Ministry of Finance
Czech Republic

Convergence Programme
of the Czech Republic

April 2011

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List of Abbreviations

CNB	Czech National Bank
CP	Convergence Programme of the Czech Republic
CZK	Czech crown 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 System of Accounts
EU	European Union (EU27 coverage)
EU27	European Union containing 27 countries
EUR	euro currency code
GDP	gross domestic product
HICP	harmonised index of consumer prices
IMF	International Monetary Fund
LFS	Labour Force Survey
MF CR	Ministry of Finance of the Czech Republic
p.p.	percentage point
USD	US Dollar currency code
VAT	value added tax

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.

Cut-off Date for Data Sources

Macroeconomic data used pertain to the March 28, 2011 release, fiscal data to the April 11, 2011 release.

Introduction

The update of the Convergence Programme for 2010–2014 presented here has for the first time been prepared in accordance with a new timetable, the so-called European Semester, approved by the European Council on 17 June 2010. The objective of the European Semester is to deepen and strengthen multilateral budget surveillance and fiscal and structural policy coordination within the EU. Therefore, from this year national fiscal policies will already be coordinated in the preparation phase of public budgets and their medium-term outlooks.

The Convergence Programme (CP), following from the medium-term expenditure frameworks for 2012–2014 approved by the Czech government (20 April 2011), was approved by the Government of the Czech Republic on 4 May 2011. It will therefore be possible to include the recommendations issued by the EU Council for the hereby presented fiscal policy intentions into the final state (and state funds) budget proposals and their medium-term outlooks. The presented CP is fully consistent with the National Reform Programme, approved by the Czech government on 27 April 2011, and respects its macroeconomic and fiscal impacts. This document corresponds with the rules established in the updated Code of Conduct for preparing the stabilisation and convergence programmes of the Stability and Growth Pact.

The update of the Convergence Programme ensues from the mandate of the coalition government which was established in mid-2010. In its Policy Statement from 4 August 2010, the government set out an ambitious programme focused on public finances reform aiming to halt growth in public indebtedness and with the specific objective to achieve a balanced budget in 2016. The government set as additional priorities to increase transparency in dealing with public funds, to limit corruption in the public sector, and to increase transparency of public procurement. It also declared its intention to reform fiscal institutions. In accordance with the Policy Statement, the government prepared its first consolidation budget already for 2011; it only managed, however, to incorporate short-term consolidation steps into the budget. Through rigorous implementation of the approved budgets in 2010, a year-on-year improvement in the structural deficit by nearly 1.2% of GDP in comparison with 2009 was achieved, and the government deficit was therefore decreased to 4.7% of GDP.

In accordance with the Annual Growth Survey (European Commission, 2011a) and with the Conclusions of the European Council from 24–25 March 2011, the government is now focused on preparing the necessary structural reforms aimed at improving long-term sustainability of public finances. This year, reforms of the pension and health care systems are being prepared. Their points of departure, intentions and impacts are already presented within this CP.

The macroeconomic scenario is based on current national accounts data, i.e. as of 28 March 2011. Even disregarding political factors, macroeconomic and fiscal development is currently encumbered with considerable uncertainties. The main sources of risk for the Czech Republic relate to the state of public budgets and the situation of the banking sector in several euro area countries.

Owing to the consolidation fiscal measures, a moderate slowdown in economic growth to 1.9% is expected for 2011. In the following years of the outlook, growth should gradually accelerate, and this should also improve the labour market situation from a demand perspective. It appears that consumer prices will rise by slightly over 2% in 2011, which is very close to the inflation target. Next year, inflation will be significantly influenced by the planned value added tax adjustments. The macroeconomic development is described in more detail in Chapter 2.

On 2 December 2009, an Excessive Deficit Procedure was initiated for the Czech Republic, recommending bringing the general government deficit below the limit of 3% of GDP in a credible and sustainable manner by 2013. EU Council recommendations were taken into account by the Parliament of the CR in April 2010. Information on progress toward achieving these recommended objectives is included in a separate subchapter within the Chapter Overall Policy Framework and Objectives.

The fiscal forecast discussed in Chapter 3 ensues from the results of the April fiscal notification (closing date for data sources 11 April 2011). We expect the government sector balance for 2011 to be about −4.2% of GDP. The general government debt will probably rise to 41.4% of GDP this year, with prospects for further growth. The evolution of the debt-to-GDP ratio in the near future will strictly follow the objective of the government to decrease deficits, supported by the binding expenditure frameworks which, among other things, will contribute to a slower growth of the debt-to-GDP ratio and to its subsequent absolute decline.

Due to the mentioned uncertainty of future economic development, part of Chapter 4 presents a sensitivity analysis of the Czech economy's development (and hence of public finances) incorporating different economic development in the European Union and higher oil prices.

In Chapter 5, the CP analyses long-term impacts of the current fiscal policy settings, and thus considers the long-term sustainability of the whole system.

The last two chapters are devoted to quality of public finances and adjustments to the institutional framework. On the one hand, they deal with changes which will take, or have taken, place on both the revenue and expenditure side. On the other hand, they discuss changes of institutional relations, the legal anchorage of authority and responsibility of the public sector, as well as changes in the system of public administration.

1 Overall Policy Framework and Objectives

Consolidation of public budgets is the priority for the coming period. The consolidation focuses not only on reduction of the general government sector deficit but also on the improvement of structural parameters of the system and on strengthening the Czech economy's pro-growth attributes.

The monetary policy conducted by the Czech National Bank (CNB) was changed to a new medium-term inflation objective from 2010, as it was no longer necessary to reflect some of the specific needs of an economy in transition on a convergence path towards more developed economies. CNB's high credibility is reflected in a firm anchoring of inflation expectations in the vicinity of the inflation target.

1.1 Fiscal Policy

In May 2010, regular elections to the Chamber of Deputies were held in the Czech Republic, leading to a new coalition government. Up to that time, a so-called interim government had held power but did not have a sufficient mandate to carry out structural reforms. Measures for mitigating the public finance deficit for 2010 and 2011 were conceived more as ad hoc corrections than changes in the system. The main objective in managing public finance was to reduce the deficit of the general government sector.

The Czech Republic was one of the first countries to commence an "exit strategy" and accept a consolidation plan. In 2010, a set of stabilisation measures was approved which should prevent further growth in the deficit and help restrain the rapid rise in indebtedness. The new government professed budget responsibility in its Policy Statement, and one of its first steps in this respect was to tighten the medium-term expenditure frameworks and approve a state budget so that the total general government deficit does not exceed 4.6% of GDP in 2011.

At the same time, intensive work began on structural reforms. These include making the social benefits system simpler and more efficient, introducing a fully funded pillar into the pension system, reforming the health care system, as well as decreasing administrative burdens by modifying the tax system and its administration (for more details see Chapters 6 and 7). Moreover, a reform of tertiary education financing emphasising and supporting science and research is being prepared.

Application of a fiscal targeting regime and adhering to the medium-term expenditure frameworks is the main instrument of fiscal policy in the process of fiscal consolidation in the Czech Republic.

Under the weight of some reform measures which reduced the revenue side, it was necessary to accept further measures on the expenditure side and to support the medium-term expenditure frameworks (more details in Chapter 3.2).

1.2 Implementing the Excessive Deficit Procedure

Expecting the general government balance to breach the reference value in 2009, the Excessive Deficit Procedure (EDP) was initiated with the Czech Republic on 2 December 2009. The Council has recommended that the Czech Republic bring the general government deficit below the 3% of GDP limit in a credible and sustainable manner by 2013. Further, the recommendation instructs:

i) during 2010–2013 to ensure annual average fiscal effort[1] of 1% of GDP;
ii) to specify the measures necessary to remedy the excessive deficit by 2013, cyclical conditions permitting; and
iii) to accelerate deficit reduction if economic or budgetary conditions turn out better than originally expected.

In connection with existing experience in adhering to the medium-term expenditure frameworks, the Czech Republic was prompted to enforce the expenditure limits more rigorously and to improve monitoring throughout the entire budget process.

The Council also identified a need for progress in pension and health care reform efforts in order to avert negative implications of population ageing.

1.2.1 Measures for 2010

The measures approved for 2010 concentrated especially on the revenue side of public budgets, where the basic and reduced VAT rates and excise taxes were increased, property taxes doubled, and certain anti-

[1] Fiscal effort is defined as a year-on-year change of the cyclically adjusted balance without one-off and temporary measures.

crisis measures already adopted abolished, such as the credit on social security contribution for employers. In addition, the ceilings for health and social security insurance contributions were raised. The expenditure side was adjusted by decreasing certain social benefits, freezing pensions, and cutting the wage bill and positions in the government sector. There was also an overall reduction of expenditures in the state budget's individual chapters. The total extent of discretionary measures for 2010 was 2.8% of GDP (see Table 1.1).

1.2.2 Measures for 2011

In accordance with the EDP requirements, another package of changes (about 2.1% of GDP) was prepared for 2011, this time more expenditure side oriented. The wage bill in the state administration was reduced by 10% and the wage bill of judges and institutional officials was also lowered (on the other hand, funds for teachers' wages were increased). Further, some social transfers were eliminated or their extent reduced. Last but not least, general cuts in the state budget were made, thus non-mandatory regular and capital expenditures also decreased. On the revenue side, the amount of social security contributions was maintained and, motorway toll rates were increased. The basic structure of the active measures carried out is summarised in Table 1.1, and a more detailed description of some items is included in Chapter 6.

Table 1.1: Structure of Active Measures Carried Out
(in % of GDP)

	2010	2011
Direct taxes	1.0	0.5
Indirect taxes	0.8	0.0
Other revenues	0.0	0.0
Social benefits	0.3	0.3
Government sector wages	0.1	0.3
Other expenditures	0.7	0.9
Total impact on balance	2.8	2.1

Source: MF CR.

1.2.3 Plan and Objectives of Fiscal Consolidation

The government has unambiguously declared that the approved medium-term expenditure frameworks will not be surpassed and the objective for the general government deficits objective will be upheld, with the intention not to surpass 2.9% of GDP in 2013. For 2014, the government approved a new objective at 1.9% of GDP, which is about CZK 84 billion, including adjustments and interest rate derivatives. The deficit trajectory has been ambitiously established so that a balanced general government budget will be attained in 2016, which should allow fulfilling the medium-term objective (MTO) of a structural deficit at 1% of GDP in that year.

Table 1.2: Fiscal Consolidation Plan
(in % of GDP)

	2012	2013	2014
Deficit target	3.5	2.9	1.9

Note: Deficit objectives designate net borrowing of the general government sector by the method applicable for EDP (EDP B.9).
Source: MF CR.

Further development of public finances in the Czech Republic is highly conditioned upon development of the domestic and foreign economies, i.e. the speed and extent of recovery in domestic and foreign markets, as well as the government's reform effort.

The government is oriented to structural and long-term reforms, which will not only be reflected in change of the general government balance now or in the years immediately to follow, but also in the medium- and long-term horizons. In recent months, parameters of the pension and health care system reforms are being discussed. Both take into account the Council's recommendations and are prepared in the context of anticipated population ageing and of higher government sector expenditures and lower revenues.

The impacts on revenues and expenditures are discussed in Chapter 3.2, Medium-term Budgetary Outlook, while Chapters 5.2, The Government's Strategy – Reforms and 6, Quality of Public Finances describe the reforms.

1.3 Monetary Policy

The CNB will continue to conduct monetary policy aided by the inflation-targeting regime. Since 1 January 2010, a new inflation target has been in effect, expressed as annual growth in the consumer price index of 2% with a tolerance band of ±1 percentage point. The CNB continues to view its inflation targets as medium-term in nature. Real inflation may temporarily deviate from them, for example as a result of changes to indirect taxes. As a matter of course, monetary policy does not react to the first-round effects of such changes but concentrates only on their second-round effects.

The current low-inflationary environment of the Czech economy and CNB's high credibility are reflected in inflation expectations anchored at levels close to the inflation target. Nevertheless, the impact of the contemplated changes to indirect taxes represents a risk for the Maastricht price stability criterion. It will also depend on the conditions used to exclude countries when calculating the criterion's reference value.

Gradual increase in short-term interest rates is consistent with the macroeconomic scenario while counting on continuing recovery in economic activity and on closing the negative output gap.

The Czech Republic's updated strategy for euro zone accession, approved by the Czech government in August 2007, did not set a new target date for that accession. This date will depend on the resolution of problematic areas as part of fundamentally reforming public finances and increasing flexibility of the Czech economy. In this respect, entry into ERM II (Exchange Rate Mechanism 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 the Ministry of Finance of the Czech Republic and the CNB "Assessment of the Fulfilment of the Maastricht Convergence Criteria and the Degree of Economic Alignment of the Czech Republic with Euro–Area", approved by the government on 22 December 2010, states that meeting all Maastricht convergence criteria is very improbable under current conditions. The major barrier to entering the monetary union will be a general government deficit higher than 3% of GDP. There also remains uncertainty as to whether the Czech economy will maintain, and will be able to further increase the degree of its alignment with the euro area. In the current situation, the government has decided not to adopt a target date for accession to the euro zone. This also implies that the Czech Republic will not strive for entry into the ERM II mechanism during 2011.

1.4 Structural Policies

A detailed outline of priorities and measures adopted in the area of structural policies is presented in the Czech Republic's National Reform Programme for 2011 (GO, 2011), which was sent to the European Commission in April 2011. In this section, therefore, only a selection of the most important measures is presented.

1.4.1 Labour Market

In the coming years, the Czech Republic will focus especially on decreasing structural unemployment and on increasing the labour force participation. In this context, a complex reform of social policy will be carried out, which will make social benefits more targeted and will increase the motivation of the economically inactive to enter the labour market. At the same time, the Czech Republic intends to significantly increase labour law flexibility, especially by lengthening the probation period, changing reasons for termination and severance pay, expanding the maximum extent of employment based on a contract for services, and introducing the possibility to temporarily allocate an employee for performing work at a different employer (see Chapter 6.2).

1.4.2 Business Environment

Measures to further improve the business environment will be targeted at removing administrative and regulatory obstacles to business, to increase broadband internet access and to further enhance eGovernment. Toward this end, entrepreneurs' administrative burdens will be measured, and on that basis particular adjustments to legal regulations will be proposed. In the eGovernment area, basic information registers in the public administration will be completed and opportunities explored how to further develop the system of secure data exchange boxes and of public administration contact points "Czech POINT".

1.4.3 Education

One of the aims of the planned measures is also to improve the efficiency of the education system and to adjust it to the needs of the Czech economy, which is markedly oriented to industry and export. In this respect, reform of tertiary education seems crucial. The reform will newly define basic types of institutions of higher learning, balance the competence of public schools' main administrative bodies, and ensure comprehensive regulation of the relationship between state and institutions of higher learning. It will emphasise diversification of universities and improvement of their quality. Last but not least, tuition fees to cover expenses for studies will be introduced.

1.4.4 Research, Development and Innovation

In the science, research, development and innovation area, attention will be drawn especially to an overall increase in quality and output while improving the interconnectedness of this area with the business sphere. The main measures planned include an increase in public spending for this high-priority area, support for private financing by making purchases of the results of research activity tax deductible, and preparation of a new National Policy of Research, Development and Innovations.

1.4.5 Energy Industry and Climate Change

The Czech Republic strives to increase energy efficiency and the proportion of energy generated from renewable sources as well as to decrease greenhouse gas emissions. Towards these ends, the Czech Republic will continue to financially support projects that contribute to decreasing energy intensity of buildings, industry and transport, as well as projects contributing to an increased share of renewable sources of energy.

1.4.6 Transport Infrastructure

The Czech Republic's main aims in transport infrastructure are to increase its capacity and quality and a more effective interconnection of all forms of transport. The transport strategy to 2025 will be updated, and priority projects will be determined on its basis. The completion of the motorway network and of the transit railway corridors together with modernisation of the existing railway network are among the highest priorities. Last but not least, alternative sources of financing the construction of transport infrastructure will be employed.

2 Economic Outlook

The Czech economy emerged from recession in mid-2009, and it is currently in a phase of not very dynamic recovery. The Convergence Programme's macroeconomic scenario was drawn up to be conservative trying to balance the possible positive and negative deviations in economic development while drawing upon the current state of knowledge.

2.1 World Economy and Technical Assumptions

The recovery of the world economy continues, equity markets are rising, as are industrial output and world trade. From a global viewpoint, growth is highly uneven. It remains high in the large developing economies, including China and India, while it is much weaker in developed economies.

The EU27 economy returned to moderate GDP growth of 1.8% in 2010 after a deep decline in 2009. Germany, which is the Czech Republic's main trading partner, enjoys the major share in that growth. Current development in the EU is characterised by marked disparities in economic output and, for example, in unemployment rates. This unevenness makes the determination of appropriate economic policies (including monetary policy) difficult. Among the risks, there is also the possibility of complications in the financial sector and high government indebtedness in a number of countries.

Commodity prices have risen significantly in all the major groups. This involves, therefore, not just the price of oil, whose rise was caused by political unrest in a number of producing countries, but also food, metals and other raw materials. Among the causes we may mention high demand, growing investments in commodity derivatives, geopolitical factors and also, for food prices, weather fluctuations. Oil prices will therefore apparently remain high – in the vicinity of USD 100/barrel for Brent crude. The increase in commodity prices will be reflected in the Czech economy by deterioration in the terms of trade.

Our assumption of EU27 growth differs only slightly from the European Commission's Common Assumptions on the External Environment.[2] On the other hand, the difference between the EC (2011b) and our estimate of oil prices is substantial. For 2011, our estimate of Brent oil prices is lower by about USD 18. The reason is that in our opinion the impact of the stated extraordinary events will probably pass over next several months and prices will lose their high risk premium. In the medium-term horizon, the pressure on oil prices could be mitigated by wider use of less energy-intensive technologies.

A conservative exchange rate assumption with stability around 1.3 EUR/USD was chosen. The koruna should continue to strengthen against the euro, and in 2014 it should reach the level of approximately 22.2 CZK/EUR. The assumption on the development of short-term interest rates is consistent with fulfilling the CNB's inflation target.

[2] We received the preliminary version of the "Common Assumptions on Development of External Environment" on 31 March 2011, which was after we had completed the work on the Macroeconomic Forecast upon which this scenario is based. We could not reflect the next version from 11 April 2011 for the same reason. Therefore, the CP was supplemented by a sensitivity analysis for certain macroeconomic indicators based on exogenous variables.

Table 2.1: Exogenous Assumptions of the Scenario

		2010	2011	2012	2013	2012
USD/EUR exchange rate	*annual average*	1.32	1.31	1.30	1.30	1.30
CZK/EUR exchange rate	*annual average*	25.3	24.1	23.5	22.8	22.2
Government bond yield to maturity 10Y	*in % p.a.*	3.7	4.1	4.3	4.3	4.3
PRIBOR 3M	*in % p.a.*	1.3	1.3	2.0	2.6	3.0
GDP EU27	*real growth in %*	1.8	1.8	2.1	2.3	2.3
Oil prices	*Brent, USD/barrel*	79.7	95.0	95.5	96.8	93.3

Source: CNB (2011), Eurostat (2011), IMF (2011). MF CR calculations.

2.2 Cyclical Developments and Current Prospects

2.2.1 GDP and the Demand Side

From the fourth quarter of 2008 to the second quarter of 2009, the Czech economy was hit by a recession, during which real GDP decreased by approximately 5%. The economy has been gradually coming out of this deep decline since the third quarter of 2009. The recovery is relatively slow, however, and growth rates are lagging behind the dynamics of 2005–2007. The peak level of economic output seen in the third quarter of 2008 will probably not be reached until the end of 2011.

The economic dynamics are partially limited by the fiscal consolidation currently underway, which reduces domestic demand and shifts the main source of growth to the goods and services balance. According to the expected scenario, however, real GDP growth should start to accelerate from 2012 towards 4.0% in 2014.

During the recession, household consumption was a stabilising component of GDP. During 2010–2012 however, it was, is and will be influenced by fiscal measures, especially by an increase of both VAT rates by 1 percentage point in 2010, a decrease in the wage bill in the general government sector in 2011, and an increase of the reduced VAT rate from 10% to 14% in 2012.

The consolidation of public finances during 2011–2013 will lead to a sustained decrease of real government consumption. Both the decrease of employment in the general government sector and a reduction in the purchase of goods and services will be reflected here.

Following a significant slump in investment activities during 2008–2010, their dynamics should gradually recover. There should be a positive impact from implementing structural reforms, reinforcement of confidence in future economic development, gradual growth in capacity utilisation, and accelerated drawing of investment grants from structural funds and the Cohesion Fund. Renewed inflow of foreign direct investment can be expected, and we expect new capacities will continue to be primarily export oriented.

The contribution of the goods and services balance in constant prices to GDP growth reached 1.0 percentage point in 2010. Foreign demand should continue in contributing to economic growth. Due to recovery of domestic demand, however, foreign trade's contribution should gradually decrease from 1.8 percentage points in 2011 to 0.2 percentage points in 2014.

Convergence in the relative level of GDP per capita compared with the EU27 average at purchasing power parity (Chart 2.2) more or less halted with the onset of the recession. Along with a recovery of more dynamic growth, the Czech Republic's relative level should again start to increase and reach approximately 85% in 2014.

Table 2.2: Economic Output

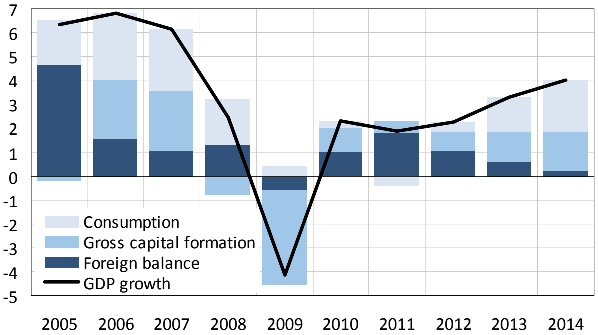
(level in CZK billion, increases in %, contributions to growth in percentage points)

	ESA Code	2010	2010	2011	2012	2013	2014
		Level	*Rate of change*				
1. Real GDP	B1*g	**3710**	**2.3**	**1.9**	**2.3**	**3.3**	**4.0**
2. Nominal GDP	B1*g	**3670**	**1.2**	**1.3**	**5.0**	**4.9**	**5.9**
Components of real GDP							
3. Private consumption expenditure	P.3	**1845**	**0.5**	**0.7**	**1.9**	**3.3**	**4.2**
4. Government consumption expenditure	P.3	**801**	**0.3**	**-3.4**	**-2.5**	**-1.3**	**0.1**
5. Gross fixed capital formation	P.51	**777**	**-4.6**	**0.7**	**3.2**	**5.6**	**7.2**
6. Changes in inventories and net acquis. of valuables (% GDP)	P.52+P.53	**48**	**1.3**	**1.7**	**1.7**	**1.7**	**1.7**
7. Exports of goods and services	P.6	**2959**	**18.0**	**12.2**	**10.8**	**10.7**	**11.5**
8. Imports of goods and services	P.7	**2720**	**18.0**	**10.6**	**10.1**	**10.7**	**12.0**
Contributions to real GDP growth							
9. Final domestic demand		**-**	**-0.7**	**-0.3**	**1.1**	**2.6**	**3.7**
10. Changes in inventories and net acquis. of valuables	P.52+P.53	**-**	**2.0**	**0.4**	**0.1**	**0.0**	**0.0**
11. External balance of goods and services	B.11	**-**	**1.0**	**1.8**	**1.1**	**0.6**	**0.2**

Note: Real levels are in 2009 prices. Changes in inventories and net acquisition of valuables on the sixth row express change in inventories as a percent of GDP in current prices. The increase of the change in inventories and net acquisition of valuables is also calculated from real values.
Sources: CZSO (2011a), MF CR (2011a).

Chart 2.1: Decomposition of GDP Growth

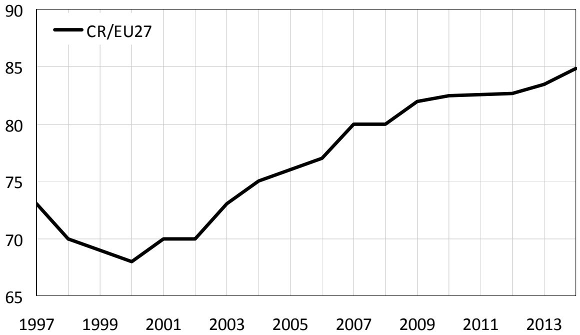
(contribution to growth in percentage points)



Source: CZSO (2011a), MF CR (2011a). MF CR calculations.

Chart 2.2: GDP per Capita

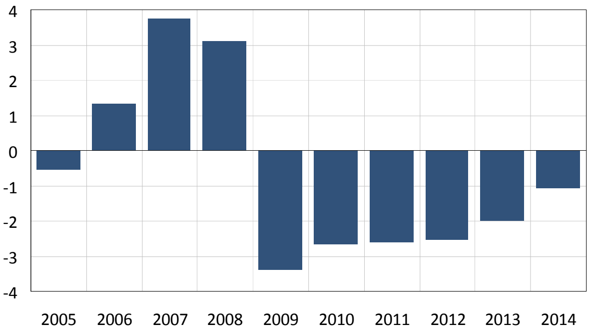
(calculated in purchase power parity, EU27=100)



Source: CZSO (2011a), Eurostat (2011), MF CR (2011a). MF CR calc.

Chart 2.3: Output Gap

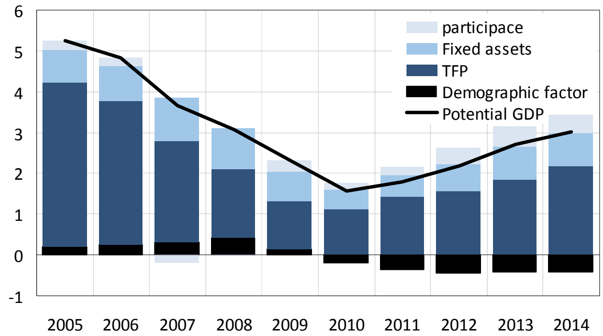
(in % of potential product)



Source: MF CR calculations.

Chart 2.4: Growth of Potential Product

(contributions to growth in percentage points)



Source: MF CR calculations.

2.2.2 Potential Product and Position within the Business Cycle

Under the present conditions, with the level of economic output changing abruptly, it is difficult to distinguish between the effects of the deepening output gap and that of the slowdown in potential GDP growth. The results of decompositions show great instability, and it is necessary to approach them with considerable caution.

The economic recession plunged the economy into a deep negative output gap and at the same time led to a significant slowdown in potential GDP growth. According to current calculations,[3] the output gap in 2009 reached a level under −3%. The deep negative output gap in the economy is evident in the low production capacities utilisation, high unemployment rate, and small number of job vacancies.

The most affected component of potential GDP is total factor productivity. Growth of its trend component fell from the high of 4% in 2005 to 1% in 2010. The slump in investments led to moderate decrease in the growth contribution from capital stock. Moreover, in 2010 the negative effect of demographic development began to express itself for the first time. On the other hand, the contribution of the participation rate during the recession remained positive which is surprising. The resulting growth of the potential product in 2010 dropped below 2%.

We believe that the deceleration of growth of the economic potential already reached its bottom in 2010. The decisive factor should be the contribution of total industrial factor productivity, which should in 2014 surpass 2 percentage points. The contribution of the growth in capital stock should, due to increased investment activity, again reach values around 1 percentage point. The contribution of participation rate should remain positive due to increased motivation to work as a result of structural measures and should compensate for the unfavourable demographic factors. Potential growth should thus in 2014 again reach approximately 3%.

Within the scenario's horizon, real GDP should still hover below the potential product. The output gap should be closing gradually. It is not expected to close fully within the CP horizon, however, and according to this scenario it should still be around −1% in 2014.

[3] Calculations of potential product and the output gap are currently made using the national methodology, also based on the Cobb-Douglas production function.

2.2.3 Prices

From a long-term viewpoint, the Czech economy can be characterised as low-inflationary (with the exception of 2008). In 2010, HICP inflation was 1.2% versus 1.6% in the euro zone and 2.1% in the EU27. Lower or comparable inflation is expected to be maintained also in the coming years, especially due to the CNB's high credibility, the highly competitive internal market, the Czech koruna's disposition for appreciation, and moderate growth in unit labour costs.

We expect inflation expectations in the coming years to remain firmly rooted in the vicinity of the CNB's inflation target. The increased world prices of fuel commodities and food represent a risk in the near term. Changes in indirect taxes, and especially VAT with a contribution of 1.2 percentage point, will contribute to an assumed one-off spike in inflation exceeding 3% in 2012.

Table 2.3: Prices of Goods and Services

(for HICP 2005=100, for the other indices 2000=100, increases in %)

	2010	2010	2011	2012	2013	2014
	Level	*Rate of change*				
1. GDP deflator	122.5	-1.1	-0.5	2.7	1.6	1.8
2. Private consumption deflator	121.5	1.3	2.0	3.2	1.5	2.0
3. HICP	113.7	1.2	2.2	3.4	1.6	2.1
4. Public consumption deflator	140.6	0.5	1.5	2.5	1.8	1.1
5. Investment deflator	104.0	-0.8	0.5	2.2	1.0	1.3
6. Export price deflator (goods and services)	86.0	-1.7	-0.8	0.1	0.3	0.5
7. Import price deflator (goods and services)	82.5	0.5	1.6	0.1	0.1	0.2

Source: CZSO (2011a), Eurostat (2011). MF CR calculations.

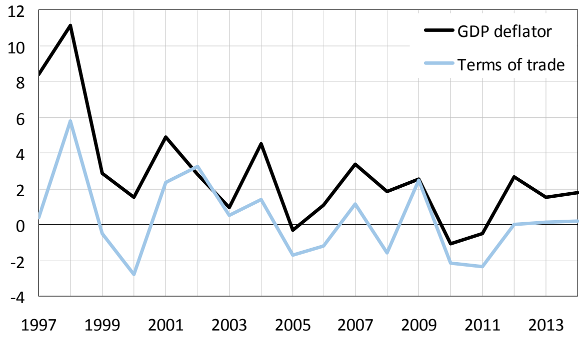
Chart 2.5: Consumer Prices (HICP)

(y-o-y growth in %)

Source: Eurostat (2011). MF CR calculations.

Chart 2.6: GDP Deflator and Terms of Trade

(y-o-y change in %)



Source: CZSO (2011a). MF CR calculations.

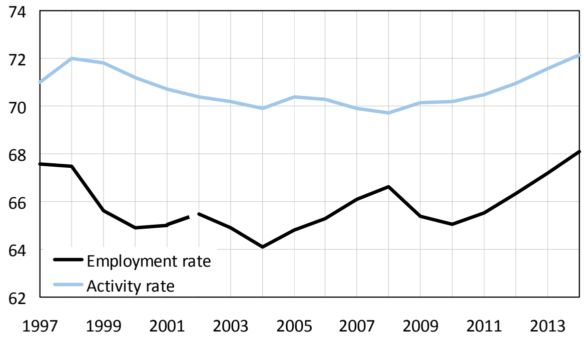
2.2.4 Labour Market and Wages

The economic downturn also affected the labour market, with a modest delay. In 2009, the short-term fiscal measures adopted helped mitigate some impacts of the recession. Decrease in employment and increase in the unemployment rate thus culminated only in the first quarter of 2010, after most of these measures had been cancelled at the end of 2009 with the aim of fiscal consolidation. Employment dropped by 0.8% in 2010. For the coming years, we expect only very moderate increase of employment growth by up to 0.7% in 2014, which should correspond to the intensity of economic recovery and the possibilities for growth in labour productivity.

The unemployment rate reached 7.3% in 2010, thus rising by almost 3 percentage points compared to 2008. In view of the economic recovery, new legislative adjustments, and improving structural characteristics of the labour market, we expect it to decrease gradually to 5.5% in the coming years.

Chart 2.7: Employment and Participation Rates

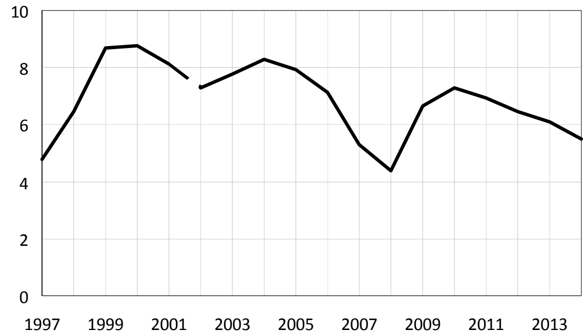
(in %)



Note: The employment rate from the Labour Force Survey is not comparable between 2001 and 2002 due to changes in methodology.
Source: CZSO (2011c). MF CR calculations.

Chart 2.8: 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 (2011c). MF CR calculations.

The decrease in compensation of employees (the sum of the wage bill and social security contributions paid by employers) of 1.6% in 2009 was replaced already the next year by modest growth of 1.1%, which was due especially to growth in social security contributions resulting from the increase in maximum premium assessment base as well as from moderate growth of average wages in the business sector.

In view of the adopted austerity measures in the budget sector, oriented especially toward decreasing wages and employment in a large part of the central government sector, we expect the wage bill to growth by just 2.1% in 2011. In the following years, compensation of employees could grow by an average 5.2%, which would be similar to growth dynamic of nominal GDP.

Table 2.4: Employment and Compensation of Employees

(price levels in common prices, increases in %)

	ESA Code	2010	2010	2011	2012	2013	2014
		Level	*Rate of change*				
1. Employment, persons		**5185**	**-0.8**	**0.1**	**0.5**	**0.6**	**0.7**
2. Employment, hours worked		**9.9**	**0.1**	**1.0**	**0.9**	**0.6**	**0.3**
3. Unemployment rate (%)		**7.3**	**7.3**	**6.9**	**6.5**	**6.1**	**5.5**
4. Labour productivity, persons		**715**	**3.1**	**1.7**	**1.8**	**2.7**	**3.3**
5. Labour productivity, hours worked		**375**	**2.2**	**0.8**	**1.4**	**2.7**	**3.7**
6. Compensation of employees	D.1	**1625**	**1.1**	**2.1**	**4.4**	**4.5**	**5.9**
7. Compensation per employee		**391**	**3.3**	**3.1**	**4.3**	**4.3**	**5.4**

Note: Employment is based on the Czech concept in the national accounts definition. Unemployment rate is from the SNA methodology. Labour productivity was calculated as real GDP (in 2009 prices) per employed person or hour worked.
Source: CZSO (2011a, 2011c). MF CR calculations.

2.3 External Transactions and Sectoral Balances

In accordance with the requirements of the "Code of Conduct", this chapter is prepared using the national accounts methodology. Based on the relationship between investments and savings, this allows a complete disaggregation of surplus or deficit in external transactions to the individual economic sectors. This differs from the analogous, more usually employed methodology of the current account of the balance of payments in its accrualisation, its categorisation of some items, and in the fact that it contains additional items, such as capital transfers.

In September 2011, the Czech Statistical Office will conduct a revision of national accounts in accordance with Eurostat requirements. The revised data will follow foreign trade according to changes in ownership. This means there will be netting out of transactions conducted by non-residents, which have a considerable share in the turnover of trade in goods in the Czech Republic. Therefore, it is necessary to understand the following data only as indicators of possible trends.

In 2008, for the first time in the history of the Czech Republic, a moderate surplus in the net lending balance was achieved. This continued in 2009. Within the scenario's horizon, a balanced or slightly deficit outcome can be expected. This should be caused by a surplus on the goods and services balance, a deficit balance for primary incomes (outflow of dividends for foreign-owned companies) and transfers, and a surplus balance of capital transfers, especially due to investment subsidies from the EU budget.

From a sector balances viewpoint, consolidation of government finances should meet with the gradually decreasing private sector surplus from the unusually high level of 6.5% of GDP in 2009.

Table 2.5: Net Lending/Borrowing
(in % of GDP)

	2010	2011	2012	2013	2014
Balance of goods and services	**4.8**	**4.5**	**5.3**	**5.8**	**5.9**
mineral fuels (SITC 3)	-3.7	-4.4	-4.1	-3.9	-3.7
Balance of primary income and transfers	**-7.1**	**-6.9**	**-7.1**	**-7.6**	**-8.1**
primary income	-6.6	-6.6	-6.9	-7.4	-8.0
transfers	-0.5	-0.3	-0.2	-0.2	-0.2
Capital transfers	**1.9**	**1.8**	**1.8**	**1.7**	**1.6**
Net lending/borrowing vis-a-vis ROW (B.9)	**-0.2**	**-0.6**	**0.0**	**-0.1**	**-0.6**
Net lending/borrowing of the private sector	**4.5**	**3.5**	**3.5**	**2.8**	**1.3**
Net lending/borrowing of general government (EDP B.9)	**-4.7**	**-4.2**	**-3.5**	**-2.9**	**-1.9**

Source: CZSO (2011a). MF CR calculations.

2.4 Growth Implications of Major Structural Reforms

By their nature, the intended reforms are systematic measures mostly supporting the supply side of the economy and are of a long-term character. Their objective is to support growth of potential product and employment over the medium and long term with expenditure savings in public budgets.

In the horizon of the CP's macroeconomic scenario, their positive influence is expected to be limited. Therefore, it is currently impossible to more precisely quantify the effects of the main reform measures on economic growth and employment.

3 General Government Balance and Debt

General government finances were in past years positively influenced especially by the peak phase of the economic cycle. The recession at the turn of 2008 to 2009 deteriorated results and thus showed the structural character of the fiscal imbalance. The 2009 deficit reached 5.9% of GDP, while in 2010 it was successfully reduced to 4.7% of GDP by strong active measures. Nevertheless, general government indebtedness increased by 8.5 percentage points from 2008 to 38.5% of GDP in 2010. The current consolidation strategy counts upon further decreasing the deficit, by an average 0.7 percentage points annually, which should slow growth in the debt-to-GDP ratio.

3.1 Actual Balances and Updated Budgetary Plans for the Current Year

According to current estimates of the Czech Statistical Office, the general government deficit reached CZK 173 billion in 2010, which is 4.7% of GDP. In contrast to 2009, there was a recovery of revenues, which after two years of decline and stagnation started growing again. The development on the revenue side was related to the gradual economic recovery and to tax-related measures valid from early 2010 (see Chapter 1.2.1). Thus, the established trend of shifting the tax burden from direct to indirect taxes continued. On the expenditure side, there was a decrease of grants, capital transfers, gross capital formation and also, due to the lower volume sold of assigned amount units[4] of CO_2, net acquisition of non-manufactured non-financial assets. Moreover, austerity measures were taken at the central government level (a decrease of compensation to employees and intermediate consumption), i.e. for expenditures related to state administrative operations. The growth rate of social benefits was significantly reduced and thus mandatory expenditures increased less than before.

Very positive development was apparent in interest costs, which grew only moderately despite relatively high debt dynamics. This fact can be attributed especially to a decrease in interest rates for all issued maturities of the government bond yield curve and to stabilisation of the risk premium for Czech government bonds, at least in comparison with most EU countries and also in contrast to 2009. This reflects a positive assessment of the consolidation strategy implemented in the Czech Republic.

For 2011, the Ministry of Finance of the Czech Republic expects the deficit to decrease to CZK 154 billion (4.2% of GDP). Thus, fiscal consolidation is expected to be in the extent of 0.5 percentage points; after adjusting for the cyclical component and one-off factors, the fiscal effort is even 0.9 percentage points. The revenues side will probably be strengthened by faster growth of certain tax incomes such as VAT and corporate income tax. VAT collection is influenced by the increase of rates from 2010, which will apparently only become significantly evident this year. For corporate income tax, the influence of accelerated depreciation can be seen. Moreover, the corporate income tax is also influenced by a decrease of the statutory rate in 2010. In view of the system of tax advances and the timetable for submitting returns, an improvement is expected on an accrual basis. Taxes on products are influenced by the payments from solar electricity production which were newly introduced in 2011. Property taxes will record a leap upward. This is caused mainly by introduction of the gift tax on unpaid acquisition of greenhouse gas emission permits.

Revenues from European funds are reaching their historically highest levels, and we assume only their moderate increase. These resources influence the balance only through their national financing part. They have considerable influence on the development of government investments, wherein they are to a considerable degree replacing national funds.

Growth dynamics on the expenditure side of the general government sector are lower than on the revenue side. According to the current assumptions, there will be an increase of other production subsidies in contrast to last year due to increase of subsidies to operators of the electricity transmission and distribution systems. Their aim is to eliminate the increase of electricity prices caused by the guaranteed purchase price from renewable sources and the large increase in the number of photovoltaic power stations. Due to the government's effort to increase the Czech Republic's absorption capacity for co-financing private projects from European funds there is an increase of investment grants to other sectors.

A risk on the expenditure side of general government budgets is the possibility for acceleration in the interest costs of the government debt, where a deterioration of last year's conditions can be expected. Due to

[4] Assigned Amount Unit (AAU) is a unit defined within the Kyoto Protocol, representing a state's tradable right to emit one tonne of greenhouse gases during 2008–2012. The Czech Republic has at its disposal according to the Kyoto commitment the right to emit in the given period a total of approximately 900 million tonnes of CO_2. Any country decreasing its emissions more that it committed to in the Kyoto Protocol can sell the surplus of its units to other countries. According to current analyses, the actual emissions will be approximately 17% below the Czech Republic's targets.

the considerable volatility in financial markets, this item represents a potential risk especially for the state budget.

A moderate increase is expected for social transfers. In contrast, the most significant decline on the expenditures side can be expected in outlays for compensation of employees, where in 2011 the wage policy measures and reduction in the number of employees in the central government administration will manifest themselves.

Risks to the presented deficit estimate and forecast for general government for 2010 and 2011 can be seen in the estimates of gross fixed capital formation, which are founded especially on the accounting reports the precision of which will be increased using data inputs from subsequent statistical surveys.

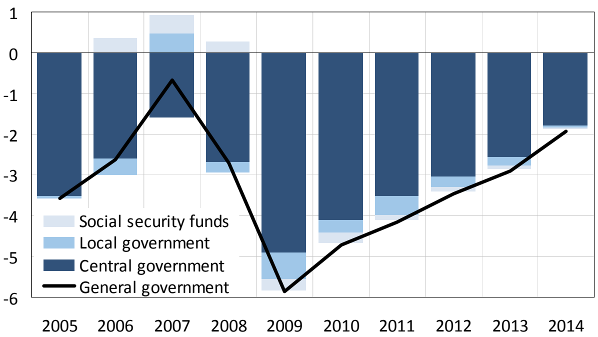
We estimate the general government debt at the end of 2011 at 41.4% of GDP, thus still remaining below the Maastricht convergence criterion and Stability and Growth Pact reference value.

3.2 Medium-term Budgetary Outlook

The medium-term budgetary outlook for 2012–2014 assumes further gradual improvement of the general government balance to –1.9% of GDP in 2014 (see Chapter 1.2.3). The current fiscal policy setting is defined by the government-approved expenditure frameworks and by the agreed targets for the deficit trajectory.

General government finances are strongly influenced by the central government balance (Chart 3.1), which will most likely hold in the future, since we assume decreasing contributions to the deficit from institutions standing outside of the central government.

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



Note: Years 2010–2011 show notification. Years 2012–2014 show outlook.
Source: CZSO (2011b). MF CR calculations.

The following subsections analyse the main factors influencing the revenue and expenditure sides separately. General government finances will be influenced not only by the expected gradual acceleration of economic output, but also by discretionary and reform changes either approved or expected to be approved.

3.2.1 Expected Revenue Development

From the fiscal viewpoint, one of the most important changes will be the increase of the reduced VAT rate by 4 percentage points in 2012 and then its unification to 17.5% in 2013. VAT collection, normally tracking the development of household and government consumption, should therefore increase by CZK 27 billion next year. We expect the year-on-year change in collections to be far less in 2013 due to the decline of the basic rate by 2.5 percentage points. Decrease of the registration limit for VAT payers by one quarter will also have a positive effect on tax collection (see Chapter 6.1.1).

Excise taxes will most probably grow only moderately, as the only significant positive change is an increase of tax rates on tobacco products in 2012 due to harmonisation with EU law.

For corporate income tax collection, we expect also only moderate growth from 2012 on, at first still positively influenced by the expiration of measures which allowed the taxpayers to shorten the depreciation period for assets in the first and second depreciation groups in 2009 and part of 2010. Tax collection in 2012 will be favourably influenced (ca CZK 7 billion annually) by taxation of lottery operators and of other gambling. In the later years we do not assume more significant growth, because, especially in connection with the tax reform, measures which will decrease revenues will come into effect. Among these, there is the possibility for tax paid from dividends to be granted a tax credit (fallout of approximately CZK 7 billion) or the possibility to increase the gift limit as a deductible item from the tax base or a zero rate for investment and pension funds. In connection with the tax reform, the decrease of the obligation to pay insurance premiums for employees can be considered a positive factor for corporate income tax, resulting in a lower level of costs and, ceteris paribus, higher taxable income. However, we do not estimate the extent of this effect to be greater than CZK 3 billion.

The autonomous personal income tax development is predicated upon a moderately optimistic outlook for evolution in the volume of wages and salaries. The accrual tax revenue in 2012 will be negatively influenced by an increase of the child credit, which is related to the planned pension reform and which should serve to compensate growth in prices of goods and services under the reduced VAT rate (fallout of CZK 4 billion). The legislative form of the new act on income taxes will have a significant negative impact. Due to changes in statutory rates, the tax base and introduction of a new credit for payers with income from employment and fringe benefits, revenue is expected to decrease by CZK 18 billion from 2013. On the other hand, cancellation of certain tax exemptions should have a positive impact under the tax reform (approximately CZK 5 billion).

The group of property taxes, specifically the gift tax, will record a decrease by approximately CZK 4.5 billion in 2013, as the validity of the amendment that taxed emission permits allocated free of charge will expire.

The largest sources of income for the Czech Republic's public budgets are without question the contributions to health and social insurance (in 2010 accounting for almost 39% of total revenues). In addition to development in the volume of wages and salaries, the planned tax reform will determine contributions to health insurance. Apart from the statutory transfer of part of the burden from the employer to the employee, which in itself will not bring higher income from the insurance premium, incomes under contracts for services over CZK 5,000 will be newly taxed. We estimate the additional revenue from this measure to be CZK 0.9 billion.

More changes will occur in contributions to social security. The most significant of these will be the possibility to exclude 3 percentage points of the contribution from the pay-as-you-go pillar to the second pillar of the pension system (see Chapter 5.2.2). Since it is now very difficult to accurately specify what percentage of people will decide to diversify their old age security sources and what income profile this group of people will have at their disposal, we consider – taking a conservative view – the more pessimistic variant which works with a fallout of CZK 20 billion per year. For self-employed persons, there is additional fallout of CZK 12 billion due to a change of contribution rates and of the contribution assessment base. In contrast, as is the case for health insurance, there will be a positive effect from taxation of income under contracts for services of over CZK 5,000 (revenue CZK 1.7 billion).

Concurrently with the tax reform, the system of employer's accident insurance will also be adjusted, where a possibility is being considered to continue its operation outside the public sector and without tying its financial results to the government sector. In such a case, the government balance would decrease by CZK 2.7 billion per year.

The impacts of the tax reform are summarised in Table 3.1. In general, it can be said that although the reform reduces direct taxation and taxation of labour, and from a long-term point of view it can therefore be considered entirely positively, it generates, per se, deficits of 0.2% of GDP in 2013 and 0.6% of GDP in 2014. Exceptional is only the year 2012, when a number of measures will not yet be in effect (apart from the taxation of gambling – see above).

Measures in connection to the pension reform will have in the following year an entirely positive effect on the balance of government institutions (ca CZK 23 billion). The increased VAT revenue should serve to cover deficits on the pension account. It could therefore decrease the total general government deficit by 0.6% of GDP in 2012. In the following years (see Table 3.2) the expected impact is more or less zero.

Among other changes on the revenue side, there is the already valid lowering of ceilings for contributions to social security back to the amount of 48times the average wage from 2012, which will decrease the revenues by approximately CZK 3.1 billion. And last but not least, also in 2012, motorway toll rates will increase by 25% (additional revenue of CZK 1.4 billion). Their gradual increase according to inflation is being considered. In 2014, expiration of payments introduced for some solar power plants will have a negative effect.

Of the non-tax revenues, the income from selling EU emission permits cannot be disregarded, the precise amount of which will depend both on the exchange rate of the Czech koruna to the euro and also on the price per permit. We currently estimate that the revenue from approximately 50% of permits sold in 2013–2014 can be in the range of CZK 12–15 billion.

Table 3.1: Impact of the Tax Reform on the General Government Balance
(in CZK billion)

		2012	2013	2014
Personal income tax	*bill. CZK*	0.1	-12.5	-13.0
Corporate income tax	*bill. CZK*	7.0	3.7	3.7
Social security contributions	*bill. CZK*	-	1.7	-10.3
Health care contributions	*bill. CZK*	-	0.9	0.3
Accident insurance	*bill. CZK*	-	-2.7	-2.7
Total impact on balance	*bill. CZK*	7.1	-8.9	-22.0
Total impact on balance	*% of GDP*	0.2	-0.2	-0.6

Source: MF CR calculations.

Table 3.2: Impact of Pension Reform Measures on the General Government Balance
(in CZK billion)

		2012	2013	2014
Value added tax	*bill. CZK*	27.0	31.9	33.4
Personal income tax (increase of deduction for children)	*bill. CZK*	-4.0	-4.0	-4.0
Social security contributions (opt-out)	*bill. CZK*	-	-20.0	-20.0
Pensions	*bill. CZK*	-	-3.5	-3.5
Compensation of higher VAT rate to those in social and material need	*bill. CZK*	-	-0.1	-0.1
Higher public expenditure in relation to the reduced VAT rate increase	*bill. CZK*	-	-5.0	-5.0
Total impact on balance	*bill. CZK*	23.0	-0.7	0.8
Total impact on balance	*% of GDP*	0.6	0.0	0.0

Source: MF CR calculations.

3.2.2 Expected Development of Expenditures

On the expenditure side, there will also be several important changes in connection to the measures being prepared. From measures already in effect, there is a decrease in the state subsidy for building savings, which should bring savings in mandatory expenses of approximately CZK 4 billion per year.

In addition to a 10% reduction in the wage bill and optimisation of the number of jobs in 2011, the consolidation effort in the public administration is further supported by maintaining the nominal level of wages for the outlook's entire duration (2012–2014). Nevertheless, wage increases are planned in some areas of general government, especially in education (CZK 4 billion in 2012) and health care (CZK 1.5 billion in 2012–2013) with a promise of better quality of services produced by these systems. In total, we expect mean growth in the volume of wages and salaries in general government by 1.2% for 2012–2014.

Amendment of the act on pension insurance, which is currently being discussed by the Chamber of Deputies of the Parliament, will also have a positive effect. This should prevent populist efforts to valorise pension insurance benefits above the mandated amount at the end of the election cycle. Moreover, it will make the system more regular and predictable. Therefore, we expect monetary social security benefits to rise only by 2.5%. Year 2013 will be an exception, when they will probably increase by 4.5% due to valorisation covering, among other things, the increase of prices caused by raising the reduced VAT rate (see Table 3.2).

In the case of social transfers in kind, higher co-financing of health care and payment by public health insurance only for the basic standard of care are expected, as intended by the health care system reform (Chapter 5.2.3). For this reason, the volume of social transfers in kind will grow only very modestly. For the remaining social transfers, the average growth will be only 2.7% as a result of the consolidation of public finances and of reform of the labour market and the social domain.

A considerable part of the savings realised in public finances should occur in government consumption, which will be significantly affected by planned revision of the ministries' agendas and their expected reduction by 5%. Savings will be about CZK 15 billion per year.

Some items on the expenditure side will be to a certain degree influenced also by the higher reduced VAT rate (for example, spending on medicaments, operating outlays), the impact of which on total expenditures of general government is expected to be approximately CZK 6 billion. Nevertheless, a certain part of these expenditures will be financed by inherent reserves and system savings, so the final impact to the overall balance shall be around CZK 1 billion lower.

The single collection point (see Chapter 7.2 for more details) will bring not only savings of administrative expenses to the taxpayers and simplification of the entire tax administration system, but also savings on the side of the public sector budget (approximately CZK 1 billion at the project's outset and nearly three times that in the project's final phase in 2014).

The consolidation effort is also noticeable in intermediate consumption, the growth of which should decelerate from 4.4% in 2012 to stagnation in 2013–2014.

Alternative financing modes are being sought for gross fixed capital formation (see e.g. Chapter 6.3) and for increasing the efficiency of the public contracts system, which should be interconnected with the gradually implemented State Treasury system. Total savings can thus be CZK 5–10 billion.

The development of expenses for interest payments should stabilise after transitional expected growth of nearly 25% in 2011, reflecting on the one hand the year-on-year decreasing general government deficit and on the other hand stable, relatively low interest rates for state bonds. The growth in interest payments should not therefore exceed 3% per year. Also a proposal for central management of state liquidity is being considered. It would include surplus liquidity on the accounts of state funds, municipalities and regions. This should decrease expenditures for debt service by approximately CZK 4 billion annually.

Table 3.3: Measures for Optimising and Increasing Efficiency of the State Administration

		2012	2013	2014
Revision and reduction of ministries' agendas by 5 %	*bill. CZK*	-	15.0	15.0
Single Collection Point	*bill. CZK*	0.4	0.6	1.0
Central management of state's liquidity via including accounts of SFs, regions and municipalities	*bill. CZK*	-	4.0	4.0
Increase in effectiveness of public procurements	*bill. CZK*	-	5.0	10.0
Total impact on balance	*bill. CZK*	0.4	24.6	30.0
Total impact on balance	*% of GDP*	0.0	0.7	0.8

Source: MF CR calculations.

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

The presented intentions of fiscal policy relate to both reforms of a structural character and also changes purely related to the budget, with the aim to limit the size of the public sector while simplifying and making it more efficient. They have been arranged so that the medium-term expenditure frameworks are not surpassed and at the same time so that the targets for the general government sector deficit relative to GDP are met.

The outcome for autonomous development of public sector finances with unchanged policies and in the absence of the stated corrective measures is summarised in Table 3.4. It shows that without proposed measures the general government deficit would be higher by approximately 0.7 percentage points on average, which is, in absolute terms, an amount just under CZK 30 billion.

Although at first glance the differences among the scenarios in the given years could seem similar, the division between revenues and expenditures will show the changes in the structure and character of consolidation over time. While 2012 is significantly influenced by higher revenues (especially the increased reduced VAT rate), 2014 will almost exclusively accentuate the expenditure side. Year 2013, then, stands almost on the border line, with 57% of active measures directed to the expenditure side.

Table 3.4: Comparison of the No-policy-change Scenario with the Intentions of Fiscal Policy

		Autonomous scenario			Forecast incl. proposals		
		2012	2013	2014	2012	2013	2014
Total revenue	*% GDP*	41.4	40.8	40.0	42.3	41.1	40.1
Total expenditure	*% GDP*	45.7	44.4	42.5	45.7	44.0	42.0
General government balance	*bill. CZK*	-167.4	-147.4	-110.2	-135.0	-118.8	-83.5
General government balance	*% GDP*	-4.3	-3.6	-2.5	-3.5	-2.9	-1.9

Source: MF CR calculations.

3.3 Structural Balance, Fiscal Stance

The structural balance in 2011 will reach −3.1% of GDP, and during 2012–2014 it will gradually improve due to the consolidation measures towards −1.6% of GDP. However, as Chart 3.2 shows, the quickly decreasing structural balance should be driven by decrease in the primary structural component, while interest expenses will probably constitute a rather stable 1.7% of GDP throughout the entire period. In order to reach the objective that the total balance is in the region of −1.9% of GDP in 2014, therefore, it will be necessary to completely balance the primary structural balance.

Among one-off and other transitional measures during 2009–2012 are one-off revenues from sales of emission permits assigned amount units and the related expenses, as well as the capital transfers expenditure to non-standard state guarantees in the amount of not more than CZK 2 billion per year throughout the entire forecast horizon. As a proportion of GDP, these are (especially at the end of the period) more or less negligible.

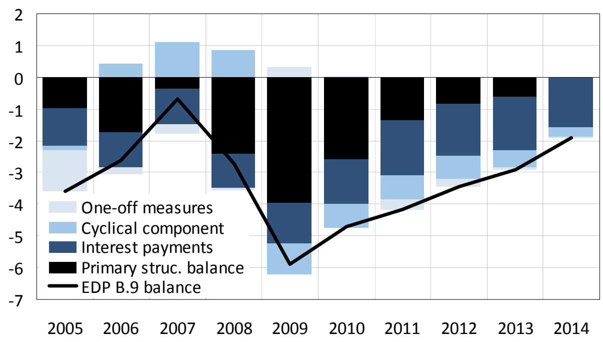
Chart 3.2 (and in more detail, Table A.5) also presents the cyclical components of the deficit, i.e. items that are sensitive to the economy's position in the business cycle. With the economy's gradual recovery, their negative influence diminishes from −0.8% in 2011 to −0.3% in 2014.

Fiscal effort, defined as the year-on-year change in the structural balance, is positive across the entire forecast horizon and its annual average during 2010–2014 reaches 0.7 percentage points. Therefore, we estimate the total fiscal effort in the given period to be 3.6 percentage points, which should ensure reaching the commitments ensuing from the Stability and Growth Pact and the requirements of the Council from the EDP (see Chapter 1.2).

The forecasted development shows that, according to the actual output gap estimate and the tax revenue prediction, lesser fiscal effort will not make the reduction of the government sector deficit below 3% of GDP possible in 2013.

Chart 3.2: Decomposition of the General Government Balance

(in % of GDP)



Source: CZSO (2011b). MF CR calculations.

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

The expected scenario for the development of public finances indicates growth in the nominal general government debt during the entire forecast period. Nevertheless, due to higher nominal growth in GDP we expect (Table 3.5) culmination of the debt-to-GDP ratio in 2013 at 42.8% of GDP and then its decrease to 42.0% in the following year. The scenario assumes a decreasing share of the primary balance on changes in the debt ratio, while the interest expenditures will increase it by approximately constant contributions of around 1.6 percentage points (Table A.4). Within the forecast horizon, we consider no new privatisation revenues.

The central government institutions sub-sector has the most substantial share in the total public debt, accounting for more than 93% of total debt. The local government institutions sub-sector represents the remaining approximately 7% of total debt, as indebtedness of the social security funds is negligible.

Nearly all of the central government debt, then, is accounted for by state debt. Therefore, its sustainable risk structure is an important stability factor for the general government.

When shaping the medium-term debt and the state's issuance strategies, main attention is focused on refinancing and market risk, representing the most important sources of financing uncertainty. Their stabilisation has been shown as crucial especially in periods of above-average volatility on international financial markets and increased uncertainty among investors. The strategy's long-term target has been to reduce the proportion of short-term state debt (i.e. debt payable within one year) from the 69% in 2000 to below a threshold of 20% and to maintain that in the coming years. This is a key stabilising element in financing the central government's borrowing needs and planning issuance activity on domestic and foreign markets.

The stable refinancing structure is also confirmed by the average maturity of the state debt (see Table 3.6). In past years, this indicator ranged from 6 to 7 years. In 2009 and 2010, the lower threshold of the average maturity (due to increased uncertainty on world financial markets) was decreased by 0.5 year, putting it in a range of 5.5–7 years. The improving situation on the global financial market and improvement in the Czech Republic's fiscal position allowed for adjusting this range in 2010 to 5.25–6.25 years for all years of the outlook.

As at the end of 2010, the state debt's structure in terms of interest paid on debt instruments generated an exposure to a change in interest rates on a one-year horizon of 31.7% of the state debt (debt with interest rate refixing up to 1 year). The interest-rate exposure expressed in this way has hovered around the aforementioned value since 2004. In terms of the debt portfolio's stability, this constitutes a threshold which can be regarded as relatively safe and comparable with the international practice of developed countries. For 2011–2014 the range for debt with interest rate refixing up to 1 year has been set to 30–40%.

In terms of interest-rate structure, the proportion of variable interest rate long-term instruments grew in 2008 and 2009 (Table 3.6). During 2011–2014, the share in the total debt of debt with variable interest rate is expected to be above 12%. The effect of derivative transactions on interest rate exposures relates to operations hedging the currency risk for foreign issues.

It can also be derived from the amount and structure of the state debt that a rise in interest rates by an average of one percentage point along the entire yield curve would lead to a rise in interest costs of the state debt issued before 2011 by approximately CZK 4.3 billion.

Table 3.5: General Government Debt by Sub-sector
(in % of GDP)

	ESA Code	2009	2010	2011	2012	2013	2014
General government	S.13	**35.4**	**38.5**	**41.4**	**42.4**	**42.8**	**42.0**
Central government	S.1311	**32.7**	**35.9**	**38.8**	**40.0**	**40.6**	**39.8**
Local government	S.1313	**2.7**	**2.6**	**2.7**	**2.5**	**2.4**	**2.2**
Social security funds	S.1314	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**

Note: Years 2010–2011 show notification. Years 2012–2014 show outlook.
Source: CZSO (2011b). MF CR calculations.

Table 3.6: The State Debt's Refinancing and Interest

		2009	2010	2011	2012	2013	2014
Refinancing							
Average maturity	*years*	**6.5**	**6.3**	**6.0**	**5.8**	**5.8**	**5.8**
Debt due within 1 year	*% of debt*	**14.7**	**16.1**	**17.6**	**17.9**	**18.8**	**19.0**
Financing reserve/debt due within 1 year	*%*	**33.8**	**30.1**	**11.7**	**9.0**	**6.4**	**6.1**
State debt's interest							
Debt with interest fixation within 1 year	*%*	**30.5**	**31.7**	**33.0**	**34.3**	**33.1**	**33.9**
Fixed interest long-term debt due within 1 year	*%*	7.0	7.5	4.5	7.0	6.6	6.8
Variable interest long-term debt	*%*	13.1	12.1	14.8	12.1	12.2	12.7
Monetary instruments	*%*	7.5	8.4	9.9	10.8	11.4	12.1
Effect of derivative operations	*%*	3.0	3.6	3.8	4.3	2.9	3.0

Note: The state debt here represents debt generated by the state budget financing. Data in the national methodology.
Source: MF CR calculations.

4 Sensitivity Analysis and Comparison with Previous Update

4.1 Comparison with Previous Convergence Programme Update

The differences of the macroeconomic scenarios between current and previous programmes are not substantial (Table 4.1). In terms of GDP growth in the EU27, after a rather quick recovery in 2010 a similar dynamic as in the CP 2010 is expected, whereas higher growth in Germany and other "northern" countries will be offset by slower growth in the southern countries. The impacts of the moderately higher oil prices will be further reinforced by the Czech koruna's expected weaker exchange rate against the dollar, so the total result will lead to a deeper deterioration of the terms of trade than expected in the 2010 CP.

The CP from January 2010 and its update both ensue from an assumption of continuing recovery in economic activity, but they differ considerably regarding its course in the individual years. Differences in the development of potential product and output gap, as well as the individual components of the GDP and key labour market indicators, stem also from this disparity.

The 2010 CP also could not have predicted the extent and timing of the fiscal austerity measures, which have feedback effects on the macroeconomic aggregates.

With respect to the public budgets and to the impact on their financing, slower growth of household consumption in 2011 and 2012, a more favourable situation and future development on the labour market, and a negative GDP deflator in 2010 can be considered the most important divergences in the macroeconomic scenarios.

Table 4.1 also shows that the real amount of the general government deficit is 0.6 percentage points lower than expected in January 2010. A number of active measures which should inhibit growth in the debt surely had positive effects. The lower trajectory is projected for the later years too.

Table 4.1: Change in the Indicators of the Scenario

		CP January 2010			CP April 2011		
		2010	2011	2012	2010	2011	2012
External assumptions							
GDP growth in EU27	*%*	1.1	2.0	2.2	1.8	1.8	2.1
Prices of oil	*USD/barrel*	81.0	92.0	91.0	79.7	95.0	95.5
Exchange rate USD/EUR		1.44	1.43	1.43	1.32	1.31	1.30
Exchange rate CZK/EUR		25.8	24.8	23.8	25.3	24.1	23.5
Real values							
GDP	*change in %*	1.3	2.6	3.8	2.3	1.9	2.3
Households consumption	*change in %*	-0.8	2.0	2.5	0.5	0.7	1.9
Government consumption	*change in %*	-1.7	0.0	-0.4	0.3	-3.4	-2.5
Gross fixed capital formation	*change in %*	-3.7	2.5	3.6	-4.6	0.7	3.2
Contribution of domestic demand	*p.p.*	-0.2	2.0	2.3	1.3	0.1	1.2
Contribution of foreign trade	*p.p.*	1.5	0.6	1.5	1.0	1.8	1.1
Potential product	*change in %*	2.5	2.5	3.0	1.6	1.8	2.2
Output gap	*%*	-5.6	-5.5	-4.8	-2.7	-2.6	-2.5
Growth							
HICP	*change in %*	1.8	1.5	1.8	1.2	2.2	3.4
GDP deflator	*change in %*	0.5	1.0	1.5	-1.1	-0.5	2.7
Employment	*change in %*	-1.6	-0.4	0.6	-0.8	0.1	0.5
Unemployment rate	*%*	8.8	8.6	7.6	7.3	6.9	6.5
Balance of goods and services	*% of GDP*	6.8	7.0	8.1	4.8	4.5	5.3
Net lending/borrowing	*% of GDP*	1.0	0.2	0.6	-0.2	-0.6	0.0
General government							
Net lending (+)/borrowing (-) (EDP B.9)	*% of GDP*	-5.3	-4.8	-4.2	-4.7	-4.2	-3.5
General government debt	*% of GDP*	38.6	40.8	42.0	38.5	41.4	42.4

Source: MF CR (2010b), MF CR (2011a). MF CR calculations.

4.2 Sensitivity Analysis

The Czech economy is small and open by nature, and therefore largely dependent on developments abroad. The sensitivity scenarios aim to show the extent of impacts from development of economic growth in the EU other than that expected as well as of alternative oil price developments (results are summarised in Table 4.2). In this chapter, we examine only the more pessimistic development of the stated indicators; an optimistic variant would have analogous inverse impacts of nearly the same size. The outcomes of the alternative scenarios are derived from the Macroeconomic Forecast (Ministry of Finance, 2011a), which is the basis for the entire CP.

4.2.1 Slower Economic Growth in the European Union

The pessimistic scenario for development in the EU is based on the assumption of slower economic growth, defined as a 1 percentage point lower real GDP growth worse starting from the beginning of 2012.

The considered scenario would be reflected in the Czech economy through exports, more than 80% of which are directed into EU countries. Lower foreign demand would lead to a decrease in net exports (and decrease of the current account balance), which would be negatively reflected in real GDP growth and the development of unemployment. The influence on inflation appears very moderate, as two conflicting effects collide here: (i) due to the influence of lower production of the Czech economy, there would be a decrease in wage pressures which would push inflation downwards; (ii) on the other hand, deterioration in the current account balance would have a depreciating influence on the Czech koruna, thus increasing the prices of imported inputs. The result would be only a minor increase of inflation within 0.1 percentage point.

The government balance would thus be influenced by lower collection of taxes from both enterprises and individuals. At the same time, the expenditure side would increase because of higher volume of unemployment benefits paid out. Higher government deficits would result in higher accumulation of debt.

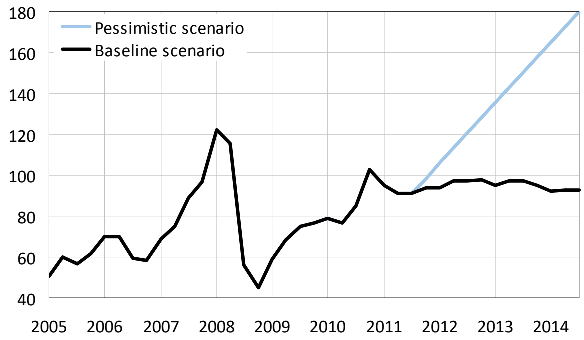
4.2.2 Faster Rise in Oil Prices on World Markets

An unfavourable development of oil prices would have a negative effect not only on the Czech economy, but it also would influence development throughout the EU. The sensitivity analysis therefore includes, apart from the direct impact of oil prices on the domestic price level, also two secondary effects: the influence of foreign inflation and of foreign demand.

A negative development on world oil markets is defined as a 10% higher year-on-year rise in oil prices in the individual years starting in 2012. The difference from the baseline scenario is illustrated by Chart 4.1. Thus, in the pessimistic variant, the price of oil would gradually rise to USD 132 per barrel in contrast with the relatively stable price ranging between USD 90 and 100 in the base scenario.

Chart 4.1: Scenario for Oil Prices

(Brent oil in USD/barrel)



Source: IMF (2011). MF CR calculations.

The results are both primary nominal impacts on inflation and secondary real effects. The differences in the first year would be rather negligible, due to the relatively small difference between the variants.

Due to the effect of gradual increase in oil prices, the internal imbalance would worsen, as measured by the current account balance. Higher raw materials prices would push the prices of companies' inputs higher, which would result in a growth of price level.

Slower growth in foreign demand would negatively affect the growth in exports, and thus also in production. This would consequently be reflected in lower GDP growth. The influence on unemployment would be negligible; a negative impact would occur rather in slower growth of real wages.

It is possible to expect that realisation of the pessimist scenario could lead to a deterioration in public finances with a subsequent effect on higher accumulation of debt. Here, another effect also could have a negative influence, as the resulting higher inflation rate is connected to higher interest rates and therefore higher debt service costs.

Table 4.2: Basic Macroeconomic Indicators – Sensitivity Scenarios

		2009	2010	2011	2012	2013	2014
Baseline scenario							
Gross domestic product	*Y-o-Y in %*	-4.1	2.3	1.9	2.3	3.3	4.0
Inflation (HICP)	*Y-o-Y in %*	0.6	1.2	2.2	3.4	1.6	2.1
Unemployment rate	*in %*	6.7	7.3	6.9	6.5	6.1	5.5
Government deficit	*% of GDP*	-5.9	-4.7	-4.2	-3.5	-2.9	-1.9
Gross government debt	*% of GDP*	35.4	38.5	41.4	42.4	42.8	42.0
Current account	*% of GDP*	-3.2	-3.8	-4.0	-3.4	-3.6	-4.1
Pessimistic scenario - slower EU growth							
Gross domestic product	*Y-o-Y in %*	-4.1	2.3	1.9	1.8	2.5	3.4
Inflation (HICP)	*Y-o-Y in %*	0.6	1.2	2.2	3.4	1.6	2.2
Unemployment rate	*in %*	6.7	7.3	6.9	6.6	6.2	5.6
Government deficit	*% of GDP*	-5.9	-4.7	-4.2	-3.7	-3.3	-2.3
Gross government debt	*% of GDP*	35.4	38.5	41.4	42.4	43.1	42.3
Current account	*% of GDP*	-3.2	-3.8	-4.0	-3.9	-4.5	-5.0
Pessimistic scenario - higher oil prices							
Gross domestic product	*Y-o-Y in %*	-4.1	2.3	1.9	2.2	3.1	3.8
Inflation (HICP)	*Y-o-Y in %*	0.6	1.2	2.2	3.5	1.9	2.5
Unemployment rate	*in %*	6.7	7.3	6.9	6.5	6.1	5.4
Government deficit	*% of GDP*	-5.9	-4.7	-4.2	-3.5	-3.0	-2.1
Gross government debt	*% of GDP*	35.4	38.5	41.4	42.4	42.9	42.1
Current account	*% of GDP*	-3.2	-3.8	-4.0	-3.4	-3.5	-4.0

Source: MF CR calculations.

4.3 Verification of the Scenario by Means of Other Institutions' Forecasts

The CP's macroeconomic scenario was compared with the forecasts of other relevant institutions. This enquiry was made in April 2011 and its results are based on the forecasts of 18 domestic and 2 foreign institutions (see MF CR, 2011c).

Generally, it can be said that the fundamental trends for future development considered in the CP 2011 macroeconomic scenario are confirmed by the averages of the other institutions' forecasts. Those divergences existing can be explained in part by inclusion of impacts from the proposed VAT changes into the Ministry of Finance's macroeconomic scenario and this factor's non-inclusion into the forecasts of some of the monitored institutions. Other planned measures also are included into the CP's macroeconomic scenario, and therefore the results of that examination lead to a different opinion concerning government consumption.

Table 4.3: Verification of 2011 Convergence Programme Scenario by Other Institutions' Forecasts

	Average of forecasts			CP April 2011		
	2012	2013	2014	2012	2013	2014
Growth in real terms						
GDP	2.8	3.2	3.3	2.3	3.3	4.0
Households consumption	1.8	2.7	2.6	1.9	3.3	4.2
Government consumption	-0.2	-1.0	0.5	-2.5	-1.3	0.1
Gross fixed capital formation	2.7	3.0	3.2	3.2	5.6	7.2
Growth						
National CPI (aop)	2.5	2.1	2.2	3.2	1.5	2.0
GDP deflator	2.0	1.8	2.0	2.7	1.6	1.8
Employment (LFS)	0.2	0.1	0.3	0.5	0.6	0.7
Unemployment rate (LFS, level in %)	6.8	6.7	6.4	6.5	6.1	5.5

Source: MF CR calculations.

5 Sustainability of Public Finances

Long-term sustainability is one of the weak spots of Czech public finances. The most serious risk is the expected demographic development, which will dramatically increase the ratio of persons of retirement age to the economically active population over the next several decades.

5.1 Fiscal Impacts of an Ageing Population

The results of the impacts of ageing are based upon long-term projections made in cooperation with the Working Group on Ageing Populations (AWG) of the Economic Policy Committee (EPC). The development analyses are based upon the assumptions on demographic development (EUROPOP2008) and the macroeconomic framework consistent for EU countries.

The stated projections do not reflect the current medium-term macroeconomic and fiscal outlooks of the Czech Republic. The projections are made under an assumption of unchanged policies (they correspond to a system which is today legislatively anchored), and therefore the reported numbers in no way reflect the debated but not yet approved reform measures.

The outcomes of the long-term projections are fully in accordance with the analyses carried out by AWG in the latest report on long-term projections (EC, 2009). In this analysis, 2007 is set as the base year. The following years, therefore, show only a trend projection which cannot be directly compared with current data. Long-term analyses do not aim to forecast specific values but only display trends and long-term dynamics.

An update of long-term projections will be made this year in connection with updating the demographic and macroeconomic assumptions, which are currently being prepared.

Table A.7 in the annex confirms that from today's point of view the pension area appears to be the most problematic in terms of the dynamics of expenditure growth. Expenditure will grow from the current level of approximately 7% of GDP to 11% due to changes in the population structure.

The growth of expenditures, among other things those depending on demographic changes, will also be seen in expenditures for health care, which will rise by more than 2 percentage points by the end of the projection horizon. Expenditures on long-term care will also raise rather dramatically, their volume more than tripling.

The sustainability analysis, which proceeds from the long-term projections, identifies the extent of necessary fiscal consolidation to ensure stability of public finances. So-called sustainability indicators are calculated, which show what measures would need to be carried out to decrease expenditures or increase revenues as percent of GDP so that they correspond to the required levels. Currently, the S1 indicator, which expresses by what percent of GDP it is necessary to increase taxes or decrease expenses so that the state debt at the end of the projection horizon (i.e. in 2060) is 60% of GDP comes to 5.3% of GDP. On the other hand, the S2 indicator, which specifies the amount of necessary fiscal effort for reaching equality of discounted revenues and expenditures on an infinite horizon, stands at 7.4% of GDP.

There has occurred a certain improvement in the sustainability analysis, which can be attributed to reform measures carried out in the pension system, in particular increasing the retirement age.

The current fiscal position is a negative factor for long-term development, resulting in higher accumulation of debt due to relatively high deficits. This will lead to significant growth in interest costs.

5.2 The Government's Strategy – Reforms

In connection with the aforementioned results of the long-term projections, reform measures in the pension and health care systems which should lead to overall improvement in long-term sustainability are currently being discussed.

5.2.1 Parametric Adjustments

This primarily concerns a set of measures reacting to a ruling of the Constitutional Court that a part of the provisions in the act on pension insurance stipulating the calculation of pension entitlement (in particular the section on the amount of reduction thresholds) to be unconstitutional.

The measures currently being discussed by the Chamber of Deputies bring in particular changes in the calculation of pensions. These aim, in accordance with the opinion of the Constitutional Court, to strengthen the relationship between the amount paid in for pension insurance and the amount of pension paid out from the pension insurance.

The proposed solution changes the design of the pension calculation by moving the second reduction threshold to 400% of the average wage, "binding" the first reduction threshold to the average wage, decreasing the benefit between the first and second reduction thresholds to 26%, decreasing the benefit above the second reduction threshold to 0%,[5] and gradually extending the decisive period to be lifelong. The stated measures are designed so that they have no effect on the state budget.

It also has been suggested to continue increasing the retirement age of men at the current pace, i.e. by 2 months per year, even after reaching the age limit of 65 years. For women, there should be an increase of the tempo of increasing retirement age for those born in 1956 and after to 6 months per year with the aim to gradually unify the retirement age for both sexes. Complete unification for all insured persons will occur in 2041 for persons born in 1975, for whom the age limit will be 66 years and 8 months. For each subsequent year of birth, the retirement age will increase by 2 more months, without limitation.

The total increase in paid pensions (regular valorisation) will, as it has until now, correspond to the rise in the consumer price index and to one-third of the growth in real wages. However, valorisation will be carried out by a regulation in accordance with specifically set rules. Thus would end the possibility for the government to discretionarily increase pensions, which has occurred repeatedly in the past.

The proposal also includes measures increasing penalisation for early old age retirement. These would decrease the attractiveness of retiring before reaching the legal retirement age.

The stated measures will significantly increase the stability of the pension system. The balance will remain in deficit for the entire period by around 0.5% of GDP compared to the previous approximately 4.5% of GDP over the long term (roughly from 2040 onward). Only in the critical period of years 2046–2066 should the pension system deficit fluctuate around 2% of GDP.

5.2.2 Pension Reform

Reform of the pension system comprises planned introduction of the second pillar of additional pension insurance. Currently, there is agreement within the governing coalition concerning the basic parameters of the reformed system, and the pertaining legislation is being prepared. Before the end of the year, the Czech Parliament should discuss the acts so that the second pillar begins to operate from the beginning of 2013.

The current form of the proposal ensues from certain recommendations of the Expert Advisory Group which has prepared its proposal for the pension reform, and also from recommendations of the government's National Economic Council.

The government's proposal introduces the second pillar with voluntary entry into the reformed system for persons under 35 years of age at the time of initiating the reform. Older persons will be able to decide about joining the new pillar half a year before the reform's initiation – that is in the second half of 2012. It will not be possible to change the decision taken by an insured person in the future.

Financing of the second pillar will be provided by funds transferred from participants in the first pillar in an amount of 3 percentage points from the total contribution rate of 28% (the employee pays 6.5 percentage points and the employer 21.5 percentage points). In addition to this, each insured person will have to pay an additional 2 percentage points from his or her own sources.[6] Moreover, each person will have the option to pay an additional 1% from his or her assessment base for insurance on the account of his or her parents drawing old age pensions.[7]

In the accumulation phase, the funds will be administered by pension companies, which will be obliged to offer the clients four funds with varying levels of risk: general, conservative, balanced and dynamic. The payout phase for the saved funds from the second pillar will be provided by a life insurance company selected by the participant. It will be possible to draw the paid benefit either in the form of a life-long annuity (optionally with an agreed payment of a survivors' pension for 3 years from the death of the participant) or an annuity paid for 20 years (in case of earlier death, the remaining funds will be subject to inheritance).

Creation of the second pillar will result in an immediate decrease of revenues in the PAYG first pillar, compensated by lower expenditures in the future. The government plans to cover this temporary period

[5] Thus, the system is in fact limited to the already mentioned level of four times the average wage. Higher incomes do not enter into calculations of the benefits and insured persons do not pay contributions to the system from them.

[6] Thus, the overall premium rate will increase to 30%, while 25 percentage points will be transferred into the current PAYG system and the remaining 5 percentage points into the newly formed second pillar.

[7] In case of utilising this option, the total premium rate for persons participating only in the first pillar would thus amount to 29%. It would be 31% for persons participating in the second pillar.

using additional revenues from the unified VAT rate (see Chapters 3.2.1 a 6.1.1).[8]

5.2.3 Reform of the Health Care Financing System

With respect to the sustainability of public finances, ensuing changes in the health care system are now relevant. The Government of the Czech Republic has approved an adjustment in regulatory fees (in particular fees for a stay in a hospital or medical facility and the fee for visiting a general practitioner with whom the patient is not registered) and is newly introducing a fee for visiting a specialist without previous recommendation of a general practitioner.

Standards for health care paid from public health insurance are being prepared. In this context, patients will accordingly be able to pay for additional uncovered above-standard care.

More information on reforms in the health care sector is presented in Chapter 6.2.4.

[8] A re-direction of additional revenues from the increased VAT rates towards the pension account is being discussed now. In case these additional revenues should not be related exclusively to the pension system, analyses of the long-term sustainability could not take this element into account.

6 Quality of Public Finances

Within the years of the outlook, the revenue and expenditure composition of public finances will presumably undergo significant changes in connection with the measures adopted in accordance with the government's Policy Statement. On the revenue side, these include, among others, adjustments related to the Concept of Reform of Direct Taxes and Levies for 2012–2013. At first, individual acts will be amended, with intended effectiveness from 1 January 2013, and in the second phase a new act on income taxes will be approved, integrating direct taxes and the mandatory insurance premium. The motivation for these amendments lies in simplifying and clarifying the system, but also in increasing its efficiency.

Adjustments on the expenditure side follow the course of the fiscal consolidation already initiated and aimed at balanced financing. These include reforms of the labour market and social benefits, as well as pension and health care reforms. At the same time, optimisation of the public administration's operation cannot be ignored.

6.1 Changes on the Revenues Side

6.1.1 Value Added Tax

Newly introduced changes include the possibility to adjust the value added tax obligation for registered uncollectible receivables and the principle of the purchaser's/VAT payer's guarantee for a supplier's payment of the tax. The purchasers have the option to withdraw from the guarantee by voluntarily paying the tax for the supplier directly to the Tax Office. The amendment also decreases the limit for exemption from VAT for deliveries from countries outside the EU from EUR 150 to EUR 22 from 1 April 2011.

Starting from 2012, the reduced VAT rate will be increased by 4 percentage points to 14% while the standard rate will remain unchanged at 20%. From 2013, the two rates will be unified at 17.5%. As of the same date, the level of turnover for mandatory registration will be decreased from CZK 1 million to CZK 750,000. These changes are to cover the fallout of revenues from the social insurance in relation to introducing the second pension pillar.

6.1.2 Personal Income Tax

Building saving interest credited to the client's account after 1 January 2011 is newly taxed with a 15% withholding tax.

For 2011, the tax exemption is temporarily decreased by CZK 1,200 per year per taxpayer. The selected funds will be purpose-bound for repairing damage caused by floods.

The tax reform concept from 2013 counts upon limiting the basic tax credit per taxpayer at 4 times the average wage. The tax benefit for having a child will be increased from the current CZK 11,604 to CZK 13,404 per year, and the maximum limit for the total annual amount of the tax bonus will increase from CZK 52,200 by CZK 8,100. The remaining standard tax credits will remain unchanged.

The personal income tax will now be 19% and its base will only be the gross wage. The premium for public health insurance will be limited to 6 times the average wage and for social security insurance to 4 times the average wage. For payers with income from employment and fringe benefits which account for costs in achieving income, an annual tax credit should be introduced in the amount of CZK 3,000 per year. The social security premium rate and the contribution rate for health insurance will be set at 6.5%. The same rate will be applied for self-employed persons.

Among other measures, it is planned to keep the 15% withholding tax on royalties, on income under contracts for services up to CZK 5,000 per month, and on interest and dividends. It is also planned to abolish a number of exemptions in the tax code.

6.1.3 Corporate Income Tax

From 2013, in connection with the Tax Reform Concept, there will be a replacement of the social and health insurance on the level of employers with a 32% tax on total wages. The base will be total income from employment and fringe benefits, the tax will be capped at 4 times the average wage times the number of employees, and also part of the base will be income under contracts for services above CZK 5,000. The revenue will be divided by means of the budgetary designation for taxes.

The tax rate will remain on the level of 19%. A tax credit in the amount of tax withheld from dividends will be newly introduced, which will eliminate double taxation and will support investment. Creation of provisions will also be simplified, as will adjustments for receivables and there will also be zero taxation on collective investment entities.

With anticipated effectiveness from 1 January 2012, the exemption of incomes of operators of lotteries and similar games will be abolished. Except for demonstrable costs (paid winnings and mandatory fees), parts of the proceeds formerly representing mandatory payment (support to sport, etc.) will be taxed.

6.1.4 Excise Taxes

From January 2012, the tax rate on cigarettes, cigars and cut tobacco will increase. The government plans a further increase of the excise tax due to European regulation (minimum excise tax of EUR 90 per 1,000 cigarettes) from the beginning of 2014.

6.1.5 Social and Health Insurance

The premium rates for social security on the side of the employers remain for this year the same as in 2010, i.e. 25%. However, employers, with exceptions, will no longer be able to deduct half of the recorded wage compensation for periods of sickness from the premium. Also the ceilings on premium contributions for social and health insurance remain at the level of 72 times the average wage for 2011.

For self-employed persons, the minimum advances on social and health insurance will increase. The premium base for social and health insurance will be 100% of gross income and the total rate will be 13%. Benefits from the social security system will be adapted to the amount of payments.

6.1.6 Inheritance and Gift Tax

For inheritance and gift tax, the exemption for the 1st and 2nd groups will be retained, and linear rates will be introduced (20% for the gift tax and 10% for the inheritance tax). The exemption limit will increase for the 3rd group from CZK 20,000 to CZK 50,000. From 2013, these taxes will be transformed into the income tax.

Part of the amendment to the law on supporting the use of renewable energy resources is also a change in the law on the inheritance, gift and real estate transfer tax, whereby electricity producers will be taxed on emission permits acquired free of charge by the gift tax at 32%.

6.2 Changes on the Expenditure Side

6.2.1 Unemployment Benefits

With the change of the act on employment in early 2011, new rules for providing unemployment compensation came into effect. Their objective is especially to increase personal responsibility of job applicants in case they terminate the employment relationship with their employer. An employee who has terminated employment voluntarily or by agreement is only eligible for 45% of the average monthly net income or for 45% of the assessment base. If the employee receives notice of termination of employment, he or she is eligible for compensation in the standard amount.[9] The duration of the compensation period is set at 5 months for persons under 50 years of age, 8 months for those 50 to 55 years of age, and 11 months for those older than 55. The compensation beneficiary will have the compensation delayed for the number of months for which he or she received severance pay, and then he or she may begin drawing support in the regular amount and duration. The possibility for additional income while drawing unemployment compensation is terminated. Moreover, unemployment compensation is refused to anyone who in the last 6 months before enrolling as a job-seeker repeatedly and voluntarily terminated suitable employment mediated by the labour office without a serious reason.[10]

6.2.2 Sickness Pay

Another component of the short-term measures to correct the public finances deficit is the employer's obligation to provide wage compensation to an employee for the first 21 calendar days of incapacity to work (in contrast to the former 14 days paid by employer and the rest paid from public insurance) in the period from 1 January 2011 until 31 December 2013.

6.2.3 Pensions

During preparation of the CP, the Chamber of Deputies advanced for its second reading the government's proposed amendment to the act on pension insurance and certain other acts with the aim to harmonize the legal regulation with the findings of the Constitutional Court (for more details see Chapter 5.2.1).

The pension reform, being prepared with the objective to create a system financially sustainable over the long term and providing adequate revenue, should be effective from January 2013. The main elements of the pension reform are presented in Chapter 5.2.2).

6.2.4 Health Care System Reform

A reform of the health care system is in preparation, consisting of the legislative intent of the act on health

[9] The standard amount of unemployment benefit is 65% for the first 2 months of the compensation period, 50% for the following 2 months, and 45% of the average monthly net income or of the assessment base for the remainder of the compensation period.

[10] However, this stipulation will probably be terminated from 1 January 2012.

insurance companies and of a set of health care reform acts: draft legislation on medical services and the terms and conditions of their provision, draft legislation on specific medical services, and draft legislation on emergency medical service. Effectiveness of the reform package is assumed from January 2012. Within the amendment of the act on health insurance companies, the reform also counts upon (among other things) fees collected from patients as components of income for the health insurance companies and continuing operation of the health insurance companies on the non-profit principle. Furthermore, it is planned to retain the institutional separation of commercial insurance in health care (after defining above-standard care) and the possibility of its operation purely in the form of joint-stock companies (outside the public sector).

Draft legislation to amend the act on public health insurance has already been submitted to the government, aiming to increase the revenues and optimise the expenses of the public health insurance system. Establishment of health care standards covered by public insurance is in preparation, with the possibility to pay more for above-standard care.

Effective from 1 April 2011, the act on temporary decrease of prices of medicaments became valid, decreasing the valid maximum prices of all medicaments and food for special medical purposes by 7% for a maximum of one year.

Regarding regulatory fees, the government approved an increase in the fee for a stay in a hospital or medical facility (from CZK 60 to CZK 100). Also a fee (with exceptions) for a visit of a specialist without a previous recommendation from a general practitioner should be introduced. The change of fees should become effective from 2012.

A reform of long-term care is also under preparation.

6.2.5 Birth Allowance

Only the poorest families (with income under 2.4times the minimum living wage) can claim birth allowance, and then only for the first child (the exception being firstborn twins).

6.2.6 Social Benefit

This will remain in effect until 31 December 2012 for families caring for at least one long-term sick or physically disabled dependent child, or if at least one of the caring parents is long-term sick or physically disabled.

6.2.7 Wages in the Public Administration

In the public administration, the minimum range of wage tariffs between the lowest and the highest wage levels was cancelled. The range of wage levels was retained, while for wages in executive positions it is possible to negotiate wages contractually.

6.3 Composition of Public Expenditure

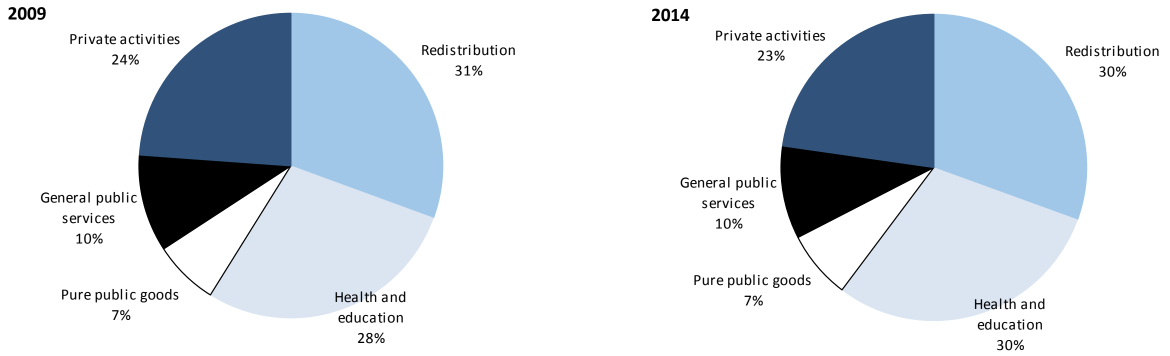
The composition of public expenditure in 2009 is shown in the following graph, as well as the expected structure of expenditure in 2014. While in nominal terms, total public expenditure shows an increase due to the growth of other macroeconomic variables, total public expenditure as percent of GDP will record a decrease from 45.9% of GDP in 2009 to 42.0% of GDP in 2014.

Chart 6.1 clearly shows only a marginal shift from the redistribution segment and expenditure on private activities towards education and health care.

Comparison of categories in time and on the basis of GDP proportion (see Table A.3 in the Table Annex) must be examined with caution, as in 2009 there occurred an exceptional decrease of GDP and a resulting increase in the individual expenditure categories relative to GDP. Except for the environmental segment, decline in relative terms is expected in all categories of public expenditures.

In the area of economic affairs, a decline is assumed, as a result of (among other reasons) application of the amendment to the act on public contracts (see Chapter 7) and an expected gradual increase in the number of projects financed in partnership with the private sector (so-called PPP projects). In the case of the aforementioned environmental category, we expect a moderate increase as a proportion of GDP in relation to assumed expenditures for cleaning up environmental damage from the past. Housing support will also record a minor decline, due in part to reduction in the state subsidy for building savings. In the case of health care, the trend continues toward partial transfer of the responsibility for health care, as well as direct co-financing of treatment, to the patients. Finally, in the case of social protection, we assume a decline of public expenditures relative to GDP due to the approved amendment to the act on employment and targeting support to the truly socially needy.

Chart 6.1: Structure of General Government Expenditure, Divided by Function



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). A 10-figure functional division of general government expenditures can be found in the Annex, Table A.3.
Source: CZSO (2011d). MF CR calculations.

7 Institutional Features of Public Finances

The consolidation of public finances should be aided by a) adjustment to the fiscal framework, to which the government obliged itself in its Policy Statement and in which it explicitly emphasised the importance of the act on budgetary discipline and responsibility; b) creation of the National Budgetary Council; and c) carrying out of other measures. The Government of the Czech Republic is aware of its duty to implement the Directive of the Council on Requirements for Budgetary Frameworks of the Member States. The Czech Republic already has experience with the operation of a fiscal framework introduced in 2004, which has all the standard features, i.e. setting fiscal objectives for the 3 following years, medium-term expenditure ceilings specifically for the central government, a medium-term fiscal outlook, and a medium-term budgetary outlook. With the objective of its implementation, the government has begun analysing the current fiscal framework and after identifying its weaknesses it will make adjustments so that the Czech Republic conforms to the obligation of the regular directive before the end of 2013.

By an amendment of the competence act, the competence of the Ministry of Finance is to be extended, specifically to include the sector of fiscal policy and preparation and evaluation of medium-term budgetary frameworks for the general government sector.

7.1 Act on Budgetary Discipline and Responsibility

Before the end of this year, the government will prepare draft legislation which will define the principles of budgetary discipline and responsibility and will cover the fiscal framework by explicitly establishing a fiscal objective including an ensuing fiscal rule for the entire general government and its individual sub-sectors. Thus, it will oblige the government to maintain a transparent and responsible policy which will not imperil the stability and long-term sustainability of public finances in the future. It will impose an obligation on the government to compose a report on its budgetary strategy. Some new obligations of the government both in the phase of preparing budget strategy and its development into state budget legislation, and also subsequently for continuous budget monitoring and ex post evaluation of the results of the past budgetary year will be introduced. The government intends to take measures toward implementing this act already during 2012 so that the act on budgetary discipline and responsibility is effective from the beginning of 2013.

Moreover, an expert discussion on establishing a National Budgetary Council has commenced. The extent of its competence will be determined on the basis of the evaluation of the current framework. This identifies the areas and specific institutional arrangement of the fiscal framework for which the intentions of the government and requirements of the Directive are not yet satisfied.

Legislative changes will also be aimed at strengthening regulation and monitoring the financing of public budgets, and, as appropriate, also of other units of general government. Apart from the changes being prepared in relation to the pension reform, also a modification of the budgetary allocation of taxes is being considered. Also the parameters not heretofore taken into account for proportions on shared taxes such as numbers of students and area criteria are to be discussed. The objective of the new legal regulation is to reduce the difference in tax revenues per inhabitant among the municipalities with the lowest and highest revenues, i.e. to optimise the curve of tax revenues per inhabitant to the benefit of medium-sized municipalities. The revenue base of the municipalities should be reinforced especially at the cost of state-wide subsidy programmes, from which development projects in municipalities are heretofore centrally (and therefore not effectively) financed. The effectiveness of the new regulation is expected in early 2013.

7.2 Tax Administration

In the Czech Republic, reform of the institutional arrangement of the tax administration system is currently underway. On 1 January 2011 a General Financial Directorate was established, which heads eight financial directorates. Thus, centralisation, specialisation of tax administration performance, the efficiency of the financing system with state property, and the use of information technology were strengthened. The tax administration should act as an independent organisation with the necessary decision and implementation autonomy and flexibility.

With effect from 1 January 2012, a Specialised Financial Office will be created, which will be dedicated to the conduct of tax administration for large and specific tax subjects with an essential benefit for the amount of taxes collected. The concept for tax administration reform is based on recommendations of the World Bank (2009).

In the next phase, the existing 199 financial offices are to be transformed into 14 financial offices in the individual regional cities, and the network of their local offices will be optimised.

The reform being prepared is in accordance with the ongoing project to create a single collection point for public budget revenues (taxes, customs and public-law insurance), which is assumed to be completed before 2014. Submissions will be presented within the system in one common form, and payments will be made to a single account.

The tax and fees administration sector went through extensive amendments in recent years. This achieved greater comprehension of legislation, modernisation and strengthening of administrative efficiency together with decreased administrative burdens (through computerisation of tax administration and simplification of tax management). Also some rigidities and ambiguities were eliminated, and a new model of tax arrears enforcement was introduced. It includes a rule according to which it is necessary to ensure that the expenditures related to enforcement are not out of proportion to the unpaid amount when selecting the mode of recovery.

7.3 The State Treasury

The State Treasury's integrated information system programme continues, and it should be entirely operational at the end of 2013. Through it, the Ministry of Finance's information systems will be interconnected, and integral, timely and consistent information will be acquired, which will allow effective and transparent management of general government finances.

Since the beginning of 2011, the partial module Central System of State Accounting Information (see below) has been put into operation, and so, to a limited extent, has the Management Information System (based on the SAP software platform), which works with information taken from the other subsystems and outputs consistent information from the key areas of the State Treasury system. From 2013, the Budgetary Information System for budget preparation and implementation will be made operational. It will be implemented as a centralised information system in all organisational components of the state. It is to support all operations for drawing up the budget and to allow establishing a proposal for the expenditures and revenues of the budgetary chapters also at the lower level of budgetary proceedings. Moreover, it will support dividing the expenditure blocks and medium-term budgeting. At the time of drawing up the budget, a detailed budget schedule will be available, which will in the following phases allow the application of modern budgetary procedures leading to increased efficiency and functionality of the government expenditure policies. The systems' implementation should lead to a decrease in autonomy of the individual chapters' administrators and to a limitation of decentralisation in the budgetary process. The possibilities will be improved for ex ante control over the availability of budgetary funds and consolidation of drawing from the budget on a state-wide level and also at the levels of the individual budgetary chapters. Transparency will be reinforced by the fact that the system will provide overall reviews of all changes in the budget and document all the adjustments to the budget according to the individual budgetary units across the entire organisational hierarchy. The system will offer continuous information on payments of the state's budgetary units for all their accounts and their attribution to budget classification. Management of all extra-budgetary resources will also be part of the system.

At the same time, the subsystems Budgetary Information System and Central State Accounting will be interconnected with the Payment System block that includes the areas of banking operations, support to managing liquidity of the State Treasury's aggregate account, and accounts for the budgetary units. The subsystem is operated and further developed by the CNB. The Payment System is already connected to the State Debt Management block and provides the Ministry of Finance with comprehensive information regarding movements on the State Treasury's aggregate account in real time. With interconnection of the State Treasury subsystems, precision and the time horizon for liquidity management information should be increased. This will help significantly in limiting the need for debt financing. The connection of other units of the general government is also being considered (e.g. state funds). This probably will occur on a contractual basis and allow better use of the potential for savings to be generated by optimising liquidity management within the aggregate account.

7.4 State Accounting

A new state accounting system is progressively being implemented which should provide a comprehensive and consistent database for effectively managing and drawing up expenditure policies. The state will not only obtain an overview of the real cash flows, receivables and liabilities, but also information about probable risks, possible expenditures and anticipated revenues, disaggregated by time and other selected criteria. Among other things, continuous information on available resources will be available, including their valuation in real prices.

Within the State Treasury's Integrated Information System, as of 1 January 2011, the Central State Accounting Information System was put into operation. It covers approximately 18,000 so-called selected accounting units (state organisational components, state funds, the Land Fund of the Czech Republic, regions, municipalities, associations of municipalities, regional councils of the cohesion regions, semi-budgetary organisations, and health insurance companies). These units submit their financial statements and reports in electronic form (data for evaluating fulfilment of the state budget, state funds budgets, and regional budgets). The adjusted basic legal framework is gradually being aligned with Czech accounting standards. For the selected accounting units (except for the health insurance companies), a unified directory of accounts has been created, and the methods of their accounting are governed by a single decree. The accounting of the selected accounting units has substantially approached that seen in the business sphere and the International Public Sector Accounting Standards (IPSAS). Specifically, assets depreciation has been introduced for all selected accounting units, as has been accounting for adjustments and for establishing organisational and other conditions for stocktaking.

For the needs of operations management, the state organisational components and state funds are obliged to account for contingent receivables and liabilities, to value assets held for trading at real values, and to submit operational accounting records. In the ensuing phases of the state accounting reform it can be assumed that in the area of operational accounting records periodicity will be shortened, the extent of the submitted data increased, and probably also the group of affected units widened.

7.5 Supreme Control Office

By an amendment to a constitutional act, the extent of the Supreme Control Office's competence under the constitution will be increased. At present, it is limited solely to controlling the management of state property and fulfilment of the state budget. From 1 January 2012, monitoring of the lawfulness in managing the property, budgetary revenues and expenditures in the regional self-governing bodies will be brought under its control competence for the first time. The proposed regulation will allow the office to conduct control activity also in relation to the property of other legal entities of public nature, especially when operating with public funds.

The broadening of the control competence should bring more transparency in public contracts and narrow the space for corruption in the state sector.

7.6 Act on Public Procurements

Increasing transparency, efficiency and cost-effectiveness of the implemented public expenditures will be aided also by an extensive legislative amendment to regulate the public procurements which will be worked out during 2011 and 2012. This will bring unified archiving, recordkeeping and publication of all crucial parameters of public contracts and decisions taken on them with the aid of tools such as the internet. This will prevent entities breaking the law from participating. Members of the selection committees for high-value contracts will be appointed by random draws. Companies applying for public contracts will be required to provide all crucial information. In monitoring procurement and evaluation, such means as electronic markets and electronic auctions will be preferred. The government has also declared in its Policy Statement to implement the so-called central purchasing (aggregation of demand from multiple buyers). Moreover, the monetary limits for mandatory conduct of public tenders will be decreased and limiting qualification measures eliminated. Last but not least, in accordance with the public contracts act, contractual agreements will not be subject to trade secrets. Similar principles are to be applied also for subsidies and grants from the state budget. All data on subsidy and grant management, including the contractual documentation, will be published at the Central Address. The government will propose similar regulation for the areas of subsidies, grants and gifts from the budgets of the regional self-governments in order to minimise the administrative burdens of the affected entities.

In early 2011, the government approved the Strategy of Electronisation of Public Procurement from 2011 to 2015 (MMR, 2011), which encompasses all categories of public contracts, including concession contracts. The strategy's main objective is to create an electronic instrument allowing all procurers to gain comprehensive support for the entire life cycle of public contracts before the end of 2015, so that there will be no legislative, financial or technological barriers in using the electronic instrument for either procurers or suppliers.

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Table Annex

Table A.1a: Macroeconomic Prospects

(level in bill. CZK, growth in %)

	ESA Code	2010 Level	2010 Rate of change	2011	2012	2013	2014
1. Real GDP	B1*g	3710	2.3	1.9	2.3	3.3	4.0
2. Nominal GDP	B1*g	3670	1.2	1.3	5.0	4.9	5.9
Components of real GDP							
3. Private consumption expenditure	P.3	1845	0.5	0.7	1.9	3.3	4.2
4. Government consumption expenditure	P.3	801	0.3	-3.4	-2.5	-1.3	0.1
5. Gross fixed capital formation	P.51	777	-4.6	0.7	3.2	5.6	7.2
6. Changes in inventories and net acquis. of valuables (% of GDP)	P.52+P.53	48	1.3	1.7	1.7	1.7	1.7
7. Exports of goods and services	P.6	2959	18.0	12.2	10.8	10.7	11.5
8. Imports of goods and services	P.7	2720	18.0	10.6	10.1	10.7	12.0
Contributions to real GDP growth							
9. Final domestic demand		-	-0.7	-0.3	1.1	2.6	3.7
10. Changes in inventories and net acquis. of valuables	P.52+P.53	-	2.0	0.4	0.1	0.0	0.0
11. External balance of goods and services	B.11	-	1.0	1.8	1.1	0.6	0.2

Note: Real levels are stated in 2009 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 (2011a), MF CR (2011a). MF CR calculations.

Table A.1b: Price Developments

(level in index, for HICP 2005=100, other indices 2000=100, growth in %)

	2010 Level	2010 Rate of change	2011	2012	2013	2014
1. GDP deflator	122.5	-1.1	-0.5	2.7	1.6	1.8
2. Private consumption deflator	121.5	1.3	2.0	3.2	1.5	2.0
3. HICP	113.7	1.2	2.2	3.4	1.6	2.1
4. Public consumption deflator	140.6	0.5	1.5	2.5	1.8	1.1
5. Investment deflator	104.0	-0.8	0.5	2.2	1.0	1.3
6. Export price deflator (goods and services)	86.0	-1.7	-0.8	0.1	0.3	0.5
7. Import price deflator (goods and services)	82.5	0.5	1.6	0.1	0.1	0.2

Source: CZSO (2011a), Eurostat (2011). MF CR calculations.

Table A.1c: Labour Market Developments

(growth v %)

	ESA Code	2010 Level	2010 Rate of change	2011	2012	2013	2014
1. Employment, persons		5185	-0.8	0.1	0.5	0.6	0.7
2. Employment, hours worked		9.9	0.1	1.0	0.9	0.6	0.3
3. Unemployment rate (%)		7.3	7.3	6.9	6.5	6.1	5.5
4. Labour productivity, persons		715	3.1	1.7	1.8	2.7	3.3
5. Labour productivity, hours worked		375	2.2	0.8	1.4	2.7	3.7
6. Compensation of employees	D.1	1625	1.1	2.1	4.4	4.5	5.9
7. Compensation per employee		391	3.3	3.1	4.3	4.3	5.4

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 2009 prices) per employed person or worked hour.
Source: CZSO (2011a, 2011c). MF CR calculations.

Table A.1d: Sectoral Balances
(in % of GDP)

	ESA Code	2010	2011	2012	2013	2014
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	**-0.2**	**-0.6**	**0.0**	**-0.1**	**-0.6**
- Balance on goods and services		4.8	4.5	5.3	5.8	5.9
- Balance of primary incomes and transfers		-7.1	-6.9	-7.1	-7.6	-8.1
- Capital account		1.9	1.8	1.8	1.7	1.6
2. Net lending/borrowing of the private sector	B.9	**4.5**	**3.5**	**3.5**	**2.8**	**1.3**
3. Net lending/borrowing of general government	EDP B.9	**-4.7**	**-4.2**	**-3.5**	**-2.9**	**-1.9**
4. Statistical discrepancy		**0.0**	**0.0**	**0.0**	**0.0**	**0.0**

Note: Data from national accounts. Years 2010–2011 notification. Years 2012–2014 outlook.
Source: CZSO (2011b). MF CR calculations.

Table A.2: General Government Budgetary Prospects
(level in bill. CZK, others in % of GDP)

	ESA Code	2010 Level	2010	2011	2012 In % of GDP	2013	2014
Net lending (+)/borrowing (-) (EDP B.9) by sub-sectors							
1. General government	S.13	**-171**	**-4.7**	**-4.2**	**-3.5**	**-2.9**	**-1.9**
2. Central government	S.1311	**-150**	**-4.2**	**-3.6**	**-3.1**	**-2.6**	**-1.8**
3. State government	S.1312	**-**	**-**	**-**	**-**	**-**	**-**
4. Local government	S.1313	**-12**	**-0.3**	**-0.5**	**-0.3**	**-0.2**	**0.0**
5. Social security funds	S.1314	**-9**	**-0.2**	**-0.1**	**-0.1**	**-0.1**	**0.0**
General government (S.13)							
6. Total revenue	TR	**1488**	**40.5**	**42.0**	**42.3**	**41.1**	**40.1**
7. Total expenditure (1)	TE	**1658**	**45.2**	**46.2**	**45.7**	**44.0**	**42.0**
8. Net lending (+)/borrowing (-)	EDP B.9	**-171**	**-4.7**	**-4.2**	**-3.5**	**-2.9**	**-1.9**
9. Interest expenditure (1)	EDP D.41	**53**	**1.4**	**1.8**	**1.7**	**1.7**	**1.6**
10. Primary balance		**-118**	**-3.3**	**-2.4**	**-1.7**	**-1.2**	**-0.3**
11. One-off and other temporary measures		**1**	**0.0**	**-0.3**	**-0.3**	**0.0**	**0.0**
Components of revenues							
12. Total taxes		**683**	**18.6**	**19.7**	**20.1**	**19.3**	**18.8**
12a. Taxes on production and imports	D.2	**422**	**11.5**	**12.0**	**12.5**	**12.4**	**12.0**
12b. Current taxes on income, wealth etc.	D.5	**261**	**7.1**	**7.6**	**7.5**	**6.9**	**6.8**
12c. Capital taxes	D.91	**0**	**0.0**	**0.1**	**0.1**	**0.0**	**0.0**
13. Social contributions	D.61	**578**	**15.8**	**15.8**	**15.8**	**15.5**	**15.1**
14. Property income	D.4	**30**	**0.8**	**0.8**	**0.8**	**0.8**	**0.8**
15. Other		**197**	**5.4**	**5.7**	**5.5**	**5.4**	**5.3**
16. Total revenue	TR	**1488**	**40.5**	**42.0**	**42.3**	**41.1**	**40.1**
p.m.: Tax burden		**1261**	**34.4**	**35.5**	**35.9**	**34.9**	**33.9**
Components of expenditures							
17. Compensation of employees	D.1	**294**	**8.0**	**7.5**	**7.2**	**6.8**	**6.5**
18. Intermediate consumption	P.2	**237**	**6.4**	**6.5**	**6.5**	**6.2**	**5.9**
19. Social payments		**733**	**20.0**	**20.1**	**19.6**	**19.3**	**18.5**
19a. Social transfers in kind supplied via market producers		**222**	**6.1**	**6.0**	**5.7**	**5.5**	**5.2**
19b. Social transfers other than in kind	D.62	**510**	**13.9**	**14.1**	**13.9**	**13.8**	**13.3**
20. Interest expenditure (1)	EDP D.41	**53**	**1.4**	**1.8**	**1.7**	**1.7**	**1.6**
21. Subsidies	D.3	**71**	**1.9**	**2.0**	**2.0**	**2.0**	**1.9**
22. Gross fixed capital formation	P.51	**170**	**4.6**	**5.0**	**5.2**	**4.9**	**4.6**
23. Other		**101**	**2.8**	**3.2**	**3.4**	**3.1**	**3.0**
24. Total expenditures (1)	TE	**1658**	**45.2**	**46.2**	**45.7**	**44.0**	**42.0**
p.m.: Government consumption (nominal)	P.3	**800**	**21.8**	**21.1**	**20.1**	**19.3**	**18.4**

Note: Years 2010–2011 notification. Years 2012–2014 outlook. 1) Data are adjusted for interest from swap operations so that it holds total revenues − total expenditures = EDP B.9.
Source: CZSO (2011b). MF CR calculations.

Table A.3: General Government Expenditure by Function

(in % of GDP)

	Code	2009	2014
1. General public services	1	**4.7**	**4.2**
2. Defence	2	**1.1**	**1.0**
3. Public order and safety	3	**2.2**	**1.9**
4. Economic affairs	4	**7.6**	**6.5**
5. Environmental protection	5	**0.7**	**0.9**
6. Housing and community amenities	6	**1.2**	**1.0**
7. Health	7	**8.0**	**7.8**
8. Recreation, culture and religion	8	**1.5**	**1.2**
9. Education	9	**5.0**	**4.8**
10. Social protection	10	**14.0**	**12.9**
Total expenditure	TE	**45.9**	**42.0**

Note: Years 2010–2011 notification. Years 2012–2014 outlook.
Source: CZSO (2011d), MF CR (2011a). MF CR calculations.

Table A.4: General Government Debt Developments

(in % of GDP)

	ESA Code	2010	2011	2012	2013	2014
1. Gross debt		**38.5**	**41.4**	**42.4**	**42.8**	**42.0**
2. Change in gross debt ratio		**3.2**	**2.8**	**1.0**	**0.5**	**-0.9**
Contributions to changes in gross debt						
3. Primary balance		**3.3**	**2.4**	**1.8**	**1.3**	**0.3**
4. Interest expenditure	EDP D.41	**1.4**	**1.7**	**1.7**	**1.6**	**1.6**
5. Stock-flow adjustment		**-1.1**	**-0.8**	**-0.5**	**-0.5**	**-0.4**
- Difference between cash and accruals		-0.9	-0.6	-0.3	-0.2	-0.2
- Net accumulation of financial assets		-0.2	-0.2	-0.2	-0.2	-0.2
- Privatisation proceeds		0.0	0.0	0.0	0.0	0.0
- Revaluation effects and other		-0.1	0.0	0.0	0.0	0.0
p.m.: Implicit interest rate on debt		**3.6**	**4.1**	**4.0**	**3.8**	**3.8**
6. Liquid financial assets		-	-	-	-	-
7. Net financial debt		-	-	-	-	-

Note: Years 2010–2011 notification. Years 2012–2014 outlook.
Source: CZSO (2011b). MF CR calculations.

Table A.5: Cyclical Developments

(in % of GDP)

	ESA Code	2010	2011	2012	2013	2014
1. Real GDP growth (%)		**2.3**	**1.9**	**2.3**	**3.3**	**4.0**
2. Net lending of general government	EDP B.9	**-4.7**	**-4.2**	**-3.5**	**-2.9**	**-1.9**
3. Interest expenditure	EDP D.41	**1.4**	**1.8**	**1.7**	**1.7**	**1.6**
4. One-off and other temporary measures		**0.0**	**-0.3**	**-0.3**	**0.0**	**0.0**
5. Potential GDP growth (%)		**1.6**	**1.8**	**2.2**	**2.7**	**3.0**
Contributions:						
- labour		0.0	-0.1	0.0	0.1	0.0
- capital		0.5	0.5	0.7	0.8	0.8
- total factor productivity		1.1	1.4	1.6	1.8	2.2
6. Output gap		**-2.7**	**-2.6**	**-2.5**	**-2.0**	**-1.1**
7. Cyclical budgetary component		**-0.7**	**-0.8**	**-0.7**	**-0.5**	**-0.3**
8. Cyclically-adjusted balance (2 – 7)		**-4.0**	**-3.4**	**-2.7**	**-2.4**	**-1.6**
9. Cyclically-adjusted primary balance (8 + 3)		**-2.5**	**-1.6**	**-1.0**	**-0.7**	**0.0**
10. Structural balance (8 – 4)		**-4.0**	**-3.1**	**-2.5**	**-2.3**	**-1.6**

Note: Years 2010–2011 notification. Years 2012–2014 outlook.
Source: CZSO (2011b). MF CR calculations.

Table A.6: Divergence from Previous Update
(GDP growth in %, general government balance and debt in % of GDP)

	ESA Code	2010	2011	2012	2013	2014
Real GDP growth						
Previous update		1.3	2.6	3.8	-	-
Current update		2.3	1.9	2.3	3.3	4.0
Difference		1.0	-0.8	-1.6	-	-
General government net lending						
Previous update	EDP B.9	-5.3	-4.8	-4.2	-	-
Current update	EDP B.9	-4.7	-4.2	-3.5	-2.9	-1.9
Difference		0.6	0.7	0.7	-	-
General government gross debt						
Previous update		38.6	40.8	42.0	-	-
Current update		38.5	41.4	42.4	42.8	42.0
Difference		-0.1	0.5	0.3	-	-

Source: MF CR (2010b), MF CR (2011a). MF CR calculations.

Table A.7: Long-term Sustainability of Public Finances
(expenditures and revenues in % of GDP, growth and rates in %)

	2007	2010	2020	2030	2040	2050	2060
Total expenditure	43.1	41.9	41.4	43.7	47.6	53.5	59.8
of which: Age-related expenditure	18.8	18.0	18.2	19.1	20.7	23.1	24.5
Pension expenditure	7.8	7.1	6.9	7.1	8.4	10.2	11.0
Social security pensions	7.8	7.1	6.9	7.1	8.4	10.2	11.0
Old-age and early pensions	7.1	6.5	6.3	6.6	7.9	9.7	10.5
Other pensions	0.7	0.5	0.5	0.6	0.5	0.5	0.6
Occupational pensions	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Health care	6.2	6.4	6.9	7.4	7.8	8.1	8.4
Long-term care	0.2	0.2	0.3	0.4	0.5	0.5	0.7
Education expenditure	3.5	3.0	3.0	3.1	2.9	3.0	3.2
Other age-related expenditures	1.0	1.0	1.0	1.0	1.0	1.1	1.1
Interest expenditure	1.1	1.0	1.8	3.2	5.5	9.0	13.9
Total revenue	42.0	41.0	40.1	40.0	40.0	39.9	39.9
of which: Property income	0.8	0.7	0.6	0.5	0.5	0.5	0.4
of which: Pension contributions	8.6	8.6	8.6	8.6	8.6	8.6	8.6
Pension reserve fund assets	0.4	3.4	17.1	32.6	45.0	42.3	24.2
of which: Consolidated public pension fund assets [1)]	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Assumptions							
Labour productivity growth	4.1	3.0	2.9	1.8	1.7	1.7	1.7
Real GDP growth	5.2	3.0	2.5	1.4	0.9	0.7	1.1
Participation rate males (aged 15–64)	78.3	80.7	81.0	78.8	78.5	79.0	78.9
Participation rates females (aged 15–64)	61.6	66.1	66.7	66.0	66.0	67.8	68.1
Total participation rates (aged 15–64)	70.0	73.5	73.9	72.5	72.3	73.5	73.5
Unemployment rate	5.4	4.5	4.5	4.5	4.5	4.5	4.5
Population aged 65+ over total population	14.6	17.9	20.2	22.9	26.3	30.9	33.4

Note: 1) assets other than government liabilities.
Source: EC (2009). MF CR calculations.

Table A.8: Basic Assumptions
(growth in %)

	2010	2011	2012	2013	2014
Short-term interest rate (CZ) (annual average)	1.3	1.3	2.0	2.6	3.0
Long-term interest rate (CZ) (annual average)	3.7	4.1	4.3	4.3	4.3
Nominal effective exchange rate (2005=100)	119.1	123.4	126.6	130.1	133.6
Exchange rate CZK/EUR (annual average)	26.4	25.3	24.1	23.5	22.8
World excluding EU, GDP growth	5.6	4.6	4.6	5.0	5.0
EU27 GDP growth	1.8	1.8	2.1	2.3	2.3
Growth of relevant foreign markets	11.0	8.0	7.5	8.0	7.0
World import volumes, excluding EU	13.8	8.2	8.0	7.5	8.0
Oil prices (Brent, USD/barrel)	79.7	95.0	95.5	96.8	93.3

Source: CNB (2011), Eurostat (2011), IMF (2011). MF CR calculations.

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