Cohesion Fund that will be channelled into infrastructure investment by way of co-financed public budgets. Resurgence in the inflow of foreign direct investment also can be expected. The tax reform measures should also stimulate the investment processes, and new capacities are expected to continue to be primarily export oriented.

The contribution of the trade balance for goods and services in constant prices to GDP growth has been positive since 2004. We anticipate a figure of 2.2 percentage points for 2008. After the global financial crisis subsides and foreign demand is restored, and along with the start-up of new capacities, another increase in the contribution of foreign trade to 1.5 percentage points can be expected during a rapid increase in foreign trade turnover’s share in GDP.

Prices

The long-term low-inflationary character of the Czech economy (with the exception of 2008) should be preserved in future years, as well. The positive influence of the inflation-targeting regime, which guides the inflation expectations of economic agents, and the high level of competition on the internal market have contributed to this development. Other anti-inflationary factors include the appreciation of the Czech koruna and smooth non-inflationary growth of unit labour costs.

Table 2.3: Prices of goods and services

	Rok 2007	Rok 2008	Rok 2009	Rok 2010	Rok 2011
Procentní změna					
HICP	3,0	6,4	2,9	3,0	2,5
Deflátor HDP	3,6	2,4	2,1	2,9	2,4
Deflátor spotřeby domácností	2,8	5,8	2,5	2,8	2,2

Source: Czech Statistical Office – price statistics and quarterly national accounts, Ministry of Finance calculations.

The increase in the average inflation rate as measured by HICP to about 6.4% in 2008 is a transient, one-time occurrence. This was caused by the combination of increasing global fuel and food prices and the large contribution of administrative measures (around 4.0 percentage points). The latter included increases in the reduced VAT rate, in excise taxes on tobacco products, and in regulated rent and energy prices.

In coming years, we expect inflation expectations to gradually approach the CNB's new inflation target (national CPI of 2% with a 1 point tolerance band) effective from 2010. This creates conditions for meeting the inflation convergence criterion.

Chart 2.10: HICP

y-o-y growth in %

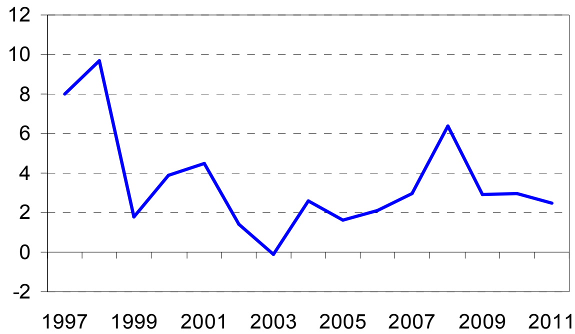
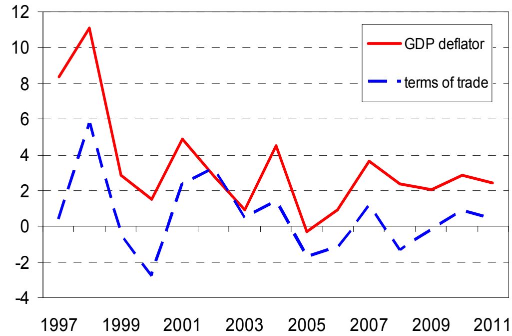


Chart 2.11: GDP deflator and terms of trade

y-o-y change in %



Source: Czech Statistical Office – price statistics and quarterly national accounts, Ministry of Finance calculations.

During the forecast time horizon, growth of the implicit GDP deflator should stabilise slightly above 2.5%, close to HICP growth.

The labour market and wages

The development of labour market indicators primarily results from the favourable position in the economic cycle. Certain structural problems still persist, however, and these are reflected especially in regional disparities. The reasons behind this development are low professional and regional mobility, the persisting lack of motivation for low-income groups actively to seek work, and the rigidity of labour contracts concluded for indefinite periods. Problems on the labour market are indicated also in the high number of job vacancies.

Table 2.4: Employment and wages

	Year 2007	Year 2008	Year 2009	Year 2010	Year 2011
Percentage changes					
Employment (ESA 95)	1,8	1,7	0,7	0,3	0,3
Compensation of employees	9,1	9,1	8,0	6,9	7,5
Compensation per employee [1]	7,1	7,3	7,3	6,7	7,3
Unit labour costs [2]	2,2	4,5	4,3	2,4	2,3
in %					
Unemployment rate ILO	5,3	4,4	4,4	4,6	4,7
Employment rate [3]	66,1	66,6	67,1	67,3	67,7
Activity rate [4]	69,9	69,8	70,3	70,6	71,2

[1] Compensation per employee (a Czech concept) according to the national accounts.
[2] Ratio of nominal compensation per employee and labour productivity growth to real GDP.
[3] Share of 15-to-64-year-old employment to population of the same age, according to the Labour Force Survey.
[4] Share of 15-to-64-year-old labour force to population of the same age, according to the Labour Force Survey.

Source: Czech Statistical Office – employment statistics and quarterly national accounts, Ministry of Finance calculations.

The demand side of the labour market will continue to be effected by relatively strong economic growth in the scenario period. Further reduction of the tax burden on labour and changes in the area of benefits for the unemployed and for those who have dropped out of the labour force, which should further strengthen motivation and prevent abuse of the system, will have a positive impact on the demand side as well as the supply side.

Chart 2.12: Employment, participation rates
in %

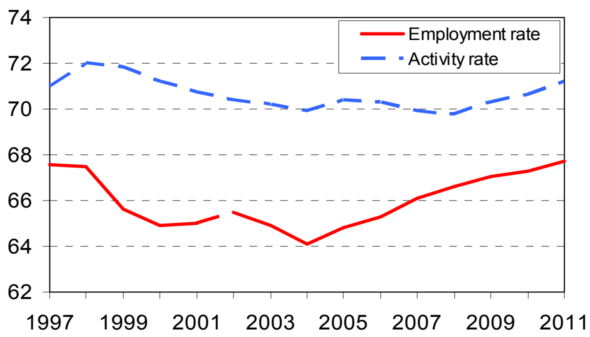
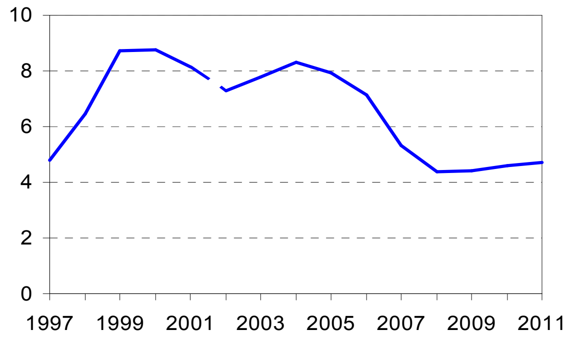


Chart 2.13: Unemployment rate
in %



Note: The employment and unemployment rates from the Labour Force Survey are not comparable between 2001 and 2002 due to changes in methodology.

Source: Czech Statistical Office – employment statistics, Ministry of Finance calculations.

We anticipate a modest rise in employment in the future, due mainly to the integration of persons outside the labour force and of foreigners. The unemployment rate should increase slightly towards its structural level, from 4.4% in 2008 to 4.7% in 2011.

The growth rate in the dynamics of employees’ compensation strengthened at the beginning of 2008, which should only have been a one-off event linked to the tax-optimisation shifts between 2007 and 2008. In future years, we expect a slowing in the growth of unit labour costs given the accelerating increase in labour productivity while there will be approximately constant growth in unit compensation of employees.

2.4 Net Lending/Borrowing and Sectoral Balances[4]

The process of gradual improvement in the net lending balance should continue despite the unfavourable effects from the external environment. After a deficit of –6.3% of GDP in 2003, the balance is currently around –1.0% of GDP, and it could achieve a surplus in 2010 for the first time in the history of the Czech Republic.

The increasing trend of the surplus in the non-fuel component of the goods balance should be halted in 2009 by the effect of limiting external demand. In future years, the surplus should again steadily rise thanks to better export performance and an improvement in the competitiveness of domestic producers. In the fuel component of the balance, the declining koruna prices of mineral fuels should have a positive effect after 2009. As for the services balance, we expect a slightly increasing surplus as a share of GDP.

Table 2.5: Net lending/borrowing

	Year 2007	Year 2008	Year 2009	Year 2010	Year 2011
% of GDP					
Balance of goods and services	5,0	5,4	5,4	6,7	8,1
- mineral fuels (SITC 3)	-3,5	-4,4	-4,9	-4,5	-4,1
- other goods	6,9	7,8	8,2	8,8	9,4
- services	1,6	2,0	2,1	2,4	2,8
Balance of primary income and transfers	-6,5	-7,8	-7,5	-8,0	-8,6
- primary income	-6,0	-8,0	-8,3	-8,7	-9,3
- transfers	-0,5	0,2	0,7	0,8	0,7
Capital transfers	0,7	1,3	1,6	1,7	1,6
Net lending/borrowing vis-a-vis ROW (B.9)	-0,8	-1,0	-0,5	0,4	1,2
Net lending/borrowing of the private sector	0,2	0,2	1,1	1,9	2,4
Net lending/borrowing of general government (EDP B.9)	-1,0	-1,2	-1,6	-1,5	-1,2

Source: Czech Statistical Office – annual national accounts, Ministry of Finance calculations.

The most significant negative component in net lending is – and will continue to be – the worsening balance of primary incomes, which reflects the increasing flow of repatriated and reinvested profits from direct investment and compensation of foreign employees. The balance of current and capital transfers will be positively affected by the balance of financial flows from the EU (structural funds, the Cohesion Fund, and resources supporting agriculture and regional development).

2.5 The Growth Implications of Structural Reforms

The CP implicitly contains the calculated effects of the reform measures approved in accordance with the National Reform Programme. These measures should contribute to an increase in the Czech economy’s potential growth in the medium-term horizon.

[4] In accordance with the rules of the “Code of Conduct”, this section is prepared using the national accounts methodology. Based on the relationship between investments and savings, this allows the complete disaggregation of a surplus or deficit in foreign relations to the individual economic sectors. This differs from the analogous, customarily employed methodology of the balance of payments current account on the one hand in its categorisation of some items and on the other in the fact that it contains additional items (capital transfers; acquisition of non-produced, non-financial assets).

A combination of reform measures will bring positive effects especially to the labour market. Reducing direct taxation and increasing the accountability for social benefits will support the motivation to work. This will be reflected in a turn in the tendency of the economic activity rate, which should thus once again register a positive contribution to potential GDP growth.

3 General Government Deficit and Debt

3.1 Current Development of Public Finances

General government finances ended 2007 with an unexpectedly good result. The general government balance reached -1.0% of GDP, which represents a year-on-year improvement of 1.7 percentage points. This figure is a full 2.4 percentage points better than the assumptions from last year's CP update.

The significant decline in the general government deficit is due to a combination of several positive factors.

- The Czech economy was at the peak of the economic cycle, and additional revenues were used wholly to reduce the deficit.
- The economic results of recent years are influenced by the extensive transfers of unspent budgetary allocations to reserve funds (RF). Contrary to the originally anticipated integration of part of the reserves into expenditures, transfers to RF reached a record level. The volume of funds accumulated in the reserves of state organisational units as of the end of 2007 amounted to 2.7% of GDP and represents resources for additional expenditures in the upcoming years.[5]
- The apparent improvement in the local government balance by 0.9 percentage points of GDP was primarily due to a drop in expenditures for gross fixed capital formation.

The expected increase in social expenditures due to measures accepted in the first half of 2006 was confirmed. The acceleration of social spending, however, was more than offset by not carrying out in particular a large volume of investment expenditures. Thus, the structure of government expenditures recorded an adverse shift.

The economic performance in 2008 is positively affected by the impacts of a set of measures approved in 2007 and aimed at stabilising public finances. These measures are more or less neutral on the side of tax revenues and yield significant savings in social expenditures. The main goal of these measures is to provide for reducing the structural deficit towards the medium-term budgetary objective. Space is created for financing expenditure priorities having positive affects on economic growth and for increasing motivation with respect to economic activity by limiting mandatory (especially social) expenditures.

By contrast, the slowing of economic growth, which is reflected in the smaller increase in revenues particularly from indirect taxes, has a negative effect on government revenues. On the expenditures side, the extraordinary indexation of pensions due to the rise in inflation and the increased drawing of funds accumulated in RF are worsening the economic performance. Transacting with reserve funds remains the greatest uncertainty of the fiscal outlook in both directions. The forecasted outcomes for general government are based on the assumption that similar savings will be achieved as in 2007.

[5] The state of RF, however, does not necessarily in a full amount indicate a potential negative impact on the general government balance in the case of incorporating reserves into expenditures. More than half of the transferred funds represent pre-financing for projects co-financed from EU funds, which will be covered at the time of their implementation by revenues coming from the EU budget.

The general government balance should be around -1.2% of GDP in 2008, which some 1.7 percentage points better than figured in the original fiscal target and the assumption in last year's CP update. The deficit, however, will probably deepen slightly compared to 2007, as the effect of the less favourable economic environment and the impact of integrating part of reserves into expenditures will outweigh savings resulting from stabilisation measures.

3.2 The Medium-Term Fiscal Outlook

The budget for 2009

The state budget for 2009 emerges from the approved expenditure limit, which should ensure achieving a general government budget balance of around -1.6% of GDP.[6] Considering the better-than-expected development of public finances in 2007 and 2008, it can be expected to achieve a deficit that is considerably lower than was planned in last year's CP.

In comparison with the previous year, however, the general government deficit will still deepen. The main causes are the further slowing in economic growth and the expected drawing of reserve funds, which may increase general government expenditures above the budgeted allocation. The higher indexation of certain social benefits (especially pensions) due to high inflation in 2008 was compensated with savings in other areas, given the obligation of adherence of the spending limits.

Risks to the estimate of the general government balance point to a higher deficit, especially in connection with the uncertain development of the external environment. In the event of faster cooling of the economy, which would be reflected in lower budgetary revenues, the government nevertheless expressed its intention to implement additional spending cuts that will ensure achieving the approved state budget deficit. This decision reflects the priority to reduce the general government deficit towards the medium-term budgetary objective and to subsequently enable the full operation of automatic fiscal stabilisers.

Table 3.1: General government balance by sub-sector

% of GDP	ESA code	Year 2007	Year 2008 (1)	Year 2009 (2)	Year 2010 (2)	Year 2011 (2)
Net lending (+)/borrowing (-) (EDP B.9) by sub-sectors						
General government	S.13	-1,0	-1,2	-1,6	-1,5	-1,2
Central government	S.1311	-2,0	-1,6	-1,7	-1,5	-1,2
Local government	S.1313	0,5	0,0	0,0	0,0	0,0
Social security funds	S.1314	0,5	0,3	0,1	0,0	0,0

(1) Notifications (October 2008).
(2) Outlook.

Source: Czech Statistical Office (2007), Ministry of Finance.

[6] The planned balance in 2009 is identical with the draft state budget. The negative impact of the poorer macroeconomic scenario as compared to the draft state budget is more or less offset by revisions to the balance estimate in 2007 from the April estimate of -1.6% to -1.0% of HDP in the October notifications.

Outlook for 2010 and 2011

According to current estimates, the approved expenditure limit for 2010 should lead to achieving a general government balance of around -1.5% of GDP. In 2011, an improvement in the balance to -1.2% of GDP can be expected. While the dynamics of government expenditures will be roughly stable, tax revenues growth will accelerate due to the ending of the process of reducing tax rates.

The drop in the general government budget balance in 2010 and 2011 should make it possible to achieve the medium-term budgetary objective for the structural balance of -1.0% of GDP by 2012 at latest.

3.3 The Structural Balance and the Fiscal Stance

The Czech economy most likely reached the peak of its economic cycle in 2007. The fiscal scenario until 2011 is based on an assumption of gradually closing the positive output gap and returning the nominal general government balance to its structural level.

The structural balance in 2008 and 2009 should reach an approximately stable level of around -1.5% of GDP. The increase in the nominal deficit in 2009, therefore, should be primarily of a cyclical nature and due to the relatively sharp expected slowing in economic growth.

According to current estimates of tax revenues, compliance with the expenditure frameworks in 2010 and 2011 should imply a slow improvement of the structural balance towards the medium-term budgetary objective.

Table 3.2: Structural balance[(a)]

% of GDP	ESA code	Year 2007	Year 2008 (1)	Year 2009 (2)	Year 2010 (2)	Year 2011 (2)
1. Real GDP growth (%)		6,6	4,4	3,7	4,4	5,2
2. Net lending of general government	EDP B.9	-1,0	-1,2	-1,6	-1,5	-1,2
3. Interest expenditure	EDP D.41	1,1	1,2	1,2	1,1	1,0
4. One-off and other temporary measures		-0,3	-0,1	0,0	0,0	0,0
5. Potential GDP growth (%)		5,1	5,2	5,0	4,8	4,8
Contributions:						
- total factor productivity		4,0	3,8	3,5	3,4	3,5
- labour		0,1	0,4	0,4	0,3	0,1
- capital		1,0	1,1	1,1	1,1	1,2
6. Output gap		2,0	1,2	-0,1	-0,5	-0,1
7. Cyclical budgetary component		0,6	0,3	0,0	-0,1	0,0
8. Cyclically-adjusted balance (2 – 7)		-1,6	-1,6	-1,6	-1,4	-1,2
9. Cyclically-adjusted primary balance (8 + 3)		-0,4	-0,4	-0,4	-0,3	-0,1
10. Structural balance (8 – 4)		-1,3	-1,5	-1,5	-1,4	-1,1

(a) The data in rows 5 to 10 are based on the current estimates of the Ministry of Finance.
(1) Estimate.
(2) Outlook.

Source: Ministry of Finance.

The fiscal policy setting will be practically neutral. Only very limited discretionary effects can be expected on aggregate demand. The inflow of resources from EU funds remains a significant expansive factor. These resources do not in principle have a direct effect on the general government balance, because they represent at one and the same time both government revenue and expense. They do, however, represent extensive additional demand-creating resources.

3.4 Government Debt

In the overall outlook horizon, the general government debt should be lower than that given by the assumptions in last year's CP update. The main factor is the lower need for financing the deficit, which, despite the expected slowing of economic growth, has fallen below the level stabilising the debt-to-GDP ratio. This will result in a drop in the proportion of debt to GDP for the entire period through 2011.

Table 3.3: Government debt by sub-sector

% of GDP	ESA code	Year 2007	Year 2008 (1)	Year 2009 (2)	Year 2010 (2)	Year 2011 (2)
Gross debt by sub-sectors						
General government	S.13	28,9	28,8	27,9	26,8	25,5
Central government	S.1311	26,5	26,5	25,7	24,8	23,7
Local government	S.1313	2,5	2,3	2,2	2,0	1,9
Social security funds	S.1314	0,0	0,0	0,0	0,0	0,0

(1) Notifications (October 2008).
(2) Outlook.

Sources: Czech Statistical Office (2007), Ministry of Finance.

At the same time, privatisation of the company Správa Letiště Praha, s.p. (Prague Airport) is expected in 2009. Cash revenues from this privatisation will further reduce the need for debt financing of the deficit.

The accumulation of currency and deposits made in 2007 positive contribution to the change in debt. A similar development is expected also in 2008. In the upcoming years, however, the use of these funds to finance government expenditures can be expected. This will be reflected in a negative contribution to the change in debt.

Table 3.4: Government debt and related indicators

% of GDP	Year 2007	Year 2008 (1)	Year 2009 (2)	Year 2010 (2)	Year 2011 (2)
Gross debt	28,9	28,8	27,9	26,8	25,5
Change in gross debt ratio	-0,7	-0,1	-0,9	-1,0	-1,3
Contributions to change in gross debt					
Primary balance	-0,2	0,0	0,4	0,4	0,1
Interest expenditure	1,1	1,2	1,2	1,1	1,0
Nominal GDP growth	-2,6	-2,0	-1,6	-1,9	-1,9
Stock-flow adjustment	1,0	0,7	-1,0	-0,6	-0,6
- Difference between cash and accruals	-0,4	-0,2	-0,1	-0,1	0,0
- Net accumulation of financial assets	1,5	1,0	-0,9	-0,6	-0,6
of which: Privatisation proceeds (3)	0,4	0,7	1,9	0,0	0,0
- Valuation effects and other	-0,1	-0,2	0,0	0,0	0,0
p.m. implicit interest rate on debt	3,9	4,2	4,3	4,2	4,1

(1) Notifications (October 2008).
(2) Outlook.
(3) Privatisation alone has no impact on the amount of the debt. However, cash revenues from privatisation are one of the potential sources of non-debt financing for the deficit.

Source: Ministry of Finance.

The outlook does not take into account any heretofore unapproved privatisation transactions. Should some additional privatisation projects take place, and should privatisation revenues be used to finance government expenditures, then the share of government debt in GDP would fall at a faster rate than in the outlook.

3.5 The Budgetary Impact of Major Reforms

General government finances during the CP horizon are influenced by a set of measures aimed at stabilising public finances that were approved in 2007 and, for the most part, became effective as from 1 January 2008. The impacts of these measures were accounted for and enumerated already in last year's CP update. So far, it has not been necessary to revise the impact estimates more significantly. Certain items among the government revenues and expenditures are developing differently from the original assumptions. The differences, however, are not of such an extant that it would be possible to determine with certainty whether this results from an inaccurate impacts estimate or is a distinctly autonomous development owing to higher-than-expected inflation, lower-than-expected economic growth, and other factors.

On the revenues side, new measures in the area of taxes and social contributions were incorporated into the current CP scenario, while on the expenditures side the effect of the decision to carry out an extraordinary adjustment of retirement pensions especially due to the rise in inflation at the turn of 2007 to 2008 was incorporated. The fiscal scenario also includes the effects of measures presented in the National Reform Programme (NPR). Fiscally significant steps are described and quantified in Section 5. The majority of NPR measures, however, are covered within the expenditure limits of the individual ministries, or state funds, and as such do not affect the fiscal scenario.

Table 3.5 summarises the incremental effects[7] of the fiscally important economic policy measures that change the fiscal outlook as compared to last year's CP update.

Table 3.5: Effects of new measures significant for the budget

Main structural reform measures	Categories affected	ESA code		Year 2008	Year 2009	Year 2010	Year 2011
Maintaining the PIT rate at the level of 15% instead of planned decrease to 12.5% in 2009	Current taxes on income and wealth	D.5	CZK bn	-	10,0	-	-
			% of GDP	-	0,2	-	-
Narrowing the CIT base	Current taxes on income and wealth	D.5	CZK bn	-2,2	-0,2	-	-
			% of GDP	-0,1	0,0	-	-
Decrease in the rate of social contributions paid by employees by 1.5 p.p. in 2009	Social contributions	D.61	CZK bn	-	-18,4	-0,7	-1,3
			% of GDP	-	-0,5	0,0	0,0
One-off indexation of pensions	Social benefits in cash	D.62	CZK bn	-6,7	6,7	-	-
			% of GDP	-0,2	0,2	-	-
Total impact on the budgetary balance		EDP B.9	CZK bn	**-8,9**	**-1,9**	**-0,7**	**-1,3**
			% of GDP	**-0,2**	**0,0**	**0,0**	**0,0**

Source: Ministry of Finance.

[7] By contrast, the effects in Section 5 are enumerated in comparison with the no-policy-change scenario and are therefore cumulative.

4 Comparison with the Previous Convergence Programme and Sensitivity Analysis

4.1 Comparison with the Macroeconomic Scenario of the Previous Convergence Programme

The differences between the macroeconomic scenarios of the current programme and last year's programme ensue from the following:

- The exogenous assumptions of the programme sharply changed.
- New observations of macroeconomic phenomena were included.
- In addition to normal corrections, the timetables for the quarterly and yearly national accounts were revised regularly.

Among the assumptions in the programme's scenario, it is assumed that development in EU countries has markedly worsened compared to the previous programme due to shocks on world financial and equity markets. The impact of higher USD prices for oil was partially offset by the weaker USD exchange rate vis-à-vis the EUR and the CZK. Nevertheless, it was noticeably reflected, together with food prices, in the inflation growth.

Table 4.1: Changes in the external assumptions of the scenario

	CP 2007			CP 2008			Difference		
	2007	2008	2009	2007	2008	2009	2007	2008	2009
GDP growth (%)									
USA	2,1	2,5	3,1	2,0	1,6	0,7	-0,1	-0,9	-2,4
EU27	2,7	2,5	2,5	2,9	1,4	0,9	0,2	-1,1	-1,6
Prices of oil									
(USD / barrel)	68	73	67	73	113	120	5	40	53
Exchange rate									
USD / EUR	1,35	1,34	1,34	1,37	1,49	1,39	0,02	0,15	0,05

Source: Ministry of Finance.

As was expected, following the very dynamic growth of 2005–2007, the economy in 2008 has slowed. Unlike in the previous programme's scenario, this slowing is much more perceptible in domestic demand. Household consumption has been affected by unexpectedly high inflation, and uncertainties about future development have clearly begun to be reflected in fixed capital formation. By contrast, nominal and real results in the area of external relations will be unexpectedly good in 2008, despite unfavourable exogenous factors. Furthermore, the employment rate is rising and unemployment declining at a faster pace in comparison to CP 2007.

Economic development in the Czech Republic during 2009 will be affected by the ongoing turbulence on global financial markets and its impact on trading partners' economies. This is also reflected in the differences from the previous CP.

Table 4.2: Change in the indicators of the macroeconomic scenario

	CP 2007			CP 2008			Difference (p.p.)		
	2007	2008	2009	2007	2008	2009	2007	2008	2009
Growth in real terms (in %)									
GDP	5,9	5,0	5,1	6,6	4,4	3,7	0,7	-0,6	-1,4
Households consumption	6,5	4,2	4,6	5,9	3,3	3,9	-0,6	-0,9	-0,7
Government consumption	-0,6	-0,4	-0,3	0,5	1,1	0,5	1,1	1,5	0,8
Gross fixed capital formation	6,0	9,0	7,8	5,8	5,1	4,5	-0,2	-3,9	-3,3
Contribution of domestic demand (pp)	6,0	5,1	4,1	5,5	2,2	3,3	-0,5	-2,9	-0,8
Contribution of foreign trade (pp)	-0,1	-0,1	1,0	1,1	2,2	0,4	1,2	2,3	-0,6
Potential product	5,2	5,5	5,6	5,1	5,2	5,0	-0,1	-0,3	-0,6
Output gap (%)	1,3	0,9	0,4	2,0	1,2	-0,1	0,7	0,3	-0,5
Growth (in %)									
HICP	2,4	3,9	2,3	3,0	6,4	2,9	0,6	2,5	0,6
GDP deflator	3,5	3,1	2,3	3,6	2,4	2,1	0,1	-0,7	-0,2
Employment	1,5	1,1	0,5	1,9	1,7	0,7	0,4	0,6	0,2
Unemployment rate (level in %)	5,5	4,8	4,5	5,3	4,4	4,4	-0,2	-0,4	-0,1
Exchange rate CZK/EUR (level)	28,0	27,4	26,6	27,8	24,9	24,7	-0,2	-2,5	-1,9
Balance of goods and services (in % of GDP)	4,2	4,3	5,2	5,0	5,4	5,4	0,8	1,1	0,2
Net lending/borrowing (in % of GDP)	-2,4	-1,6	-0,4	-0,8	-1,0	-0,5	1,6	0,6	-0,1

Source: Ministry of Finance.

4.2 Comparison with the Fiscal Framework of the Previous Convergence Programme

The fiscal scenarios for last year's and this year's CP updates are compared in Table 4.3. In 2007, the general government balance as well as general government debt achieved markedly more favourable values than expected. This was caused by higher than expected economic growth that was reflected in higher revenues from taxes and social contributions, but also especially by a considerable volume of the budgeted expenditures being put away into reserve funds.

Thanks to the higher level of tax revenues, and provided that the expenditure limits are maintained, the deficits anticipated in the coming years may be markedly lower than those predicted in last year's update. The difference relative to the original plans, however, will be substantially less than that in 2007, especially due to the more dramatic slowdown of economic growth and the anticipated gradual incorporation of reserves into expenditures.

In addition to the expected lower deficits, the approved privatisation of Správa Letiště Praha, s.p. (Prague Airport) in 2009 is reflected in the faster decline in debt as a proportion of GDP. This privatisation should bring additional funds for non-debt financing of the deficit in the coming years.

Table 4.3: Comparison with the previous convergence programme

% of GDP	ESA code	Year 2007	Year 2008 (1)	Year 2009 (2)	Year 2010 (2)	Year 2011 (2)
Real GDP growth (%)						
Previous update		5,9	5,0	5,1	5,3	.
Current update		6,6	4,4	3,7	4,4	5,2
Difference		0,7	-0,6	-1,4	-0,9	.
General government net lending						
Previous update	EDP B.9	-3,4	-2,9	-2,6	-2,3	.
Current update	EDP B.9	-1,0	-1,2	-1,6	-1,5	-1,2
Difference		2,4	1,7	1,0	0,8	.
General government gross debt						
Previous update		30,4	30,3	30,2	30,0	.
Current update		28,9	28,8	27,9	26,8	25,5
Difference		-1,5	-1,5	-2,3	-3,2	.

(1) Forecast, notifications (October 2008).
(2) Outlook.

Source: Ministry of Finance.

4.3 Sensitivity Analysis

The Czech economy is small, open and, to a large extent, dependent upon raw materials. The development of prices for mineral resources usually represents the greatest risk for the domestic economy's development.[8] Therefore, the sensitivity analysis is based on a simulation of oil shock impacts. An unfavourable development of raw material prices, however, does not have a negative impact only on the Czech economy, but it very likely also affects economic development in the EU as a whole.[9] We decided to test the sensitivity of the Czech economy based on various developments of the aforementioned factors and using two scenarios.

The pessimistic scenario is based on simulating impacts of an oil shock, which is defined as a 10% growth in the price of oil against the so-called steady state value (long-term average). The start of the shock is dated at the beginning of 2008.

The optimistic scenario is based on a decline in oil prices by 10% compared to the long-term average. For the sake of simplicity, we assume that the two scenarios are symmetrical.

Simulation results

The settings of the scenarios mentioned above are characterised by the nominal and secondary real impacts on the Czech economy. Due to the assumed gradual passing of the negative oil shock, we can expect an immediate worsening of the external imbalance measured by the balance of payment's current account. Furthermore, CPI inflation will also accelerate temporarily.

[8] For a quantitative analysis of the effects of the aforementioned factors on Czech economic development, the Ministry of Finance is employing a new macroeconomic model as a trial.
[9] For this purpose, the model is supplemented with a very simple model of the EU-15 economy.

The real impact on GDP or its individual components may be relatively complex. As results from the simulations, the growth in the price of oil has negative effects particularly on private consumption and investments. It must also be mentioned that this growth influences the economic performance within the EU, which is reflected in a lower demand for Czech exports. These circumstances contribute to the negative real impact of an oil shock on Czech GDP.

The oil shock in the pessimistic scenario negatively affects government finances due to the lower revenues and moderately faster growth of social expenditures. Less favourable fiscal development in the pessimistic scenario would lead to a share of government debt in GDP some 0.5 percentage points higher than that in the baseline scenario by the end of the period in 2011.

Table 4.4: Basic macroeconomic indicators – baseline scenario

		Year 2007	Year 2008	Year 2009	Year 2010	Year 2011
Gross domestic product	volumes, y/y in %	6,6	4,4	3,7	4,4	5,2
Inflation	y/y in %	3,0	6,4	2,9	3,0	2,5
Unemployment rate[1]	in %	5,3	4,4	4,4	4,6	4,7
Government deficit	in % of GDP	-1,0	-1,2	-1,6	-1,5	-1,2
Gross government debt	in % of GDP	28,9	28,8	27,8	26,8	25,5
Current account	in % of GDP	-1,8	-2,5	-2,3	-1,4	-0,6

Source: Ministry of Finance.

Table 4.5: Basic macroeconomic indicators – optimistic scenario

		Year 2007	Year 2008	Year 2009	Year 2010	Year 2011
Gross domestic product	volumes, y/y in %	6,6	4,6	3,9	4,6	5,3
Consumer price index	y/y in %	3,0	6,2	2,8	2,9	2,5
Unemployment rate	in %	5,3	4,3	4,3	4,5	4,7
Public deficit	in % of GDP	-1,0	-1,2	-1,4	-1,5	-1,2
Gross public debt	in % of GDP	28,9	28,7	27,6	26,5	25,2
Current account	in % of GDP	-1,8	-2,4	-2,1	-1,3	-0,6

Source: Ministry of Finance.

Table 4.6: Basic macroeconomic indicators – pessimistic scenario

		Year 2007	Year 2008	Year 2009	Year 2010	Year 2011
Gross domestic product	volumes, y/y in %	6,6	4,3	3,4	4,3	5,1
Consumer price index	y/y in %	3,0	6,6	3,0	3,1	2,5
Unemployment rate	in %	5,3	4,4	4,5	4,6	4,8
Public deficit	in % of GDP	-1,0	-1,3	-1,7	-1,6	-1,2
Gross public debt	in % of GDP	28,9	28,9	28,0	27,1	25,9
Current account	in % of GDP	-1,8	-2,7	-2,5	-1,5	-0,7

Source: Ministry of Finance.

5 Quality of Public Finances – Revenues and Expenditures

5.1 General Government Revenues

In 2008, the total tax revenues collected by the general government sector are develop approximately as forecasted. Value added tax (VAT) collection is slightly worse due to, in particular, a more substantial slowdown of spending on final consumption expenditures than expected. In contrast, revenues from direct taxes are higher than expected.

The share of indirect taxes (the item "taxes on production and imports") in GDP continues to increase and should rise from 10.9% in 2007 to around 11.2% of GDP in 2008. The main factor has been the increase in the reduced VAT rate from 5% to 9% effective from 1 January 2008, with the impact being felt particularly in the categories of food, construction work for social housing, housing services, and regular public transport. Within excise taxes, from the beginning of 2008 the tax rate on tobacco products has been increased, and, in the context of initiating the environmental tax reform, the introduction of a tax on electricity, natural gas and solid fuels also increased the revenues from indirect taxes.

In comparison with the aforementioned growth in the share of indirect taxes in GDP, a direct income taxes as a proportion of GDP will gradually decline over the period 2008–2010, dropping from 9.3% of GDP in 2007 to an expected level of 8.1% of GDP by 2010. In addition to introducing a flat personal income tax (PIT) rate of 15% and reducing the corporate income tax (CIT) rate from 24% to 21% in 2008, there will be a further gradual reduction in the CIT rate in accordance with the approved legislation: to 20% in 2009 and further to 19% in 2010. Another reduction in tax rates is not expected in 2011, and the share of current income taxes will show moderate growth of 0.1 percentage points year-on-year.

Similar to income taxes, also the share of social contributions paid on the part of employees and employers will fall. From 2008, a ceiling was introduced for the annual assessment base for social and health insurance premiums amounting to four times the average annual wage in the national economy. From the start of 2009, the premia rates for sickness insurance and the contribution to the national employment policy will be reduced. With respect to employees, the premium rates will be lowered by a total of 1.5 percentage points, while, as regards employers, in accordance with the new Act on Sickness Insurance already approved, the rate will be lowered by 1.0 percentage point.[10] Reducing social contributions with respect to employees compensates for an originally planned drop in the PIT rate. The PIT rate will be kept at the present rate of 15%, even though its reduction to 12.5% was approved in 2007. An additional counterbalance to the said drop in government revenues due to the reduction in the sickness insurance premium will be represented on the expenditures side by the positive impact of an employer's obligation to pay sickness benefits during the first 14 days of an employee's illness, which also enters into effect from 1 January 2009 under the new Act on Sickness Insurance (for more information, see last year's CP update). From 2010, in accordance with this Act, another drop in the rate of the premium paid on the side of employers, by 0.9 percentage points, is planned.

[10] The impacts of the new Act on Sickness Insurance were described, quantified and included in the outlook in the previous CP update and thus are no longer contained in the boxes or tables of this section.

Overall, social contributions in proportion to GDP can be expected to drop from 16.3% in 2007 to approximately 15.2% in 2010.

The item "property income" shows a decline after 2008 due to the unforeseen recurrence of this year's record dividends. Within the category "other", a gradual rise can be traced due to grant revenues from the EU budget.

The total tax quota shows a constant decline over time. From values of 36.6% and 35.7% of GDP for 2007 and 2008, respectively, it will gradually fall to a value of around 33.7% of GDP by 2011 (see Table 5.1).

Table 5.1: General government revenues

% of GDP	ESA code	Year 2007	Year 2008 (1)	Year 2009 (2)	Year 2010 (2)	Year 2011 (2)
Components of revenues						
Total taxes		**20,2**	**19,5**	**19,4**	**18,9**	**18,6**
Taxes on production and imports	D.2	10,9	11,2	11,1	10,8	10,4
Current taxes on income, wealth etc.	D.5	9,3	8,3	8,3	8,1	8,2
Capital taxes	D.91	0,0	0,0	0,0	0,0	0,0
Social contributions	**D.61**	**16,3**	**16,2**	**15,7**	**15,3**	**15,1**
Property income	**D.4**	**0,8**	**1,0**	**0,8**	**0,7**	**0,5**
Other		**4,3**	**4,4**	**4,6**	**4,7**	**4,8**
Total revenue	**TR**	**41,7**	**41,0**	**40,6**	**39,6**	**39,0**
p.m.: Tax burden		**36,6**	**35,7**	**35,1**	**34,2**	**33,7**

(1) Prediction.
(2) Outlook.

Sources: Czech Statistical Office (2007), Ministry of Finance.

Box 5.1: Changes in taxation

Corporate income tax

In 2008, the restriction on the deductibility of financial costs, which had been introduced in the 2007 reform, was abolished. In addition, the CIT base was reduced through an exemption for so-called service fees collected by companies operating fixed-odds betting. In 2008, the impact of these measures on CIT will be approximately CZK -2 billion, with an expected impact in the following years of approximately CZK -2.2 billion.

Personal income tax

The government decided to abandon its original plan to reduce the PIT rate from 15% to 12.5% as of 1 January 2009. The rate will remain at the level of 15%. In comparison with the original outlook, the positive impact for general government revenues is estimated at CZK 10 billion per year.

Reduction in social insurance premium rates

From 2009, in response to the maintaining the PIT rate, the social insurance rate for employees will be lowered by 1.5 percentage points. This constitutes a zero-adjustment to the premium rate for employees for sickness insurance and for the contribution to the state employment policy. The total premium rate for pension insurance, sickness insurance and contribution to the state employment policy will thus be reduced from 33% to 31.5%. For self-employed individuals, the rate will be lowered by 0.4 percentage points. This measure will reduce government revenues by ca CZK 18.4 billion in 2009, by a further CZK 19.1 billion in 2010, and finally by CZK 20.3 billion in 2011.

The impacts of active tax policy measures are summarised in Table 5.2

Table 5.2: The impact of revenue measures[1]

CZK bn	Year 2008	Year 2009	Year 2010	Year 2011
Maintaining the PIT rate at the level of 15% instead of planned decrease to 12.5%	-	10,0	10,0	10,0
Adjustment of the CIT base	-2,2	-2,4	-2,4	-2,4
Decrease in the rate of social contributions paid by employees by 1.5 pp	-	-18,4	-19,1	-20,3
Total impact on revenue	**-2,2**	**-10,8**	**-11,5**	**-12,7**
Total impact on revenue (% of GDP)	***-0,1***	***-0,3***	***-0,3***	***-0,3***

[1]The impacts in Section 5 are expressed in comparison with no-policy-change scenarios (i.e. they are cumulative).

Source: Ministry of Finance.

5.2 General Government Expenditures

Owing to austerity measures in the area of social outlays and a moderate increase in government consumption, total general government expenditures declined as a percent of GDP. This share has shown a constant decreasing trend since 2004 and should gradually decrease further from 42.6% in 2007 to 40.2% of GDP in 2011.

Social transfers are a key component of mandatory general government expenditures and recorded a year-on-year drop from 18.2% of GDP in 2007 to approximately 17.8% of GDP in 2008, due particularly to a decrease in monetary payments for social benefits.

The share of interest payment expenditures should also begin to show a decreasing trend due to the anticipated modest drop in interest rates and the declining share of debt relative to GDP.

Gross fixed capital formation shows an increasing tendency, which can be attributed especially to the gradual increase in funds drawn from the EU budget. In comparison with the development anticipated for the period 2008–2011, growth in gross fixed capital was very low in 2007 and recorded an unfavourable shift in the structure of general government expenditures, particularly towards social expenditures. An attempt to reverse this negative trend in 2008 in the form of savings measures in the social area (described in more detail in the previous CP update) should result in returning social transfers to a lower level. Sufficient space will thereby be created within the approved expenditure limits for targeted growth oriented general government expenditure investments. Acceleration in investment activity is nevertheless critically dependent on the realisation of projects co-financed through EU funds, which carry with them a large volume of domestic resources intended for national financing and pre-financing.

Table 5.3: General government expenditures

% of GDP	ESA code	Year 2007	Year 2008 (1)	Year 2009 (2)	Year 2010 (2)	Year 2011 (2)
		Components of expenditures				
Compensation of employees	**D.1**	**7,6**	**7,3**	**7,1**	**6,9**	**6,8**
Intermediate consumption	**P.2**	**6,2**	**6,0**	**5,6**	**5,1**	**4,8**
Social transfers		**18,2**	**17,8**	**17,9**	**17,5**	**17,0**
Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	5,3	5,3	5,4	5,4	5,3
Social transfers other than in kind	D.62	12,9	12,4	12,4	12,1	11,8
Interest expenditure	**EDP D.41**	**1,2**	**1,3**	**1,3**	**1,2**	**1,1**
Subsidies	**D.3**	**1,8**	**1,8**	**1,8**	**1,7**	**1,7**
Gross fixed capital formation	**P.51**	**4,7**	**4,8**	**5,2**	**5,3**	**5,4**
Other		**3,0**	**3,2**	**3,4**	**3,4**	**3,5**
Total expenditures	**TE**	**42,6**	**42,2**	**42,2**	**41,1**	**40,2**
p.m.: Government consumption (nominal)	**P.3**	**20,4**	**19,8**	**19,4**	**18,6**	**17,8**

(1) Prediction.
(2) Outlook.

Sources: Czech Statistical Office (2007), Ministry of Finance.

Box 5.2: Changes in social expenditures

Extraordinary pension indexation

In April 2008, an amendment to the Act on Pension Insurance was approved that newly establishes a government obligation to index pensions if the increase in prices reaches the 5% mark (previously, the limit under the law was 10%). For this reason, in 2008, an extraordinary indexation of pensions was carried out with a one-off increase in government expenditures of CZK 6.7 billion, effective from 1 August 2008.

Payment of sickness insurance benefits

A provision on the non-payment of sickness benefits for the first three days of sick leave was abolished (i.e. the exclusion period, defined in last year's CP update) based on a decision of the Constitutional Court. During the period from 1 June 2008 to 31 August 2008, therefore, benefits will also be paid for the first 3 days in the amount of 60% of the assessment base. From 1 September 2008 to 31 December 2008, under the new regulation adopted in a shortened legislative process, sickness benefits will be paid for these days in the amount of 25% of the assessment base. From 1 January 2009, a new Act on Sickness Insurance will come into effect (see last year's CP for its parameters). As compared to original expectations, this development resulted in a negative impact on public outlays amounting to CZK 1.2 billion in 2008.

Changes in payments from public health insurance

Expenditures from public health insurance will be affected by an increase in the financing of emergency services (strengthening the role of their financing from health insurance), the inclusion of vaccinations into payments from public health insurance (transfer of competences from the state) and, by contrast, the removal of company preventive health care from financing through public health insurance (transfer of obligation to the employer) and the financing of post-mortem examinations from outside of health care facilities (transfer of payment obligation to regions). The positive impact on government outlays is estimated at about CZK 160 million, stemming from expected changes due to legal amendments that should come into effect in 2009.

Table 5.4: The impact of expenditure measures[1]

CZK bn	Year 2008	Year 2009	Year 2010	Year 2011
Reduction of the inflation limit for one-off indexation of pensions (one-off indexation as at 1 August 2008)	6,7	-	-	-
Parametrical changes in the pay-as-you-go pension system	-	-	-0,4	-0,8
Adjustments of sick benefits following the decision of the Constitutional Court (impact during 1 September–31 December 2008)	1,2	-	-	-
Other adjustments in social expenditures	0,1	-0,3	-0,3	-0,3
Changes in public health insurance	-	-0,2	-0,2	-0,2
Total impact on expenditures	**8,0**	**-0,5**	**-0,9**	**-1,3**
Total impact on expenditures (% of GDP)	***0,2***	***0,0***	***0,0***	***0,0***

[1] *The impacts in Chapter 5 are expressed in comparison with no-policy-change scenarios (i.e. they are cumulative).*

Source: Ministry of Finance.

The individual types of government expenditure in proportion to GDP are shown in Table 5.5.

Table 5.5: General government expenditures by function

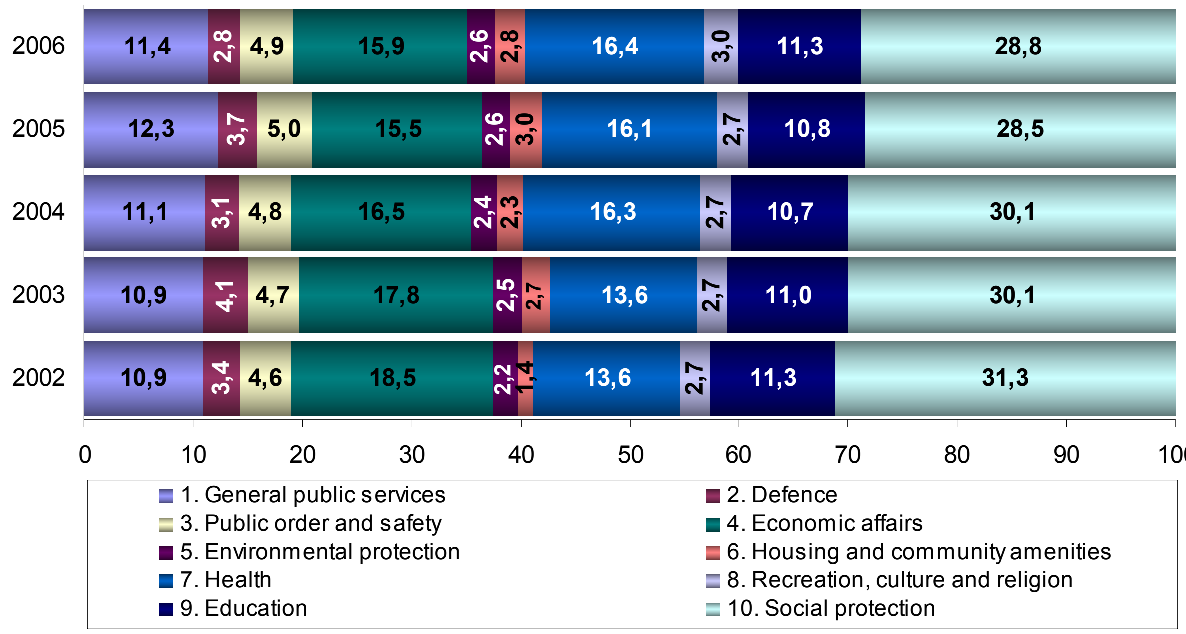
% of GDP	ESA code	Year 2002	Year 2003	Year 2004	Year 2005	Year 2006
1. General public services	1	5,0	5,2	5,0	5,5	5,0
2. Defence	2	1,6	1,9	1,4	1,6	1,2
3. Public order and safety	3	2,1	2,2	2,2	2,2	2,2
4. Economic affairs	4	8,6	8,4	7,5	7,0	7,0
5. Environmental protection	5	1,0	1,2	1,1	1,2	1,2
6. Housing and community amenities	6	0,7	1,3	1,0	1,4	1,2
7. Health	7	6,3	6,4	7,4	7,2	7,2
8. Recreation, culture and religion	8	1,3	1,3	1,2	1,2	1,3
9. Education	9	5,2	5,2	4,8	4,8	5,0
10. Social protection	10	14,5	14,3	13,6	12,8	12,6
Total expenditure	TE	46,3	47,3	45,1	44,9	43,8

Note: Total expenditures do not correspond precisely to the current version of the yearly national accounts. This is due to the different periodicity for publishing the main aggregates of the annual national accounts (every half year in April and October) and the expenditures of general government institutions by function (once a year in December).

Source: Czech Statistical Office.

Chart 5.1 presents the structure of the outlays of general government institutions by function (COFOG). A decrease is evident in the share for economic affairs and that of defence. In contrast, the opposite trend was recorded for health, i.e. an increasing share in total general government expenditures.

Chart 5.1: Government expenditures by function *(% of total expenditures)*



Source: Czech Statistical Office.

6 Sustainability of Public Finances

6.1 The Government's Strategy

Long-term sustainability is one of the weak spots of public finances. The most serious risk is the expected demographic development, which will somewhat dramatically increase the share of persons of retirement age in the working population over the next several decades. The government is continuously engaged in the issue of an ageing population and its impact on the long-term sustainability of public finances.

The pension system

The approach to resolving the pension system issue has been divided into three phases. The proposal of measures for the first phase was approved in the summer of 2008 and contains stabilising parametric adjustments to the current pay-as-you-go scheme. The main adjustments include continuing to increase the retirement age at the current rate progressively to 65 years of age,[11] coordinating the age for entitlement to "permanent" widow's or widower's pension based on retirement age, and converting full disability pension into retirement pension at the age of 65. It was also agreed to extend the minimum insurance period and to limit its compensatory periods, the current definition of disability was modified, and a special reserve account for pension reform was created (see Box 6.1 for more details).

The second prepared phase will involve separating the assets of shareholders and clients in the voluntary supplementary pension insurance scheme and additional adjustments geared to increasing the motivation of clients and the participation of employers in supporting supplementary pension insurance. A guarantee of minimum income for pensioners in the amount of the minimum subsistence level will also be introduced.

During the third phase, an additional savings pillar for the pension system is being considered that either would be based on a scheme to "opt out" of the state pay-as-you-go system at a certain level or would become an obligatory pillar from a certain time.

The health care system

The health care system reform has also been divided into several phases. The first phase, which was launched in 2007 and incorporated into the set of measures for stabilising public finances, was described in detail in last year's CP update. In 2008, certain partial adjustments were approved for the system of service charges (see Box 6.1). Certain measures are being considered to take effect from 1 January 2009. These include exempting children under six from doctor's fees and reducing the annual limit for selected fees and supplementary payments for medication for children under 15 from CZK 5,000 to CZK 3,000.

Currently, there are proposals in the legislative process for acts containing specific system changes aimed at, among others, clarifying health care terminology, strengthening fair

[11] The age limit of 65 applies for men and women with a maximum one child. The age limit for women according to the number of children remains differentiated: the target limit is 64 for women with two children, 63 with three children and 62 with four or more children.

competition among health service providers by establishing uniform conditions for providing these services, clarifying the positions of the provider and the patient and their mutual relationships (particularly with the goal of strengthening the interests and rights of the patient), and increasing the quality of care and the safety of the patient through greater and more effective monitoring and inspection. Another part of the newly prepared legislation aimed at developing the public health insurance system, clarifying the insured person's entitlements from the insurance system (including to establish limits on the availability of care), positioning and regulating of health insurance companies with the goal of their more transparent functioning and greater responsibility of the management, and strengthening supervision over the operating performance of health insurance companies and the fulfilment of their obligations to insured persons is already prepared and awaits the start of the legislative process. The specific solutions under consideration here probably will be reflected in laws beginning from 1 January 2010 at the earliest.

The goal of the reform laws is to increase competition among insurance service providers as well as health insurance companies through the use of market mechanisms. The financing and provision of health care should thereby be made more effective.

Box 6.1: Adjustments to the health care and pension systems

The health care system

A law partially adjusting the system of service charges has been in effect since 1 September 2008. Institutional care for newborns (from birth until released from hospital) and organ donors has been exempted from a service charge. This partial adjustment of the obligation pertains to a small circle of people.

The pension system

In the first stage of pension reform, it was agreed to continue in the process of gradually increasing the retirement age. The retirement age for insurees born after 1968 will be 65 for men and women who have raised no more than one child. For women born after 1968 who have raised 2, 3, or 4 or more children, the retirement age will be 64, 63, and 62, respectively. In accordance with the extension of the retirement age, the age limit for entitlement to a "permanent" widow/widower's pension also is increased in the final phase to 61, while the age limit for entitlement to retirement pension for a shorter term of insurance is increased in the final phase to 70. Another measure is the change of disability pensions to retirement pensions upon reaching 65 years of age, with effect from 2010.

Another measure is gradual extension of the required insurance period for entitlement to retirement pension from 25 to 35 years (including compensatory insurance periods), or to 30 years (i.e. only the period during which the insurance was paid), beginning in 2010. Nevertheless, there remains a possibility for entitlement to retirement pension even upon achieving a shorter insurance period, but that required shorter insurance period also is extended from 15 to 20 years. Non-contributory insurance periods, with several exceptions, will be valued at 80% for pension entitlement. The compensatory insurance period during studies is now abolished.

As a measure to increase labour market flexibility with effect from 2010, payment of half the retirement pension will be made possible after the entitlement to retirement pension for gainful activity arises, and for every 180 calendar days of this gainful activity the percentage retirement pension assessment will increase by 1.5% of the calculation basis. At the same time, there will be abolished the condition established earlier that to remain entitled to payment of retirement pension a retired person could not have additional income from gainful activity if the employment relationship was established for a period exceeding one year.

In the area of disability pensions, the division of disabilities into full disability or partial disability (and, therefore, also the division of disability pensions into fully disabled or partially disabled) will be abolished and a single type of disability (and, therefore, also a single type of disability pension) in three tiers depending on the percentage decrease in working capacity of the insuree will be introduced. The first tier relates to a decrease in working capacity by at least 35% and at most 49%. The second tier concerns a reduction of at least 50% and at most 69%, while the third tier covers a reduction of 70% or greater. For each full year of insurance, the percentage disability pension assessment will amount to 0.5% of the calculation basis for a disability pension granted for a first-tier disability, 0.75% of the calculation basis for a second-tier disability, and 1.5% of the calculation basis for a third-tier disability. It is estimated that around 74–75% of insurees who are currently categorised as partially disabled will be registered in the first tier (a result of which will be a reduction in the existing pension). About 24–25% of insurees who are currently categorised as partially disabled would be categorised in the second tier.

6.2 The Fiscal Consequences of Ageing: A Long-Term Projection

Analysis of long-term public expenditure development based upon an assumption of unchanging policies emerges from the medium-term macroeconomic and fiscal scenario through 2011 presented in previous sections and for later periods from the common assumptions discussed by the EPC's Working Group on the Ageing Population (AWG). Thus, newly approved assumptions on demographics (EUROPOP2008) and the macroeconomic framework that are over the long term consistent for EU countries were used in the analysis. The projection period was extended to 2060.

Table 6.1: Macroeconomic projection assumptions

% of GDP	Year 2007	Year 2010	Year 2020	Year 2030	Year 2040	Year 2050	Rok 2060
Labour productivity growth	4,1	3,8	2,9	1,8	1,7	1,7	1,7
Real GDP growth	6,6	4,4	2,5	1,4	0,9	0,7	1,1
Participation rate males (aged 15–64)	78,3	78,7	81,0	78,8	78,5	79,0	78,9
Participation rates females (aged 15–64)	61,6	63,3	66,7	66,0	66,0	67,8	68,1
Total participation rates (aged 15–64)	70,0	71,0	73,9	72,5	72,3	73,5	73,5
Unemployment rate	5,3	4,6	4,5	4,5	4,5	4,5	4,5
Population aged 65+ over total population	14,4	15,4	20,2	22,9	26,3	30,9	33,4

Sources: Ministry of Finance, AWG.

As compared with previous years, the results, summarised in Table 6.2, include the positive effects of the first phase of pension reform, relating in particular to the further extension of the age limit, the division of disability pensions from two into three groups, and the automatic administrative qualification of disability pensions as retirement pensions after reaching 65 years of age. The last of these measures has neutral impacts on expenditures.

Table 6.2: Long-term sustainability of public finances

% of GDP	Year 2007	Year 2010	Year 2020	Year 2030	Year 2040	Year 2050	Year 2060
Total expenditure	42,4	41,1	40,1	41,8	44,6	49,5	54,5
of which: Age-related expenditure	19,2	18,7	18,8	20,1	21,9	24,8	26,5
Pension Expenditure	8,2	7,7	7,7	8,1	9,6	11,5	12,4
Social security pensions	8,2	7,7	7,7	8,1	9,6	11,5	12,4
Old-age and early pensions	7,5	7,1	7,1	7,4	9,0	10,9	11,8
Other pensions	0,7	0,6	0,6	0,7	0,6	0,6	0,6
Occupational pensions	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Health care	6,3	6,3	6,7	7,3	7,8	8,5	8,9
Long-term care	0,2	0,3	0,3	0,4	0,5	0,5	0,7
Education expenditure	3,6	3,4	3,1	3,3	3,1	3,1	3,4
Other age-related expenditures	1,0	1,0	1,0	1,0	1,0	1,1	1,1
of which: Interest expenditure	1,1	1,1	0,8	1,2	2,1	4,2	7,5
Total revenue	41,4	39,6	39,0	39,0	39,0	39,0	39,0
of which: Property income	0,8	0,7	0,5	0,5	0,5	0,5	0,5
of which: From pension contributions (or social contributions if appropriate)	8,6	8,6	8,6	8,6	8,6	8,6	8,6
Pension reserve fund assets [(a)]	0,4	2,9	13,2	22,9	26,3	9,8	0,0
of which: Consolidated public pension fund assets (assets other than government liabilities)	0,0	0,0	0,0	0,0	0,0	0,0	0,0

(a) The cumulative positive balance on the pension account (assets of pension security funds) will be depleted between 2030 and 2040.

Source: Ministry of Finance.

Due to these measures, population changes thus have slightly more moderate impacts on public finances. Nevertheless, growth as a percentage of GDP in expenditures sensitive to the age structure of the population will be 7.2 percentage points for 2007–2060. The largest volume outlays on old-age pensions contribute most to this growth. The increase in these expenditures under an assumption of no-policy-change would cause a deepening of the primary deficit, a rise in interest payments (from the current 1.1% to 7.5% of GDP), and a rapid accumulation of government debt.

Chart 6.1: Projection of expenditures

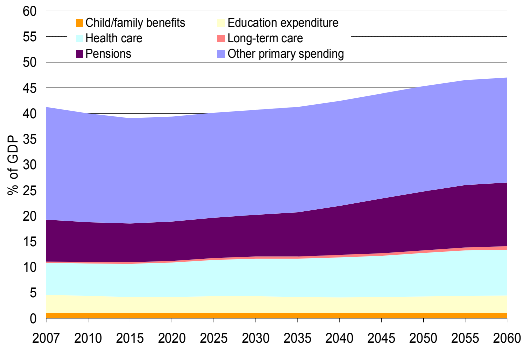
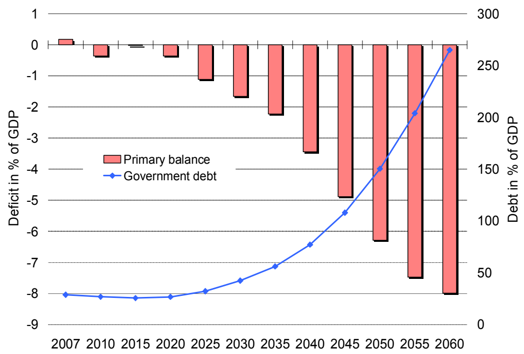


Chart 6.2: Primary deficit and debt



Source: Ministry of Finance.

The analysis identifies the scope of fiscal consolidation necessary to secure sustainability in the horizon to 2060. In this respect, it would thus be necessary to implement such measures as would reduce the share of expenditures or increase the share of revenues in GDP by 2.5 percentage points in 2011 (the so-called S1 indicator). This means that the overall general government balance should register a surplus in 2011 of 1.4% of GDP. In order to ensure the permanent solvency of the general government, a fiscal correction of 6.0% of GDP would be needed in 2011 (the so-called S2 indicator).

Table 6.3: Scope of needed fiscal consolidation

% of GDP	Year 2011	Year 2012	Year 2013
1. Revenues	39,0	39,0	39,0
2. Primary expenditures	39,1	39,1	39,1
3. Primary balance (1-2)	-0,1	-0,1	-0,1
4. Sustainability gap S1 (1)	2,5	2,6	2,7
5. Required primary balance (3+4)	2,4	2,5	2,6
6. Required total balance	1,4	1,8	1,9
Sustainability gap S2 (2)	6,0	6,1	6,2

(1) Permanent fiscal consolidation (S1) expresses as a percentage of GDP the necessity to permanently increase taxes (from the given year) or reduce expenditures in order to achieve a government debt of 60% of GDP at the end of the projection period.

(2) Permanent fiscal consolidation (S2) is similar but for an indefinite time horizon.

Source: Ministry of Finance.

The sustainability analysis showed some improvement that possibly can be attributed to the reform measures presented,[12] and particularly to the increase in the retirement age.

[12] The results given in the previous CP, however, are not fully comparable to last year's due to moderately more optimistic long-term macroeconomic and demographic assumptions. The long-term projection period also was extended by 10 years to 2060, which, from the point of view of sustainability indicators, extends the time for fiscal consolidation.

7 Changes to the Institutional Framework for Fiscal Policy

7.1 Medium-Term Horizon of the Budgetary Process

In the first half of this decade, the Czech Republic carried out a series of reform measures that introduced a medium-term horizon to the budgetary process. Medium-term fiscal targets were established, and the composition of medium-term expenditure frameworks was started (from 2004, see previous programmes for a detailed description). This contributed to the formulation of a medium-term expenditure policy for the state budget and state funds. The government regularly submits information on the functioning of these instruments together with budgetary documentation to the Chamber of Deputies of the Parliament in the course of approving the state budget.

The compilation of the expenditure frameworks forms an integral component of budgetary legislation today and also incorporates a government obligation to explain any possible non-fulfilment thereof. Nevertheless, in the past expenditure limits have been increased beyond the scope of adjustments permitted by law.

While none of the reform measures implemented as from the beginning of 2008 contain steps aimed at reinforcing the binding nature and enforceability of fiscal regulations, they nevertheless explicitly declare the principle of not exceeding the expenditure frameworks as one of the main fiscal instruments for fiscal consolidation. Adherence to the expenditure frameworks is strongly dependent on public review and the provision of transparent information. The Ministry of Finance, therefore, regularly evaluates the adherence to these frameworks in its publication "Fiscal Outlook of the Czech Republic".

7.2 Reserve Funds

From 2008, the possibility for transferring unused resources into reserve funds came to an end. The creation of reserves and their drawing as budgetary units to cover extra expenditures had greatly distorted the general government balance, making it difficult to formulate budgetary policy and adhere to defined fiscal targets. The impact of executed cash transfers, moreover, disrupted the otherwise efficient state debt policy and caused disproportionate growth in the costs of debt service.

This replacement of cash transfers to reserve funds with claims will lead to more effective financing of the state budget deficit. As a result, the adopted amendment to the budgetary regulations will enable the government, at its discretion, to reduce the amount of claims arising. By the end of 2008, undrawn resources in reserve funds of state organisational units will be composed primarily of resources intended for expenditures co-financed from the EU budget.

7.3 Local Government Institutions

In addition to the aforementioned measures implemented in the past at the central government level, a new procedure has been prepared for monitoring and evaluating the economic performance of municipalities and the semi-budgetary organisations they establish.

The local government sub-sector represents a significant segment of the general government sector. Nevertheless, the state may intervene in the finances of municipalities only in a very limited manner. The new monitoring procedure will proceed based upon a system of mutually linked indicators inspired by financial analysis used in the business sphere. Particular attention is given to the so-called "monitoring indicators" – credit risk and overall liquidity. These are supplemented by a set of indicators that support the objective evaluation of the status of municipal finances.

Limits have been created for the monitoring indicators to identify the enhanced risks associated with the operations of municipalities and their semi-budgetary organisations. Municipalities whose economic performance is found to be unsatisfactory will receive a letter from the Ministry of Finance and be requested to provide explanations for such situations. A list of these municipalities also will be sent to the relevant higher regional autonomous entities. Information on the results will be submitted to the government. All data sources necessary for calculating these indicators will be openly accessible on the website of the Ministry of Finance. Monitoring of the finances of individual municipalities should be implemented for the first time in 2008.

7.4 Transformation Institutions and Autonomous Government Agencies

Following the termination of the activities of the National Property Fund and Czech Consolidation Agency, the activities of the company Česká inkasní, which in the past carried out, for example, the transformation of Československá obchodní banka (ČSOB), were terminated in the first quarter of 2008. Its sole function was the unblocking of insolvent and irrecoverable receivables and the financial restructuring of selected entities.

Midway through 2008, the government also approved terminating the activities of the State Cultural Fund of the Czech Republic, whose activities were limited from its inception by a shortage in its own financial resources. Thus, the fragmentation within the government sector is gradually being reduced and expenditure centres with insufficient resources for financing their activities are gradually being dissolved.

7.5 Simplification of the Tax System

In addition to a gradual reduction in the tax burden, one of the main goals of the public finance reform is simplification of the tax system. This should involve the gradual integration of the collection of taxes, customs and premiums for public insurance.

The fundamental principles of the upcoming changes stem from the recommendations and conclusions of a technical mission of the World Bank carried out in 2008. A single, integrated system of authorities should be created that will take over the current tax and customs competences as well as the authority to collect compulsory social security payments and contributions to the state employment policy and compulsory health insurance.

The tax and customs administrations should simultaneously undergo dramatic modernisation. The ultimate aim is to integrate the administration of all taxes, the administration of customs duties and the collection of public insurance payments within a single institution. The unification of tax return forms and payment of all taxes and insurance premiums to one account should improve the situation for citizens. A specialised tax and customs authority also should be created for large and specific taxable subjects.

Unification of the collection of taxes, customs and insurance premiums at a single location will greatly simplify tax-related administration for taxpayers, reduce the bureaucratic burden and improve the taxpayer's perception of compulsory payments. As a result, the system of taxes, customs and insurance premiums overall will be better arranged and the accessibility and quality of services for the public will be improved. Electronic communication with clients should also be strengthened. This will reduce direct administrative costs connected with the collection of tax revenues, as well as indirect, so-called induced administrative costs to taxpayers. The integration of tax and customs authorities should occur from 1 January 2010, and that for the collection of taxes and premiums for public insurance from 1 January 2012.

7.6 Measures for Regulating and Managing Fiscal Risks

Recently, there has been great progress in building methodological support within the public-private partnership (the so-called PPP) process. The Ministry of Finance has prepared and, in co-operation with external agencies, is still preparing a range of methodological manuals. Some of these have already been published on the Ministry's web pages (e.g. Presentation of PPP Projects in State Budget Documentation, Methodology for Evaluating the Quantitative Aspects of Value for Money in PPP Projects, Managing Risks in PPP Projects, and others). A number of other methodological supporting documents are under preparation.

The methodological materials are accompanied by a series of seminars and lectures for employees of ministerial departments and representatives from higher regional autonomous entities and important municipalities.

Within the framework of budgetary documentation for the state budget, the Ministry of Finance has also begun, in the interests of maximum fiscal prudence and transparency, to present its calculations on the long-term fiscal impacts of the pilot PPP projects in preparation (including those not yet approved) on the performance of the state budget and state funds.

7.7 The State Treasury

Implementation of the state treasury project approved by the government should help improve the management of public finances and financial risks. The aim of the project is to create a fully automated, integrated information system that will be focused on supporting the processes and activities of the state treasury.

The implementation schedule was approved with a target for operation starting in 2010. In the first phase, the organisational units of the state and the semi-budgetary organisation will be added to the system. The activities of the state treasury will consist in directed planning, record keeping, collecting state revenues and executing payments; immediate accounting for any movements that occur when dealing with state assets and liabilities; and implementation of automated financial and management controls for dealing with state budget funds and reporting on state finances. The results of a tender for two subsystems of the integrated information system for the state treasury are already known.

7.8 Programme Budget Procedure

The Czech Republic endeavours in the long term to take into account the suitability and effectiveness of outlays made in the budgetary process with the aim of its optimisation. Adjustments to the current system of programme financing for reproducing assets and an introduction of output and target orientated budgeting for all state budget expenditures should serve to that purpose. Control and evaluation mechanisms will also form a part of these efforts.

Budgeting by way of expenditure blocks will be founded on the unambiguous establishment of goals that should be achieved by the given activities and are measurable with the help of pre-defined indicators. These goals will be established for the budgetary year and for at least another two successive years.

At the current time, amendments are being prepared to the legal standards for transforming the current programme financing and elaborating the medium-term outlook for the state budget, which should become effective as of 1 January 2009. A pilot version of the target-oriented budgeting methodology is expected to be tested as early as 2009 during preparation of the budget in the chapter of the Ministry of Education, Youth and Sports, specifically in the section on regional education. This example will be subsequently used as a methodological aid for other chapters of the state budget.

8 Annexes

8.1 Table Annex

Sources: Czech Statistical Office, Czech National Bank, Ministry of Finance.

Table 8.1: Economic growth
(from quarterly accounts, CZK billion, increase in %)

	ESA code	Year 2007 level[1])	Year 2007 rate of change	Year 2008 rate of change	Year 2009 rate of change	Year 2010 rate of change	Year 2011 rate of change
1. Real GDP	B1*g	3427	6,6	4,4	3,7	4,4	5,2
2. Nominal GDP	B1*g	3551	10,4	6,9	5,8	7,4	7,7
Components of real GDP							
3. Private consumption expenditure	P.3	1660	5,9	3,3	3,9	4,2	4,2
4. Government consumption expenditure	P.3	688	0,5	1,1	0,5	0,0	0,0
5. Gross fixed capital formation	P.51	838	5,8	5,1	4,5	6,2	7,0
6. Changes in inventories and net acquisition of valuables (% of GDP) [2])	P.52+P.53	96	2,7	1,6	1,9	1,7	1,7
7. Exports of goods and services	P.6	2822	14,6	11,6	7,1	9,3	10,7
8. Imports of goods and services	P.7	2676	13,8	9,3	7,1	8,8	9,7
Contribution to real GDP growth							
9. Final domestic demand			4,4	3,0	3,1	3,6	3,7
10. Change in inventories and net acquisition of valuables	P.52+P.53		1,1	-0,9	0,2	0,0	0,0
11. External balance of goods and services	B.11		1,1	2,2	0,4	0,9	1,5

[1]) *Real level in 2006 prices.*
[2]) *In current prices.*

Table 8.2: Price development
(in %)

	ESA code	Year 2007 level[1])	Year 2007 rate of change	Year 2008 rate of change	Year 2009 rate of change	Year 2010 rate of change	Year 2010 rate of change
1. GDP deflator		118,6	3,6	2,4	2,1	2,9	2,4
2. Private consumption deflator		114,0	2,8	5,8	2,5	2,8	2,2
3. HICP		105,1	3,0	6,4	2,9	3,0	2,5
4. Public consumption deflator		131,9	3,7	3,7	2,7	3,0	3,0
5. Investment deflator		104,3	2,2	1,9	0,7	0,7	0,7
6. Export price deflator (goods and services)		93,6	0,2	-5,6	1,2	3,3	2,0
7. Import price deflator (goods and services)		88,6	-1,0	-4,3	1,4	2,5	1,6

[1]) *2000 = 100; for the HICP, 2005 = 100.*

Table 8.3: Labour market development

	ESA code	Year 2007 level	Year 2007 rate of change	Year 2008 rate of change	Year 2009 rate of change	Year 2010 rate of change	Year 2011 rate of change
1. Employment (thous. persons) [1]		5162	1,8	1,7	0,7	0,3	0,3
2. Employment (bill. hours worked) [2]		10,06	1,0	0,8	0,2	0,2	0,2
3. Unemployment rate (%) [3]		5,3	5,3	4,4	4,4	4,6	4,7
4. Labour productivity (thous. CZK/person) [4]		664	4,7	2,6	2,9	4,1	4,9
5. Labour productivity (CZK/hour)[5]		341	5,5	3,6	3,5	4,3	5,0
6. Compensation of employees (bill. CZK)	D.1	1513	9,1	9,1	8,0	6,9	7,5
7. Compensation per employee (thous. CZK/person)		358	7,1	7,3	7,3	6,7	7,3

[1] *Employed population, domestic concept in national accounts definition.*
[2] *Definition according to national accounts.*
[3] *Harmonised definition, Eurostat; level.*
[4] *Real GDP per employed person (in 2006 prices).*
[5] *Real GDP per hour worked (in 2006 prices).*

Table 8.4: Analysis of the change in the net financial position

% of GDP	ESA code	Year 2007	Year 2008	Year 2009	Year 2010	Year 2011
1. Net lending/borrowing vis-a-vis the rest of the world *of which*	B.9	-0,8	-1,0	-0,5	0,4	1,2
- Balance on goods and services		5,0	5,4	5,4	6,7	8,1
- Balance of primary incomes and transfers		-6,5	-7,8	-7,5	-8,0	-8,6
- Capital account		0,7	1,3	1,6	1,7	1,6
2. Net lending/borrowing of the private sector	B.9	0,2	0,2	1,1	1,9	2,4
3. Net lending/borrowing of general government	EDP B.9	-1,0	-1,2	-1,6	-1,5	-1,2
4. Statistical discrepancy		0,0	0,0	0,0	0,0	0,0

Table 8.5: General government budget

	ESA code	Year 2007	Year 2007	Year 2008 (1)	Year 2009 (2)	Year 2010 (2)	Year 2011 (2)
		CZK bn	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (+)/borrowing (-) (EDP B.9) by sub-sectors							
1. General government	S.13	-34,9	-1,0	-1,2	-1,6	-1,5	-1,2
2. Central government	S.1311	-69,3	-2,0	-1,6	-1,7	-1,5	-1,2
3. State government	S.1312	-	-	-	-	-	-
4. Local government	S.1313	18,3	0,5	0,0	0,0	0,0	0,0
5. Social security funds	S.1314	16,1	0,5	0,3	0,1	0,0	0,0
General government (S.13)							
6. Total revenue	TR	1 470,3	41,7	41,0	40,6	39,6	39,0
7. Total expenditure (3)	TE (3)	1 505,2	42,6	42,2	42,2	41,1	40,2
8. Net lending (+)/borrowing (-)	EDP B.9	-34,9	-1,0	-1,2	-1,6	-1,5	-1,2
9. Interest expenditure (3)	EDP D.41	40,9	1,2	1,3	1,3	1,2	1,1
10. Primary balance		6,1	0,2	0,0	-0,3	-0,4	-0,1
11. One-off and other temporary measures		-10,2	-0,3	-0,1	0,0	0,0	0,0
Components of revenues							
12. Total taxes		714,2	20,2	19,5	19,4	18,9	18,6
12a. Taxes on production and imports	D.2	385,4	10,9	11,2	11,1	10,8	10,4
12b. Current taxes on income, wealth etc.	D.5	328,0	9,3	8,3	8,3	8,1	8,2
12c. Capital taxes	D.91	0,8	0,0	0,0	0,0	0,0	0,0
13. Social contributions	D.61	576,7	16,3	16,2	15,7	15,3	15,1
14. Property income	D.4	29,1	0,8	1,0	0,8	0,7	0,5
15. Other		150,3	4,3	4,4	4,6	4,7	4,8
16. Total revenue	TR	1 470,3	41,7	41,0	40,6	39,6	39,0
p.m.: Tax burden		1 290,9	36,6	35,7	35,1	34,2	33,7
Components of expenditures							
17. Compensation of employees	D.1	268,6	7,6	7,3	7,1	6,9	6,8
18. Intermediate consumption	P.2	219,2	6,2	6,0	5,6	5,1	4,8
19. Social payments		640,8	18,2	17,8	17,9	17,5	17,0
19a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	187,1	5,3	5,3	5,4	5,4	5,3
19b. Social transfers other than in kind	D.62	453,7	12,9	12,4	12,4	12,1	11,8
20. Interest expenditure (3)	EDP D.41	40,9	1,2	1,3	1,3	1,2	1,1
21. Subsidies	D.3	62,5	1,8	1,8	1,8	1,7	1,7
22. Gross fixed capital formation	P.51	165,9	4,7	4,8	5,2	5,3	5,4
23. Other		107,3	3,0	3,2	3,4	3,4	3,5
24. Total expenditures (3)	TE (3)	1 505,2	42,6	42,2	42,2	41,1	40,2
p.m.: Government consumption (nominal)	P.3	718,5	20,4	19,8	19,4	18,6	17,8

(1) Estimate.
(2) Outlook.
(3) Expenditures are adjusted for interest on swap transactions so that TR-TE = EDP B.9.

Table 8.6: General government debt

% of GDP	Year 2007	Year 2008 (1)	Year 2009 (2)	Year 2010 (2)	Year 2011 (2)
1. Gross debt	28,9	28,8	27,9	26,8	25,5
2. Change in gross debt ratio	-0,7	-0,1	-0,9	-1,0	-1,3
Contributions to change in gross debt					
3. Primary balance	-0,2	0,0	0,4	0,4	0,1
4. Interest expenditure	1,1	1,2	1,2	1,1	1,0
5. Nominal GDP growth	-2,6	-2,0	-1,6	-1,9	-1,9
6. Stock-flow adjustment	1,0	0,7	-1,0	-0,6	-0,6
- Difference between cash and accruals	-0,4	-0,2	-0,1	-0,1	0,0
- Net accumulation of financial assets	1,5	1,0	-0,9	-0,6	-0,6
of which: Privatisation proceeds	0,4	0,7	1,9	0,0	0,0
- Revaluation effects and other	-0,1	-0,2	0,0	0,0	0,0
p.m. implicit interest rate on debt	3,9	4,2	4,3	4,2	4,1
7. Liquid financial assets	-	-	-	-	-
8. Net financial debt	-	-	-	-	-

(1) Estimate.
(2) Outlook.

Table 8.7: Cyclical development

% of GDP	ESA code	Year 2007	Year 2008 (1)	Year 2009 (2)	Year 2010 (2)	Year 2011 (2)
1. Real GDP growth (%)		6,6	4,4	3,7	4,4	5,2
2. Net lending of general government	**EDP B.9**	-1,0	-1,2	-1,6	-1,5	-1,2
3. Interest expenditure	**EDP D.41**	1,1	1,2	1,2	1,1	1,0
4. One-off and other temporary measures		-0,3	-0,1	0,0	0,0	0,0
5. Potential GDP growth (%)		5,1	5,2	5,0	4,8	4,8
contributions:						
- total factor productivity		4,0	3,8	3,5	3,4	3,5
- labour		0,1	0,4	0,4	0,3	0,1
- capital		1,0	1,1	1,1	1,1	1,2
6. Output gap		2,0	1,2	-0,1	-0,5	-0,1
7. Cyclical budgetary component		0,6	0,3	0,0	-0,1	0,0
8. Cyclically-adjusted balance (2 – 7)		-1,6	-1,6	-1,6	-1,4	-1,2
9. Cyclically-adjusted primary balance (8 + 3)		-0,4	-0,4	-0,4	-0,3	-0,1
10. Structural balance (8 – 4)		-1,3	-1,5	-1,5	-1,4	-1,1

(1) Estimate.
(2) Outlook.

Table 8.8: Divergence from the previous update

% of GDP	ESA code	Year 2007	Year 2008 (1)	Year 2009 (2)	Year 2010 (2)	Year 2011 (2)
Real GDP growth (%)						
Previous update		5,9	5,0	5,1	5,3	.
Current update		6,6	4,4	3,7	4,4	5,2
Difference		0,7	-0,6	-1,4	-0,9	.
General government net lending (% of GDP)						
Previous update	EDP B.9	-3,4	-2,9	-2,6	-2,3	.
Current update	EDP B.9	-1,0	-1,2	-1,6	-1,5	-1,2
Difference		2,4	1,7	1,0	0,8	.
General government gross debt (% of GDP)						
Previous update		30,4	30,3	30,2	30,0	.
Current update		28,9	28,8	27,9	26,8	25,5
Difference		-1,5	-1,5	-2,3	-3,2	.

(1) Estimate.
(2) Outlook.

Table 8.9: Long-term sustainability of public finances

% of GDP	Year 2007	Year 2010	Year 2020	Year 2030	Year 2040	Year 2050	Year 2060
Total expenditure	42,4	41,1	40,1	41,8	44,6	49,5	54,5
of which: Age-related expenditure	19,2	18,7	18,8	20,1	21,9	24,8	26,5
Pension Expenditure	8,2	7,7	7,7	8,1	9,6	11,5	12,4
Social security pensions	8,2	7,7	7,7	8,1	9,6	11,5	12,4
Old-age and early pensions	7,5	7,1	7,1	7,4	9,0	10,9	11,8
Other pensions	0,7	0,6	0,6	0,7	0,6	0,6	0,6
Occupational pensions	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Health care	6,3	6,3	6,7	7,3	7,8	8,5	8,9
Long-term care	0,2	0,3	0,3	0,4	0,5	0,5	0,7
Education expenditure	3,6	3,4	3,1	3,3	3,1	3,1	3,4
Other age-related expenditures	1,0	1,0	1,0	1,0	1,0	1,1	1,1
Interest expenditure	1,1	1,1	0,8	1,2	2,1	4,2	7,5
Total revenue	41,4	39,6	39,0	39,0	39,0	39,0	39,0
of which: Property income	0,8	0,7	0,5	0,5	0,5	0,5	0,5
of which: From pension contributions (or social contributions if appropriate)	8,6	8,6	8,6	8,6	8,6	8,6	8,6
Pension reserve fund assets	0,4	2,9	13,2	22,9	26,3	9,8	0,0
of which: Consolidated public pension fund assets (assets other than government liabilities)	0,0	0,0	0,0	0,0	0,0	0,0	0,0

Labour productivity growth	4,1	3,8	2,9	1,8	1,7	1,7	1,7
Real GDP growth	6,6	4,4	2,5	1,4	0,9	0,7	1,1
Participation rate males (aged 15–64)	78,3	78,7	81,0	78,8	78,5	79,0	78,9
Participation rates females (aged 15–64)	61,6	63,3	66,7	66,0	66,0	67,8	68,1
Total participation rates (aged 15–64)	70,0	71,0	73,9	72,5	72,3	73,5	73,5
Unemployment rate	5,3	4,6	4,5	4,5	4,5	4,5	4,5
Population aged 65+ over total population	14,4	15,4	20,2	22,9	26,3	30,9	33,4

Table 8.10: Basic assumptions

	Year 2007	Year 2008	Year 2009	Year 2010	Year 2011
Short-term interest rate *(CZ) (annual average)*	3,1	4,0	3,8	3,7	3,4
Long-term interest rate *(CZ) (annual average)*	4,3	4,7	4,4	4,3	4,2
Nominal effective exchange rate *(2005 = 100)*	107	119	118	120	123
Exchange rate CZK/EUR *(annual average)*	27,8	24,9	24,7	24,2	23,7
World excluding EU, GDP growth	5,0	3,9	3,0	4,0	4,6
EU27 GDP growth	2,9	1,4	0,9	1,7	2,0
Growth of relevant foreign markets	6,4	4,3	3,1	4,0	4,5
World import volumes, excluding EU	7,2	4,9	4,1	5,0	5,5
Oil prices *(Brent, USD/barrel)*	73	113	120	115	115

Sources: Czech Statistical Office, Czech National Bank, Ministry of Finance.