Ministry of Finance
Czech Republic

Convergence Programme
of the Czech Republic

April 2014

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List of Abbreviations

CNB	Czech National Bank
CP	Convergence Programme of the Czech Republic
CZK	Czech koruna currency code
CZSO	Czech Statistical Office
EC	European Commission
EDP	Excessive Deficit Procedure
EDP B.9	Net lending/borrowing of the general government applied under the EDP
ERM II	Exchange Rate Mechanism II
ESA 95	European methodology of national accounting (of 1995)
ESA 2010	European methodology of national accounting (of 2010)
EU, EU28	European Union containing 28 countries
EUR	euro currency code
GDP	gross domestic product
LFS	Labour Force Survey
MF CR	Ministry of Finance of the Czech Republic
PAYG	pay-as-you-go system
pp	percentage point
USD	US Dollar currency code
YoY	year-on-year

Symbols Used in Tables

A dash (–) in place of a number indicates that the phenomenon did not occur or is not possible for logical reasons.
"Billion" means a thousand million.

Cut-off Date for Data Sources

Macroeconomic data used pertain to the 1 April 2014 release, fiscal data to the 4 April 2014 release and survey of macroeconomic forecasts of the CR to the 16 April 2014 release. Notification of general government deficit and debt was approved by Eurostat on 23 April 2014.

Note

In some cases, published aggregate data do not match the sums of individual items to the last decimal place due to rounding.

Introduction

The submitted update of the Convergence Programme of the Czech Republic is focused on the period 2014–2017. The importance of this strategic document of the Government of the Czech Republic, which defines the direction of the government's macroeconomic policies, also consists in the fact that it will be used as a basis for the European Commission's and EU Council's decision-making on abrogation of the excessive deficit procedure. In December 2009, the Council of the EU stated that the Czech Republic should reduce its excessive deficit, caused by both the effect of automatic stabilisers and discretionary stimuli to the economy, below 3% of GDP. At the same time, the Council of the EU demanded the average annual fiscal efforts of the government sector reach at least 1 pp in 2010–2013. Deficit should have been reduced on clearly defined measures that would ensure credible and sustainable correction of the excessive deficit. The result attained by government sector in 2013 of −1.5% of GDP, average fiscal effort of 1.1 pp over the given period and the last year's structural deficit lower than the level of the medium-term budgetary objective all testify to the successful fulfilment of the consolidation strategy. On the other hand, necessary fiscal restriction through direct and indirect channels has left its mark in the prolongation and deepening of the negative output gap.

The Convergence Programme of the Czech Republic (CP) was approved by the Government of the CR on 28 April 2014 and is consistent with the National Reform Programme of the CR approved by the Government of the CR on 16 April 2014. The CP fully corresponds with the rules on the content and format of stability and convergence programmes (EFC, 2012). In April, the CP was also presented and discussed with the relevant committees of the Chamber of Deputies and the Senate of the CR.

The update of the CP ensues from the aims of the Government of the CR, which was formed following the early election to the Chamber of Deputies of the Parliament of the CR held on 25 and 26 October 2013. The government of the CR in its Policy Statement of 12 February 2014 resolved to "…promote an economic programme … based on supporting business, a functioning and transparent state administration, an effective labour market, a long-term sustainable pension scheme, social reconciliation within society and investment in education, science and research." The government's intentions are thus in line with the Annual Growth Survey 2014 of the European Commission (2013a), which is directed particularly towards continued differentiated, growth-friendly fiscal consolidation of public finances, supporting competitiveness, tackling unemployment and the social consequences of the economic recession and the modernisation and professionalization of public administration.

The CP is divided into seven chapters. Chapter 1 sets out the economic and political intentions and targets of the Government of the CR, including progress already achieved in reducing the excessive deficit of the general government sector. The chapter also summarises the CR's responses to the latest recommendations of the Council of the EU, also presented at the committees of the Parliament of the CR.

The macroeconomic scenario of the CP, detailed in Chapter 2, is based on data known as of 1 April 2014. The Czech economy has gone through two periods of economic decline over the last five years, while the second recovery occurred in mid-2013. According to current data, real gross domestic product (GDP) decreased by 0.9% in 2013, reaching nearly 98% of the level in 2008. In the outlook, we expect a slight acceleration of economic growth. All components of aggregate demand should contribute, but gradually increasing domestic consumption will be the most significant contributor. The risks of the scenario are approximately balanced. Nevertheless, due to the size and openness of the economy, the major risks lie in the external environment.

The outcome of general government sector in 2013, which is a key year in terms of the aforementioned excessive deficit procedure, and the fiscal strategy in the next few years, are the subject of Chapter 3. This Chapter is based on the results of the Deficit and Debt Notifications approved by Eurostat as of 23 April 2014 and on the economic-policy intentions of the Government (closing date for data sources 9 April 2014). The forecast estimates a general government deficit of 1.8% of GDP in 2014 and then around 2.3% in 2015, with a subsequent decrease to 1.7% in 2017. After its slight decrease in 2013, general government debt as a percentage of GDP will probably fall again in 2014, down to 44.9% of GDP. The reason is mainly integration of additional liquidity in the system. In 2017, debt should reach the level of 47.1% of GDP.

The macroeconomic and fiscal scenarios are verified in Chapter 4 by comparison with the forecasts of other public and independent private institutions. The scenario is also supplemented with a sensitivity analysis and an analysis of the variances between the current scenario and the last CP's update.

In Chapter 5, aspects of long-term sustainability are monitored, whereby, in addition to the implications of the current pension scheme, attention is also paid to the size and structure of guarantees of the government sector. The last two chapters analyse the qualitative aspect of government sector revenues and expenditure (Chapter 6), as well as implemented or planned changes in the institutional environment, transparency and efficiency (Chapter 7).

1 Overall Policy Framework and Objectives

The motto of the current government of the CR is to support and develop "a socially and environmentally oriented market economy" (Policy Statement of the Government, 2014). The aim of the economic and political mix is to increase the competitiveness of the economy and strengthen the country's social and regional cohesion through long-term sustainable economic growth. The priority is to identify and implement growth-supporting measures across different spheres of the economy. From the perspective of fiscal policy, the government also expressly declared that it will take pains to ensure that development of the general government sector finances will remain at a safe level below the reference deficit value of 3% of GDP. In monetary policy, in November 2013 the Czech National Bank (CNB) began to use the exchange rate as an additional monetary policy instrument after the possibilities afforded by the traditional interest rates channel were more or less exhausted.

1.1 Fiscal Policy

Over the last four years, the Czech Republic has made a number of steps towards stabilising government sector finances, despite two waves of recession and a relatively deep negative output gap. Government sector deficit decreased from 5.8% of GDP in 2009 to 1.5% of GDP in 2013. The marked increase in government debt was also brought under control, and its level slightly decreased to 46% of GDP in 2013. This result was achieved by a relatively strongly restrictive fiscal policy, the total extent of which was 4.5 pp, measured by a change in the structural balance between 2009 and 2013 (for details see subchapter 3.3).

For 2014 and further years the restrictive fiscal policy was abandoned under the Resolution of the Government of the CR No. 283/2013. This was supported by the accommodative monetary policy in terms of historically low interest rates and since the end of 2013 (see later) also by foreign exchange interventions. Wherever possible, the state budget and budgets of state funds were drawn up for 2014 less procyclically, with an increase in expenditure in pro-growth areas.

The current government intends to continue in this direction (more details in subchapter 3.2). At the same time, it has no intention of forgoing its efforts to increase the effectiveness of public administration and tax collection, or to identify internal savings in the public finance system. The result will be a neutral fiscal policy in the following years while maintaining the total amount of the tax burden in the economy. Based on the above, expected deficits should decrease from 2.3% of GDP in 2015 to 1.7% of GDP in 2017, which implies a deficit adjusted for the impact of the business cycle and one-off and temporary measures around 1.7% of GDP over the horizon of the CP (Table 1.1).

Table 1.1: Fiscal Policy Stance
(in % of GDP)

	2015	2016	2017
General government balance	**-2.3**	**-2.0**	**-1.7**
Structural balance	-1.8	-1.7	-1.7
Primary structural balance	-0.5	-0.4	-0.4

Source: MF CR.

1.2 Implementing the Excessive Deficit Procedure

In expectation that the general government balance would exceed the reference value in 2009, an Excessive Deficit Procedure was initiated with the Czech Republic on 2 December 2009. The Council of the EU (2009) recommended the Czech Republic to bring the general government deficit below the 3% of GDP limit in a credible and sustainable manner by 2013 (inclusive). In addition, the recommendation instructed the following to:

i. ensure an annual average fiscal effort[1] of 1 % of GDP during 2010–2013;
ii. specify the measures necessary to remedy the excessive deficit by 2013, cyclical conditions permitting; and
iii. accelerate the deficit reduction in the event that economic or budgetary conditions transpire as more favourable than originally expected.

In the evaluation of last year's update of the CP (Council of the EU, 2013), the CR was also urged to:

i. correct the excessive deficit in 2013 in a sustainable manner and to achieve the fiscal effort required by the Council of the EU;
ii. choose a fiscal strategy for 2014 and the following years that will ensure fiscal effort adequate for sufficient progress to achieve the medium-term objective;
iii. prioritise expenditure in support of growth;
iv. allocate funds in time for the remaining projects co-financed from EU funds from the programming period 2007–2013;

[1] The fiscal effort is defined as a year-on-year change in the cyclically adjusted balance net of one-off and temporary measures (the structural balance).

v. reduce high taxation on labour by transferring the burden to areas less harmful for economic growth;
vi. reduce discrepancy in taxation between employees and self-employed persons; and
iv. adopt measures improving compliance with tax regulations as well as reduce related administrative costs (establishment of the Integrated Revenue Agency), including harmonisation of some tax bases.

Table 1.2 outlines the amount of year-on-year discretionary measures implemented, among others, in accordance with the Council last recommendations. It is apparent from the structure that in the period decisive for assessing excessive deficit reduction, both the revenue and expenditure side have been affected. In total, more emphasis was given to the revenue side, as these discretionary measures accounted for 59% of the volume of changes made between 2010 and 2013. Detailed analyses of individual measures from 2010 to 2012 form part of previous CPs, while the measures implemented in 2013 form part of the subchapter 3.1.1 in this CP. The new coalition government identifies itself with the Council of the EU recommendations. This is reflected both in its Policy Statement and in numerous already prepared legislative regulations and non-legislative steps. The levels of deficits from 2014 to 2017 should ensure sustainability of the excessive deficit correction. The government's intentions are presented in the following chapters.

Table 1.2: Structure of Discretionary Measures in 2010–2013
(in % of GDP)

	2010	2011	2012	2013
Revenue Discretioanry Measures	**41.4**	**11.2**	**9.3**	**23.9**
Taxation of labour	14.2	6.9	-8.9	5.4
Taxation of consumption	28.9	6.7	12.3	17.5
Taxation of capital	2.4	-2.6	0.5	-2.0
Other revenues	-4.1	0.2	5.4	3.0
Expenditure Discretionary Measures	**34.1**	**12.2**	**-7.3**	**19.8**
Cash social benefits	4.9	7.5	-2.2	8.7
Compensation of employees	8.6	8.7	-5.6	0.4
State administration optimisation and operating expenditures	17.6	8.7	-2.2	3.4
Other expenditures	3.0	-12.7	2.7	7.3
Total	**75.5**	**23.4**	**2.0**	**43.7**
% of GDP	2.0	0.6	0.1	1.1

Note: "Other expenditures" do not cover financial compensation to churches in 2012 and flat-rate corrections of the EU-reimbursements in 2012 and 2013.
Source: MF CR.

1.3 Monetary Policy

The CNB continues to conduct monetary policy aided by an inflation-targeting regime. Since 1 January 2010, the inflation target has been defined as a year-on-year increase in the consumer price index of 2% with a tolerance band of ±1 percentage point. The CNB views its inflation target as medium term in nature. Actual inflation can therefore temporarily deviate from the inflation target, while it typically does not react to some primary price fluctuations at all (e.g. modifications in indirect taxes).

With respect to the continued undershooting of the inflation target, despite a decrease in interest rates to the technical minimum (2-week repo rate has been at 0.05% since November 2012), in November 2013 the CNB started using the exchange rate as an additional monetary policy instrument. The current volume of foreign exchange interventions against the koruna has reached EUR 7.5 billion (approximately CZK 200 billion). Based on CNB public releases, we assume that foreign exchange interventions will be used until mid-2015. In accordance with this assumption and the expected macroeconomic development, we expect stability or a gradual slow increase in short-term interest rates.

The CR's updated strategy for accession to the euro area, approved by the Czech government in August 2007, has not set a target date for such accession. This date will depend on resolving problem areas as part of reforming public finances and increasing the flexibility of the Czech economy. In this respect, entry into Exchange Rate Mechanism II (ERM II) is still viewed only as a necessary condition for adopting the euro, and hence the length of time spent in ERM II should be kept to a minimum.

The joint document of MF CR and CNB, "Assessment of the Fulfilment of the Maastricht Convergence Criteria and the Degree of Economic Alignment of the Czech Republic with the Euro Area", approved by the government on 18 December 2013, states that the fiscal problems of the euro area, together with the still difficult to predict development of monetary union, do not create an environment favourable for adopting the single currency in the CR in the future. As regards the country's level of preparedness to adopt the euro, it is particularly suitable to keep the general government sector structural balance at least at the level of the medium-term objective, to reduce administrative barriers for business and to increase labour market flexibility. Considering these facts, and in accordance with the remarked Updated Accession Strategy of the CR to the Euro Area, the government has not yet established a target date for joining the Euro Area and will not endeavour to enter into ERM II during 2014.

1.4 Structural Policies

The CR's priorities and targets in the area of structural policies are described in detail in the National Reform Programme of the CR 2014 (Government Office, 2014). Here, we only include a list of the most important ones.

1.4.1 Labour Market

In the labour market, the CR's main intention is to create suitable conditions for long-term sustainable employment. These will be based on a targeted active employment policy, the development of employees' qualifications and the coordinated approach of the state, local public administration, employers and the non-profit sector. In this respect, the CR will modify the investment incentive system and improve employers' motivation to invest in regions with an above-average unemployment rate. Further, the CR has prepared a bill on the provision of childcare within children's group (employer kindergartens) in order to improve reconciliation between family and work life.

1.4.2 Business Environment

Measures in the business environment focus particularly on improving conditions for business, increasing the attractiveness of the investment incentive system and ensuring high quality digital infrastructure. To this end, the government of the CR approved 53 new measures that will be implemented from 2014 and will lead to a reduction of entrepreneurs' administrative and regulatory burden. Last but not least, the CR is preparing an Economic Diplomacy Concept and an Investment Support Concept.

1.4.3 Education

The main target of education reform is to strengthen equal access to education and to reconcile secondary and university education with labour market requirements. In order to support technical branches of study, the government of the CR intends to modify the system of financing the regional education system so as to better reflect the long-term chances of graduates to succeed on the labour market. The role of employers in the area of career consultancy will also be strengthened, and a career system for teachers will be prepared.

1.4.4 Research, Development and Innovation

The main targets in the area of research, development and innovation include improving quality and increasing motivation to use the results of research, development and innovation by the private and public sectors. The prepared amendment on publically funded support for research, experimental development and innovation will introduce new tools to support the financing of research, development and innovation. These tools should make support more effective and reduce administration. Other measures include programmes supporting the provision of venture capital and improving the usage of potential industrial property rights.

1.4.5 Energy Industry and Climate Change

The Czech Republic has been striving for a long time for an effective transition to a competitive low-carbon economy and reduced dependence on fossil fuels. For this purpose, the State Energy Concept and the National Action Plan of the CR for Renewable Energy Sources will be updated.

1.4.6 Transport Infrastructure

In order to boost the capacity and quality of its transport infrastructure, the CR will focus on completing construction of its backbone transport infrastructure and interconnection of the remaining regions and important industrial centres to core routes and lines. The already approved strategic document on Transport Policy of the CR for 2014–2020, with a forecast up to 2050, will continue in transport infrastructure including its financing with the approved Transport Sectoral Strategies.

2 Economic Outlook

The Czech economy emerged from a six-quarter recession in the second half of 2013; however, the economic recovery is very slow. We envisage economic growth of 1.7% in 2014, in the following years GDP growth should slightly accelerate. In spite of the weakening of the koruna due to the CNB's foreign exchange interventions, the year 2014 should be characterised by very low inflation. However, from the second half of 2014 inflation should be within the tolerance band of the inflation target. Due to the relatively slow economic recovery and employers' efforts to increase labour productivity, employment should grow only very slightly and the decrease in the unemployment rate should be only tiny. Net lending/borrowing vis-à-vis rest of the world should remain in surplus. The macroeconomic scenario of the CP has been drawn up conservatively.

2.1 World Economy and Technical Assumptions

The economic situation and outlook differ considerably in individual regions. While economic growth should accelerate in the USA, mainly due to household consumption dynamics, it should slow down in Japan due to the impacts of fiscal consolidation. The economic growth of developing economies has slowed, but still maintains its high dynamics. However, development in the last few years has highlighted internal imbalances and the need for structural reforms.

For the whole of 2013, GDP of the EU28 showed *de facto* stagnation and has not yet reached the pre-crisis level of 2008. The slight economic recovery during the year was mainly caused by household consumption due to the gradually improving labour market situation and increasing confidence of consumers. The improvement of the situation was also apparent in some economies of the south of the Euro Area.

The assumptions of the CP scenario are comparable to those of the Winter Forecast of the EC (2014a). We expect GDP of the EU28 to increase in 2014 by 1.6% (versus growth of 1.5% in the EC forecast); for 2015 we expect growth of 1.8% (versus 2.0% in the EC forecast). We expect further improvement in consumer and business sentiment. In the outlook, private investment and consumption should replace net exports as the principal driver of growth. However, the short-term outlook continues to be associated with a certain degree of uncertainty.

In 2013, the average price of Brent crude oil was 108.6 USD per barrel; the year-on-year decrease was in line with expectations. In the horizon of the CP scenario we expect a gradual decline towards 95 USD a barrel in 2017. For 2014 and 2015 we expect a slightly higher price of crude oil than the Winter Forecast of the EC.

For the USD/EUR exchange rate we assume stability at the level of 1.35 USD/EUR. Basically, this scenario is identical to the EC forecast, which expects an exchange rate of 1.36 USD/EUR in 2014 and 2015. After sharply weakening due to the CNB's intervention in November 2013, the CZK/EUR exchange rate should fluctuate around 27.25 CZK/EUR until mid-2015. Thereafter the koruna should again start to strengthen against the euro, but at a slower pace than would otherwise correspond to a long-term trend.

Table 2.1: Exogenous Assumptions of the Scenario

		2013	2014	2015	2016	2017
USD/EUR exchange rate	*annual average*	**1.33**	**1.35**	**1.35**	**1.35**	**1.35**
CZK/EUR exchange rate	*annual average*	**26.0**	**27.3**	**27.2**	**26.8**	**26.4**
Government bond yield to maturity 10Y	*in % p.a.*	**2.1**	**2.4**	**2.6**	**2.8**	**3.0**
PRIBOR 3M	*in % p.a.*	**0.5**	**0.4**	**0.4**	**0.8**	**1.0**
GDP EU28	*real growth in %*	**0.1**	**1.6**	**1.8**	**2.0**	**2.3**
Oil prices (Brent)	*USD/barrel*	**108.6**	**104.8**	**100.5**	**96.5**	**95.0**

Source: CNB (2014), EIA (2014), Eurostat (2014). MF CR calculations.

2.2 Actual Developments and Medium-term Scenario

2.2.1 GDP and the Demand Side

In mid-2013, the Czech economy emerged from a six-quarter recession; however, the subsequent recovery was very slow (except for Q4 2013, when growth was considerably influenced by one-off factors). In 2013, GDP showed a year-on-year decrease of 0.9%. We already expect GDP growth of 1.7% in 2014, while in the following years growth should accelerate gradually up to 2.5% in 2017. Across the whole horizon of the macroeconomic scenario, all expenditure components should contribute positively to GDP growth.

In 2014, household consumption dynamics will be depressed by limited growth of real disposable income and only slow improvement of the situation on the labour market. Conversely, a reduction in household pessimism should take effect, which could mitigate the creation of precautionary savings. As a result, household consumption could increase by 0.6%, whereupon growth could accelerate up to 1.9% in 2017.

In the horizon of the macroeconomic scenario, growth in real government consumption should fluctuate at around 1%. Higher expenditure in health care and, to a lesser extent, an increase in intermediate consumption will be the main factors standing behind the growth in real government consumption.

In the scenario horizon, the development of gross fixed capital formation should be positively influenced by the dynamics of gross operating surplus and by economic growth not only in the CR, but also in the countries of our main trading partners. In 2014 and 2015, a considerable improvement in the drawing of funds from the EU financial perspective 2007–2013 should also contribute. Investment in fixed capital could therefore increase by 2.7% in 2014 and by 2.0% in 2015. Further, growth of gross fixed capital formation could accelerate up to 3.1% in 2017.

The increase in the foreign trade surplus in current prices that occurred in 2013 was accompanied by a considerable improvement in the terms of trade. The contribution of foreign trade to YoY growth of real GDP reached −0.3 pp in 2013. In the whole scenario horizon, however, foreign trade contributions should be positive, despite the expected further improvement of the terms of trade in 2014 and 2015.

Economic level of the Czech Republic in terms of GDP per capita using purchasing power parity, reached approximately 80% of the EU28 average in 2013. After a period of convergence, when in the years 2000 to 2007 the relative economic level of the Czech Republic compared to the EU28 countries increased from 71 to 83%, there has been a stagnation or slight decline. Due to the slow economic recovery in 2014, maintaining the same economic level is assumed. In the following years of the outlook the relative economic level of the Czech Republic should gradually increase, thus partially closing the gap to the EU28 average.

2.2.2 Potential Product and Position within the Business Cycle

Under current conditions, it is difficult to separate the impact of a deepening of the negative output gap and the slowdown of potential product growth. This difficulty leads to less robust decomposition results, which must be treated with considerable caution. The volatility of results was further increased by changes in the collection of excise taxes. This led us to abandon use of GDP for calculating potential product. Instead, we use gross value added, which – unlike GDP – does not include net taxes on products.

Due to long periods of recession and sluggish economic growth, growth of potential product slowed considerably, down to approximately 0.3% in 2013.

Table 2.2: Economic Output

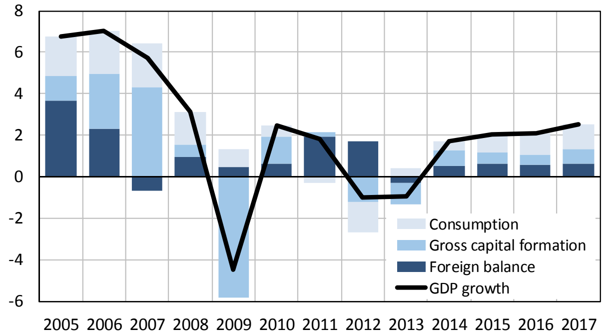
(level in CZK billion, increases in %, contributions to growth in percentage points)

	ESA Code	2013 *Level*	2013	2014	2015 *Rate of change*	2016	2017
Real GDP	B1*g	**3810**	**-0.9**	**1.7**	**2.0**	**2.1**	**2.5**
Nominal GDP	B1*g	**3884**	**1.0**	**3.6**	**3.7**	**3.1**	**3.9**
Components of real GDP							
Private consumption expenditure	P.3	**1947**	**0.1**	**0.6**	**1.5**	**1.6**	**1.9**
Government consumption expenditure	P.3	**802**	**1.6**	**0.8**	**0.7**	**1.2**	**1.2**
Gross fixed capital formation	P.51	**857**	**-3.5**	**2.7**	**2.0**	**2.1**	**3.1**
Changes in inventories and net acquis. of valuables (% of GDP)	P.52+P.53	**1**	**0.2**	**0.2**	**0.2**	**-0.1**	**0.0**
Exports of goods and services	P.6	**3006**	**0.2**	**3.8**	**4.2**	**4.4**	**4.9**
Imports of goods and services	P.7	**2802**	**0.6**	**3.4**	**3.8**	**4.1**	**4.7**
Contributions to real GDP growth							
Final domestic demand		**-**	**-0.4**	**1.0**	**1.3**	**1.5**	**1.9**
Changes in inventories and net acquis. of valuables	P.52+P.53	**-**	**-0.2**	**0.2**	**0.1**	**0.0**	**0.0**
External balance of goods and services	B.11	**-**	**-0.3**	**0.5**	**0.6**	**0.6**	**0.6**

Note: Real levels are in 2012 prices. Changes in inventories and net acquisition of valuables on the sixth row express change in inventories as a per cent of GDP in current prices. The increase of the change in inventories and net acquisition of valuables is also calculated from real values.
Source: CZSO (2014a), MF CR (2014a).

Chart 2.1: Decomposition of GDP Growth

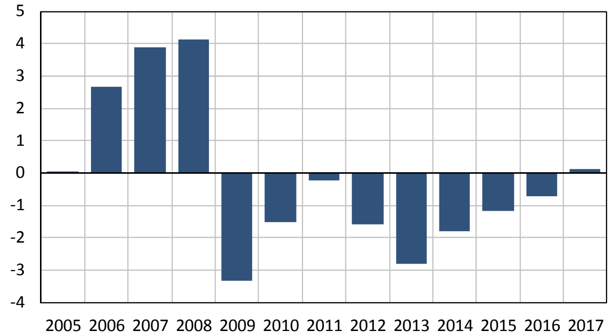
(contribution to growth in percentage points)



Source: CZSO (2014a), MF CR (2014a). MF CR calculations.

Chart 2.2: Output Gap

(in % of potential product)



Source: MF CR calculations.

The recession which lasted from Q4 2011 to Q1 2013 again resulted in a large negative output gap. By the end of the recession it had reached −3.0%. However, the following quarters of recovery mitigated the figure to −2.2% in Q4 2013. The negative output gap is reflected in the economy by close to record-breaking values of registered unemployment, the low number of vacancies, below-average utilisation of capacities and a slow increase in prices and wages. With renewed economic growth, the output gap should gradually close before the end of the CP horizon.

Total factor productivity is the most heavily affected component of potential product. Its trend component growth gradually decreased from a level of 4.3% in 2005, and has been more or less stagnating since 2011. A decline in investment has led to a decrease in the contribution of capital stock growth. From 2010 on, the negative impact of demographic changes has started to weigh down on potential growth quite strongly. On the other hand, the contribution of participation rate has been very positive. This is due not only to changes in demographic structure, in which the structural share of age groups with a naturally high participation rate is increasing, but also to the population's increased appetite for being involved in employment to at least partially offset the decrease in real disposable income.

According to our calculations, growth of potential product has stayed below 1% since 2010, though this result probably underestimates reality. We assume, however, that the slowdown in the growth of economic potential had already reached its trough in 2013. In the CP macroeconomic scenario outlook, the potential product growth rate should be close to 2%.

2.2.3 Prices

Inflation measured by the harmonised index of consumer prices reached 1.4% in 2013. The increase in prices was caused almost exclusively by administrative measures, in particular by an increase in both value added tax rates by 1 pp and excise taxes on tobacco products, and by growth of some regulated prices. Growth of market prices was minimal under the conditions of the negative output gap. Since the beginning of 2014, administrative measures have had an anti-inflationary impact, especially thanks to a substantial reduction of electricity prices with an impact on YoY inflation of −0.4 pp.

To prevent any long-term undershooting of the inflation target, the CNB started using the exchange rate in November 2013 as an additional monetary policy instrument (see also subchapter 1.3). The aim of exchange rate interventions against the Czech koruna is to maintain the CZK/EUR exchange rate at values weaker than 27 CZK/EUR. Despite the weakening of the Czech koruna, the average inflation rate according to the harmonised consumer price index should reach only 1% in 2014.

Table 2.3: Prices of Goods and Services

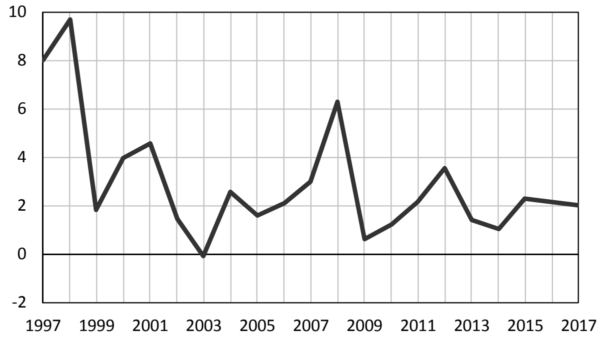
(indices 2005=100, increases in %)

	2013	2013	2014	2015	2016	2017
	Level	*Rate of change*				
GDP deflator	109.4	1.9	1.8	1.7	1.0	1.3
Private consumption deflator	114.9	1.1	0.7	2.0	2.1	2.0
Harmonised index of consumer prices	121.9	1.4	1.0	2.3	2.1	2.0
Public consumption deflator	117.7	0.1	0.9	1.1	0.4	0.8
Investment deflator	103.0	0.2	1.3	1.0	0.7	0.7
Export price deflator (goods and services)	98.0	1.6	3.4	0.3	0.3	0.3
Import price deflator (goods and services)	101.8	0.1	2.2	-0.2	0.3	0.3

Source: CZSO (2014a), Eurostat (2014). MF CR calculations.

Chart 2.3: Harmonised Index of Consumer Prices

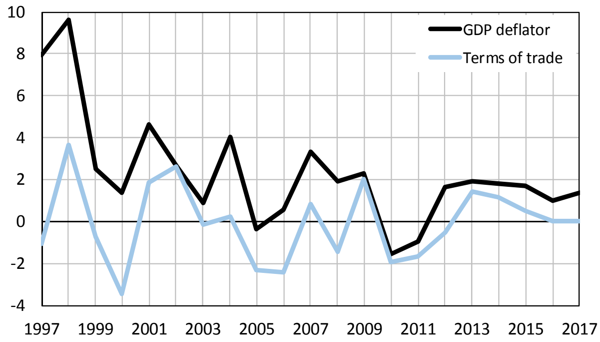
(y-o-y growth in %)



Source: Eurostat (2014). MF CR calculations.

Chart 2.4: GDP Deflator and Terms of Trade

(y-o-y change in %)



Source: CZSO (2014a). MF CR calculations.

In 2015, inflation should be determined by the negative output gap on the one hand and by the lagged effects of the weakened koruna on the other. The introduction of a third value added tax rate for selected goods of 10% should, together with cancellation of the fee for visits to doctors, decrease inflation by 0.2 pp. In the following years, growth of the harmonised index of consumer prices should be in line with the inflation target.

2.2.4 Labour Market and Wages

In spite of the unfavourable economic situation, employment increased by 0.9% in 2013, especially due to a marked increase in the share of part-time jobs. From the demographic point of view, women aged 25–49 contributed most to this result. This signals an increase in labour supply by the so-called additional worker effect, whereby households have reacted to a substantial decrease in disposable income with efforts to secure additional incomes from economic activity.

This effect was also reflected in the seasonally adjusted unemployment rate (Labour Force Survey methodology), which has now been decreasing since the beginning of 2013, and in a full-year-on-year comparison it stagnated at 7.0% in 2013. A positive sign that the risk of greater structural unemployment becoming entrenched is receding is the decreasing rate of long-term unemployment.

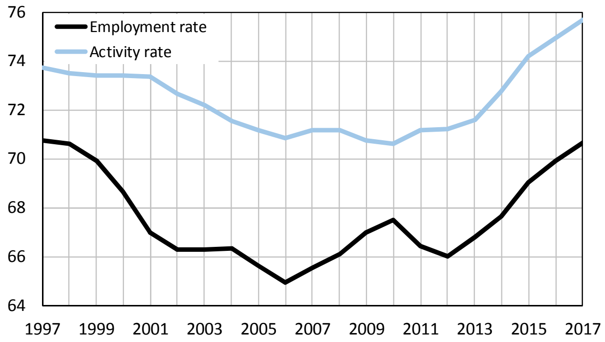
Considering the expected economic recovery, we forecast a gradual decrease in the unemployment rate to 6.0% in 2017, whereby any larger decrease could be hindered in these years by a more intensive utilisation of core employees following a considerable cyclical decrease in the number of worked hours per employee in 2013.

In the CP outlook, we expect to observe a trend growth in the participation rate. The number of persons in age cohorts with the highest participation rate is expected to increase, which will be only partially counter-balanced by shifts in other groups; the overall demographic effect will be therefore positive. A further positive effect should be brought about by the gradual increase in the statutory retirement age, which should also influence the effective retirement age.

Compensation of employees (the sum of the wage bill and social security contributions paid by the employer) decreased by 0.4% in 2013. The main cause of the decrease was shifting a considerable volume of extraordinary bonuses to Q4 2012 in an effort to avoid paying the second, higher statutory PIT rate that came into effect on 1 January 2013. Another important reason was a continuing decrease in real labour productivity.

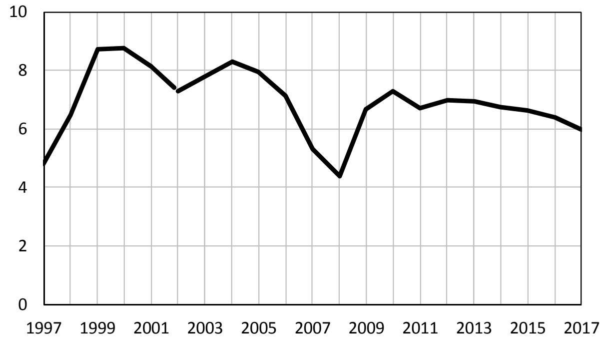
For 2014, we expect a growth in compensation of employees of 1.8%. The decrease in the net operating surplus of 2009–2012 should thereby be partially compensated. Moreover, the statistical effect of the shift in bonuses will have a positive effect in 2014. In the following years, the development of compensation of employees will be dampened by its slight increase in the budgetary sphere.

Chart 2.5: Employment and Participation Rates
(in %)



Note: The employment rate from the Labour Force Survey is not comparable between 2001 and 2002 due to changes in methodology.
Source: CZSO (2014c). MF CR calculations.

Chart 2.6: Unemployment Rate
(in %)



Note: The unemployment rate from the Labour Force Survey is not comparable between 2001 and 2002 due to changes in methodology.
Source: CZSO (2014c). MF CR calculations.

Table 2.4: Employment and Compensation of Employees
(price levels in common prices, increases in %)

	ESA Code	2013 *Level*	2013	2014	2015 *Rate of change*	2016	2017
Employment, persons		**5124**	**0.9**	**0.3**	**0.2**	**0.2**	**0.2**
Employment, hours worked		**9.1**	**-0.8**	**-0.7**	**-0.3**	**0.0**	**-0.1**
Unemployment rate (%)		**7.0**	**7.0**	**6.8**	**6.6**	**6.4**	**6.0**
Labour productivity, persons		**761**	**-1.8**	**1.4**	**1.9**	**1.8**	**2.3**
Labour productivity, hours worked		**421**	**-0.2**	**2.4**	**2.3**	**2.1**	**2.6**
Compensation of employees	D.1	**1649**	**-0.4**	**1.8**	**3.7**	**3.6**	**4.1**
Compensation per employee		**390**	**-1.9**	**1.2**	**3.5**	**3.3**	**3.9**

Note: Employment is based on domestic concept of national accounts. Rate of unemployment is based on the methodology of the Labour Force Survey. Labour productivity is calculated as real GDP (in 2011 prices) per employed person or worked hour.
Source: CZSO (2014a, 2014c). MF CR calculations.

2.3 External Transactions and Sectoral Balances

In accordance with the requirements of the Code of Conduct (EFC, 2012), this subchapter has been prepared using national accounts methodology, which allows the surplus or deficit in economic relations with the rest of the world to be completely divided among individual economic sectors . The difference from the analogical, commonly used, balance of payments methodology lies in accrualization and classification of some items, e.g. capital transfers.

In 2013, the Czech economy recorded, for the first time in the history of the independent CR, a positive net lending/borrowing vis-à-vis the rest of the world of 1.1% of GDP. CR thus became an exporter of capital.

A steady improvement in the balance of goods and services continued, with the surplus rising to 6.4% of GDP. The persistently deficit balance of primary incomes recorded a surprising, probably one-off, improvement of 0.8 pp to –6.6% of GDP, especially in the liability item of re-invested profits from foreign direct investment. The balance of current transfers was slightly deficit at the level of −0.9% of GDP and the surplus of capital transfers increased to 2.2% of GDP.

In the horizon of the CP, no major changes in relations with the rest of the world should occur. With further widening of surpluses of the balance of goods and services and deficits of the balance of primary incomes, net lending/borrowings should fluctuate around 1% of GDP with a slightly decreasing tendency.

From the perspective of sectoral balances, with the given general government deficits as a ratio to GDP, the private sector surpluses should fluctuate around 3% of GDP.

Table 2.5: Sectoral Balances
(in % of GDP)

	ESA Code	2013	2014	2015	2016	2017
Net lending/borrowing vis-à-vis the rest of the world	B.9	**1.1**	**1.2**	**1.2**	**1.0**	**0.8**
of which : Balance on goods and services		6.4	7.7	8.4	8.8	9.1
of which : Balance of primary incomes and transfers		-7.5	-8.9	-9.5	-10.0	-10.4
of which : Capital account		2.2	2.4	2.3	2.2	2.2
Net lending/borrowing of the private sector	B.9	**2.6**	**3.1**	**3.5**	**3.0**	**2.5**
Net lending/borrowing of general government	EDP B.9	**-1.5**	**-1.8**	**-2.3**	**-2.0**	**-1.7**
Statistical discrepancy		**0.0**	**0.0**	**0.0**	**0.0**	**0.0**

Note: National Accounts Methodology. Net lending/borrowing of general government for 2013–2014 notification, years 2015–2017 outlook.
Source: CZSO (2014a). MF CR calculations.

3 General Government Balance and Debt

The recession at the turn of 2008 and 2009 brought a considerable worsening of the general government sector balance in the CR. The downturn was intensified by the European Economic Recovery Plan, the aim of which was to stimulate the EU countries' economies. From 2010, the coordinated consolidation of public finances has again been initiated at the European level, since in a number of countries an excessive government sector deficit was identified and the debt crisis of the Euro Area reached its full intensity. The CR had four years to remove its excessive deficit in a sustainable way. The result of 2013 shows just how strong was the determination of the Czech authorities to fulfil this requirement. Moreover, for the first time since EU accession, in 2013 the CR overachieved the medium-term budgetary objective set for the CR as a structural deficit of 1% of GDP.

3.1 Actual Balances and Updated Budgetary Plans for the Current Year

3.1.1 2013 Development

According to preliminary data from the CZSO, in 2013 the government sector deficit was 1.5% of GDP. Compared to 2012, this amounts to an improvement of 2.8 pp. For a realistic comparison, the result of 2012 must be adjusted for relatively large one-off operations such as the financial compensation of the property settlement with churches and religious societies (approximately CZK 59 billion) and correction of reimbursement from EU funds (approximately CZK 12 billion). These corrections will also be applied in the following years, but to a lesser extent (in 2013 approximately CZK 2.5 billion and in 2014 CZK 0.8 billion is expected). After adjustment for the aforementioned influences, the balance in 2012 reached only −2.4% of GDP, and in 2013 an improvement of 0.9 pp occurred. Considering the substantially deeper output gap, fiscal efforts accounted for 1.3 pp, similarly as in the previous two years.

The total growth of revenue reached 2.4% in 2013. This was due to 3.0% higher tax revenues, in particular due to the increase in value added tax revenue that rose by 6% with a 1.3% growth of the economic base. The explanation can be seen in the change in both rates of 1 pp, which according to cur-rent estimates contributes approximately 0.4 pp to fiscal efforts.

Excise tax revenues decreased by 1.3% in 2013 despite the relatively sizeable stockpiling of tobacco products at the end of the year. In addition to the beginning of 2014, the rates also changed in 2013, while better collection due to the stockpiling of 2013 is negated, to a certain extent, by stockpiling in 2012. The year-on-year decrease was mainly caused by lower revenues of the tax on mineral oils.

Personal income tax revenues increased by 3.7% in 2013, in spite of a nearly 1% decrease in the wage bill. This development is the result of a number of discretionary measures, such as introducing the second statutory rate of personal income tax or cancelling the basic discount for working pensioners. The total discretionary effect is approximately 0.2% of GDP and thus contributes 0.2 pp to fiscal effort in 2013. Social security contributions increased by 1.1% in 2013.

Corporate income tax increased by 2.0% in 2013 with discretionary measures only a relatively small amount (just under 0.1% of GDP). The principal measure concerned a decrease in the tax duty by the extent of flood damages of 2013. This relief also applied to self-employed persons who fall under personal income tax; in this case, however, the impact was negligible. Other tax revenues changed slightly over time.

A considerable year-on-year increase could be seen in property incomes, which rose by more than 21.5%. In 2013, the amount of CZK 6 billion was transferred from Forests of the CR, state enterprise, to the state budget revenues. Most of this sum was then assigned by the CZSO as a current dividend increasing government sector revenue. The second impact was the methodical recording of dividends paid to the government sector, when previously the net amount after taxation was recorded in revenues. Newly recorded items include the amount before taxation on the revenue side and then the tax paid by the government sector on the expenditure side. The modification increases the level of revenue property incomes and expenditure direct taxes, but has no impact on the deficit. The change was applied so far only in 2013, periods further back in time will be modified by the CZSO as late as in September 2014 due to transition to the new standard ESA 2010. The forecast for the current year and the outlook for the following years already take into account the new recording procedure. Income transfers in total increased by 2.5% in 2013.

General government sector expenditure decreased by 4.0% in 2013, a reduction brought on by the aforementioned one-off factors (financial compensation to churches and the correction of reimbursement of EU funds). After adjusting for these influences, expenditure increased by 0.2% only.

Final consumption expenditure the general government increased by 1.7% after three years of continual decrease. This growth was caused by an increase in government sector intermediate consumption (i.e.

mainly purchases of goods and services), which increased by 2.3%, also after three years of continuous decrease. Expenditure on employees' wages also increased by 2.6% YoY (during the previous three years, it had generally decreased). Another important component includes social benefits in kind (expenses of health insurance companies related to health care). They only increased by 0.5%, which is historically the lowest growth for the whole available time series (i.e. since 1995). The main reason for this was the relatively restrictive Reimbursement Decree of 2013, which very much helped dampen the expenditure of health insurance companies on health care.

Expenditure on property income decreased by 3.7% due to expenditure on interest costs involving state debt management, where the very small increase in debts was positively reflected, as was the favourable development of interest rates of state bonds.

Government sector investment decreased once again, now for the fourth year in a row, by more than 12%. Considering the accrual subsidy development on the revenue side (a decrease of approximately CZK 2 billion), investment paid from national sources mainly decreased. In terms of subsector, investment expenditure was reduced most at the level of local government institutions, less so at the central government level (mainly the Road and Motorway Directorate). The total effect of the decrease in investment with the impact on the deficit is more than 0.3% of GDP. From 2009, the share of investment of the government sector in GDP has decreased cumulatively by nearly 2.2 pp.

Capital transfers of the government sector to other sectors also contributed to a decrease on the expenditure side. In addition to the two aforementioned one-off operations, a decrease in costs from transfers of the State Environmental Fund in connection to the Green Savings Programme has had a considerable impact. Other expenditure transfers increased slightly by approximately 1.8%.

The year 2013 can be summarised briefly as a year with a considerable fiscal effort of 1.3 pp, visible both in the tax area (value added tax, less personal income tax) and on the expenditure side in the decrease in investment expenditure from national sources.

3.1.2 2014 Development

In 2014, we can expect a deterioration of the government sector deficit to 1.8% of GDP, i.e. by 0.4 pp, and considering the output gap development, the structural balance would deteriorate by approximately 1 pp.

According to current estimates, government sector revenues should increase by 2.8%, primarily due to the accrualization of income transfers from the EU (particularly investment ones). Tax revenues should increase to a relatively limited extent – by only 0.5%, or 1.0% if we include social security contributions in tax revenues.

Indirect taxes should decrease by 1.0% in 2014. A crucial factor for this group is the development of excise taxes collection, where several effects are reflected. These include stockpiling tobacco products, the tax collection of which is included in 2013 at the expense of 2014, the decrease in the rate on payments from electricity generated by solar radiation (the period for which they will be paid is, however, pro-longed), and from mid-2014, the expected reintroduction of returns of excise tax on mineral oils for agricultural primary manufacturers (government Resolution No. 201/2014). In total, excise taxes should decrease by more than 5%. Value added tax should increase by 0.8%, whereby the impacts on this tax, resulting from a change in legislation, are basically negligible in 2014.

The expected 3.2% growth in the collection of direct taxes should be driven by corporate income tax, which will increase by 3.7%, and by personal income tax, the collection of which should increase by 2.7%. A more substantial discretionary change will only occur for personal income tax, where a positive effect of nearly 0.1% of GDP is expected to follow from the restriction, from this year, of child tax credit to residents from the EU, Norway and Iceland only. From the fiscal viewpoint, other changes are very small. Social security contributions should increase by 1.6%, which is mostly an autonomous development mirroring the expected increase in the wage bill in the economy.

A decrease of 7.4% can be expected in property incomes, particularly due to lower expected dividends, mainly of the former National Property Fund in comparison with 2013. The transfer of profits from Forests of the CR, state enterprise, will be slightly lower, classified as government sector revenue. At present, an increase in a dividend from ČEZ is not included in the estimate, which would possibly improve government sector balance. The forecast includes revenue from the sale of licences to mobile operators of CZK 8.5 billion.

We forecast a considerable increase in income transfers from EU structural funds, mainly of capital transfers, where we expect growth of more than 72%. This item is a reflection of the gross fixed capital formation (government investment) on the expenditure side of the government sector. The forecast expects 95% of the allocated amount to be obtained for the programming period of 2007–2013, whereby funds so far not paid for pre-financing from the last programming period are to be distributed between 2014 and 2015, thus causing a considerable increase. The total effect on government sector deficit is only in the amount of

Czech financing, whereby the effect can be estimated at an annual level of 0.2% of GDP.

Government sector expenditure should rise by 3.8% YoY, which is the quickest pace for the last four years. After adjustment for expenditure financed from EU funds, however, the growth of total government sector expenditure is only 1.8%.

Final consumption expenditure should maintain the dynamics of last year and increase by 1.7%. We can expect a slight increase of 1.5% for intermediate consumption. Compensation of employees should increase as a consequence of several discretionary measures (in particular a 2% increase in the wage bill of state administration) by nearly 2%.

A more considerable YoY increase can be expected for social transfers in kind (2.5%). Both a change in the Reimbursement Decree to strengthen levels of hospital care by more than 0.1% of GDP, and an increase in the payment for state insured persons due to a decrease in patient co-participation, will be reflected here. It can be expected that a drop in patient co-participation will be compensated by health insurance companies increasing payments to health care facilities.

A large increase of nearly 5% is also expected for social benefits, where two effects will be reflected. The first is an increase in the payment for state insured persons in 2014, which, while increasing this item, is revenue of the system of health insurance companies. Only the subsequent increase in payments for medical care has an impact on the deficit. The second effect is an increase in assistance social benefits, where long-term unfavourable economic development is increasingly reflected in the social problems of households. Pensions will probably increase only slightly with a still limited valorisation scheme.

As already mentioned above, in 2014 a considerable increase in investment expenditure can be expected of nearly 29%, due to expected greater investment financed from European resources. Stagnation is expected for investment from Czech resources, as the priority of government units will be to utilise the allocation of the programming period 2007–2013.

The forecast risks can be regarded as basically balanced. Risks primarily concern possible non-utilised allocations of European funds that would, under certain conditions, represent savings on Czech financing for the government sector. Another risk is economic development of the Czech Republic which differs markedly from expectations.

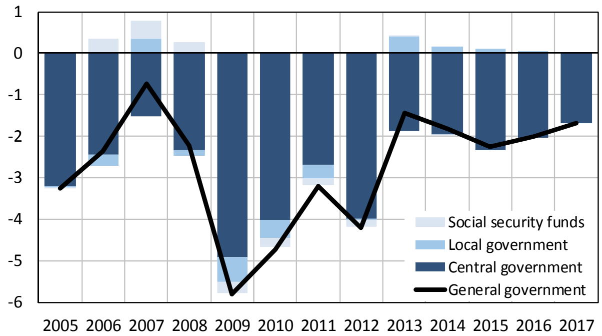
3.2 Medium-term Budgetary Outlook

The submitted update of the CP has considerably revised the expected government sector performance in the medium-term horizon in comparison with the trajectory presented in the CP 2013. The causes of the significant decrease in expected deficits for the period of the budgetary outlook mainly include the considerably better than expected economic result in 2013, the already known trends for revenues and expenditure in the current year, as well as the expected macroeconomic development in combination with the government's planned measures. We predict a decrease of government deficits in subsequent years from 2.3% in 2015 to 1.7% of GDP in the CP forecast horizon.

On the one hand, the current setting of fiscal policy is determined by the update of the expenditure framework for the state budget and state funds for 2015–2017 approved by the government and, on the other hand, by the assumptions using available data sources regarding the development of other government sector units. A number of measures adopted in recent years, the effectiveness of which is planned for future years, have participated in shaping fiscal policy, as have government intentions to cancel some valid measures and introduce others.

Government sector performance has always been strongly influenced by the central government balance (Chart 3.1), which most probably will not change in future. As economic recovery accelerates at the end of the medium-term horizon, we can also expect higher revenues in all units of the governmental institution sector, derived from a higher collection of taxes sensitive to the business cycle.

Chart 3.1: Government Balance by Sub-sectors
(in % of GDP)



Note: Years 2013–2014 notification, years 2015–2017 outlook.
Source: CZSO (2014b). MF CR calculations.

Table 3.1: Original Impact on the General Government Balance of Measures to Be Terminated
(year-on-year discretional change, in CZK billion)

	2015	2016	2017
Revenue Discretioanry Measures	**-13.7**	**-26.4**	**-0.6**
Personal income tax	-14.6	-3.1	-
Corporate income tax	-0.1	-5.5	-
Social security contributions	-1.3	-1.8	-
Value added tax	2.4	-16.0	-0.6
Expenditure Discretionary Measures	**-**	**2.4**	**0.1**
Total	**-13.7**	**-24.0**	**-0.6**
% of GDP	-0.3	-0.6	0.0

Source: MF CR.

Table 3.2: Impact of Recently Planned Measures on the General Government Balance
(year-on-year discretional change, in CZK billion)

	2015	2016	2017
Revenue Discretioanry Measures	**-4.7**	**-0.2**	**-0.2**
Personal income tax	-2.9	-	-
Corporate income tax	-	-	-
Social security contributions	-	-	-
Value added tax	-4.2	-0.2	-0.2
Consumption taxes	2.4	-	-
Other revenue measures	-	-	-
Expenditure Discretionary Measures	**-5.6**	**-0.1**	**-0.1**
Cash social benefits	-5.4	-0.1	-0.1
Compensation to employees	-	-	-
Health care	-0.2	0.0	0.0
Other expenditure measures	-	-	-
Total	**-10.3**	**-0.2**	**-0.2**
% of GDP	-0.2	0.0	-0.0

Source: MF CR.

Table 3.3: Impact of other, already valid, Measures on the General Government Balance
(year-on-year discretional change, in CZK billion)

	2015	2016	2017
Revenue Discretioanry Measures	**-0.9**	**0.7**	**0.9**
Personal income tax	-	-	-
Corporate income tax	-	-	-
Social security contributions	7.1	0.2	0.2
Value added tax	0.6	0.5	0.7
Consumption taxes	-	-	-
Other revenue measures	-8.5	-	-
Expenditure Discretionary Measures	**-7.2**	**-2.6**	**-1.7**
Cash social benefits	-4.9	-0.2	-
Compensation to employees	-2.3	-2.4	-1.7
Health care	-	-	-
Other expenditure measures	-	-	-
Total	**-8.1**	**-1.8**	**-0.8**
% of GDP	-0.2	0.0	0.0

Source: MF CR.

3.2.1 Expected Development of Revenues

In comparison with the last update of the CP, planned measures of the new coalition government will lead to considerable changes in the area of direct and indirect taxation in the medium-term outlook. These changes mainly result from the government's decision to cancel the reform of direct taxes and payments already approved in the past in connection with establishing the Integrated Revenue Agency (calculation of impacts of all cancelled measures – see Table 3.1), but they also stem from other changes mainly concerning the setting of value added tax and direct taxation.

The collection of personal income tax will be influenced positively by the expected development of the wage bill in the domestic economy. In 2015, when the collection of personal income tax will still be hampered by the effects of discretionary measures with an overall slightly negative impact, we expect a collection growth of 1.7%. In the following two years of the outlook, the development should mirror the wage bill increase that is forecast at 3.6% in 2016 and 4.1% in 2017.

In 2015, the effect of discretionary measures on the collection of personal income tax will be approximately CZK −3 billion. In that year, the basic personal tax credit for working pensioners will be reintroduced with the effect of CZK −2.5 billion. The temporary cancellation of the allowance formed part of the consolidation package of 2012, and was originally planned for 2013–2015. Thus the effect of this measure is being shortened by 1 year. Furthermore, from 2015 an increase in tax credit is proposed for a second and any additional child by CZK 1,200 annually in comparison with the current situation (an effect of CZK −0.9 billion). Additional revenue of approximately CZK 1.3 billion should be raised by a further limitation on flat expense deductions for self-employed persons, whereby payers using the 60% lump-sum will only be allowed to claim expenses to the maximal annual amount of CZK 1.2 million, which means, that the applicable lump-sum will be fixed for incomes above CZK 2 million per year.

In 2016, a systemic change in the setting of personal income tax will be made, although it will not have any significant impact on the deficit. Starting from 2016, the tax base, which is currently the total sum of gross wages and the employer's contributions to social security, will consist of the level of gross wages only. The respective changes in tax rates and tax allowances will also correspond to this change, and will be set so that the requirement for budgetary neutrality is met.

In terms of contributions for social security and health insurance as the budgetary most important item for the government sector, we expect relatively robust autonomous growth, similarly to that for personal income tax. In addition, growth will be supported in 2015 by the positive effect of discretionary budgetary measures. Of the original package of changes in relation to the reform of direct taxes and payments, now largely cancelled, several measures which will result in burdening some earlier exempted employee benefits with insurance premium have been retained. These should increase the state budget revenue by approximately CZK 2 billion.

The scenario of the updated CP expects revenues from accident insurance provided through the government sector from 2015. In the first year, revenues from this item should reach CZK 5.1 billion, and CZK 0.6 billion after adjustment for planned expenditure for accident insurance benefits. For the period of the medium-term outlook, in contrast, we do not expect any other additional opt-out impacts on the amount of revenue from pension insurance.

The expected economic recovery will also exert a positive effect on the collection of corporate income tax, where we expect increases of 3–4% per year. Except for two measures with an entirely marginal fiscal effect (tax recognisable expenditure for the establishment and operation of employer kindergartens, restriction on the opportunity to use the zero rate for investment fund taxation), no other legislative changes with any impact on the revenues of this tax are currently elaborated.

Plans presented in the last update of the CP for value added tax have undergone considerable conceptual changes. Already from 2015, a second reduced value added tax rate of 10% will be introduced in accordance with the Policy Statement of the Government. This rate will apply to drugs, books as well as on the irreplaceable child nutrition. A drop in collection resulting from the introduction of the third tax rate is estimated at CZK 4.2 billion. As a consequence of this measure, there will only be limited growth of total value added tax collection in 2015. The unification of both rates at 17.5% was initially planned for 2016, but the government currently intends leaving the tax rates at present 15 and 21%. For 2016 and 2017, we expect a collection growth of ca. 3% YoY, which corresponds to the expected increase in final consumption of households and the general government sector.

The collection of other consumption taxes will only be influenced by the government's measures in 2015, when the additional effect of increase of excise tax on tobacco products from the previous year will manifest. The measure will bring CZK 2.8 billion into the government sector budget. In contrast, the government's decision to reintroduce the return of 40% of paid excise tax on mineral oils for agricultural primary producers will have a negative impact on excise tax revenues of CZK 0.4 billion. We expect excise tax collection in 2015 to grow by 2.5% and we estimate excise taxes to increase by 0.5% in the forecast of government sector revenues in the following two years of the outlook, when no other discretionary changes are assumed.

For 2015–2017, we are not considering at present any other fiscally important changes. A year-on-year decrease in the category Other Revenues in 2015 will be caused by implementation of one-off revenue in 2014 in the form of revenues from the frequency auction for mobile operators in the amount of CZK 8.5 billion.

3.2.2 Expected Development of Expenditures

In the years of the outlook, we expect a slight relaxation of some expenditure of the general government sector, although the effect of the considered discretionary measures on the expenditure side is very limited – only in units of billions CZK. The average year-on-year increase in total expenditure should fluctuate at 2.4%, which is considerably less than the expected growth of nominal GDP. The share of government sector expenditure in GDP should decrease from 42.4% in 2014 to 41% in 2017.

After the declared wage bill freeze in state administration until 2016, presented in the last update of the CP, this stance has been revised. Following on from the approved 2% increase in the wage bill in state administration in 2014, we also expect growth in the following period by 1% in each year of the outlook. In 2015 and 2016, the wages of doctors should also increase. The impact of an increase in compensation of employees in the period of the outlook is quantified at CZK 2 billion on average per year.

In other items making up government consumption, more significant changes will occur in social transfers in kind. As a consequence of a decrease in patient co-participation caused by the abolition of regulatory fees in health care (from 2015, only the fee for use of emergency medical services will be kept), a drop in the revenues of medical service providers will be compensated by an increase in payments of the state to the public health insurance system. The effect of this measure is estimated at approximately CZK −2.2 billion in 2015. On the other hand, considerable savings in the health care sector will occur due to planned changes in value added tax, by introducing a second reduced rate of 10% for drugs (a reduction of government sector expenditure by CZK 2 billion).

At present, we expect an average growth of nominal government consumption expenditure of 1.8% in 2015–2017. Considering the fact that rationalisation of expenditure and savings in current expenditure inside the government sector are key priorities of the coalition government, it can be expected the submission of specific proposals with quantified impacts on making savings in general government sector expenditure in subsequent updates of the CP.

Changes compared to the last update of the CP occur in mandatory social benefits, specifically in expenditure on pensions. Starting from 2015, pensions will again be valorised according to the formula valid until 2012. Growth of consumer prices will be fully reflected in the total increase in paid pensions as well as a third of the growth of real wages, with government discretion to increase these expenditures above the minimal statutory limit. The decision to reduce the limit of the valorisation scheme by one year will increase general government sector expenditure by approximately CZK 5.4 billion in 2015. In the same year, the amount of the existence and the subsistence minimum will also increase, which will result in a slight increase (CZK 0.4 billion) in some social benefits amounts of which (or entitlement to their payment) are determined by the levels at which these minima are set.

As already mentioned in the section concerning the expected development of revenues, accident insurance will be introduced from 2015 that will increase the social expenditure of the general government sector in the first year of operation by approximately CZK 4.5 billion. The whole system of accident insurance should be, however, slightly in surplus with regards to the government sector balance.

After a four-year decrease in gross fixed capital formation in 2010–2013 and the expected strong recovery of government sector investment activity in 2014, we also expect a nearly identical level of investment for 2015. The reason for the sharp increase in general government sector investment in 2014 and 2015 is the expected increase in the disbursement of EU funds from the programming period 2007–2013 from which it is necessary to draw down most of the subsidies until the end of 2015. We consider the assumption of significant growth in the volumes of investment co-financed under the Economic and Social Cohesion Policy as realistic, as it is based on knowledge of the amount so far not utilised from the allocation intended for the CR and the volume of funds already covered by contracts on provision of subsidies between the managing body and final grant beneficiary.

Although the new financial perspective 2014–2020 is valid from 2014, once the possibility of simultaneously drawing funds from both programming periods is concluded in 2016, we expect a considerable decrease in investment co-financed from EU funds, which will be reflected in a total decrease in gross fixed capital formation of the government sector by approximately 8%. In 2017, we are forecasting only a very slight increase, which is also given by the fact that we are conservatively expecting an average 3% growth of investment from national resources during three years of the outlook.

For the period 2015–2017, we expect low growth of interest payments expenditure, which will be determined partly by a favourable situation on the financial markets and partly by the achieved and planned structure of the debt portfolio and effective liquidity management. The average growth of interest payments of approximately 2% annually in the period of the medium-term outlook should stabilise the share of costs of debt servicing approximately at the level of 1.4% of GDP.

The forecast does not include the expected lease of the JAS 39 Gripen fighters (Government resolution No. 169/2014), which will probably be recorded as a one-off expenditure, as intermediate consumption according to the ESA 95 methodology and as gross fixed capital formation according to the ESA 2010 methodology (impact approximately 0.5% of GDP in 2015). The JAS 39 Gripen fighters will be included in government sector expenditure only based on knowledge regarding specification of the contract and final price.

3.2.3 Comparison of Intentions with a No-policy-change Scenario

The economic policy intentions in comparison with autonomous scenario, i.e. scenario which take into account the current legal state are illustrated in Table 3.4. It is evident, that unlike decision to cancel the direct taxes and payments reform in 2015 and refusal of unification of value added tax rates in 2016, new measures on the expenditure side have no significant influence. Provided there is no implementation of new discretionary measures, government sector revenues would be 0.2% of GDP lower in 2015 and 0.8% of GDP lower in both 2016 and 2017. The expenditure would be lower by 0.2% of GDP in the whole horizon of CP. The total balance would therefore be lower particularly in 2016 and 2017 by 0.6% of GDP.

Table 3.4: Comparison of the No-policy-change Scenario with the Intentions of Fiscal Policy
(in % of GDP)

	2014	2015	2016	2017
Total revenue	**40.6**	**39.9**	**39.5**	**39.3**
Total revenue at unchanged policies	40.4	39.8	39.4	39.2
Cumulative discretionary revenue measures	0.2	0.1	0.1	0.1
Total expenditure	**42.4**	**42.2**	**41.5**	**41.0**
Total expenditure at unchanged policies	42.1	41.5	40.8	40.2
Cumulative discretionary expenditure measures	0.3	0.7	0.7	0.8
Total balance with discretionary measures	**-1.8**	**-2.3**	**-2.0**	**-1.7**
Total balance without discretionary measures	-1.7	-1.7	-1.4	-1.1
Total cumulative discretionary measures	-0.1	-0.6	-0.6	-0.6

Note: Autonomous scenario does not consider any additional government measures, i.e. it takes into account the current legal state. Discretionary measures in this table incorporate all non-autonomous changes, i.e. both those improving and worsening the balance. Discretionary measures in 2014–2017 are represented cumulatively, thus containing effect of changes in previous years.
Source: MF CR calculations.

3.3 Structural Balance, Fiscal Stance

The structural balance in 2013 reached −0.3% of GDP. In the years of the outlook, it should deteriorate to −1.7% of GDP as a consequence of the reduced emphasis on government sector consolidation. Interest expenditure should see only limited growth in the medium-term outlook, in relative terms it should stagnate around 1.4% GDP. As a consequence, the primary structural balance will develop similarly to that of the structural balance.

The only one-off measure on the revenue side that we expect in the forecast is revenue from the auction of newly released frequency bands, the amount of which is 0.2% of GDP in 2014. In 2014–2016, we further expect to see expenditure capital transfers to non-standard state guarantees to a maximum amount of CZK 2 billion per year and in 2014–2017 expenditure on interest from state guarantees not exceeding CZK 1 billion per year. Corrections of reimbursement of EU funds are also accounted for as one-off expenditure (see previous chapters).

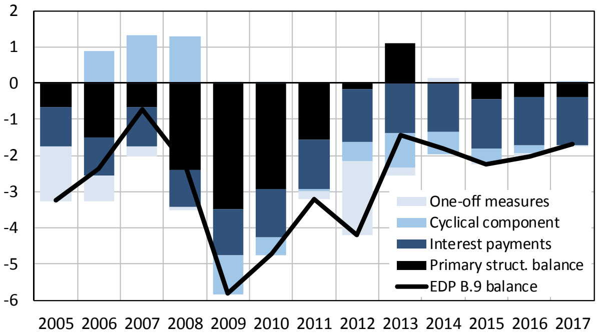
Chart 3.2 (and in more detail, Table P.5) record the development of the cyclical component of the deficit, i.e. the impact of items which are clearly sensitive to the economy’s position in the business cycle. Since H2 2013, the negative output gap has been closing in line with the gradual economic recovery (see Chart 2.2). This trend should continue in the years of the outlook so that in 2017 we expect the output gap to be roughly balanced. We expect the cyclical component of the balance to improve from −1.0% in 2013 to 0.0% in 2017.

3.3.1 Assessment of the Fiscal Effort

Fiscal effort, defined as the year-on-year change in the structural balance, equalled in 2010–2013 (the horizon decisive for the excessive deficit procedure) the average annual value of 1.1 pp. Thus it has more than fulfilled the Council of the EU’s recommendation (see Chapter 1.2) and reduced the deficit below 3% of GDP. We estimate total fiscal effort in the given period to be at ca. 4.5 pp.

In 2015, the growth of structural deficit will be caused by advancement of several non-systemic measures which have been improving the balance as part of the consolidation pack. In the years following, according to the current setting of the government’s economic policy, the fiscal policy stance shall be neutral, which should leave space for the effect of automatic stabilisers and the spontaneous resurrection of the economy.

Chart 3.2: General Government Balance
(in % of GDP)



Source: CZSO (2014b). MF CR calculations.

The view of fiscal effort and structural balance is supplemented by the expenditure rule of the Stability and Growth Pact, which compares the growth of adjusted real expenditures of the government sector with the average growth of the potential product. In the case country is not in line with its medium-term objective, the average growth of the potential product (1.6%) is decreased by the convergence clause (ca. 1.2pp) which should provide the return to the medium-term objective. The comparison is shown in Table 3.5.

In 2012, the European Commission developed a new method (EC, 2012b; EC, 2013b) for evaluating the effectiveness of measures for the excessive deficit procedure. The method compares the values of the average annual fiscal effort recommended by the Council of the EU, the values of estimated fiscal effort that are ascertained directly as a year-on-year change in the structural balance and the values of adjusted fiscal effort reflecting the impacts of changes in potential GDP growth and changes in estimates of government sector revenues.

Table 3.5: Adjusted Real Expenditures Growth and the Expenditure Benchmark of the Stability and Growth Pact
(growth in %)

	2015	2016	2017
Adjusted Real Expenditures	**2.1**	**2.2**	**1.3**
Expenditure Benchmark (SGP)	**0.5**	**0.5**	**0.5**

Source: MF CR calculations.

In order to record the impacts of these changes, this method was applied for 2010–2013, whereby the estimates from the CP 2010 and the CP 2011 for 2013 serve as the original estimates of the values and the current CP values serve as the new value estimates. The results of the calculations are shown in Table 3.6. From the table it is apparent that the fiscal effort in 2011–2013 was relatively strong and above the value recommended by the Council of the EU. After deducting the revisions of potential GDP and revenue of the government sector, the average value of adjusted fiscal efforts is even higher by 0.3 pp, i.e. 1.4 pp annually. A considerable revision was made in particular in 2010 due to higher revenue of the government sector, despite lower than originally estimated GDP growth.

Table 3.6: Assessment of the Fiscal Effort in 2010–2013
(in percentage points)

	2010	2011	2012	2013
Current estimate of fiscal effort	**0.5**	**1.3**	**1.3**	**1.3**
Impact of revisions in potential output growth	-0.6	-0.5	-0.2	-0.1
Impact of revisions on composition of economic growth or of other effects on revenue	-0.9	0.6	0.2	0.3
Adjusted fiscal effort	**1.9**	**1.2**	**1.3**	**1.1**

Source: MF CR calculations.

3.4 General Government Debt, Strategy and Stability of the State Debt

According to current estimates, we expect just a slight increase in the nominal value of government debt in 2014. Considering the expected recovery of GDP growth, we forecast slight growth of the debt quota during the whole horizon of the CP forecast (see Table 3.7), while the relative amount of the debt should increase from ca. 45% in 2014 to ca. 47% of GDP in 2017. The expected dynamics of the development of total government debt of the CR improved considerably in comparison with last year's update of the CP. The reason is the further engagement of the liquidity system of the government sector and its more effective management. The contributions of interest expenditure to a change in the debt quota should basically remain throughout the period at a constant level, while the impact of contributions of the primary balance, in spite of some expected deterioration in 2015–2016, will not be too pronounced. Further, the forecast does not envisage any privatisation revenues, as the government has not yet decided to privatise any other major entities.

After adjusting the level of gross government debt by the value of liquid financial assets (currency, deposits and securities including holdings in exchange-listed companies), so-called net financial debt in 2013 amounted to 63.1% of overall gross debt. In other words, the size of the relatively liquid amount for repayment of the debt, if required, would amount to 17.0% of GDP. We expect the ratio of net financial debt to total debt to increase to approximately 69% in 2017.

When looking at the distribution of gross general government debt among the individual levels of government (Table 3.7), it is clear that the subsector of central government institutions represents the decisive share; in 2013 it made up 94% of total debt, and this share should continue to grow further very marginally. The local government institutions sub-sector accounts for the remaining ca. 6% of total debt, since the indebtedness of social security funds is negligible. Nearly all central government debt is subsequently accounted for by state debt, i.e. debt generated by the state budget. Therefore, the sustainable risk structure of state debt is a crucial stability factor for the debt of the general government sector as a whole.

When shaping the medium-term state debt and the state issuance strategy (see MF CR, 2013b), primary attention has been given to refinancing, interest and currency risk, which represent the most significant sources of financing uncertainty. Their stabilisation remains especially crucial in periods of above-average volatility on international financial markets and increased uncertainty among investors. The key indicator for assessing refinancing risk is the share of short-term state debt (the share in total debt of debt payable within 1 year). Its share was 15.8% at the end of 2013, when compared to the end of 2012 the value of the share of short-term state debt decreased by 2.1 pp. The share decreased in connection with the approval of the amendment to Act No. 218/2000 Coll., on Budgetary Rules and on the Amendment of Some Related Acts, which came into effect on 1 January 2013. It brought about a considerable extension of the CZK summary account of the State Treasury and the possibility to maintain summary accounts of the State Treasury in foreign currencies. The result has been an accrual of available liquidity of the state. In the monitored period, we forecast a share of short-term debt of 13–15%, which represents a sufficient reserve from the set limit which equals, starting from 2014, the level of 20%. In addition to short-term debt, medium-term debt (due within 5 years) is also managed actively. Since 2012, the share of medium-term debt within total debt has been set at a maximum of 70%. Management of the refinancing risk is thereby divided between short-term and medium-term state debt. The share of medium-term state debt was 53.6% at the end of 2013.

The stable refinancing structure is confirmed by the average maturity of state debt (Table 3.8), which ranged from 6 to 7 years in 2006–2008. In 2009–2012, the target band for this ratio was repeatedly shifted downwards. The main reason for these changes was prolonged uncertainty regarding development in the euro area and the resulting preference of investors to buy state bonds with shorter maturity. For 2013, the target band for the average period until the maturity of state debt has been left at 5–6 years. At the end of 2013, the average maturity of state debt reached 5.6 years.

The most important market risk for managing state debt is the interest rate risk. Since 2006, a strategic target is set each year for refixing the interest of the debt portfolio within 1 year, i.e. the share of debt which is sensitive to interest rate fluctuations on the financial markets in the following year. For 2014, the band has been left at the level of 30–40%, providing an outlook around the middle of the interval. This target is in accordance with that of the average period before state debt refixing occurs in the band of 4.0 to 5.0 years. At the end of 2013, interest refixing of the debt portfolio within 1 year stood at 35.4% of total state debt. As far as the interest structure is concerned, the share of state debt with variable interest to total state debt reached 16.8% in 2013. Between 2014 and 2017, the share of state debt with variable interest to overall state debt should not exceed 20.0%. The effect of derivative transactions on interest rate exposures relates to operations hedging the currency risk of foreign issues.

Another market risk to which the state debt portfolio is exposed is currency risk. Starting from 2011, currency risk has also been actively managed, while from 2014 the foreign-currency exposure of state debt is taking into account the foreign-currency exposure of state financial assets. The foreign-currency exposure of state financial assets reduces the foreign-currency exposure of the debt portfolio, respectively providing a more credible picture of the real currency risk.

For 2014, the share of net foreign-currency exposure of state debt to total state debt must not exceed the limit of 15% + 2 pp (with the exception of short-term excess due to unexpected depreciation of the domestic currency). At the end of 2013, this indicator was 9.4%, i.e. below the limit. An increase in the ratio of 1.3 pp compared to the end of 2012 can be explained by the weakening of the CZK during 2013 as a consequence of launching foreign exchange interventions (see subchapter 1.3). At the end of 2013, the share of net foreign-currency exposure of state debt denominated in EUR to the total net foreign-currency exposure of state debt reached the value of 89.4%, whereby the indicator value had increased by 2.0 pp compared to the end of 2012. In the medium-term horizon, no large change in the currency exposure structure is expected.

Table 3.7: General Government Debt by Sub-sector and Net Financial Debt
(in % of GDP)

	ESA Code	2012	2013	2014	2015	2016	2017
General government	S.13	**46.2**	**46.0**	**44.9**	**46.0**	**47.1**	**47.1**
Central government	S.1311	43.4	43.2	42.2	43.5	44.7	44.8
Local government	S.1313	2.9	2.9	2.8	2.6	2.5	2.4
Social security funds	S.1314	0.0	0.0	0.0	0.0	0.0	0.0
Net financial debt [1)]		**26.4**	**29.1**	**29.9**	**31.0**	**32.1**	**32.6**

Note: Years 2013–2014 show notification. Years 2015–2017 show outlook.
1) Net financial debt is a difference between gross debt and liquid financial assets (monetary gold, Special Drawing Rights, currency and deposits, securities other than shares (consolidated at market value), shares and other equity quoted in stock exchange).
Source: CZSO (2013b). MF CR calculations.

Table 3.8: The State Debt's Refinancing, Interest and Debt Denominated in Foreign Currency

		2012	2013	2014	2015	2016	2017
Refinancing							
Average maturity	*years*	**5.7**	**5.6**	**5.7**	**5.7**	**5.8**	**5.8**
Debt due within 1 year	*% of debt*	**17.9**	**15.8**	**13.9**	**14.8**	**13.8**	**14.0**
State Debt's Interest							
Debt with interest fixation within 1 year	*% of debt*	**37.5**	**35.4**	**36.1**	**34.0**	**33.5**	**33.5**
Fixed interest long-term debt due within 1 year	*% of debt*	6.5	8.5	7.4	4.5	5.7	8.4
Variable interest long-term debt	*% of debt*	14.9	16.8	19.8	19.4	18.0	15.9
Monetary instruments	*% of debt*	11.3	7.2	7.1	6.6	6.2	5.9
Effect of derivative operations	*% of debt*	4.8	2.9	1.8	3.5	3.6	3.4
Foreign Currency Exposition							
Debt denominated in foreign currency[1)]	*% of debt*	**17.7**	**19.0**	**14.0**	**15.6**	**16.9**	**18.7**
Foreign currency exposition[2)]	*% of debt*	**8.1**	**9.4**	**9.8**	**10.9**	**11.1**	**11.2**
EUR exposition	*% of debt*	7.0	8.4	8.8	10.0	10.8	10.9

Note: The state debt here represents debt generated by the state budget financing. Data in the national methodology.
1) State debt denominated in foreign currencies.
2) State debt denominated in foreign currencies adjusted for collateral and assets.
Source: MF CR.

4 Comparison with Previous Update and Sensitivity Analysis

4.1 Comparison with Previous Convergence Programme Update

Compared to the scenario of the previous CP, the macroeconomic scenario of the updated CP provides a slightly more favourable view of economic and fiscal development (Table 4.1).

For the whole of 2013, instead of the expected stagnation, real GDP showed a decrease due to a longer recession, but the nominal GDP level was higher. This is the result of a lower than expected decrease in effective domestic demand, and further of the fact that an increase in the surplus of the balance of goods and services in current prices was achieved by an improvement in the terms of trade.

Moreover, the labour market showed remarkable resilience at a time of economic decline. The change in net lending/borrowing vis-à-vis rest of the world from a deficit to a surplus was also unexpected (see subchapter 2.3).

In contrast, economic recovery in 2014 should be slightly more intensive compared to the scenario of the last CP. The improvement of estimates for 2014 especially concerns real GDP, government consumption, investment and foreign trade. To a great extent, the future development of real gross fixed capital formation will be influenced by the need to draw down as much EU funding from the 2007–2013 financial perspective as possible before the end of 2015. The expected quicker recovery of the global economy should be reflected in a higher contribution of foreign trade to GDP growth. Conversely, household consumption expenditure will be relatively lower.

The forecast for GDP development as a whole in 2015 remains similar to that in the previous CP.

Table 4.1: Change in the Indicators of the Scenario

		April 2013 CP			April 2014 CP		
		2013	2014	2015	2013	2014	2015
External Assumptions							
GDP growth in EU28	*%*	-0.2	0.7	1.3	0.1	1.6	1.8
Prices of oil (Brent)	*USD/barrel*	108.0	102.0	98.8	108.6	104.8	100.5
Exchange rate USD/EUR	*USD/EUR*	1.30	1.30	1.30	1.33	1.35	1.35
Exchange rate CZK/EUR	*CZK/EUR*	25.4	25.2	24.9	26.0	27.3	27.2
Real Values							
GDP	*change in %*	0.0	1.2	2.1	-0.9	1.7	2.0
Households consumption	*change in %*	-1.2	1.0	2.1	0.1	0.6	1.5
Government consumption	*change in %*	-0.2	-1.7	-0.8	1.6	0.8	0.7
Gross fixed capital formation	*change in %*	-0.4	0.9	2.6	-3.5	2.7	2.0
Contribution of final domestic demand	*p.p.*	-0.8	0.4	1.5	-0.4	1.0	1.3
Contribution of foreign trade	*p.p.*	0.4	0.3	0.4	-0.3	0.5	0.6
Output gap	*%*	-3.1	-3.0	-2.2	-2.8	-1.8	-1.2
Others							
Nominal GDP	*CZK bn.*	3858	3939	4079	3884	4023	4173
Harmonised index of consumer prices	*change in %*	2.1	1.7	1.9	1.4	1.0	2.3
GDP deflator	*change in %*	0.4	0.9	1.4	1.9	1.8	1.7
Employment	*change in %*	-0.2	0.0	0.1	0.9	0.3	0.2
Unemployment rate	*%*	7.6	7.7	7.3	7.0	6.8	6.6
Balance of goods and services	*% of GDP*	5.4	5.4	5.7	6.4	7.7	8.4
Net lending/borrowing	*% of GDP*	-1.3	-1.2	-1.3	1.1	1.2	1.2
General Government							
Net lending/borrowing (EDP B.9)	*% of GDP*	-2.8	-2.9	-2.8	-1.5	-1.8	-2.3
General government debt	*% of GDP*	48.5	50.3	51.2	46.0	44.9	46.0

Source: MF CR (2013c, 2014a). MF CR calculations.

As has been described above in subchapter 3.1, reduction in government sector investment expenditure had a considerable impact on the government sector balance, as did the effects of stockpiling tobacco products. A change in tax assignment which altered the share of local budgets in the total revenue clearly also played a role here (see also subchapter 6.3). For 2014 and the following years, we do not expect the deficit to rise significantly above 2% of GDP (more detail – see chapters 3.1.2 and 3.2).

4.2 Sensitivity Analysis

In the case of the small and open Czech economy, economic development is largely dependent on development of the external sector, in particular within EU countries. Sensitivity analyses thus focus on this aspect and show the importance of the impacts of worse than expected growth dynamics in the EU on the domestic economy and the impact of the CZK exchange rate. The alternative scenarios are derived from the baseline scenario of the CP described in Chapters 2 and 3.

4.2.1 Slower Economic Growth in the EU in 2015

The first scenario is based on the assumption that GDP growth in the EU will be in 2015 by approximately 2 pp lower than in the baseline scenario. This lower growth corresponds to the amount of standard deviation of growth for the period of 2000–2013.

Considering the interdependence of the Czech economy with the EU, this scenario would impact negatively on real growth in the CR, mainly through exports, 80% of which are sent directly to EU countries. Lower foreign demand would lead to a decrease in export activity and a deterioration of the current account balance; however, this would be partially compensated by lower imports. A worse result for foreign trade would be negatively reflected in real GDP growth and in the development of unemployment. This effect would be most marked in 2015. The impacts on inflation appear relatively small, since two opposing effects would be at work here: (i) wage pressures would diminish due to lower production in the Czech economy, pressing down on inflation; (ii) on the other hand, deterioration of the current account balance would have a depreciating influence on the CZK, thus increasing the prices paid by companies for imported inputs. Subsequently, depreciation would partially compensate a decrease in exports, which would, however, not reverse the resulting effect.

Investment activity of firms would also be affected negatively, the growth rate of which would slow by approximately 0.7 pp compared to the baseline scenario. Household consumption would record a decrease in the growth rate by approximately 3.2 pp, in particular as a consequence of lower wage growth (and higher unemployment) and foreign exchange depreciation, which increases the prices of imported consumer goods.

The general government sector balance would be influenced by the lower collection of taxes from individuals paying a portion from wages and companies paying from their profits. Together with an increase in spending due to a greater amount of paid out unemployment benefits, government deficits would deteriorate by 1.2 pp in the first year and by 0.5 pp and 0.1 pp, respectively, in the following years. Higher deficits would subsequently accumulate into higher debt, approximately by 3.6 pp in the last year of the monitored period. On the other hand, debt accumulation would be slowed slightly by lower interest rates.

The Czech economy should gradually recover in line with the gradual recovery of foreign demand during the course of 2016.

4.2.2 Faster appreciation of the exchange rate after CNB's abandonment of intervention

The other scenario is focused on different CZK/EUR exchange rate development after the CNB stops using the exchange rate in mid-2015 as an additional monetary policy instrument. In this scenario we assume that the Czech koruna will appreciate faster than in baseline from Q3 2015 and will reach 25 CZK/EUR already in Q3 2016. Linear trajectory of appreciation is assumed.

In an open economy, the exchange rate is an important factor for foreign trade. Appreciation of exchange rate would mean the terms of trade would fluctuate. Export prices would therefore increase, which would worsen the price competitiveness of domestic production and the volume of exports would decrease. On the other hand, prices of imports would decrease due to the stronger CZK and their volume would increase. Both facts would cause net exports to worsen and have a negative impact on GDP.

The production activity of firms would be lower compared with the basic scenario, with harmful effects on the labour market where the unemployment rate would increase (by approximately 0.2 pp in 2015 and by 0.4 pp in 2016) and pressure would be exerted to lower wage growth. Despite this negative effect, consumption would increase slightly, in particular cheaper imported consumption, although demand for domestic production would also increase slightly due to lower prices. In total, a lower GDP growth and lower price level would work to decrease interest rates and support for investment.

The government sector balance would decline slightly deeper into deficit, in particular due to the worse results of firms as a consequence of a decline in foreign trade and to a certain extent due to lower wages (and therefore lower revenues from income taxes). Higher collection of taxes on consumption would only partially compensate this shortage. On the other hand, expenditure would increase only slightly due to higher payments of unemployment benefits. As a consequence of the slightly worse budget balance, debt accumulation would also be slightly mitigated in this scenario by lower interest rates.

Table 4.2: Basic Macroeconomic Indicators – Sensitivity Scenarios

		2013	2014	2015	2016	2017
Baseline Scenario						
Gross domestic product	*Y-o-Y in %*	**-0.9**	**1.7**	**2.0**	**2.1**	**2.5**
Private consumption	*Y-o-Y in %*	0.1	0.6	1.5	1.6	1.9
Gross fixed capital formation	*Y-o-Y in %*	-3.5	2.7	2.0	2.1	3.1
Exports of goods and services	*Y-o-Y in %*	0.2	3.8	4.2	4.4	4.9
Imports of goods and services	*Y-o-Y in %*	0.6	3.4	3.8	4.1	4.7
Harmonised index of consumer prices	*Y-o-Y in %*	**1.4**	**1.0**	**2.3**	**2.1**	**2.0**
Unemployment rate	*in %*	**7.0**	**6.8**	**6.6**	**6.4**	**6.0**
General government balance	*% of GDP*	**-1.5**	**-1.8**	**-2.3**	**-2.0**	**-1.7**
Gross government debt	*% of GDP*	**46.0**	**44.9**	**46.0**	**47.1**	**47.1**
Exchange rate	*CZK/EUR*	**26.0**	**27.3**	**27.2**	**26.8**	**26.4**
Alternative Scenario I - Lower GDP Growth in EU in 2015						
Gross domestic product	*Y-o-Y in %*	**-0.9**	**1.7**	**0.7**	**1.9**	**2.6**
Private consumption	*Y-o-Y in %*	0.1	0.6	-1.7	-0.1	1.4
Gross fixed capital formation	*Y-o-Y in %*	-3.5	2.7	1.3	2.3	3.6
Exports of goods and services	*Y-o-Y in %*	0.2	3.8	2.4	3.9	5.0
Imports of goods and services	*Y-o-Y in %*	0.6	3.4	1.4	2.9	4.5
Harmonised index of consumer prices	*Y-o-Y in %*	**1.4**	**1.0**	**2.0**	**1.6**	**1.6**
Unemployment rate	*in %*	**7.0**	**6.8**	**7.8**	**6.5**	**5.9**
General government balance	*% of GDP*	**-1.5**	**-1.8**	**-3.5**	**-2.5**	**-1.8**
Gross government debt	*% of GDP*	**46.0**	**44.9**	**48.1**	**50.7**	**50.7**
Alternative Scenario II - Faster appreciation to 25 CZK/EUR level						
Gross domestic product	*Y-o-Y in %*	**-0.9**	**1.7**	**1.8**	**1.6**	**2.5**
Private consumption	*Y-o-Y in %*	0.1	0.6	1.5	1.9	2.2
Gross fixed capital formation	*Y-o-Y in %*	-3.5	2.7	2.1	3.0	4.0
Exports of goods and services	*Y-o-Y in %*	0.2	3.8	4.0	4.1	5.0
Imports of goods and services	*Y-o-Y in %*	0.6	3.4	4.0	4.9	5.2
Harmonised index of consumer prices	*Y-o-Y in %*	**1.4**	**1.0**	**2.2**	**2.0**	**1.9**
Unemployment rate	*in %*	**7.0**	**6.8**	**6.8**	**6.8**	**5.9**
General government balance	*% of GDP*	**-1.5**	**-1.8**	**-2.3**	**-2.1**	**-1.6**
Gross government debt	*% of GDP*	**46.0**	**44.9**	**46.1**	**47.8**	**47.8**
Exchange rate	*CZK/EUR*	**26.0**	**27.3**	**26.9**	**25.3**	**25.0**

Source: MF CR calculations.

4.3 Verification of the Macroeconomic Scenario by Other Institutions' Forecasts

Macroeconomic scenario of the CP was also compared with forecasts of other relevant institutions. The survey was conducted in April 2014 and its results are based on forecasts of 17 domestic institutions, together with the latest forecasts of the EC (2014a), the IMF (2014) and the OECD (2014). However, not all forecasts cover the whole CP timeframe. Verification of the year 2017, for instance, is based on a sample of only nine respondents, at best.

Key trends of the macroeconomic scenario of the CP 2014 are consistent with forecasts of other institutions. In 2014–2017, the Czech economy should be gradually recovering, though as far as growth structure is concerned, there are differences between the CP and forecasts of other institutions. This is most apparent in the case of gross fixed capital formation, where the difference probably stems from the fact that the CP, unlike the forecasts of other institutions, takes into account the likely significant increase in investment co-financed by the EU funds (see Chapter 2.2.1).

Forecasts of inflation rate confirm that inflation expectations remain well anchored close to the CNB's inflation target.

Economic growth should have a positive impact on the labour market. However, the decline in unemployment rate should be only gradual. Employment should witness a modest growth throughout the forecast horizon, largely due to employers' trying to increase productivity of labour.

Table 4.3: Verification of 2014 Convergence Programme Scenario by Other Institutions' Forecasts

	Avearage of Forecasts				April 2014 CP			
	2014	2015	2016	2017	2014	2015	2016	2017
Growth in Real Terms								
Gross domestic product	**1.8**	**2.4**	**2.6**	**2.5**	**1.7**	**2.0**	**2.1**	**2.5**
Households consumption	0.7	1.5	2.0	2.3	0.6	1.5	1.6	1.9
Government consumption	1.0	1.1	1.1	1.4	0.8	0.7	1.2	1.2
Gross fixed capital formation	1.5	3.1	3.7	4.0	2.7	2.0	2.1	3.1
National consumer price index (aop)	**1.1**	**2.1**	**1.8**	**2.1**	**1.0**	**2.3**	**2.1**	**2.0**
GDP deflator (growth)	**1.6**	**1.7**	**1.7**	**1.9**	**1.8**	**1.7**	**1.0**	**1.3**
Employment (LFS)	**0.3**	**0.3**	**0.3**	**0.3**	**0.2**	**0.2**	**0.2**	**0.2**
Unemployment rate (LFS, level in %)	**6.9**	**6.7**	**6.3**	**6.0**	**6.8**	**6.6**	**6.4**	**6.0**

Source: MF CR (2014b).

5 Sustainability of Public Finances

Long-term sustainability has consistently been one of the most significant challenges for Czech public finances. The most serious risk lies in the expected demographic development, which over the next several decades will likely considerably increase the ratio of persons in retirement age to the economically active population.

5.1 The Government's Strategy – Reforms

Reform measures introduced to the pension and health care systems have recently been implemented. These aim, on the one hand, to improve the long-term sustainability of government sector finances and, on the other, to diversify the risks of allocating funds to ensure appropriate living standards in old age.

5.1.1 Parametric Adjustments

In response to a ruling of the Constitutional Court which found part of the provisions of the act on pension insurance stipulating the calculation of pension entitlement (in particular the section on the amount of reduction thresholds) to be unconstitutional, a set of parametric changes to the pension system was approved with effect from the 30th of September 2011 (for more details – see MF CR, 2012c). These involve modifying the reduction thresholds when calculating pensions (in a budgetary neutral manner) and shifting the statutory retirement age without a fixed upper limit and, at the same time, removing benefits for women with children (i.e. a uniform retirement age will be applied to all persons born in a certain year). As regard these measures, no change has yet been made, although a measure is being prepared at present under which the retirement age according to the current regulation would be subject to regular revision and, if the demographic projection changed considerably, ad hoc modification would be made. This proposal has not yet been discussed by the government.

For 2013–2015, the total increase in pensions paid out (regular indexation) was limited to one third of the consumer price index growth and one third of real wage growth. However, the government has approved an amendment according to which the valorisation system would return to its original basis from 1 January 2015, and thus it should correspond at the very least to consumer price index growth and one third of real wage growth. Pension increases will always be carried out by a specific government decision.

The penalty for early old-age retirement was increased, thus reducing the attractiveness of retiring before reaching the legal retirement age. Specifically, the penalty rate was increased from 0.9% to 1.2% for the period from the 361st day to the 720th day before reaching the statutory retirement age. The percentage assessment of earnings-related old-age pension subsequently decreases by this percentage for every 90 days, also when already commenced.

In addition to this, a so-called preretirement scheme has been established, which enables those subscribing to an additional insurance pension (the 3rd pillar) to already draw funds 5 years before reaching the statutory retirement age without imposing any sanctions. However, preretirement is conditional upon having a minimum amount of accumulated funds in the private 3rd pillar so as to provide a monthly pension amounting to at least a third of the average wage. The old-age pension will not be subsequently reduced for the years when the pre-pension is drawn. The possibility to draw preretirement was only used by 274 persons before the end of 2013. As to the sustainability of the pension system, the impact of this measure is absolutely negligible.

5.1.2 Pension Savings Pillar

Reform of the pension system includes the introduction of pension savings pillar. The Parliament of the Czech Republic first approved the reform in November 2011 and, following a veto by the President, was approved in its final form in November 2012. Pension savings pillar was launched at the beginning of 2013.

With effect from the 1st of January 2013, the act introduced (funded) a pension savings pillar with voluntary entry for persons under 35 years of age at the time the reform was initiated. Older persons not drawing an old age pension were allowed to decide whether to join the new pillar within half a year after the reform was launched, i.e. in the first half of 2013. This measure, however, was only valid for employed (or self-employed) persons at the time the reform was initiated. It did not apply to the unemployed or economically inactive persons; for such persons, the 6 month period will commence from the time they first become pension insurance payers following the initiation of the reform. It will not be possible in future to alter the decision taken by an insured person.

Financing for the pension savings pillar is provided by funds transferred from participants in the first pillar to the amount of 3 pp from the total contribution rate of 28% (the employee pays 6.5 pp and the employer 21.5 pp). In addition to this, each insured person has to pay an additional 2 pp from his or her own sources. The overall contribution rate thus increases to 30% for persons who have withdrawn, of which 25 pp is directed into the existing pay-as-you-go system (PAYG) and the remaining 5 pp into the newly created pension savings pillar.

In the accumulation phase funds are administered by pension companies, which will be obliged to offer their clients four funds with varying levels of risk: state bond fund, conservative, balanced and dynamic. The pay-out phase for accumulated funds from the pension savings pillar will be provided by a life insurance company selected by the participant. It will be possible to draw the paid benefits either in the form of a lifelong annuity (as an optional alternative, with an agreed payment of a survivor's pension for 3 years from the death of the participant to a person designated by the participant in the pension insurance contract, and who need not be the same person entitled to the survivor's pension from the first pillar) or alternatively an annuity paid for 20 years (in the case of premature death, the remaining funds will be subject to inheritance).

Fees paid to pension companies are explicitly defined by the Act on Pension Savings (No. 426/2011 Coll., Section 32). Fees are determined for property management and the appreciation of funds in pension funds (except for the state bond fund).

Participation in the pension savings pillar will understandably have an impact on the sum of the old-age pension, but not, however, on the amounts of other pensions (both the disability and survivor's pension). For old-age pensions, when calculating the old-age pension from the 1st pillar, a percentage of the percentage pension assessment will be decreased for participants in the pension savings pillar, from 1.5% to 1.2% for the years when they subscribed to the pension savings pillar. A specific situation arises when a subscriber to the pension savings pillar becomes eligible for a third degree disability pension. In such case, after reaching retirement age, he or she will have the possibility to ask for the old-age pension to be paid out to the same amount as he or she had received the disability pension, and 60% of funds from the pension savings pillar will be transferred to the state budget. This will lead to a situation as if he or she had never joined the pension savings pillar, and therefore as if he or she had paid the contribution rate of 28% into the PAYG system, and not 25%.

Creation of the pension savings pillar only resulted in a slight decrease in revenues for the PAYG first pillar (CZK 211 million in the whole of 2013, i.e. nearly 0.1% of the total amount collected in pension insurance), which was compensated by the higher reduced value added tax rate in the interim period. The reason behind the marginal drop in revenues in the PAYG system is the low attractiveness of the pension savings pillar: during the whole of 2013 only 83 thousand persons withdrew. At pre-sent, the new government is considering whether to terminate the pension savings pillar, both for reasons of principle and as a consequence of low participation.

5.1.3 Reform of the Health Care Financing System

Topics currently relevant in the health care system particularly include changes to benefit areas, changes to the categorisation of levels of hospital care, and adjustments in the sphere of spa care. In 2013, fees for medical facility stays were cancelled with effect from the 1st of January 2014. Except emergency service fees, the government also plans to cancel all remaining regulatory fees. The drop in revenues from fees will be paid to the state budget's debit by increasing payments for state insured persons (for whom, moreover, regular valorisation is planned) and by savings in the health care sector. In July 2013, the Constitutional Court cancelled above-standard medical operations for which patients could pay in facilities without contracts with health insurance companies. The effect on the public health insurance system is, however, entirely negligible (it mainly influences patients themselves). Further, the government wants to strengthen state supervision of health insurance flows and the operation of health insurance companies.

5.2 Fiscal Impacts of a Population Ageing

The consequences of the impacts of an ageing population are based on long-term projections made in cooperation with the Ageing Working Group of the Economic Policy Committee. Development analyses are based on assumptions of demographic development (EUROPOP) and the macroeconomic framework consistent for all EU countries. These projections do not therefore reflect the current medium-term macroeconomic and fiscal outlooks for the CR. Projections are carried out under an assumption of unchanged policies (reflecting the system which is legislatively underpinned at the time of drafting the projection). Long-term analyses do not aim to forecast specific values, but only to illustrate trends and long-term dynamics. The projections end in 2060.

Long-term projections were updated for the last time at the beginning of 2013 in connection with the introduction of the pension savings pillar, including a modified valorisation system. The results of the projections were reviewed by the Ageing Working Group on the 6th of March 2013. At the time this update was developed, it was very difficult to estimate the number of persons who would decide to withdraw and provide for themselves in old age with the pension savings pillar in addition to the PAYG system. With respect to the fact that the reform came into effect on the 1st of

January 2013 and experience from abroad suggested that most people withdraw immediately before the deadline for making the decision expires (the deadline for people older than 35 years was 30 June 2013), it was assumed that the top two deciles would withdraw (approximately 1 million people). The assumption was based on studies conducted by independent institutions which took into consideration the financial benefits associated with the withdrawal. If we assume that the reform would remain valid (the principle of no-policy change), then the financial calculation would probably be one of the main criteria for any decision on whether to withdraw, and in this case it seemed most reasonable to assume the two highest deciles.

Today it is obvious that the original assumption for the number of withdrawn people was very optimistic. Nevertheless, the assumption of a withdrawal of the highest two deciles would not cause any significant decrease in expenditure (the difference is approx. 0.1% of GDP). With respect to the fact that information on current numbers of pension savings pillar participants are roughly at the level of one tenth of the originally expected level, the effect on expenditure in the long term is in fact negligible (0.05% as a percentage of GDP). Therefore it was decided that the European Commission will use, up to the next peer review for the Ageing Report 2015, the results from the previous Ageing Report (EC, 2012). These results of pension projections in the horizon of 2010–2060 are summarised in Table P.7.

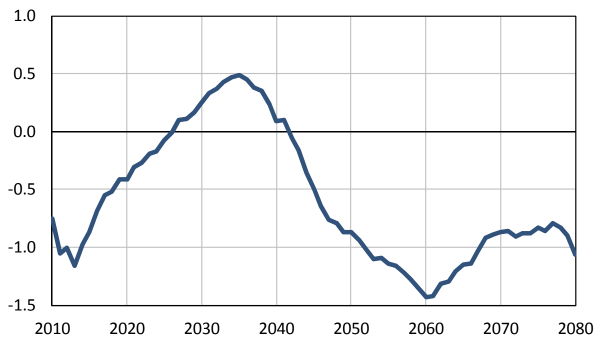
From today's viewpoint, the biggest problem in the dynamics of expenditure growth still appears to be those on pensions (see Table P.7). These will increase from a starting level of 9.1% in 2010 to 11.8% of GDP in 2060, primarily due to changes in the population structure, which predominates over other (positive) effects on this share. Nevertheless, pensions do not represent any problem for long-term sustainability until 2030.

Growth in outlays, also including those dependent on demographic changes, will also be seen in health care expenditure from the public health insurance system, which is set to rise by 1.7 pp by the end of the projection period. Long-term care expenditures will rise the fastest, with its volume approximately doubling. In volume terms, however, these constitute a very small expenditure item.

The sustainability analysis, based on long-term projections, identifies the extent of fiscal consolidation necessary to ensure the stability of public finances. So-called sustainability indicators are calculated, showing the scope of measures required for decreasing expenditure or increasing revenues as a percentage of GDP in order that they correspond to the required levels. Currently, the S1 indicator, which expresses the percentage of GDP by which it is necessary to raise revenues or permanently reduce expenses so that state debt amounts to 60% of GDP in 2030, has reached 2.2% of GDP. The S2 indicator, which specifies the amount of fiscal effort necessary for reaching parity between discounted revenues and expenditures on an infinite horizon, stands at 6.2% of GDP. The new S0 indicator, which specifies possible fiscal risks over a short period of time, is at the level of 0.2 for the CR for 2013, a figure placed significantly below the critical limit of 0.43.

In essence, the impacts resulting from pension reform (particularly the parametrical changes in the PAYG system valid from the end of September 2011) have only a marginal effect on the amount of these indicators, since the most important impact on the pension system balance will only come to light after the end of the projection period. Development on the pension account after 2060 is shown in Ministry of Labour and Social Affairs projections depicted in Chart 5.1. Naturally this aspect also has an impact on the value of the S2 sustainability indicator which, based on the Ageing Working Group methodology, is being driven upwards.

Chart 5.1: The Ministry of Labour and Social Affairs Projection of Pension Account Balances
(in % of GDP)



Note: The dissimilarities in balances from the Ageing Working Group of the Economic Policy Committee are explained by different macroeconomic assumptions.
Source: Ministry of Labour and Social Affairs.

Despite the improvement in terms of the current fiscal position compared to the last sustainability evaluation, the debt development continues to appear as a negative factor of the long-term development resulting from prevailing high deficits in relative terms which will lead to a growth in interest costs.

5.3 Government Guarantees

In addition to the fiscal impacts of the ageing population on the sustainability of public finances, the state of government guarantees should also be mentioned here. In the Czech Republic, the most important components in this area are guarantees for liabilities of the Export Guarantee and Insurance Corporation or the Czech Export Bank (around 10% of GDP), guarantees for the banking sector, in particular guarantees in relation to the CNB and CSOB arising from the resolution of the crisis in 2000 involving the former Czech bank IPB (around 6% of GDP), and loan guarantees for infrastructure projects and investments in railway transport (approximately 0.4% of GDP).

The last guarantee provided by the government to date was a state guarantee for the benefit of CNB to secure a loan for the International Monetary Fund from the CNB's foreign exchange reserves to the total amount of EUR 2.53 billion (Act No. 216/2013 Coll.). As of the 31st of December 2013, EUR 142 million was drawn from this loan.

In addition to this, on the 6th of March 2013 (Government Resolution No. 170/2013) the government approved an increase in the insurance capacity of the Export Guarantee and Insurance Corporation by an additional CZK 10 billion to invest in building the Khormala power station in Iraq. Thus the total year-on-year increase was CZK 30 billion in the insurance capacity of the Export Guarantee and Insurance Corporation.

The total amount of guarantees at the end of 2013 amounted to approximately 16.5% of GDP, of which guarantees relating to the former Czech bank IPB represented approximately 4% of GDP. It should be mentioned, however, that the settlement of this guarantee in relation to the CNB and the CSOB bank, which should be paid no later than by 2016, is expected to equate to a fraction of this amount. To date, CZK 5.8 billion has been paid in this guarantee, i.e. approx. 0.2% of GDP. As this guarantee is concerned, no compensation was paid out for this reason in 2013.

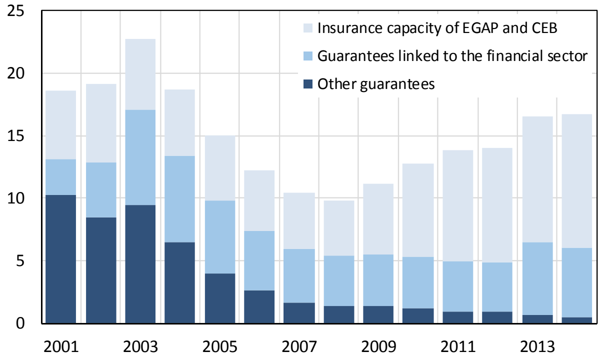
The increase in government guarantees in 2013 was mainly due to an increase in the insurance capacity of the Export Guarantee and Insurance Corporation or the Czech Export Bank and to the inclusion of the whole guarantee for the CNB loan on behalf of the International Monetary Fund. The CNB's foreign exchange interventions also had unfavourable effects by increasing the Czech koruna value of guarantees denominated in foreign currencies.

Above the framework of state guarantees, we expect guarantees amounting to about 0.2% of GDP in the government sector, the biggest share of which is a guarantee to the Prague Public Transit Company to purchase trams. In June 2013, the Capital City of Prague decided to provide a guarantee for CZK 8 billion, of which approximately a half should have been paid out until the end of August 2013. Other significant guarantees include those for regional hospitals (approx. CZK 1.5 billion) or guarantees provided by state funds (approx. CZK 0.5 billion).

For 2014, 0.2% of GDP is expected to be paid out in the area of government guarantees. Provision of new guarantees in 2014 is not expected.

Chart 5.2: Government Guarantees

(in % of GDP)



Note: "EGAP" refers to the Export Guarantee and Insurance Corporation and "CEB" to the Czech Export Bank.
Source: MF CR.

6 Quality of Public Finances – Revenue and Expenditure

The government of the CR has clearly declared its determination not to manage public finances simply by changing basic parameters, such as changes in tax rates or indexation of individual expenditure categories. The target is to rationalise and increase the effectiveness of how the government sector functions, remove all forms of wastage, to fight corruption and clientelism. In public finance terms, the result of these efforts should be a higher amount of collected taxes without the need to increase the tax burden, or the ability to provide a greater volume of public goods without the need to increase total expenditure.

6.1 Strategy of Tax Policy

The basic point of departure of the current tax policy is the Policy Statement of the government. The main thesis of tax policy is above all to increase the effectiveness of tax collection and to fight tax evasion. The reasoning behind this course of action is to increase tax revenues of the government without increasing the tax burden. In the course of 2014, no new tax regulations will be issued which by nature would have a significant impact on the amount of the total tax burden. The most important changes in the tax area in 2014 include the cancellation of Act No. 458/2011 Coll., relating to the establishment of the Integrated Revenue Agency. The valid wording of the act no longer corresponds to the current legislative status of other related statutory standards and directly contradicts the intentions of the current government. However, the underlying ideas of the Integrated Revenue Agency, i.e. the simplification of tax and insurance premium collection and administration, and limiting the risks of any tax collection shortfalls, continue to be supported by the government.

6.2 Fighting Tax Evasions

In the area of increasing the effectiveness of tax collection and fighting tax evasion and fraud, further support is planned for tax administration digitisation and conducting effective inspections of retail and service sales. The introduction of sales record-keeping by electronic means with direct interconnection to the Financial Administration of the CR will contribute to this measure, whereby the Financial Administration of the CR will have an ongoing overview of the amount of sales made by tax entities. Other measures helping to strengthen the effectiveness of tax collection include the introduction of control statements, which allow the cross-checks of the items on input/output. Furthermore, the information duties for payments from legal and natural persons to entities in tax havens, and establishing the duty to prove the origin of property will be introduced. Last but not least, personnel and technical augmentation of the Financial Administration of the CR is also expected. In response to increasing cases of value added tax fraud, an amendment to the act was proposed which extends the list of goods supplied to which the regime of transferred tax duty can be applied, the so-called reverse charge. Now it will be possible to use reverse charge if the following goods are supplied: mobile phones, integrated circuit equipment, game consoles, tablets and laptops, cereals and technical plants, including oil seeds and sugar beet, and the supply of raw and semi-processed metals, including precious metals. Another measure targeted at fraud in connection to value added tax, and that is also included in this amendment, is the introduction of the quick reaction mechanism. This mechanism allows use of the reverse charge regime to be determined by government resolution for a maximum period of nine months. From November 2013 onwards, rules have been tighten for fuel distributors in the form of a deposit introduction in the amount of CZK 20 million.

In addition to the area of value added tax, new measures against tax evasion in the area of excise taxes are also being prepared. These measures will mainly include stricter conditions for issuing permits to handle selected products in the conditional tax exemption regime. The purpose of stricter conditions is so that entities regarded as risky based on predefined criteria are prevented from entering the system in which selected products are transported in the conditional tax exemption regime.

The government also plans to increase the effectiveness of the collection of payments from lotteries and other similar games, and to prevent tax evasion related to the operation of illegal lotteries and games on the Internet. In this area, analyses of future possible forms of gambling taxation are currently being developed. All these measures should contribute to more effective tax collection, and thus to increasing tax revenues while preserving the current tax burden.

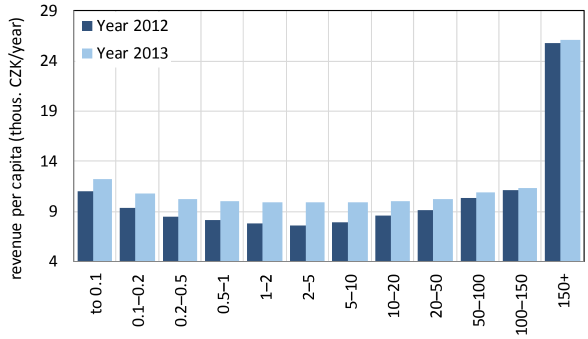
6.3 Tax Assignment

With effect from 2013, the methodology for calculating the portions of individual municipalities in shared taxes was changed (also see CP 2013). This mainly concerned the introduction of a new criterion which takes into account the number of children in kindergartens and primary schools and, on the other hand, the limitation of the weighting given to the area of a municipality's cadastral territory in the calculation formula. The aim of this measure was to decrease differences between revenues per capita in the various size categories of municipalities, and to reduce the relative disadvantage of medium-sized municipalities. In 2013, the total volume of shared taxes was increased by approximately CZK 12 billion, which led to an increase in the average revenue per capita in all size categories of municipalities. At the same time, average revenues were considerably levelled out according to size categories, when municipalities with 200 to 50,000 inhabitants recorded practically the same average revenue per capita in 2013. Higher average revenue is apparent in the smallest municipalities and especially in the four biggest towns in the CR.

For the period of the medium-term outlook, we do not expect any other conceptual change in the calculation methodology; however, from 2016, according to the current legislation, the portion of local budgets in nation-wide revenues of value added tax and personal income tax from dependent activity will be further increased, by billions CZK.

Chart 6.1: Changes in Tax Assignment

(The size of municipality on horizontal axis in thous. of inhabitants)



Source: MF CR.

6.4 Rationalisation of Government Sector Operation

In the first phase, such measures were introduced that did not require any change in the current legislation, and could be started more or less immediately after the new government was appointed. Measures mainly included due diligence over the economic management of selected ministries, during which the way state property is disposed of and assigned funds managed is examined. Increased attention is being paid to checking the conditions of signed contracts on outsourced services (with the emphasis on legal, marketing or consultancy services), where contracts disadvantageous for the state are terminated or modified, where possible. Other efforts will include centralising property administration and the purchasing of individual government sector institutions. Property use should thereby become more effective (or unnecessary property identified) and unit costs of the government sector in purchasing goods and services should be reduced. Considerable savings can also be achieved by quality liquidity management through the treasury system (see Chapter 7.3.1).

6.5 Composition of Public Expenditure

In the period of the medium-term budgetary outlook, the trend, which started after the crisis year of 2009, of a decreasing share of general government sector total expenditure in GDP will continue. It is necessary to take into account that the amount of expenditure in 2012 was influenced, in accordance with the ESA95 methodology, by the one-off recording of financial compensation of the property settlement between the state and churches of CZK 59 billion or 1.5% of GDP, as well as the flat-rate correction of refunds from the EU of CZK 11.9 billion or 0.3% of GDP (see MF CR 2013a). If 2009 and 2017 are compared, the proportion of expenditure should decrease by nearly 4 pp of GDP, while this change is relatively equally distributed over the aforementioned 8-year period.

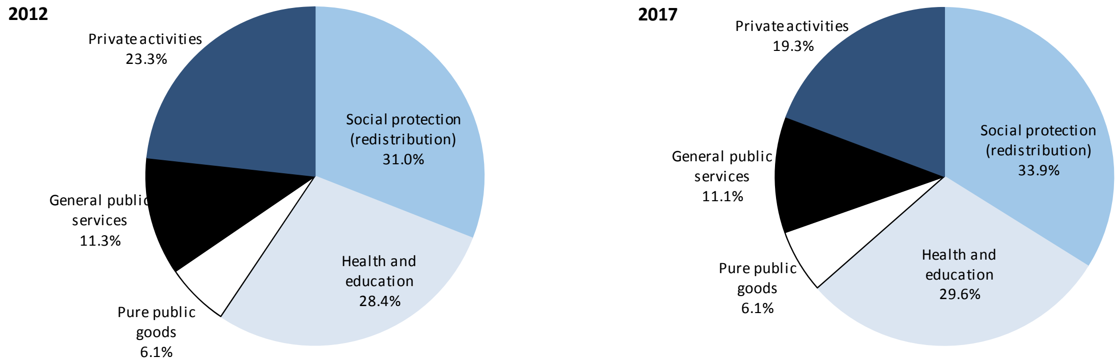
During the general decrease in the percentage of government sector expenditure in GDP after 2009, a marked growth was recorded only in environmental protection expenditure. The considerable year-on-year increase in 2012 recorded for the groups General Public Services and Recreation, Culture and Religion was caused by the aforementioned one-off operations, and thus does not signify any change in the trend for the following period.

In the years of the outlook, in accordance with the total trend we expect to witness a relative decrease in expenditure in almost all monitored categories (see also Table P.3 in the annex).

The only exception is the area of Social Protection, where the share of expenditure in GDP will stagnate. We expect that in 2017 more than half of government expenditure (approximately 21% of GDP) will be used to cover expenditure on social security and health insurance of citizens. Chart 6.2 indicates the structure of public expenditure in 2012 and its expected structure in 2017. In the period of these years, while total expenditure will relatively decline, the share of expenditure in Social Protection to the detriment of other categories will probably grow.

Chart 6.2: Structure of General Government Expenditure, Divided by Function

(in % of total expenditure)



Note: The category "Pure public goods" includes "Defence" and "Public Order and Security". The category "Private activities" is a sum of "Economic Affairs", "Environmental Protection", "Housing and Community Amenities", and "Recreation, Culture and Religion". For details about the division see ECB (2009).

Notice: The chart depicts a medium-term projection rather than a forecast.

Source: CZSO (2014d). MF CR calculations.

7 Institutional Features of Public Finances

A necessary precondition for healthy and sustainable public finances is a strong national institutional framework of fiscal and budgetary policy. The most important steps in providing such strength can be seen both at the macroeconomic level in terms of preparation of legislation in the area of fiscal responsibility, and at the microeconomic level in strengthening the transparency and effectiveness of public finances.

7.1 Fiscal Responsibility

In June 2013, MF CR submitted to the government a draft of the Act on Rules of Fiscal Responsibility, which would implement the draft of the Constitutional Act on Fiscal Responsibility and the draft of the modification act amending other related legal regulations. Despite government support for these acts, the approval process was terminated due to the dissolution of the Chamber of Deputies. This legislation also represented the main instrument for implementing Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States. The CR could not therefore ensure that the necessary regulations came into effect in order to achieve compliance with the Directive mentioned before the end of 2013. Nevertheless, the new government continues in its preparation of the necessary transposition measures that will follow up the main steps in the aforementioned draft legislation. These regulations are scheduled to come into effect from 1 January 2015.

7.1.1 Numerical Fiscal Rules

Basic building blocks of the strengthened fiscal framework should be, as described in detail in the previous CP (MF CR, 2013c), as follows:

- the expenditure rule derived from the rule of structural deficit (see the Box following), which should lead to achieving the medium-term objective, with the existence of an automatic corrective linking the government sector real expenditure with its level derived using the rule.
- the rule for the share of the debt of a municipality or region in total average revenue for the last four years. If the amount of debt of a municipality or region exceeds this level, it will be possible to annually suspend tax revenue designated to a municipality or region at the amount of 5% of the difference between the total amount of debt reached and 60% of the average of its real total revenue for the last four years. It will be possible to release the suspended tax revenue imposed on a municipality or region only for payment of its debt. The rule should help to ensure responsible management of local government budgets respecting the principle of their economic autonomy.
- possible failure to meet the aforementioned fiscal rules will be “insured against” by a set of rules specified in the constitutional act, regulating the level of the government debt to GDP ratio.

Effective and timely monitoring of compliance with the rules will also be ensured based on reliable and independent analysis conducted by independent entities or entities that are independent in relation to the fiscal authorities of Member States.

7.1.2 Macroeconomic and Tax Forecasts

MF CR regularly publishes, as an inseparable part of its Macroeconomic Forecast, comparisons with forecasts of important domestic and foreign institutions. The Macroeconomic Forecast of the CR published in April has also included since 2011 a comprehensive assessment of the quality and success of previous forecasts. Further, the semi-annual Fiscal Outlook of the CR newly includes a sensitivity analysis assessing the development of the main fiscal variables with different assumptions concerning GDP growth rates and interest rates. The method for verifying the impartiality of macroeconomic and tax forecasts used in the preparation of budgets is also discussed.

Box: Proposal of a Fiscal Rule of Structural Deficit

The Ministry of Finance prepared a proposal of structural balance rule last year that should determine expenditure ceilings for state budget and state funds. The proposal has been further modified this year so that the maximal general government expenditure, which the state budget and state funds’ budgets are derived from, corresponded to the medium-term objective (structural deficit of 1 % of GDP). The general government expenditure would be then:

$$G_{t+1} \leq CAR_{t+1} - k_{t+1} - M_{t+1} + U_{t+1} + MTO_{t+1}$$

General government expenditure for the following year t+1 (G_{t+1}) should not be higher than the forecasted cyclically adjusted revenues in year t+1 (CAR_{t+1}), corrected for accumulated forecast errors (k_{t+1}) and one-off and other temporary measures in t+1 (M_{t+1}). Additionally, the expenditures might be increased for supposed escape clauses (for example state of war, removal of natural disaster damages, etc.) in year t+1 (U_{t+1}) and for 1 % of estimated nominal GDP for year t+1 (MTO_{t+1}) that adjusts structural balance towards the medium-term objective.

7.2 Increasing Transparency

7.2.1 Specialised Information Portal

In H1 2013, MF CR launched a specialised information portal enabling the public free access to budgetary and accounting information for the state budget, municipal governments and the regional councils of cohesion regions. Information made accessible comes from the State Treasury system and is regularly updated. Detailed ("drop-down") budgets are also presented, broken down into individual items of the budgetary structure. In the course of 2013, other user tools were added. They include, for example, the possibility of dynamic data analysis by means of an advanced reporting tool, automatic exports for third party systems in the format of open data, more detailed comparisons of municipality economic management, etc.

7.2.2 Statistical Data on General Government

At the end of February 2014, MF CR published a new data presentation on its website, where statistical information required by the Directive 2011/85/EU and other information which strengthens the transparency of the public finances system is gradually being published. Fiscal information for the individual subsectors of the general government sector is published and updated regularly, as well as a detailed correlation table which clarifies the methodology used when switching between data on a cash basis (or equivalent numerical data from public budgets if data on a cash basis are not available) and data according to the ESA 95 standard. Further, data on government guarantees, obligations from partnership projects of both private and public sectors, obligations from public company activity and overdue loans will be published in accordance with the publication calendar. A report on the impact of tax reliefs on revenues of the general government sector, and the information on ownership interests in both private and public companies, will also be published, if economically significant amounts are involved. Above the framework of the directive requirements, lists are published of institutional units making up the public sectors and general government sector (according to ESA 95). Detailed methodological descriptions have also been published together with all the aforementioned information.

7.2.3 Budget for Citizens

In order to describe the process of preparation, implementation and assessment of the state budget and its current approved version to the general public, MF CR has prepared the information manual "State Budget in a Nutshell". In addition to the above areas, the publication also describes a number of related subjects, such as state debt, the context of the public finances system, the relationship to the EU budget and the characteristics of healthy public finances. The publication was published on 30 March 2014 on the Ministry's website and distributed to universities of economics, employers, trade unions, the Chamber of Deputies of the Parliament of the CR, the Senate and other institutions.

7.3 Public Finance Effectiveness

7.3.1 State Treasury

Most modules of the Integrated State Treasury Information System are in their standard operational phase, the targets of which can be summarised in the following points:

- provable and verifiable economic result in relation the assets and liabilities of the state,
- central management of all funds of the state,
- management of state budget availability,
- management control integration,
- process and data integration,
- interconnection of material and financial management,
- introduction of the Central System of Accounting Information of the State.

The government is preparing to update budgetary rules, which will include strengthening the MF CR role in managing the liquidity of state funds, modifying rules for implementation of funds from the EU budget by strengthening the role of the provider, and implementing the directive on requirements for budgetary frameworks of Member States.

The government will promote the centralisation and control of all accounts in state administration at the State Treasury. MF CR will increase the effectiveness of the state liquidity management, in particular through "cash pooling". Substantial participation of all state institutions in the State Treasury will enable active, effective and transparent management of expenditure at the central level. MF CR aims at promoting the State Treasury as complex instrument for effective and functional management of public finances, thus streamline the management of cash, state debt and short-term investment of surplus liquidity of the general government sector.

7.3.2 State Accounting

Discussion will be opened in the field of the state accounting on the harmonisation with international accounting standards for the general government sector. The state accounting will be handled following the development of the State Treasury and Inner Control and Supervision System. The concept assumes cardinal adjustments in the current legislation and methodology of the accounting of the general government and also of the budgetary rules in order to unify the means of accounting and reporting according to controlling and reporting requirements, which should lead to the fulfilment of the idea of the development of the effective and functional management of public finance.

7.3.3 Key Analytical Indicators

Key analytical indicators are a newly introduced element in the system of monitoring and evaluating the performance of the accounting units of state administration. Accounting performance indicators are focused on the condition and development of the operational economic result of accounting units of state administration, with the emphasis on operating costs. In their informative and monitoring functions, they enable comparison of the condition and development of accounting units' cost effectiveness in individual chapters of the state budget, the condition among the chapters in relation to each other and in relation to the determined extent of the central tendency (the mean value).In the relation to the central tendency, the indicators can also fulfil normative function, and thus actively participate in the process of the state budget development in the area of public administration. Specifically, wage costs, operating cost effectiveness and property cost effectiveness are monitored.

7.3.4 Tax Administration

Steps aimed at increasing the effectiveness of the collection of funds for government sector budgets and reducing the administrative burdens of tax entities continue. The government coalition continues to support the basic assumption of the Integrated Revenue Agency, i.e. simplification of the tax system and the tax and insurance premium administration. The bases for calculating health insurance and social security will be unified with calculations of corresponding tax bases. This change will be designed to be neutral in terms of budget. The government will also strive to simplify the collection and administration of tax and insurance premiums, which will limit risks of any drop in their collection. (See also chapters 6.1 and 6.2.)

The government will take measures necessary for increasing the effectiveness of tax, customs duty and social security contribution collection and will prevent the misuse and circumvention of tax regulations (e.g. tax administration digitalisation, by measures aimed at effective control of the reported retail sales of goods and services, by extension of rules on transferring tax duty to value added tax, by communication between tax administration authorities, the Czech Social Security Administration, the Customs Administration of the CR, the Financial Analytical Department of the MF CR, the Police of the CR and the Prosecutor's Office).

7.3.5 Public Inspection

A completely new legal regulation of financial management is being prepared which will regulate so-called management responsibility for the fulfilment of public budgets and audits (the Act on Internal Management and Control System in Public Administration). The proposed independent verification for ensuring the objectives of proper public administration and public funds management will replace the current legal regulation adopted as part of harmonisation with EU law.

The aim is to create legal conditions for introducing the functional model of an internal control system according to the framework developed by the European Commission, i.e. control systems of management responsibility and internal audit systems in order to cover the competences of general government sector entities. Modernisation of legal conditions will contribute to gradually overcoming the fragmentation of the current management and control system through centres and tools of computer technology (the State Treasury and other systems in accordance with the standard of the International Organisation of Supreme Audit Institutions).

At the same time, the additional costs of operating non-effective duplicate control systems in various lines of financial management will be prevented, while forensic and investigative elements of the full control process will be developed, both at the ascertaining phase and in the implementation or corrective phases. Further, the same regime for protecting public funds from internal, national and foreign sources will be established. Last but not least, the new regulation will contribute to the gradual removal of existing barriers which are preventing the introduction of European and international good practice and standards for the effective development and operation of proper administration tools and internal control systems of public finances management. The prepared legal regulation will be consulted with the General Directorate of the European Commission – Budget and will take into account the implementation of the Directive 2011/85/EU.

The government also assumes that the competences of the Supreme Audit Office will be extended.

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Table Annex

Table A.1a: Macroeconomic Prospects

(level in CZK billion, growth in %, contributions to growth in percentage points)

	ESA Code	2013	2013	2014	2015	2016	2017
		Level			*Rate of change*		
Real GDP	B1*g	**3810**	**-0.9**	**1.7**	**2.0**	**2.1**	**2.5**
Nominal GDP	B1*g	**3884**	**1.0**	**3.6**	**3.7**	**3.1**	**3.9**
Components of real GDP							
Private consumption expenditure	P.3	**1947**	**0.1**	**0.6**	**1.5**	**1.6**	**1.9**
Government consumption expenditure	P.3	**802**	**1.6**	**0.8**	**0.7**	**1.2**	**1.2**
Gross fixed capital formation	P.51	**857**	**-3.5**	**2.7**	**2.0**	**2.1**	**3.1**
Changes in inventories and net acquis. of valuables (% of GDP)	P.52+P.53	**1**	**0.2**	**0.2**	**0.2**	**-0.1**	**0.0**
Exports of goods and services	P.6	**3006**	**0.2**	**3.8**	**4.2**	**4.4**	**4.9**
Imports of goods and services	P.7	**2802**	**0.6**	**3.4**	**3.8**	**4.1**	**4.7**
Contributions to real GDP growth							
Final domestic demand		**-**	**-0.4**	**1.0**	**1.3**	**1.5**	**1.9**
Changes in inventories and net acquis. of valuables	P.52+P.53	**-**	**-0.2**	**0.2**	**0.1**	**0.0**	**0.0**
External balance of goods and services	B.11	**-**	**-0.3**	**0.5**	**0.6**	**0.6**	**0.6**

Note: Real levels are stated in 2012 prices. Change in inventories and net acquisition of valuables on the row 6 expresses a share of change in inventories on GDP in current prices. Increase in change in the stock of inventories and net acquisition of valuables is calculated from real figures.
Source: CZSO (2014a), MF CR (2014a). MF CR calculations.

Table A.1b: Price Developments

(indices 2005=100, growth in %)

	2013	2013	2014	2015	2016	2017
	Level			*Rate of change*		
GDP deflator	**109.4**	**1.9**	**1.8**	**1.7**	**1.0**	**1.3**
Private consumption deflator	**114.9**	**1.1**	**0.7**	**2.0**	**2.1**	**2.0**
Harmonised index of consumer prices	**121.9**	**1.4**	**1.0**	**2.3**	**2.1**	**2.0**
Public consumption deflator	**117.7**	**0.1**	**0.9**	**1.1**	**0.4**	**0.8**
Investment deflator	**103.0**	**0.2**	**1.3**	**1.0**	**0.7**	**0.7**
Export price deflator (goods and services)	**98.0**	**1.6**	**3.4**	**0.3**	**0.3**	**0.3**
Import price deflator (goods and services)	**101.8**	**0.1**	**2.2**	**-0.2**	**0.3**	**0.3**

Source: CZSO (2014a), Eurostat (2014). MF CR calculations.

Table A.1c: Labour Market Developments

(growth in %)

	ESA Code	2013	2013	2014	2015	2016	2017
		Level			*Rate of change*		
Employment, persons		**5124**	**0.9**	**0.3**	**0.2**	**0.2**	**0.2**
Employment, hours worked		**9.1**	**-0.8**	**-0.7**	**-0.3**	**0.0**	**-0.1**
Unemployment rate (%)		**7.0**	**7.0**	**6.8**	**6.6**	**6.4**	**6.0**
Labour productivity, persons		**761**	**-1.8**	**1.4**	**1.9**	**1.8**	**2.3**
Labour productivity, hours worked		**421**	**-0.2**	**2.4**	**2.3**	**2.1**	**2.6**
Compensation of employees	D.1	**1649**	**-0.4**	**1.8**	**3.7**	**3.6**	**4.1**
Compensation per employee		**390**	**-1.9**	**1.2**	**3.5**	**3.3**	**3.9**

Note: Employment is based on domestic concept of national accounts. Rate of unemployment is based on the methodology of the Labour Force Survey. Labour productivity is calculated as real GDP (in 2012 prices) per employed person or worked hour.
Source: CZSO (2014a, 2014c). MF CR calculations.

Table A.1d: Sectoral Balances

(in % of GDP)

	ESA Code	2013	2014	2015	2016	2017
Net lending/borrowing vis-à-vis the rest of the world	B.9	**1.1**	**1.2**	**1.2**	**1.0**	**0.8**
Balance on goods and services		6.4	7.7	8.4	8.8	9.1
Balance of primary incomes and transfers		-7.5	-8.9	-9.5	-10.0	-10.4
Capital account		2.2	2.4	2.3	2.2	2.2
Net lending/borrowing of the private sector	B.9	**2.6**	**3.1**	**3.5**	**3.0**	**2.5**
Net lending/borrowing of general government	EDP B.9	**-1.5**	**-1.8**	**-2.3**	**-2.0**	**-1.7**
Statistical discrepancy		**0.0**	**0.0**	**0.0**	**0.0**	**0.0**

Note: Data from national accounts. Net lending/borrowing of general government for 2013–2014 based on notification, for 2015–2017 outlook.
Source: CZSO (2014b). MF CR calculations.

Table A.2a: General Government Budgetary Prospects

(level in CZK billion, others in % of GDP)

	ESA Code	2013 Level	2013	2014	2015	2016	2017
			In % of GDP				
Net lending (+)/borrowing (-) (EDP B.9) by sub-sectors							
General government	S.13	**-56**	**-1.5**	**-1.8**	**-2.3**	**-2.0**	**-1.7**
Central government	S.1311	-73	-1.9	-2.0	-2.4	-2.1	-1.7
State government	S.1312	-	-	-	-	-	-
Local government	S.1313	15	0.4	0.2	0.1	0.0	0.0
Social security funds	S.1314	1	0.0	0.0	0.0	0.0	0.0
General government (S.13)							
Total revenue	TR	**1588**	**40.9**	**40.6**	**39.9**	**39.5**	**39.3**
Total expenditure [1)]	TE	**1645**	**42.4**	**42.4**	**42.2**	**41.5**	**41.0**
Net lending (+)/borrowing (-)	EDP B.9	**-56**	**-1.5**	**-1.8**	**-2.3**	**-2.0**	**-1.7**
Interest expenditure [1)]	EDP D.41	54	1.4	1.4	1.4	1.4	1.3
Primary balance		-2	-0.1	-0.5	-0.9	-0.7	-0.3
One-off and other temporary measures		**-8**	**-0.2**	**0.1**	**-0.1**	**-0.1**	**0.0**
Components of revenues							
Total taxes		**767**	**19.7**	**19.2**	**18.8**	**18.7**	**18.5**
Taxes on production and imports	D.2	483	12.4	11.9	11.6	11.5	11.3
Current taxes on income, wealth etc.	D.5	283	7.3	7.3	7.2	7.2	7.2
Capital taxes	D.91	0	0.0	0.0	0.0	0.0	0.0
Social security contributions	D.61	**606**	**15.6**	**15.3**	**15.3**	**15.4**	**15.5**
Property income	D.4	**34**	**0.9**	**0.8**	**0.8**	**0.8**	**0.8**
Other		**181**	**4.7**	**5.3**	**5.0**	**4.6**	**4.6**
Total revenue	TR	**1588**	**40.9**	**40.6**	**39.9**	**39.5**	**39.3**
p.m.: Tax burden		**1373**	**35.4**	**34.5**	**34.1**	**34.1**	**34.0**
Components of expenditures							
Compensation of employees + Intermediate consumption	D.1+P.2	**509**	**13.1**	**12.9**	**12.7**	**12.5**	**12.4**
Compensation of employees	D.1	293	7.6	7.4	7.3	7.3	7.1
Intermediate consumption	P.2	216	5.6	5.4	5.3	5.3	5.3
Social payments		**778**	**20.0**	**20.1**	**20.1**	**20.0**	**19.7**
of which: Unemployment benefits [2)]		17	0.4	0.5	0.4	0.4	0.4
Social transfers in kind supplied via market producers	D.631	234	6.0	6.0	5.9	5.8	5.7
Social transfers other than in kind	D.62	544	14.0	14.2	14.2	14.2	14.0
Interest expenditure [1)]	EDP D.41	**54**	**1.4**	**1.4**	**1.4**	**1.4**	**1.3**
Subsidies	D.3	**77**	**2.0**	**2.0**	**2.0**	**1.9**	**1.9**
Gross fixed capital formation	P.51	**108**	**2.8**	**3.5**	**3.3**	**3.0**	**2.9**
Capital transfers	D.9	**46**	**1.2**	**1.1**	**1.1**	**1.0**	**1.0**
Other		**72**	**1.9**	**1.5**	**1.7**	**1.7**	**1.7**
Total expenditures [1)]	TE	**1645**	**42.4**	**42.4**	**42.2**	**41.5**	**41.0**
p.m.: Government consumption (nominal)	P.3	**802**	**20.7**	**20.3**	**19.9**	**19.6**	**19.3**

Note: Years 2013–2014 notification. Years 2015–2017 outlook.

1) Data are adjusted for interest from swap operations so that it holds total revenues less total expenditures are equalled to net lending/borrowing in EDP B.9 terms.

2) Includes cash benefits (D.621 and D.624) and in kind benefits (D.631) related to unemployment benefits.

Source: CZSO (2014b). MF CR calculations.

Table A.2b: No-policy Change Projections

(level in CZK billion, others in % of GDP)

	2013 Level	2013	2014	2015	2016	2017
		In % of GDP				
Total revenue at unchanged policies	**1588**	**40.9**	**40.6**	**39.7**	**38.7**	**38.5**
Total expenditure at unchanged policies	**1645**	**42.4**	**42.4**	**42.0**	**41.3**	**40.8**

Source: MF CR.

Table A.2c: Amounts to Be Excluded from the Expenditure Benchmark

(level in CZK billion, others in % of GDP)

	2013	2013	2014	2015	2016	2017
	Level	*In % of GDP*				
Expenditure on EU programmes fully matched by EU funds revenue	**54**	**1.4**	**2.1**	**1.9**	**1.5**	**1.5**
Cyclical unemployment benefit expenditure	**1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Effect of discretionary revenue measures (year-on-year changes)	**24**	**0.6**	**0.2**	**-0.1**	**0.0**	**0.0**
Revenue increases mandated by law	-	-	-	-	-	-

Note: Revenue increases mandated by law can be defined as revenue increases that occur automatically to offset corresponding increases in specified expenditures (such as an automatic increase of social security contributions in reaction to a surge in social security expenditure).
Source: MF CR.

Table A.3: General Government Expenditure by Function

(in % of GDP)

	Code	2012	2017
General public services	1	**5.0**	**4.6**
Defence	2	**0.9**	**0.8**
Public order and safety	3	**1.8**	**1.7**
Economic affairs	4	**5.6**	**5.1**
Environmental protection	5	**1.4**	**1.2**
Housing and community amenities	6	**0.7**	**0.5**
Health	7	**7.8**	**7.5**
Recreation, culture and religion	8	**2.7**	**1.1**
Education	9	**4.8**	**4.7**
Social protection	10	**13.8**	**13.9**
Total expenditure	TE	**44.5**	**41.0**

Note: Year 2017 outlook.
Source: CZSO (2014d), MF CR (2014a). MF CR calculations.

Table A.4: General Government Debt Developments

(in % of GDP, average maturity in years)

	ESA Code	2013	2014	2015	2016	2017
General government gross debt		**46.0**	**44.9**	**46.0**	**47.1**	**47.1**
Change in gross debt ratio		**-0.1**	**-1.2**	**1.1**	**1.1**	**0.0**
Contributions to changes in gross debt						
Primary balance		**-0.1**	**-0.5**	**-0.9**	**-0.7**	**-0.4**
Interest expenditure	EDP D.41	**1.4**	**1.4**	**1.3**	**1.4**	**1.3**
Stock-flow adjustment		**-1.1**	**-1.4**	**0.5**	**0.5**	**0.1**
Difference between cash and accruals		-0.5	-1.4	0.0	0.0	0.0
Net accumulation of financial assets		-1.0	0.0	0.5	0.5	0.1
Privatisation proceeds		0.0	0.0	0.0	0.0	0.0
Valuation effects and other		0.4	0.0	0.0	0.0	0.0
p.m.: Implicit interest rate on debt		**3.0**	**3.0**	**2.9**	**2.9**	**2.8**
Liquid financial assets		**17.0**	**16.4**	**16.3**	**16.2**	**15.7**
Net financial debt [1)]		**29.1**	**28.5**	**29.7**	**30.8**	**31.4**
Debt amortization (existing bonds) since the end of the previous year [2)]		**2.8**	**3.6**	**3.1**	**3.7**	**3.3**
Debt denominated in foreign currency [2) 3)]		**4.1**	**4.1**	**4.8**	**5.0**	**5.1**
Average maturity [2)]		**5.6**	**5.7**	**5.7**	**5.8**	**5.8**

Note: Years 2013–2014 notification. Years 2015–2017 outlook.
1) Net financial debt is a difference between gross debt and liquid financial assets (monetary gold, Special Drawing Rights, currency and deposits, securities other than shares (consolidated at market value), shares and other equity quoted in stock exchange).
2) Figures only for the state debt. The state debt represents a debt generated by the state budget financing.
3) State debt denominated in foreign currencies adjusted for collateral and assets.
Source: CZSO (2014b). State debt data MF CR. MF CR calculations.

Table A.5: Cyclical Developments

(growth in %, output gap in % of potential GDP, contributions in percentage points, other in % of GDP)

	ESA Code	2013	2014	2015	2016	2017
Real GDP growth (%)		**-0.9**	**1.7**	**2.0**	**2.1**	**2.5**
Net lending of general government	EDP B.9	**-1.5**	**-1.8**	**-2.3**	**-2.0**	**-1.7**
Interest expenditure	EDP D.41	**1.4**	**1.4**	**1.4**	**1.4**	**1.3**
One-off and other temporary measures		**-0.2**	**0.1**	**-0.1**	**-0.1**	**0.0**
Potential GDP growth (%)		**0.3**	**0.7**	**1.3**	**1.6**	**1.7**
contribution of labour		0.1	-0.1	-0.2	-0.2	-0.4
contribution of capital		0.4	0.4	0.5	0.6	0.6
total factor productivity		-0.1	0.4	1.0	1.3	1.5
Output gap		**-2.8**	**-1.8**	**-1.2**	**-0.7**	**0.1**
Cyclical budgetary component		**-1.0**	**-0.6**	**-0.4**	**-0.2**	**0.0**
Cyclically-adjusted balance		**-0.5**	**-1.2**	**-1.9**	**-1.8**	**-1.7**
Cyclically-adjusted primary balance		**0.9**	**0.1**	**-0.5**	**-0.4**	**-0.4**
Structural balance		**-0.3**	**-1.3**	**-1.8**	**-1.7**	**-1.7**

Note: Years 2013–2014 notification. Years 2015–2017 outlook.
Source: CZSO (2014b). MF CR calculations.

Table A.6: Divergence from Previous Update

(GDP growth in %, general government balance and debt in % of GDP)

	ESA Code	2013	2014	2015	2016	2017
Real GDP growth (%)						
Previous update		**0.0**	**1.2**	**2.1**	**2.6**	**-**
Current update		**-0.9**	**1.7**	**2.0**	**2.1**	**2.5**
Difference		-0.9	0.5	-0.1	-0.5	-
General government net lending (% of GDP)						
Previous update	EDP B.9	**-2.8**	**-2.9**	**-2.8**	**-2.8**	**-**
Current update	EDP B.9	**-1.5**	**-1.8**	**-2.3**	**-2.0**	**-1.7**
Difference		1.4	1.0	0.5	0.8	-
General government gross debt (% of GDP)						
Previous update		**48.5**	**50.3**	**51.2**	**51.9**	**-**
Current update		**46.0**	**44.9**	**46.0**	**47.1**	**47.1**
Difference		-2.5	-5.5	-5.3	-4.8	-

Source: MF CR (2013a, 2014a). MF CR calculations.

Table A.7: Long-term Sustainability of Public Finances

(expenditures and revenues in % of GDP, growth and rates in %)

	2010	2020	2030	2040	2050	2060
Total expenditure	45.2	38.1	39.6	41.2	44.1	47.0
of which: **Age-related expenditures**	20.2	20.3	21.3	22.3	24.2	25.5
Pension expenditure	9.1	8.7	8.9	9.7	11.0	11.8
Social security pensions	9.1	8.7	8.9	9.7	11.0	11.8
Old-age and early pensions	7.2	6.9	6.9	7.5	8.8	9.5
Other pensions	1.9	1.8	2.1	2.2	2.2	2.3
Occupational pensions	0.0	0.0	0.0	0.0	0.0	0.0
Health care	6.9	7.3	7.8	8.1	8.4	8.5
Long-term care	0.8	0.9	1.1	1.2	1.3	1.5
Education expenditure	3.4	3.4	3.6	3.3	3.4	3.7
Non age-related expenditures	25.0	17.8	18.3	18.9	20.0	21.5
of which: **Interest expenditure**	1.4	1.4	1.8	2.4	3.5	5.0
Total revenue	40.4	35.3	35.5	35.7	35.8	36.1
of which: **Property income**	0.8	0.6	0.7	0.8	0.9	1.1
of which: **Pension contributions**	8.4	8.5	8.6	8.7	8.7	8.8
Pension reserve fund assets	0.6	0.0	0.1	0.0	0.0	0.0
of which: **Consolidated public pension fund assets**	0.0	0.0	0.0	0.0	0.0	0.0
Systemic Pension Reforms [1]						
Social contributions diverted to mandatory private scheme	-	-	-	-	-	-
Pension expenditure paid by mandatory private scheme	-	-	-	-	-	-
Assumptions						
Labour productivity growth	2.2	2.0	1.8	1.8	1.7	1.5
Real GDP growth	2.3	1.8	1.7	1.5	1.1	1.2
Participation rate of males (aged 20–64)	85.1	86.9	86.1	85.5	86.8	87.3
Participation rate of females (aged 20–64)	66.5	68.7	68.8	68.4	70.9	71.7
Total participation rate (aged 20–64)	75.9	77.9	77.6	77.1	79.0	79.7
Unemployment rate	7.1	6.2	6.0	5.9	5.9	5.9
Population aged 65+ over total population	15.4	19.8	22.1	25.1	28.8	30.6

Note: 1) The fully-funded pillar in the Czech Republic is based on optional entry system.
Source: EC (2012a). MF CR calculations.

Table A.7a: Contingent Liabilities

(in % of GDP)

	2013	2014
General government sector guarantees	16.5	16.8
of which: Linked to the financial sector	5.8	5.6

Source: MF CR.

Table A.8: Basic Assumptions

(interest rates and growth in %)

	2013	2014	2015	2016	2017
Short-term interest rate (CZ) (annual average)	0.5	0.4	0.4	0.8	1.0
Long-term interest rate (CZ) (annual average)	2.1	2.4	2.6	2.8	3.0
Nominal effective exchange rate (2010=100)	97.3	92.9	93.3	94.6	96.0
Exchange rate CZK/EUR (annual average)	26.0	27.3	27.2	26.8	26.4
World excluding EU, GDP growth	2.7	3.5	3.7	3.5	3.6
EU28 GDP growth	0.1	1.6	1.8	2.0	2.3
Growth of relevant foreign markets	1.2	3.3	3.1	3.2	3.2
World import volumes, excluding EU	3.0	5.2	5.5	5.6	5.6
Oil prices (Brent, USD/barrel)	108.6	104.8	100.5	96.5	95.0

Source: CNB (2014), EIA (2014), Eurostat (2014). MF CR calculations.

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