Ministry of Finance
Czech Republic

Convergence Programme
of the Czech Republic

April 2012

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Contents

List of Tables

Table Annex

List of Charts

List of Abbreviations

CNB	Czech National Bank
CP	Convergence Programme of the Czech Republic
CZK	Czech koruna currency code
CZSO	Czech Statistical Office
EC	European Commission
EDP	Excessive Deficit Procedure
EDP B.9	Net lending/borrowing of the general government applied under the EDP
ERM II	Exchange Rate Mechanism II
ESA 95	European methodology of national accounting
EU, 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
PRIBOR	Prague Interbank Offered Rate
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 23, 2012 release, fiscal data to the April 11, 2012 release.

Note

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

Introduction

The update of the Convergence Programme for 2011–2015 presented here has for the second time in a row been prepared in accordance with a new timetable, the European Semester, and for the first time under the regime of new European legislative measures, the so-called “six-pack”, fundamentally changing economic–political coordination. The objective of the European Semester is to deepen and strengthen multilateral budget surveillance as well as fiscal and structural policy coordination within the EU. National fiscal policies are therefore coordinated in the preparation phase of public budgets and their medium-term outlooks.

Since the end of last year, the set of six legal regulations further extending the preventive and corrective component of the Stability and Growth Pact and introducing mechanisms for monitoring and correcting macroeconomic imbalances is in effect. The package also includes a Council Directive requiring member states to standardise and modernise national budgetary frameworks. The “six-pack” is considered to be the most comprehensive reinforcement of economic–political coordination between EU countries in the last 20 years.

The current Convergence Programme (CP) of the Czech Republic was approved by the Government of the Czech Republic on 25 April 2012 and it endeavours to be as consistent as possible with the National Reform Programme, approved by the Czech government on 11 April 2012. The CP corresponds with the rules established in the updated Code of Conduct (January 2012) of the Stability and Growth Pact for preparing the stability and convergence programmes. The document was also discussed with the substantively relevant committees of the Chamber of Deputies and the Senate of the Parliament of the Czech Republic.

This update of the CP proceeds from the mandate of the coalition government adopted in mid-2010. In its Policy Statement from 4 August 2010, the government set out a number of ambitious reform programmes, including a public finances reform. It aims to eliminate the structural deficit and achieve a balanced budget by 2016. The government adopted additional priorities to enhance transparency in dealing with public funds, limit corruption, and increase transparency in public procurement. It also declared its intention to reform the fiscal framework as a whole.

Structural reforms aimed at improving long-term sustainability of public finances were prepared and adjusted in accordance with the Annual Growth Survey (European Commission, 2011) and Recommendations of the Council to the CP from 30 November 2009 and 1 July 2011. Last year, reforms of the pension and health care systems were approved. Their points of departure, intentions and impacts are presented in several chapters herein. Additional structural reforms are also included, although the fiscal impacts are given only for the more important reforms.

The CP is divided into seven interconnected chapters. The first chapter lists the main directions in which the Czech Republic has been headed in recent years and in which it is planning to go. The chapter reflects that on 2 December 2009 an Excessive Deficit Procedure was initiated for the Czech Republic, which recommends the general government to bring the deficit below 3% of GDP in a credible and sustainable manner by 2013. The relevant committees of the Czech Parliament were informed of the EU Council’s recommendations for remedying the excessive deficit.

The CP’s macroeconomic scenario is based on data available as of 23 March 2012. Even excluding political factors, macroeconomic and fiscal development is today encumbered with considerable uncertainties. The main sources of risk relate to potential further escalation of problems in the euro zone and transmission of negative external shocks to the Czech economy. Due to the influence of fiscal consolidation measures and the unfavourable economic situation in the euro zone, economic growth is expected to stagnate in 2012. Growth should gradually accelerate in subsequent years of the outlook. Chapter 2 addresses macroeconomic development in greater detail.

The fiscal forecast discussed in Chapter 3 proceeds from the results of the April fiscal notification (closing date for data sources 11 April 2012). We expect the government sector balance for 2012 to be −3.0% of GDP. The general government debt will probably rise to 44.0% of GDP. In coming years, the government is resolved to strictly follow the deficit targets, to which end those discretionary measures already realised and prepared should contribute.

Chapter 4 follows on from the fiscal section with a sensitivity analysis of short-term shocks influencing development of the Czech economy and finances in the government sector. Verification of the CP’s macroeconomic framework by forecasts from independent institutions is an equally important part of this chapter.

Chapter 5 monitors long-term impacts of the current fiscal policy settings. Particular attention is devoted to long-term sustainability in relation to ageing of the population. In this respect, crucial changes were implemented last year in pension system.

The final two chapters deal with the qualitative side of public finances and adjustments to the institutional framework. On the one hand, they address changes boosting the quality of public finances on both the revenue and expenditure sides (Chapter 6). On the other, they discuss changes in institutional relations, the legal anchorage of authority and responsibility of the public sector, as well as changes in the system of public administration (Chapter 7). In particular, the final chapter contains information on the ongoing fiscal framework reform of the Czech general government sector.

1 Overall Policy Framework and Objectives

Consolidation of public budgets is the priority for the coming period. The consolidation focuses not only on reducing the general government deficit but also on improving structural parameters of the system, such as the quality of public finances, support for the business environment, bureaucracy reduction, fighting corruption, and strengthening the Czech economy's pro-growth attributes.

The monetary policy conducted by the Czech National Bank (CNB) was moved 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 path towards convergence with 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. Measures for mitigating the public finance deficit for 2010 and 2011 were conceived more as ad hoc corrections than systemic changes. The main objective in managing public finances was to reduce the general government deficit.

The Czech Republic was among the first countries to commence consolidating public finances. 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 committed itself to budget responsibility in its Policy Statement, and one of its first steps in this respect was to tighten the medium-term expenditure framework to maintain the headline deficit target.

Fiscal and budgetary policies of future years are determined through stepwise preparation and implementation of deeper structural reforms in the spheres of diversifying sources of financing for old-age pensions, reforming the health care system, making the social benefits system simpler as well as more efficient and reducing administrative burdens by modifying the tax system and its administration (for more details see Chapters 5, 6 and 7). Moreover, a reform of tertiary education financing is being prepared emphasising support for science and research.

Another key factor shaping fiscal policy in recent years has been building pressure for faster consolidation, ensuing from the commitment to the EU (see Chapter 1.2) and due to the accentuated sensitivity of financial markets which exceedingly penalise insufficient consolidation effort by the government in an environment of stagnating and moderately growing economies.

1.2 Implementing the Excessive Deficit Procedure

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

i) during 2010–2013 to ensure annual average fiscal effort[1] of 1% of GDP;
ii) to specify those 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 to be better than originally expected.

In consideration of experience hitherto in adhering to medium-term expenditure frameworks, the Czech Republic was urged to (apart from Council (2009) also EC (2012a)) enforce the expenditure limits more rigorously and to improve monitoring throughout the entire budget process.

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

In evaluating the CP from 2011 and the level of progress achieved in the aforementioned areas, the Council (2011) also instructed the Czech Republic to:

i) carry out the planned consolidation in 2011 and adopt lasting measures compensating for revenue shortfalls and exceeding planned expenditures;
ii) adopt fiscal measures planned for 2012;
iii) support the general government's performance targets for 2013 with specific measures;
iv) avoid cutting growth-inducing expenditures;
v) increase the efficiency of public tenders;
vi) continue shifting the tax burden from labour to consumption; and

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

vii) improve compliance with tax obligations and reduce tax evasion.

Attention was also given to the long-term sustainability of public finances, within both the pay-as-you-go (PAYG) and the fund-financed pillars of the pension system. According to the Council, the Czech Republic should focus its efforts on further changes to the PAYG pillar so that the system creates no fiscal imbalances in future. For the planned fund pillar, the Council recommended to introduce a planned comprehensive pension reform. It also recommended ensuring that the system is attractive, transparent, and has a low level of administrative expenses.

The following paragraphs outline measures already implemented in line with the Council's recommendations.

1.2.1 Measures for 2010

The measures adopted for 2010 concentrated on the revenue and expenditure sides in approximately equal proportion. Both VAT rates and excise taxes were increased, property taxes doubled, and certain counter-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 spending side was adjusted by decreasing selected 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 2.2% of GDP. Through rigorous implementation of the approved budgets, the structural deficit was improved by almost 0.8 p.p. in comparison to 2009, thus reducing the government deficit to 4.8% of GDP.

1.2.2 Measures for 2011

In 2011, another package of changes balanced evenly between revenues and expenditures was added (amounting to ca 1.6% of GDP). The wage bill in the state administration was reduced by 10% and the wage bill of institutional officials was also lowered. On the other hand, funds for teachers' and physicians' wages were increased. Furthermore, some social transfers were also eliminated or their extent reduced. Last but not least, general cuts in certain expenditures of the state budget were made, thus non-mandatory regular and capital expenditures also decreased. On the revenue side, the social security contributions rate was maintained and, for example, motorway toll rates were increased. These measures helped reduce the structural deficit by a significant 1.6 p.p. to 2.6% of GDP, resulting in a total deficit of 3.1% of GDP. The year 2011 was extremely crucial for adopting and amending legislation reforming the pension system (see Chapters 5.2.1 and 5.2.2) and reworking the health care system (Chapter 6.2.2).

In 2011, the Constitutional Court adjudged several cases (see MF CR, 2011a) in relation to which it called for remedy during the year or by year's end, or directly nullified the pertinent provision. These cases concerned pension insurance, the manner of approving a package of social legislation, and taxation of contributions to building society savings. The package of social legislation was re-adopted in an amount of CZK 11.2 billion, the redistribution mechanism in a section of the Act on Pension Insurance was modified, and the loss of revenues from 50% taxation of the state contribution for building savings (CZK 5.4 billion) was successfully compensated by savings within the system.

1.2.3 Measures for 2012

In the last CP, the government's consolidation strategy for 2012 counted upon a deficit of 3.5% of GDP. However, the vigour of consolidation measures accompanied by responsible budgetary behaviour in a number of units of the general government sector in 2011 resulted in the deficit's being significantly lower. The target for 2012 was therefore improved by 0.5 p.p. to 3.0% of GDP. A more detailed analysis of the forecast development of general government finances for this year is covered in Chapter 3. The basic structure of the active measures carried out in 2010–2012 is summarised in Table 1.1.

In January 2012, the fundamental novelisation in the field of public procurements was passed, described in detail in Chapter 6.2.5.

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

	2010	2011	2012
Direct taxes	0.3	0.5	-0.3
Indirect taxes	0.8	0.0	0.6
Other revenues	0.1	0.3	0.2
Social benefits	0.3	0.2	-0.1
Government sector wages	0.2	0.2	-0.1
Other expenditures	0.5	0.4	0.4
Total impact on balance	2.2	1.6	0.7

Source: MF CR.

1.2.4 Plan and Objectives of Fiscal Consolidation

The government has unambiguously declared that the trajectory of targets for total general government deficits (Table 1.2) will be upheld. The intention is to complete the EDP by 2013, at latest, and to continue with consolidation until a balanced budget is achieved in 2016. The approved trajectory, along with the current estimate as to the size of the output gap implies that in 2015 the Czech Republic should reach its medium-term budgetary objective (MTO) of a 1% structural deficit relative to GDP.

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

	2013	2014	2015
Headline deficit target	2.9	1.9	0.9

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

Apart from the significant reform-and-consolidation effort, further improvement of public finances will be strongly influenced by developments of the domestic and foreign economies, i.e. the speed and extent of recovery in domestic and foreign markets.

The impacts of individual measures for maintaining the fiscal consolidation trajectory are described in Chapter 3.2 and the reforms in Chapter 5.2 and 6.

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 p.p. The CNB continues to view its inflation targets as medium-term in nature. Real inflation may temporarily deviate from the target, 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 strong credibility are reflected in inflation expectations anchored at levels close to the inflation target. Nevertheless, the impact of contemplated changes to indirect taxes represents a risk for meeting the Maastricht price stability criterion. It will depend also on the specific application of the methodology when establishing the criterion's reference value (definition of conditions for including [or not including] countries into the calculation).

Stability in short-term interest rates is consistent with the Ministry's macroeconomic scenario, which anticipates only slight recovery in economic activity and a gradually closing of 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 held to a minimum. A joint document of the Ministry of Finance and CNB, "Assessment of the Fulfilment of the Maastricht Convergence Criteria and the Degree of Economic Alignment of the Czech Republic with the Euro Area", was approved by the government on 14 December 2011. It states that the fiscal problems of the euro zone and the continuing heightened volatility on world financial markets do not create a favourable environment for future adoption of the euro in the Czech Republic. As regards the country's preparedness to adopt the euro, it is necessary in particular to complete the process of public budgets consolidation and to increase flexibility in the labour market. Considering these facts, and in accordance with the approved updated strategy for euro zone accession, the government has not yet established a target date for joining the euro zone and will not endeavour to enter into ERM II during 2012.

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 (Government Office, 2012). 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 intends to focus especially on increasing the employment of women, young people and seniors; improving efficiency in intermediating employment; ensuring a sufficiently large and appropriately qualified workforce; and increasing the mobility of employees, including foreign workers. The Czech Republic is fully implementing a social reform to help activate groups of its citizens excluded from the labour market and will continue a number of subprojects directed to achieving the established priorities.

1.4.2 Business Environment

Measures in the business environment area are aimed at removing administrative and regulatory obstacles to business, modernising and increasing efficiency of the public administration's operations, and fighting corruption. Fundamental changes will occur in the areas of incorporation, termination and administration of business entities, which will simplify the conduct of business, reinforce motivation for good management of companies, and improve the position of creditors.

Public administration registers will also be established, allowing secure data sharing between public authorities, and, last but not least, the process of awarding public tenders will be improved and its transparency increased (see also Chapter 7).

1.4.3 Education

The reforms aim especially to improve efficiency of the educational system with the goal of increasing the quality of graduates, strengthen their competitiveness in the labour market and make better use of their potential for the society as a whole. The most important measure in this area is the reform in university education, which emphasises improving the quality of tertiary education and diversification of universities. In relation to this, the financing of universities will be changed as a system of financial aid for students is being prepared which will eventually allow tuition fees to be introduced.

1.4.4 Research, Development and Innovation

The main targets established in the research, development and innovation area include increasing the sector's output, improving the method of its financing and increasing the innovative potential of the Czech economy. New priorities for research, experimental development and innovations will therefore be adopted. Government support for investments will be extended also to companies operating in the area of industrial research, development and innovation of technologically advanced products and advanced technologies, and in strategic services closely related to the development of information technologies.

1.4.5 Energy Industry and Climate Change

The Czech Republic actively 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, 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, will continue to be supported.

1.4.6 Transport Infrastructure

In the area of transport infrastructure, the Czech Republic is striving to boost its capacity and quality by completing construction of the backbone transport network and to make the interconnection of all types of transport more effective. For the purpose of effective planning, a proposed new Transport Policy of the Czech Republic for 2014–2020 with an outlook to 2050 will be produced, and priority projects will be derived from it. Last but not least, securing necessary funds and their economical use for the selected projects also will be crucial.

2 Economic Outlook

Czech economic output is currently stagnating due to the indirect effects of the debt crisis in the euro zone and the impacts of fiscal consolidation. The macroeconomic scenario for the Czech Republic's Convergence Programme anticipates modest recovery consistent with the assumption of gradually expanding economic output among the Czech Republic's main trading partners, although this is subject to downside risks.

2.1 World Economy and Technical Assumptions

The global economy continues to recover, as reflected also on stock markets and in world trade. Nevertheless, growth dynamics in 2012 should diminish vis-à-vis 2011, both in large countries with growing shares in the global economy (China, Brazil, India) and in the European Union.

The European economy as a whole grew by just 1.5% in 2011 and still has not surpassed the pre-crisis level of 2008. At the end of 2011, the EU27 also found itself in a moderate recession, which should abate, however, in the first half of 2012.

The development in the EU is characterised by marked divergence. The German economy, which is the main driver of the euro zone, exceeded its pre-crisis GDP level during 2011, though it, too, was unable to avoid quarter-on-quarter decline in 2011's fourth quarter. The economies in the southern wing of the euro zone, on the other hand, are severely affected by the debt crisis and their economic output is falling.

The anxiety on financial markets was overcome, at least temporarily, by ECB measures directed to providing sufficient liquidity to European banks and restructuring the Greek debt.

It can be expected that the EU27's GDP will decline negligibly this year, while sustainable moderate recovery should occur in subsequent years. The indicated development is, however, based on the rather uncertain assumption that the troubles in those countries stricken by the debt crisis will be resolved without marked shocks and impacts on the other member countries.

While prices of most commodities decreased in 2011, it remained high for Brent crude oil. We assume the price of oil will remain around USD 115 per barrel for the scenario's horizon. This is due especially to anxiety concerning geopolitical unrest in producer countries (Iran and Syria in particular). On the other hand, recession in a number of economies points to a drop in prices. Estimates are further complicated by the high level of speculation.

A conservative exchange rate assumption with stability around 1.3 USD/EUR was chosen. This is identical to the assumptions of the European Commission (EC, 2012). The koruna should strengthen slightly against the euro and in 2015 reach approximately 24.6 CZK/EUR. The assumption on the development of short-term interest rates is consistent with fulfilling the CNB's inflation targets.

Our assumptions for oil prices differ only slightly from the preliminary version of the European Commission's Common Assumptions on the External Environment (EC, 2012), as our assumption for 2012 is USD 4.5 lower while for 2013 it is practically identical.

Table 2.1: Exogenous Assumptions of the Scenario

		2011	2012	2013	2014	2015
USD/EUR exchange rate	*annual average*	1.39	1.30	1.30	1.30	1.30
CZK/EUR exchange rate	*annual average*	24.6	25.0	24.9	24.7	24.6
Government bond yield to maturity 10Y	*in % p.a.*	3.7	3.4	3.5	4.0	4.4
PRIBOR 3M	*in % p.a.*	1.2	1.2	1.2	1.3	1.5
GDP EU27	*real growth in %*	1.5	-0.2	0.8	1.4	1.9
Oil prices (Brent)	*USD/barrel*	111.0	115.0	113.0	115.0	115.3

Source: CNB (2012), Eurostat (2012), IMF (2012). MF CR calculations.

2.2 Cyclical Developments and Current Prospects

2.2.1 GDP and the Demand Side

Economic output has not yet reached the level at the peak of the cycle at the turn of 2008 and 2009, prior to the recession. Growth of seasonally-adjusted GDP has slowed since mid-2010 due to the secondary effects of the debt crisis in the euro zone and intensive fiscal consolidation. In the second half of 2011 the economy stagnated.

In the near term, there is cause for cautious optimism in the decreased tension on European financial markets and indications of recovery in our most important trading partners' economies. On the other hand, continuing fiscal consolidation and low levels of consumer and business confidence will negatively affect the growth dynamics. This should lead to more prudent microeconomic decision-making, and thus to a decrease in gross domestic expenditures.

We expect GDP to expand by 0.2% in 2012, and therefore the stagnation will more or less continue. Growth should gradually pick up in the subsequent years, reaching 2.8% in 2015.

Households' consumption is being pressed down by unfavourable income situation, low confidence and temporarily higher inflation due to the increased VAT. As a result of the modest economic recovery, however, consumption could stabilise in 2013, and its subsequent growth should gradually increase to arrive at 2.8% in 2015.

The consolidation of public finances during 2012–2015 will bring about a decline in real government consumption. This will be reflected both by a decrease in employment in the general government sector and by a reduction in purchases of goods and services.

Gross fixed capital formation declined by 1.2% in 2011, while the future development of investment expenditures is extraordinarily uncertain. Pessimistic expectations, apprehensions about possible impacts of the debt crisis in the euro zone and limited public investment spending will have negative effects. On the other hand, the high capacities utilisation of successful export companies and their underinvestment are starting to be felt. New investments could also be stimulated by a heightened influx of financing from EU structural funds, assuming the current problems with their drawing are resolved. This should result in roughly unchanged investment spending during 2012, followed by slightly accelerating growth up to 3.2% in 2015. We expect inventories building to contribute slightly to growth within the scenario horizon.

Foreign trade is the main positive factor for the economy's development. The slowdown in imports growth due to declining domestic demand is considerably stronger relative to the slowing in exports due to weaker foreign demand. The result is a significantly positive contribution from foreign trade to GDP growth year on year. For 2011, foreign trade's contribution was 2.6 p.p., which was the highest value since 2006. We expect positive contributions throughout the entire horizon of the macroeconomic scenario.

Convergence in the relative level of GDP per capita at purchasing power parity compared with the EU27 average (Chart 2.2) halted after 2007 with the onset of recession. Along with a recovery of more dynamic growth, the Czech Republic's relative level should again start to increase and reach approximately 82% of the EU27 average in 2015.

Table 2.2: Economic Output

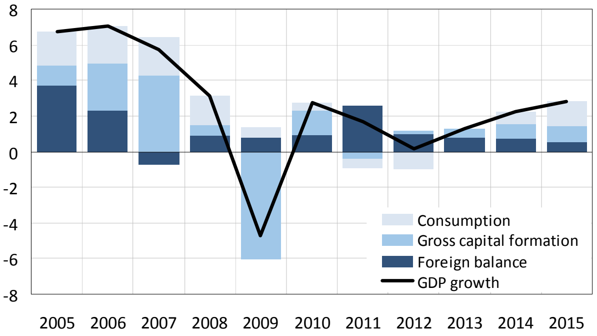
(level in CZK billion, increases in %, contributions to growth in percentage points)

	ESA Code	2011 *Level*	2011	2012	2013 *Rate of change*	2014	2015
1. Real GDP	B1*g	3842	1.7	0.2	1.3	2.2	2.8
2. Nominal GDP	B1*g	3809	0.9	2.1	2.7	3.7	4.4
Components of real GDP							
3. Private consumption expenditure	P.3	1891	-0.5	-0.4	0.2	2.0	2.8
4. Government consumption expenditure	P.3	814	-1.4	-3.7	-0.5	-1.8	-0.2
5. Gross fixed capital formation	P.51	928	-1.2	-0.5	2.1	2.8	3.2
6. Changes in inventories and net acquis. of valuables (% of GDP)	P.52+P.53	23	0.5	0.8	0.7	0.9	1.0
7. Exports of goods and services	P.6	2600	11.0	3.2	3.7	4.8	5.1
8. Imports of goods and services	P.7	2415	7.5	2.1	2.8	4.1	4.8
Contributions to real GDP growth							
9. Final domestic demand		-	-0.8	-1.1	0.5	1.3	2.2
10. Changes in inventories and net acquis. of valuables	P.52+P.53	-	-0.1	0.3	0.0	0.2	0.2
11. External balance of goods and services	B.11	-	2.6	1.0	0.8	0.8	0.5

Note: Real levels are in 2010 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.

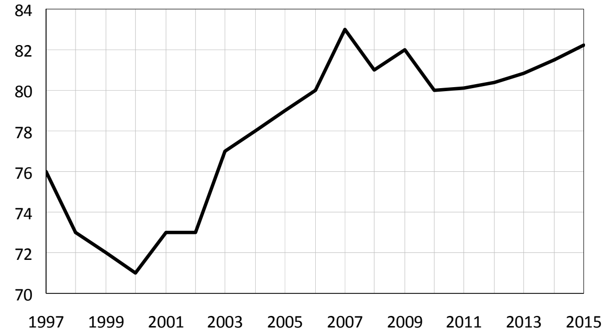
Sources: CZSO (2012a), MF CR (2012a).

Chart 2.1: Decomposition of GDP Growth
(contribution to growth in percentage points)



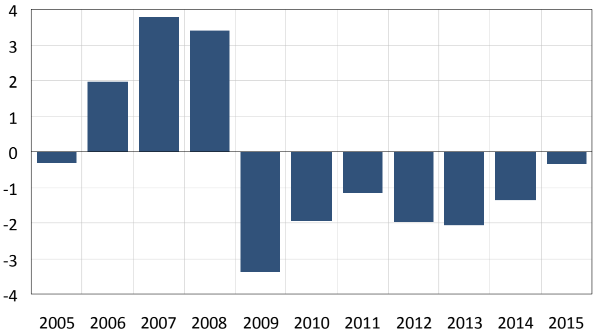
Source: CZSO (2012a), MF CR (2012a). MF CR calculations.

Chart 2.2: GDP per Capita
(calculated in purchase power parity, EU27=100)



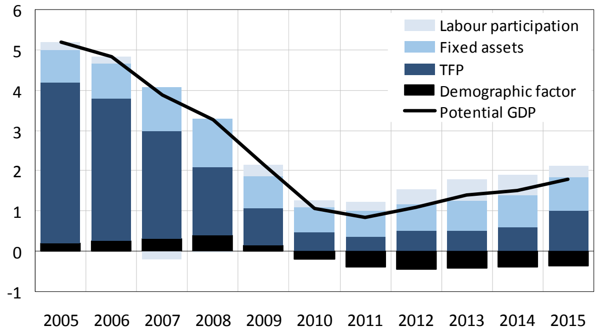
Source: CZSO (2012a), Eurostat (2012), MF CR (2012a). MF CR calc.

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 present conditions, it is difficult to distinguish between the effects of a deepening output gap and a slowdown in potential GDP growth. The results of decompositions[2] show great instability, and it is necessary to approach them with considerable caution.

The recession from the turn of 2008 and 2009 led to a significant slowdown in potential GDP growth and at the same time plunged the economy into a deep negative output gap (−3.4% in 2009). This was evident in the low production capacities utilisation, high unemployment rate, and small number of job vacancies. In 2010 and 2011, the output gap was gradually approaching −1%.

The most affected component of potential GDP is the total factor productivity. The growth of its trend component fell from 4% in 2005 to 0.4% in 2011. The slump in investments led to a decrease in the growth contribution from the capital stock. Moreover, the negative effect of demographic development began to show itself rather dramatically as from 2010. On the other hand, the contribution of the participation rate is surprisingly positive. According to MF CR calculations, the growth of potential product in 2011 dropped below 1%, though this calculation probably undervalues the reality.

We believe that the slowing of growth in economic potential already touched bottom in 2011. The decisive factor for its reinvigoration should be the contribution of the total industrial factor productivity, which should reach 1 p.p. in 2015. Due to increased investment activity, the contribution of growth from the capital stock should again reach values around 0.8 p.p. The contribution from the participation rate should remain positive due to increased motivation to work as a result of structural measures and should partially compensate for the unfavourable demographic factors. The potential growth should thus return to 2% in 2015.

After deepening to −2%, the output gap should be closing gradually in 2012 and 2013 and reach approximately −0.3% in 2015.

[2] 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). The inflation rate, measured by the harmonised index of consumer prices (HICP), reached 2.1% in 2011. It was 0.6 p.p. higher in the euro zone, while in the EU27 it even slightly exceeded 3%.

Administrative measures, and especially the increase in the reduced VAT rate, will significantly contribute to an expected one-off rise in inflation to over 3% in 2012. Inflationary expectations, however, should remain firmly rooted in the vicinity of the inflation target.

The low inflation rate in the vicinity of the inflation target is expected to be maintained in the coming years, especially due to the CNB's strong credibility, the competitive internal market, the Czech koruna's disposition to appreciate, and moderate growth in unit labour costs.

Table 2.3: Prices of Goods and Services

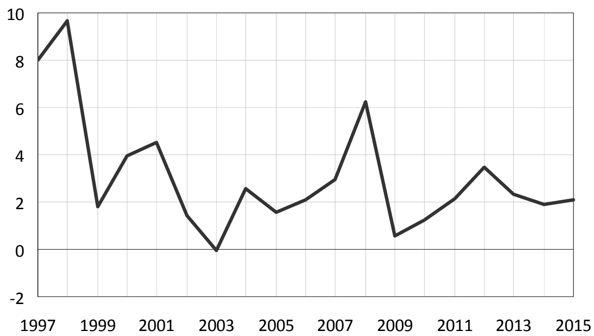
(indices 2005=100, increases in %)

	2011	2011	2012	2013	2014	2015
	Level			*Rate of change*		
1. GDP deflator	105.3	-0.7	2.0	1.4	1.4	1.5
2. Private consumption deflator	112.2	1.8	3.3	2.3	1.8	2.0
3. HICP	116.2	2.1	3.5	2.3	1.9	2.1
4. Public consumption deflator	114.6	-0.2	2.0	1.3	1.7	1.6
5. Investment deflator	103.7	-0.1	1.3	1.4	1.1	1.3
6. Export price deflator (goods and services)	92.9	0.3	2.3	1.1	0.4	0.2
7. Import price deflator (goods and services)	99.1	2.7	2.9	1.5	0.7	0.4

Source: CZSO (2012a), Eurostat (2012). MF CR calculations.

Chart 2.5: Harmonized Index of Consumer Prices

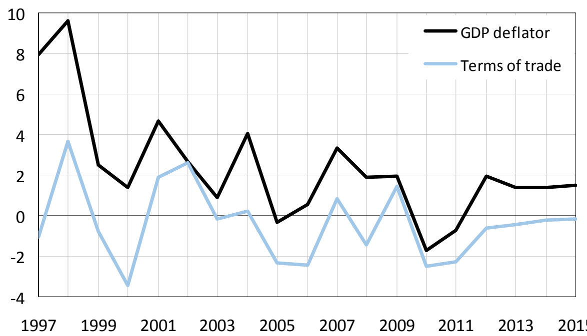
(y-o-y growth in %)



Source: Eurostat (2012). MF CR calculations.

Chart 2.6: GDP Deflator and Terms of Trade

(y-o-y change in %)



Source: CZSO (2012a). MF CR calculations.

2.2.4 Labour Market and Wages

The moderate recovery in 2010 and 2011 was also reflected in the labour market indicators. In 2011, the unemployment rate decreased y-o-y from 7.3% to 6.7% and the employment rate rose by 0.4%. The greatest employment gains continue to be seen in the entrepreneur segment, and specifically entrepreneurs without employees, which is most likely the result of high taxation of employment-based work. The impacts of this trend on general government revenues are indisputably negative.

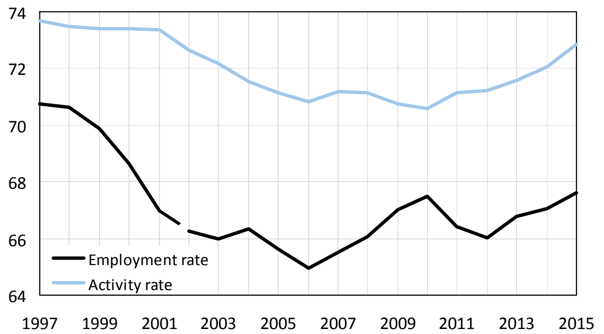
Demographic development has newly become a negative factor for the labour market, as the working-age population began to diminish from 2010.

The levelling off of real GDP growth since the second half of 2011 should *de facto* continue also this year. This could result in a renewed rise in the unemployment rate to 7.2% in 2013. Despite the relatively slow economic growth, we expect the labour market indicators to improve in the coming years due to the legislative adjustments from 2012 and structural characteristics improving over the long term. We also expect to see a gain in the participation rate over the CP horizon, especially due to gradual increase in the statutory retirement age. This should be reflected – albeit to a lesser degree – in a rise in the effective retirement age.

Compensation of employees (the sum of the wage bill and social security contributions paid by employers) rose in 2011 by just 1.4% due to the 10% decrease in the wage bill for the central government sector and continuing decline in the share of employees in total employment.

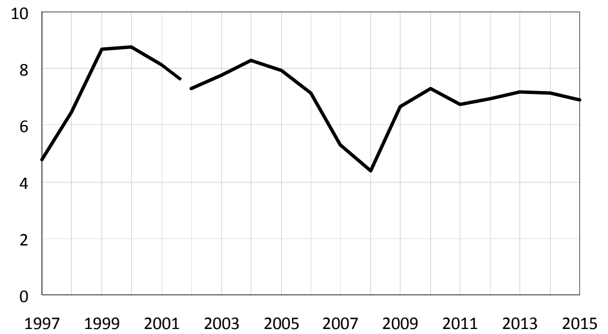
For 2012, we again expect low growth in compensation of employees in roughly the same amount due to the worsened economic situation and lowering of the ceiling for social insurance from 72 to 48 times the average wage. Compensation of employees should grow on average by 3.7% in subsequent years, i.e. approximately at the rate of nominal GDP growth. Employment incomes will be limited in the CP's horizon by freezing of the wage bill in the budgetary sector and at the same time by slow improvement in the economic situation for the private sector.

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 (2012c). 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 (2012c). MF CR calculations.

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

	ESA Code	2011	2011	2012	2013	2014	2015
		Level	*Rate of change*				
1. Employment, persons		5067	0.3	-0.3	0.1	0.2	0.4
2. Employment, hours worked		9.0	-0.9	-1.0	-0.2	0.0	0.1
3. Unemployment rate (%)		6.7	6.7	7.0	7.2	7.1	6.9
4. Labour productivity, persons		760	1.4	0.5	1.2	2.0	2.5
5. Labour productivity, hours worked		423	2.6	1.2	1.5	2.3	2.7
6. Compensation of employees	D.1	1599	1.4	1.4	2.8	3.7	4.4
7. Compensation per employee		387	1.6	2.5	2.9	3.6	4.1

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 2010 prices) per employed person or worked hour.
Source: CZSO (2012a, 2012c). MF CR calculations.

2.3 External Transactions and Sectoral Balances*

In terms of net lending/borrowing vis-à-vis the rest of the world, the Czech economy has been running a very moderate deficit for several years.[3]

The result is the sum of a gradually increasing 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. No substantial changes should occur in this area within the CP horizon.

From a sector balances viewpoint, the consolidation of government finances should meet with the gradually decreasing private sector surplus from the record level of 4.6% of GDP in 2009.

* In accordance with the requirements of the "Code of Conduct", this chapter is prepared using the ESA 95. Based on the relationship between investments and savings, this allows a complete disaggregation of surplus or deficit in external transactions among the individual economic sectors. This differs from the more usually employed methodology of the current account of the balance of payments in its accrual accounting, its categorisation of some items, and in the fact that it contains additional items, such as capital transfers.

[3] In September 2011, the CZSO conducted a revision of national accounts in accordance with Eurostat requirements. The revised data track foreign trade according to changes in ownership rather than the original crossing of borders. The revision resulted in a deterioration of net lending/borrowing by approximately 1% of GDP.

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

	ESA Code	2011	2012	2013	2014	2015
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	**-1.5**	**-1.1**	**-0.9**	**-0.8**	**-0.8**
of which : Balance on goods and services		4.1	4.7	5.1	5.4	5.6
of which : Balance of primary incomes and transfers		-7.7	-7.7	-8.0	-8.2	-8.4
of which : Capital account		1.8	1.8	1.9	1.8	1.8
2. Net lending/borrowing of the private sector	B.9	**1.6**	**1.9**	**2.0**	**1.1**	**0.1**
3. Net lending/borrowing of general government	EDP B.9	**-3.1**	**-3.0**	**-2.9**	**-1.9**	**-0.9**
4. Statistical discrepancy		**0.0**	**0.0**	**0.0**	**0.0**	**0.0**

Source: CZSO (2012a). MF CR calculations.

2.4 Growth Implications of Major Structural Reforms

The positive impact of the prepared and already approved substantial structural reforms (see Chapters 1.4, 5 and 6) will in most cases become apparent only after a long period of time, as they constitute fundamental systemic changes the objective of which is to boost the growth of potential GDP and employment and at the same time reduce the general government deficit. Their macroeconomic influence should therefore have only a limited impact in the CP's horizon. Consequently, it is currently impossible to more precisely quantify the effects of the main reform measures on the economic growth and employment, with the exception of the impact of the increase in indirect taxes.

The contribution of the increase of the VAT rate to the CPI growth, which aims to compensate the revenue shortfall caused by the introduction of the voluntary fund-financed pension pillar and to promote the fiscal consolidation, should reach 1.1 p.p. in 2012 and 0.7 p.p. in 2013. The higher inflation will decrease the dynamics of real household consumption to the extent of 0.6–0.8 p.p. in 2012 and about 0.4–0.6 p.p. in 2013. The negative impact on the real growth of GDP should therefore be 0.2–0.4 p.p. in 2012 and 0.1–0.3 p.p. in 2013.

3 General Government Balance and Debt

In the middle of the last decade, general government finances were positively influenced by the peak phase of the economic cycle. The recession at the turn of 2008 and 2009 brought a deep slump in general government finances and thus revealed the structural character of the fiscal imbalance. The deficit culminated in 2009 at the level of 5.8% of GDP. Active interventions and reforms managed to reduce the deficit in 2011 to almost half (to 3.1%). Annual deficits and slow economic growth are, however, accompanied by a growing ratio of debt to GDP, which has risen by 12.5 p.p. since 2008 to 41.2% of GDP in 2011. The current consolidation strategy counts upon further decreasing the deficit, by an average 0.5 p.p. annually, which should slow growth in the debt-to-GDP ratio.

3.1 Actual Balances and Updated Budgetary Plans for the Current Year

3.1.1 Finances in 2011

According to the preliminary data from CZSO, government finances for 2011 ended the year in a deficit of CZK 117.9 billion, i.e. 3.1% of GDP. Although tax revenues (especially indirect taxes) were almost 0.5% of GDP lower than expected, savings on the expenditure side markedly outweighed that factor.

This was especially due to government investments, for which the original assumption of no change versus 2010 proved unfounded. Investments were lower by almost 0.7% of GDP. These concerned especially the investments financed from domestic sources, while the size of investment grants from the EU has remained more or less stable over time. Government entities are probably very cautiously aware of the current economic development, including their own financial situations, and thus started economising on non-mandatory items upon which they mostly can decide autonomously. Another factor was intermediate consumption, which was 0.4% of GDP lower due to the general government consolidation. Other revenue and expenditure items were mostly in line with the expectations, and any slight differences compensated one another.

On the revenue side, legislative adjustments resulted in almost 6% growth in indirect taxes. The higher collection of taxes on tobacco products contributed to this result, as the announced increase in rates for 2012 led to stockpiling. Taxation of photovoltaic power station operators, which was first collected in 2011, also had a positive impact on revenues, as well as introduction of the domestic reverse charge mechanism on the collection of value added tax.

The collection of direct taxes grew in 2011 by nearly 7%. A number of legislative changes were made in this area, including, for example, in the individual income tax (with the most significant influence from a one-off decrease in a taxpayer credit relating to past flood-damage measures). No significant legislative changes were introduced in the corporate income tax, though this tax is still positively influenced by the temporary acceleration in depreciation from 2009. It is presumed that 2012 will be the last year when the phasing out of this measure will have a positive effect. Retaining the same insurance rate and the ceiling of the annual social insurance assessment base at the 2010 level also had a positive effect on the revenues side.

Among capital and other revenues, capital transfers in the form of donated emission permits were taxed and motorway toll rates were raised by about one-quarter.

Despite numerous changes in the tax area in 2011, a large part of the consolidation of general government was realised on the expenditure side. In particular, wages paid to employees of the central state administration were decreased (with the exception of educators and physicians, whose wages were increased), selected social benefits were reduced, and general savings were made on non-mandatory expenses, especially regular expenses.

3.1.2 Finances in 2012

Further consolidation efforts are expected in 2012 in the extent of 0.5 p.p., even despite the deepening output gap, which will result in a decrease in the total deficit of government institutions to 3% of GDP. The outlook for this year already incorporates the development of government investments and intermediate consumption, taking into account the government-approved freezing of expenditures for 2012 in the amount of CZK 23.6 billion.

On the revenue side, a 2% gain in general government revenues is expected. The most significant growth in revenues should be recorded in indirect taxes, as the reduced VAT rate rose by 4 p.p. at the start of the year. The increased excise tax on tobacco products, which is part of the VAT tax base, will also have a slightly positive effect on VAT. In general, however, despite the increase in rates on tobacco products in accordance with harmonisation with the EU, levelling off at last year's level is forecasted for excise taxes.

Only a slight revenue increase of 1.2% is expected for income taxes, with the newly introduced taxation of incomes from lotteries at 20% being the main positive influence. For the personal income tax, on the other hand, certain legislative changes were made (especially increase of the child credit, which should compensate for the rise in prices caused by this year's administrative measures) that should contribute to a y-o-y decrease in collection of this tax by 2.1%.

The growth in revenues from social security contributions is expected to reach 0.9%, while legislative changes (lowering of the assessment base ceiling and amendment of the Health Insurance Act) will to a substantial degree balance one another out.

General government expenditures should rise by 1.8%. Consolidation effort in this area is focused on intermediate consumption with an assumed 4.2% decrease (primarily due to the aforementioned general freezing of expenditures). As other legislative measures on the expenditure side already have a significantly lower impact, consolidation efforts are expected especially on the revenue side this year.

Another crucial component of expenditures, which is also the most problematic to forecast, is government investments. These are expected to increase by a slight 1.3% after the last year's sharp slump. This probably will be fully paid from national funds, as investment grants from the EU will probably decrease. Therefore, slow recovery in the general government's investment activity can be anticipated. The assumptions for other expenditure components should come as no great surprise, or they represent no legislative change with a more significant impact.

A methodological risk in the development of general government finances in 2012 may be posed by the full recording of the planned settlement of property relations between the state and churches and religious societies. Under the ESA 95 methodology, the 30-year flow of financial compensations would be recorded at once in its full extent in the year of approving the act, and thus the deficit for 2012 would statistically be increased by 1.5% of GDP (for more details see MF CR, 2011b). Since this is a methodological-accounting operation, it has no impact on the general government's actual finances in 2012 or on the consolidation trajectory, and it will be incorporated in the balance for the year in which the relevant act is approved.

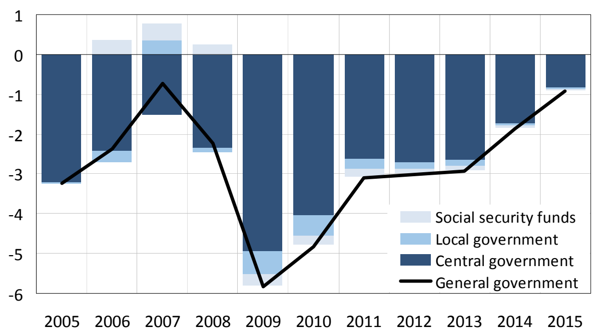
Finally, the consolidation effort could be negatively influenced by non-reimbursement of part of cash funds from several suspended EU operation programmes. Enumeration of these impacts on yearly deficits is complicated by methodological uncertainty: it is not clear, if the impact would cover all years of previous drawing or only the year when the suspension would be decided.

3.2 Medium-term Budgetary Outlook

The medium-term budgetary outlook for 2013–2015 assumes further gradual improvement of the general government balance towards overall balance in 2016 (see Chapter 1.2.4). The current fiscal policy setting is defined, on the one hand, by the government-approved targets for the deficit trajectory and the national expenditure frameworks for the state budget and state funds derived therefrom and, on the other hand, by the Proposal of Medium-Term Expenditure Frameworks for 2013–2015 approved by the government on 11 April 2012. The frameworks proposal (MF CR, 2012b) contains key parameters for preparing the state budget for the years of the CP's horizon, including quantifying the set of measures needed to implement the government's consolidation strategy.

General government finances have always been strongly influenced by the central government balance (Chart 3.1), which will most likely not change in future, although we do assume that central government deficits will decrease significantly. With accelerating economic recovery at the end of the medium-term outlook horizon, greater revenues of all general government units from the higher collection of shared taxes can be assumed, as can higher absolute revenues from tax titles the parameters of which will be adjusted by the budgetary consolidation measures.[4]

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



Note: Years 2011–2012 notification, years 2013–2015 outlook.
Source: CZSO (2012b). MF CR calculations.

3.2.1 Expected Revenue Development

From the fiscal viewpoint, one of the most important changes during 2013–2015 will be the prepared temporary increase in both VAT rates by 1 p.p. to 15% and 21%, respectively. Starting in 2016, the two rates should be unified at the already approved 17.5%. VAT

[4] The shared income from discretionary measures will not relate solely to the changes in VAT rates and statutory progression of the personal income tax.

collection, normally tracking the development of nominal household and government consumption, should increase due to this operation by almost CZK 18 billion during 2013 to 2015. In 2014, moreover, the minimum limit for registering VAT payers will be decreased (see Chapter 6.1.1), which should generate another CZK 4–5 billion. The rise in excise taxes will also have a positive impact on VAT collection (approximately CZK 1.2 billion). For 2013, we forecast growth in total VAT collection by more than 8%. In subsequent years, growth should converge with the development of nominal outlays on final consumption.

Excise taxes will be increased in the horizon of the CP's outlook for two reasons. The first is harmonisation of the tax on tobacco products with the EU law, which will take place in 2012 and the two following years. The collection of this tax should grow by CZK 2 billion each year. The second reason is the planned consolidation package, the most significant revenue-generating element of which is the introduction of carbon tax in 2014 (about CZK 6 billion). The total effect of the package (see Table 3.2) on excise taxes is estimated between CZK 10 billion and over CZK 11 billion as from 2014.

For the personal income tax, apart from the moderate growth of the wage bill early in the CP's horizon with a gradual onset, general government revenue will also be positively influenced by a number of stabilisation measures. The package of temporary consolidation adjustments prepared for 2013–2015 should have the most marked effect especially for this tax, as the collection is assumed to increase by over CZK 8 billion in the package's first year in effect and by CZK 36 billion in the two following years. The planned measures include, for example, an increase in the statutory rate of the personal income tax by 1 p.p. (about CZK 14 billion), abolition of the employees tax credit (impact of CZK 13 billion), limiting the use of flat-expense deductions for the self-employed (CZK 3.5 billion) and introduction of statutory progression (around CZK 2 billion). The increase in the personal income tax rate and the abolition of the employees' tax credit should come into effect since 2014, the other measures already since 2013.

Moreover, the already approved reform of direct taxes and payments will become effective as from 2014. Unaccompanied by the aforementioned package, this reform would decrease the burden on income from work by approximately CZK 19–23 billion and would therefore rather significantly decrease the revenue side at a time of fiscal consolidation.

The largest sources of income for the Czech Republic's public budgets are the contributions to social and health insurance (in 2011 accounting for almost 39% of total revenues). In addition to development in the total wage bill, contributions to health insurance will also be determined by the approved reform of direct taxes and payments, as part of the rate (2 p.p.) will transfer by law from the employer to the employee. The abolition of ceilings for health insurance will be a new feature (approximately CZK 1.8 billion).

More changes will occur in contributions to social security. The most significant of these will be the possibility to exclude 3 p.p. of the contribution paid by the employee into the newly introduced private pension saving pillar (see Chapter 5.2.2). Since it is now very difficult to make even a general estimate of what percentage of people will decide to diversify their old age security sources (by joining the new pillar) and what income profile this group of people will have at their disposal, taking a conservative view we assume the technical variant which speaks to a fallout of CZK 20 billion (starting from 2013). From the other measures, a fallout of CZK 6 billion in the social insurance contributions for self-employed persons is expected as from 2014 due to a change of rates and of the assessment base. We also assume that the shift of the tax burden from the employer to the employee should positively influence growth in wages and salaries, which would imply a higher tax base for income taxes including social security contributions.

The accident insurance system has undergone significant changes in comparison with the last CP. The original intention to provide accident insurance from 1 January 2013 via the public sector will be cancelled and replaced with a commercially based system. This should, however, have no serious impacts on the general government balance, as the original system of public accident insurance was conceived as more or less deficit-neutral.

The corporate income tax will not be significantly modified in the years of the outlook. All discretionary measures affecting this tax are caused solely by the amendment of direct taxes and payments and have a purely negative impact on the general government balance: approximately CZK –1 billion in 2014 and CZK –6.5 billion in 2015. The drop in revenues in 2015 is caused by the tax exemption for dividends.

The group of property taxes, specifically the gift tax, will record a decrease of approximately CZK 2.2 billion in 2013, as applicability of the amendment that taxed emission permits allocated free of charge will expire. From 2013, a portion of emission permits will be sold at auction. The impact of this operation is very difficult to quantify, as it depends not only on the CZK/EUR exchange rate but also on the price per permit, which appears to be rather volatile. We estimate that the income from 20–30 million permits sold may range between CZK 5 and 7 billion annually in the years of the outlook.

The termination of payments introduced for certain solar power plants will have a negative effect on other revenues in 2014. We assume a fallout of CZK 6.2 billion per year. As regards planned stabilisation steps, the real estate transfer tax rate should be increased as from 2013 (income of CZK 2.5 billion) and an insurance premium tax should be introduced in 2014, as is common in the insurance sectors of many other EU countries (estimated collection of CZK 5 billion). Last but not least, annual transfers of some CZK 4 billion are expected from the state-owned forests enterprise.

The impacts of the already effective reform of direct taxes and payments are summarised in Table 3.1. In general, it can be said that although the reform reduces direct taxation and taxation of labour as a factor of production, and from a long-term point of view it can therefore be considered pro-growth oriented, it generates, per se, a deficit of 0.3–0.4% of GDP. Government sector revenues are positively influenced especially by the taxation of gambling, which should alone improve the balance by almost CZK 9 billion, including abolition of the tax exemption for lotteries and other similar games. The taxation of gambling is accompanied, however, by the abolishment of the fee for an operated gaming machine and a reduction in the collection of administrative fees at the municipality level. The "net impact" related to taxation of gambling is thus almost 50%. Taxation of gambling by means of the lottery tax is valid already from 2012, while all others will take effect only in 2014.

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

	2012	2013	2014	2015
Personal income tax	**-**	**-**	**-19.4**	**-22.5**
of which: change of tax assessment base (gross wage), tax rate (19%) and deductions	-	-	-22.1	-22.7
Corporate income tax	**-**	**-**	**-1.5**	**-7.0**
Social security contributions	**-**	**-**	**-3.5**	**4.9**
Value added tax (decrease of mandatory registration limit to CZK 750,000)	**-**	**-**	**4.1**	**5.0**
Tax on lotteries (including reduction or abolition of some fees)	**4.7**	**4.7**	**4.7**	**4.7**
Total impact on balance	**4.7**	**4.7**	**-15.6**	**-14.9**
% of GDP	0.1	0.1	-0.4	-0.3

Source: MF CR calculations.

3.2.2 Expected Development of Expenditures

On the expenditure side, a number of consolidation measures are mitigated by the rise in wages and salaries of physicians, judges, state prosecutors and educators; by compensations to the socially needy due to the increase in the price level caused by changes in indirect taxes; and by higher government outlays on operations as well as, for example, on medicaments.

After decrease in the volume of compensations to employees in the state administration in 2010 and 2011 totalling CZK 16.4 billion, the volume of wages paid from national sources is expected to remain at this level. This, by itself, does not mean a decrease in the average annual wage, as it is always up to the particular chapter or fund administrator to decide how he or she will optimise the number of employees. On the other hand, the increase in wages of selected groups of government sector employees (see Table 3.3) will result in a rise in expenditures by approximately CZK 2 billion in each year of the outlook. It is nevertheless uncertain, how will the overall reduction of expenditures affect the wages. We expect the total compensations to employees in the government sector more likely to remain at the same level, not only due to the almost identical total level of the wage bill in the central state administration, but also because in 2014, in connection with the considered backwarding of effect of the reform of direct taxes and payments (Chapter 3.2.1), the legal rate of contributions to social and health insurance will drop by 2 p.p., which will in turn reduce the government's total costs for its own employees.

It has been possible to expect a more marked increase in cash social benefits in the years of the CP outlook due to the changes in the VAT rates. Nevertheless, the package of additional budget-balancing changes being considered (Table 3.2) plans to limit the pension valorisation scheme (see also Chapter 5.2.1), which should save CZK 9.5 billion in 2013, CZK 15.6 billion in 2014 and CZK 21.4 billion in 2015. Valorisation will continue in the usual manner thereafter. The aforementioned package also considers cancelling the housing supplement, which should have a slightly positive effect (ca CZK 0.8 billion). The overall development of cash social benefits will also reflect previously implemented changes, and thus we estimate growth in these benefits of around 2.5%.

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 public health insurance system reform (Chapter 6.2.2). Savings of around CZK 3 billion annually are expected. For this reason, the volume of social transfers in kind will grow only modestly, at a rate of less than 2%.

A considerable part of savings realised in general government sector should occur in government consumption, which will be significantly affected by planned revision of the agendas of ministries, state funds and a number of central government offices. The revisions will be associated with reducing duplication, integration and merger of offices, and general cuts of expenditures. The total impact is estimated at just under CZK 13 billion in 2013 and over CZK 37 billion in 2015, when optimisation of the state administration should peak (Table 3.2). This means y-o-y savings of around CZK 12 billion. The higher VAT rate will have a negative effect, estimated to be CZK 5 billion, especially on intermediate consumption and social transfers in kind.

The reform of direct taxes and payments is accompanied by creation of a Unified Revenue Collection Agency (Chapter 7.2). This will bring not only administrative cost savings to taxpayers and simplification of the entire tax administration system, but also savings on the side of the public sector budget. In the initial phase of project realisation, only modest savings of about CZK 0.4 billion are expected, while at least CZK 1 billion is expected in the project's final phase.

Alternative financing modes are being sought for the gross fixed capital formation (see e.g. Chapter 6.3) and for increasing efficiency of the public contracts system, which should be interconnected with the gradually implemented State Treasury system (Chapter 7.3). Total savings are difficult to estimate precisely, though approximately CZK 5 billion can be regarded as the lower estimate. We expect the development of investments in the government sector to accelerate gradually at a moderate average rate of 4.2% annually. We regard the given development scenario to be realistic, especially considering the 15% slumps in 2010 and 2011 (for the reasons behind the slump, see Chapter 3.1.1).

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

	2013	2014	2015
Personal income tax	**8.3**	**36.0**	**36.0**
Abolition of employees tax credit	-	13.0	13.0
Abolition of basic allowance for working pensioners	2.0	2.5	2.5
Increase of the personal income tax rate by 1pp	-	13.9	13.9
Tax surcharge of 7% above the social insurance contribution cap	1.8	2.1	2.1
Reduction of flat-expense deductions for self-employed	3.5	3.5	3.5
Increase of the withholding tax against tax havens to 35%	1.0	1.0	1.0
Social security contributions	**1.8**	**1.8**	**1.8**
Health insurance cap abolition	1.8	1.8	1.8
Value added tax and excises	**19.9**	**27.9**	**28.9**
VAT rates change (reduced rate 15%, basic 21%)	17.7	17.7	17.7
Abolition of selected excises exemptions [1)]	2.0	3.0	3.0
Introduction of excise on selected commodities [2)]	0.2	7.2	8.2
Other revenues	**6.5**	**11.5**	**11.5**
Increase of real estate transfer tax by 1pp (to 4%)	2.5	2.5	2.5
Introduction of tax on premiums	-	5.0	5.0
Funds transfer from Forests of the CR, State Enterprise	4.0	4.0	4.0
Social benefits	**10.3**	**16.4**	**22.2**
Abolition of the supplement for housing	0.8	0.8	0.8
Change in pension indexation formula (1/3 of CPI percentage change)	9.5	15.6	21.4
State administration optimisation	**12.7**	**24.6**	**37.5**
Simplification of the state administration agendas, elimination of duplicities	-	11.9	24.8
Expenditure decrease according to the state budget freeze in 2012	12.7	12.7	12.7
Other expenditures	**2.0**	**2.0**	**2.0**
Reduction of renewable energy sources subvention	2.0	2.0	2.0
Total impact on balance	**61.5**	**120.2**	**139.9**
% of GDP	1.5	2.9	3.2

Note: 1) Abolition of the green oil, abolition of the tax exemption on the natural gas for households. 2) Increase of tobacco taxes on the level of cigarette taxation, taxation of still wine, introduction of carbon tax.
Source: MF CR calculations.

For 2013–2015, we expect growth in expenses for interest payments of approximately 8.6% on average. This is caused both by the accumulation of debt from previous periods to the relatively high current level and additional (albeit lower) planned government sector deficits, as well as by the expected rise in interest rates along the entire yield curve. Given that the debt crisis of certain euro zone countries remains unresolved, this approach seems to be the most appropriate when taking a cautious approach.

Table 3.2 gives a relatively detailed list of the impacts of the planned set of revenue and expenditure consolidation measures, the original validity of which was limited only to 2013–2015. Over one-quarter of the weight of the planned package consists in increasing direct taxes and almost in an identical extent in increasing taxation through indirect taxes. Overall, including the other revenues, 60% of the consolidation due to this package results from adjustments on the revenue side of the budget.

One-quarter of the total impact of the package's expenditure consists in optimising the state administration and approximately 15% in limiting and abolishing cash social benefits.

The planned consolidation measures should compensate not only for the shortfall in revenues caused by the reform of direct taxes and payments but also for the fallout on the order of 0.5% of GDP which may be caused by introduction of the voluntary capital pension pillar. Their primary objective, however, is to ensure that the Czech Republic achieves its domestic and international commitments regarding the amount of the general government deficit expressed as a proportion of GDP.

In addition to the set of planned measures meant for stabilising the budget listed and quantified in Table 3.2, no other discretionary changes are planned within the years of the CP outlook. Table 3.3 summarises the other changes on the expenditure side valid from 2012. Nevertheless, their sum, with the exception of 2012, is negligible from a macroeconomic and budgetary standpoint.

Table 3.3: Impact of Other Expenditure Measures

	2012	2013	2014	2015
Compensation of employees (salaries, including social security contributions)	**-5.6**	**-7.8**	**-9.8**	**-11.8**
of which: increase salaries of doctors and other staff	-1.5	-3.2	-5.2	-7.2
Expenditures on social benefits	**-3.1**	**-5.6**	**-4.6**	**-1.8**
of which: increase in pension expenditures as a consequence of indexation formula chan	-0.4	-0.5	-0.5	-0.5
of which: increase of living and existence minimum	-0.8	-0.8	-0.8	-0.8
Other expenditures	**7.9**	**13.1**	**15.5**	**16.9**
of which: cut in building saving scheme contributions	5.4	5.4	5.4	5.4
of which: changes in the health system	4.6	7.4	8.4	9.9
of which: increase in efficiency of public procurement	-	5.0	5.0	5.0
State budget expenditures freeze in 2012	**23.6**	-	-	-
Total impact on balance	**22.8**	**-0.3**	**1.0**	**3.3**
% of GDP	0.6	0.0	0.0	0.1

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 government sector while simplifying and making it more efficient. They have been composed so that the targets for the general government sector deficit relative to GDP will be met, i.e. so that a clear message is continuously communicated that the consolidation strategy will be fulfilled despite a poorer economic environment.

The outcome of the autonomous development of government sector finances with unchanged policies and in the absence of all stated corrective and reform measures is summarised in Table 3.4.

It shows that without the contemplated measures the general government deficit would be approximately 3.3 p.p. higher on average (without the measures of 2011 only the deficit would be higher by 2.1 p.p.). Rather, without all the measures in 2011–2015 would the general government deficit be 5.5 % of GDP, i.e. 4.6 p.p. higher than that established by the government.

A general look at the composition of discretionary measures in the years of the outlook indicates that 57 % of the corrections and adjustments are carried out on the revenue side of the budget, and thus 43 % on the expenditure side, the same ratio stands true also for the timeframe of 2013–2015 (more detailed information on the majority of measures is contained in the previous three tables).

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

	2011	2012	2013	2014	2015
Total revenue	**40.3**	**40.2**	**40.2**	**40.4**	**40.2**
Total revenue at unchanged policies (autonomous scenario)	39.5	39.0	38.5	38.0	37.9
Discretionary revenue measures	0.8	1.3	1.7	2.4	2.3
Total expenditure	**43.4**	**43.2**	**43.1**	**42.2**	**41.1**
Total expenditure at unchanged policies (autonomous scenario)	44.2	44.7	44.6	44.1	43.4
Discretionary expenditure measures	-0.8	-1.5	-1.5	-1.9	-2.3
Total balance with discretionary measures	**-3.1**	**-3.0**	**-2.9**	**-1.9**	**-0.9**
Total balance without discretionary measures (autonomous scenario)	-4.7	-5.8	-6.1	-6.1	-5.5
Total discretionary measures	1.6	2.8	3.2	4.2	4.6

Source: MF CR calculations.

3.3 Structural Balance, Fiscal Stance

The structural balance in 2012 will reach −2.4% of GDP, and during 2013–2015 it will gradually improve due to the consolidation measures towards −0.8% of GDP. However, as Chart 3.2 shows, the quickly shrinking structural deficit should be driven by decrease in the negative primary structural component and increase in the positive primary structural component, while interest costs will likely rise moderately throughout the entire period from 1.5% of GDP in 2012 to 1.8% of GDP in 2015. A primary structural surplus of 1.0% of GDP will thus be necessary in order to reach the objective that the total balance is in the region of −0.9% of GDP in 2015.

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

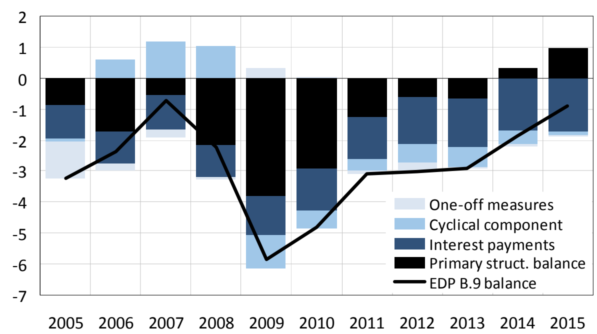
Here, as in Chapter 3.1.2, we do not take into account the one-off income from auction sales of newly issued frequency bands amounting to approximately 0.2% of GDP nor the one-off expense of 1.5% of GDP in relation to the property settlement between the state and churches. Both factors, only one of which is addressed here, will be included if implemented. The church settlement, however, involves only the statistical-methodological recording of the operation, which in no way relates to an actual outflow of funds in the given year.

The Chart 3.2 (and in more detail, Table A.5) also records the cyclical components of the deficit, i.e. the items that are sensitive to the economy's position in the business cycle. While in 2012–2013 we expect the negative output gap to deepen (see Chart 2.3), the negative influence of the cyclical component should decrease in 2014–2015 along with the gradual economic recovery from −0.7% in 2013 to −0.1% in 2015.

Fiscal effort, defined as the y-o-y change in the structural balance, is equal to an average annual value of 0.7 p.p. in the horizon decisive for EDP, i.e. during 2010–2013. Although this does not conform to the EU Council's recommendation (see Chapter 1.2) for average annual fiscal effort for the given period, it will reduce the deficit below the target of 3% of GDP. We therefore estimate the total fiscal effort in the given period to be 2.9 p.p. Despite the planned fallout in revenues due to introduction of the voluntary fully-funded pillar of the pension system, the strongly pro-reform and consolidation-oriented government policy should thus ensure a decrease in the total general government deficit to below 3% of GDP in 2013. The sustainability of the current policy will depend also on the steps taken after 2015.

Chart 3.2: Decomposition of the General Government Balance

(in % of GDP)



Source: CZSO (2012b). MF CR calculations.

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

The expected scenario for development of the general government sector indicates growth in the nominal debt throughout the entire forecast period. Expressed as a proportion of GDP (Table 3.5), the debt-to-GDP ratio can be expected to culminate at 45.1% of GDP in 2013 and then decrease to 43.4% in 2015. The scenario assumes a decreasing share of the primary balance on changes in the debt ratio, while the interest expenditures should increase it by contributions of around 1.5–1.7 p.p. (Table A.4). In the forecast, we do not consider any privatisation revenues, because the government currently has not decided about setting more significant subjects for privatization.

After adjusting the level of gross debt by the value of liquid financial assets (currency, deposits and securities including shares quoted in stock exchange), the so-called net financial debt in 2011 was 62% of the total gross debt. In other words, the size of the relatively liquid amount for repayment of the debt would, if needed, be 15.7% of GDP. We expect the ratio of net financial debt to total debt to increase only slightly in future to approximately 70% in 2015.

The central government institutions sub-sector has the most substantial share in the total public debt, accounting for almost 94% of the total debt. The local government institutions sub-sector represents the remaining approximately 6% of total debt, as indebtedness of the social security funds is negligible (Table 3.5). Nearly all of the central government debt, then, is accounted for by state debt, i.e. debt generated by the state budget. Therefore, the sustainable risk structure of the state debt is an important stability factor for the debt of the general government sector as a whole.

When shaping the medium-term state debt and the state's issuance strategies (see MF CR, 2011d), primary attention is focused on the refinancing and market risk, representing the most significant sources of financing uncertainty. Their stabilisation has been shown to be especially crucial 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 the short-term state debt (i.e. debt payable within 1 year) from the 69% in 2000 to below the threshold of 20% in 2006 and to maintain that level thereafter. Beginning in 2012, this threshold has been raised to 25%. Moreover, the medium-term state debt (payable within 5 years) has also begun to be actively managed. As from 2012, its target contribution to the total debt is 70%. Management of the refinancing risk is thereby divided between short-term and medium-term state debt.

The stable refinancing structure is confirmed by the average maturity of the state debt (Table 3.6), which in past years has ranged from 6 to 7 years. In 2009 and 2010, the lower threshold was decreased by half a year due to increased uncertainty on world financial markets, while the target band was narrowed to 5.25–6.25 years for 2011. Average maturity was 5.8 years at the end of 2011. The heightened uncertainty on capital markets, reflected in investors' greater interest in short-term financial instruments, led to establishing a band of 5–6 years for 2012.

The most important market risk for managing the state debt is the interest rate risk. As from 2011, the strategic target in this area is an average refixing period for the state debt of 4–5 years, which corresponds to the international practice of optimising the costs of state debt and the risk resulting from refixing rates. The primary instruments in 2012 are issuing activities and drawing of loans from the European Investment Bank. Should the average refixing period for the state debt deviate outside the target interval, derivative operations will be used. The average refixing period for the state debt was around 4.6 years at the end of 2011. As compared to previous years, the average refixing period is decreasing, as a result of which the costs for servicing the state debt are on average generated at the shorter end of the yield curve. Over a long-term perspective, we can therefore expect relative savings on interest costs.

A strategic target for interest rate refixing of the short-term debt portfolio, i.e. the share of the debt which is sensitive to fluctuations in interest rates on the financial market in the following year, has been established each year since 2006. For 2012, the band is kept at the level of 30–40% with a view to the upper part of the interval. This target is in accordance with the introduction of average refixing in a band of 4–5 years and leads to identical results for the portfolio. Interest rate refixing of the short-term debt portfolio was 34.8% at the end of 2011.

In terms of interest-rate structure, 14.8% of long-term instruments had variable interest rates in 2011. During 2012–2015, the share of debt with variable interest rate should not exceed 17.0%. The effect of derivative transactions on interest rate exposures relates to operations hedging the currency risk for foreign issues.

Starting from 2011, the currency risk is now also actively managed, and the share of foreign-currency debt must not exceed the limit of 15% + 2 p.p. (with the exception of short-term exceedance due to unexpected depreciation of the domestic currency). The share of foreign-currency debt at the end of 2011 was 8.9%. Its decrease versus the end of 2010 was caused by the fact that no foreign issue was made (except for final sale of a variable interest rate bond from the Ministry's portfolio in the amount of EUR 37.5 million). No significant change in the structure of currency exposure is expected in the long-term horizon.

Table 3.5: General Government Debt by Sub-sector

(in % of GDP)

	ESA Code	2010	2011	2012	2013	2014	2015
General government	S.13	**38.1**	**41.2**	**44.0**	**45.1**	**44.8**	**43.4**
Central government	S.1311	**35.6**	**38.6**	**41.5**	**42.5**	**42.2**	**40.9**
Local government	S.1313	**2.6**	**2.6**	**2.6**	**2.7**	**2.6**	**2.5**
Social security funds	S.1314	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**

Note: Years 2011–2012 show notification. Years 2013–2015 show outlook.
Source: CZSO (2012b). MF CR calculations.

Table 3.6: The State Debt's Refinancing and Interest

		2010	2011	2012	2013	2014	2015
Refinancing							
Average maturity	*years*	**6.3**	**5.8**	**5.5**	**5.3**	**5.1**	**5.1**
Debt due within 1 year	*% of debt*	**16.1**	**19.3**	**19.8**	**21.7**	**24.8**	**24.4**
Financing reserve/debt due within 1 year	*%*	**30.1**	**24.4**	**22.0**	**18.7**	**15.8**	**16.0**
State Debt's Interest							
Debt with interest fixation within 1 year	*% of debt*	**31.7**	**34.5**	**37.6**	**38.8**	**39.5**	**39.5**
Fixed interest long-term debt due within 1 year	*% of debt*	7.5	5.4	7.3	6.1	6.3	6.4
Variable interest long-term debt	*% of debt*	12.1	14.8	14.9	16.2	15.0	15.0
Monetary instruments	*% of debt*	8.4	10.8	12.4	13.4	15.1	15.0
Effect of derivative operations	*% of debt*	3.6	3.5	3.0	3.1	3.1	3.1
Foreign Currency Exposition							
Debt denominated in foreign currency	*% of debt*	**10.4**	**9.2**	**11.4**	**12.0**	**12.0**	**12.0**
Debt denominated in EUR	*% of debt*	9.1	8.0	10.3	10.8	10.8	10.8

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 main source of differences compared to the scenario of the previous CP (Table 4.1) is the escalation of the debt crisis in the euro zone during the second half of 2011 and the subsequent drop in economic output dynamics for the majority of EU countries. Growth prospects for 2012 and 2013 thus deteriorated considerably. Another factor specific to the Czech Republic is in the fiscal efforts that are more intensive than originally intended. Certain national account indicators were also influenced by methodological revision.

This has resulted in a negative deviation in all components of GDP in 2012 and 2013 with the exception of foreign trade's contribution to GDP growth. Here, the decline or slowdown in the growth of domestic demand is compensated by the worsened outlook for foreign demand.

The higher expected inflation in 2013 is due to the newly considered increase in both VAT rates by 1 p.p. as well as assumptions of a weaker CZK/EUR exchange rate and higher oil prices.

The worsening of the economic output forecast is reflected on the labour market by the expected development in employment, unemployment and compensation of employees.

With respect to public budgets, a worsening forecast for the labour market situation, and especially the outlook for wage development in conditions of high taxation of employment, as well as substantially weaker expected household consumption can be considered the most important divergences in the macroeconomic scenarios.

Divergences in external transactions are primarily due to an implemented revision of national accounts.

The reasons for the significantly lower general government deficit for 2011 and the argumentation for the change in the target of headline deficit in 2012 are analysed more closely in chapters 1.2 and 3.1.

Table 4.1: Change in the Indicators of the Scenario

		April 2011 CP			April 2012 CP		
		2011	2012	2013	2011	2012	2013
External Assumptions							
GDP growth in EU27	*%*	1.8	2.1	2.3	1.5	-0.2	0.8
Prices of oil (Brent)	*USD/barrel*	95.0	95.5	96.8	111.0	115.0	113.0
Exchange rate USD/EUR	*USD/EUR*	1.31	1.30	1.30	1.39	1.30	1.30
Exchange rate CZK/EUR	*CZK/EUR*	24.1	23.5	22.8	24.6	25.0	24.9
Real Values							
GDP	*change in %*	1.9	2.3	3.3	1.7	0.2	1.3
Households consumption	*change in %*	0.7	1.9	3.3	-0.5	-0.4	0.2
Government consumption	*change in %*	-3.4	-2.5	-1.3	-1.4	-3.7	-0.5
Gross fixed capital formation	*change in %*	0.7	3.2	5.6	-1.2	-0.5	2.1
Contribution of final domestic demand	*p.p.*	-0.3	1.1	2.6	-0.8	-1.1	0.5
Contribution of foreign trade	*p.p.*	1.8	1.1	0.6	2.6	1.0	0.8
Potential product	*change in %*	1.8	2.2	2.7	0.8	1.1	1.4
Output gap	*%*	-2.6	-2.5	-2.0	-1.1	-2.0	-2.1
Growth							
HICP	*change in %*	2.2	3.4	1.6	2.1	3.5	2.3
GDP deflator	*change in %*	-0.5	2.7	1.6	-0.7	2.0	1.4
Employment	*change in %*	0.1	0.5	0.6	0.3	-0.3	0.1
Unemployment rate	*%*	6.9	6.5	6.1	6.7	7.0	7.2
Balance of goods and services	*% of GDP*	4.5	5.3	5.8	4.1	4.7	5.1
Net lending/borrowing	*% of GDP*	-0.6	0.0	-0.1	-1.5	-1.1	-0.9
General Government							
Net lending (+)/borrowing (-) (EDP B.9)	*% of GDP*	-4.2	-3.5	-2.9	-3.1	-3.0	-2.9
General government debt	*% of GDP*	41.4	42.4	42.8	41.2	44.0	45.1

Source: MF CR (2011c), MF CR (2012a). MF CR calculations.

4.2 Sensitivity Analysis

The Czech economy is small and markedly open by nature, and therefore it depends greatly on developments in the external sector. The first two scenarios of the sensitivity analysis were thus selected to show the extent of impacts from development of economic growth in the EU other than that expected. We take into consideration both a situation of sudden drop in GDP growth dynamics in the first year of the simulation, as well as a case of long-term worsening in economic development in which the simulated decline in growth within the EU is enduring. A third alternative scenario simulates impacts of increased domestic interest rates on the Czech economy. The alternative scenarios are derived from the Macroeconomic Forecast (Ministry of Finance, 2012a), which is the basis for the CP's macroeconomic framework.

4.2.1 Slower Economic Growth in the EU in 2012

The first scenario for development in the EU is based on the assumption of slower economic growth, defined as real GDP growth 1 p.p. lower versus the base scenario, occurring only in 2012. The scenario would be reflected in the Czech economy primarily through exports, more than 80% of which are directed to EU countries. Lower foreign demand would lead to a decrease in net exports and worsening of the current account balance, which would be negatively reflected in real GDP growth and in the development of unemployment. The influence on inflation appears very moderate, as two 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 keep inflation downwards; (ii) on the other hand, deterioration in the current account balance would have a depreciating influence on the Czech koruna, thus raising prices of imported inputs. The result would be only a minor decrease of inflation in 2012. The general government balance would thus be influenced by lower tax collections from both enterprises and individuals. Meanwhile, the spending side would rise due to paying out a higher volume of unemployment benefits. Larger government deficits would then accumulate as debt in subsequent years. The Czech economy should gradually recover along with the gradual recovery in foreign demand as from 2013.

Table 4.2: Basic Macroeconomic Indicators – Sensitivity Scenarios

		2011	2012	2013	2014	2015
Baseline Scenario						
Gross domestic product	*Y-o-Y in %*	1.7	0.2	1.3	2.2	2.8
Inflation (HICP)	*Y-o-Y in %*	2.1	3.5	2.3	1.9	2.1
Unemployment rate	*in %*	6.7	7.0	7.2	7.1	6.9
Current account	*% of GDP*	-2.9	-2.4	-2.3	-2.2	-3.8
General government balance	*% of GDP*	-3.1	-3.0	-2.9	-1.9	-0.9
Gross government debt	*% of GDP*	41.2	44.0	45.1	44.8	43.4
Alternative Scenario I - Lower GDP Growth in EU in 2012						
Gross domestic product	*Y-o-Y in %*	1.7	-0.6	1.3	2.4	2.9
Inflation (HICP)	*Y-o-Y in %*	2.1	3.4	2.3	2.1	2.2
Unemployment rate	*in %*	6.7	7.2	7.2	7.0	6.8
Current account	*% of GDP*	-2.9	-3.4	-2.6	-2.0	-2.3
General government balance	*% of GDP*	-3.1	-3.5	-2.9	-1.8	-1.0
Gross government debt	*% of GDP*	41.2	44.1	45.5	45.6	44.7
Alternative Scenario II - Permanently Lower GDP Growth in EU						
Gross domestic product	*Y-o-Y in %*	1.7	-0.6	0.6	1.6	2.3
Inflation (HICP)	*Y-o-Y in %*	2.1	3.4	2.2	2.0	2.3
Unemployment rate	*in %*	6.7	7.2	7.5	7.3	7.0
Current account	*% of GDP*	-2.9	-3.4	-3.6	-3.3	-3.5
General government balance	*% of GDP*	-3.1	-3.5	-3.4	-2.3	-1.3
Gross government debt	*% of GDP*	41.2	44.1	46.3	46.9	46.1
Alternative Scenario III - Higher Interest Rate						
Gross domestic product	*Y-o-Y in %*	1.7	-0.1	1.0	2.0	2.7
Inflation (HICP)	*Y-o-Y in %*	2.1	3.3	1.9	1.6	1.9
Unemployment rate	*in %*	6.7	7.2	7.5	7.4	7.0
Current account	*% of GDP*	-2.9	-2.4	-2.4	-2.4	-2.6
General government balance	*% of GDP*	-3.1	-3.3	-3.2	-2.0	-0.8
Gross government debt	*% of GDP*	41.2	43.7	45.8	46.1	45.0

Source: MF CR calculations.

4.2.2 Enduring Lower Economic Growth in the EU

The second scenario examines long-term unfavourable economic development in the EU, defined as real GDP growth 1 p.p. lower in each year of the CP forecast horizon.

In this scenario, the same mechanism as in the previous scenario would cause negative repercussions for the Czech economy in each year of the anticipated pessimistic development in the EU. The economy has a tendency, however, to begin gradually to recover, and the negative impacts of developments abroad would therefore be slightly mitigated in each subsequent year. Nevertheless, the ratio of debt in the government sector to GDP should continue to rise, peaking, as in the other scenarios, in 2014.

4.2.3 Increase in the Domestic Interest Rate

The final scenario is based on the assumption of a sharp rise in the domestic interest rate by 0.5 p.p., albeit only in 2012.

A higher interest rate raises the cost of current consumption due to higher opportunity costs in the case of postponing consumption in time. Domestic demand and prices would thus decline, and growth in investments would be inhibited by higher interest rates on loans. This all would be reflected by a decline in GDP growth and increase in unemployment.

As in the case of lower GDP growth in the EU, general government revenues would be influenced by lower tax collections from both enterprises and individuals. Government expenditures would rise along with higher unemployment. A negative balance would thus again be reflected in accumulation of debt.

Interest rate changes occur very gradually, and thus even a return to the original level would take a longer time. This implies that the impact of the examined sudden interest rate increase on the Czech economy would be longer term in nature.

4.3 Verification of the Macroeconomic Scenario by Other Institutions' Forecasts

The CP's macroeconomic scenario was compared with the forecasts of other relevant institutions. This enquiry was made in April 2012 and its results are based on the forecasts of 15 domestic institutions with the actual forecast of the EC (2012c) and IMF (2012b). However, not all of the forecast cover the whole CP timeframe, e.g. the 2015 verification is based on a sample of eight respondents only.

Forecasts confirm the extraordinary uncertainness in the perception of the future development. For 2014 and 2015 is the average of the forecasts influenced to a great deal by two forecasts which, probably in the consequence of fears of the yet-unsolved debt crisis in the Euro area, consider stagnation of the Czech economy as the most probable scenario in the CP timeframe. For that reason, we also include the extreme values (minimum and maximum) aside of the mean of the forecasts for the 2014 and 2015 (Table 2.4).

The differences in the government consumption trajectory probably stem from the fact, that the CP includes the quantification of impacts of the measures described in Chapter 2.4. Forecasts of the inflation rate confirm that inflation expectations remain well anchored at the CNB's inflation target.

The fundamental trends of the macroeconomic scenario in the CP 2012 are broadly consistent with the other institutions' forecasts, at the same time the downward risks are accented.

Table 4.3: Verification of 2012 Convergence Programme Scenario by Other Institutions' Forecasts

	Forecast of Other Institutions							April 2012 CP		
	2013		2014			2015		2013	2014	2015
	average	*min*	*average*	*max*	*min*	*average*	*max*			
Growth in Real Terms										
GDP	1,6	0,0	1,9	3,0	0,0	2,0	3,5	1,3	2,2	2,8
Households consumption	0,6	-1,0	1,3	2,6	-1,0	1,2	2,8	0,2	2,0	2,8
Government consumption	-0,4	-1,8	0,0	1,7	-0,2	0,3	1,0	-0,5	-1,8	-0,2
Gross fixed capital formation	1,3	-1,9	1,6	3,3	-1,9	1,8	3,9	2,1	2,8	3,2
Growth										
National CPI (aop)	2,2	1,3	2,1	3,3	1,6	2,2	3,4	2,3	1,8	2,0
GDP deflator	1,6	0,7	1,5	2,3	0,6	1,6	2,2	1,4	1,4	1,5
Employment (LFS)	0,0	-0,2	0,0	0,3	-0,5	0,0	0,4	0,1	0,2	0,4
Unemployment rate (LFS, level in %)	7,1	6,1	7,2	8,9	6,8	7,3	8,0	7,2	7,1	6,9

Source: MF CR (2012c).

5 Sustainability of Public Finances

Long-term sustainability is consistently one of the most significant challenges for the Czech public finances. The most serious risk is in the expected demographic development, which over the next several decades will quite dramatically boost the ratio of persons of retirement age to the economically active population.

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 (EUROPOP2010) and the macroeconomic framework consistent for the EU countries.

The long-term projections were updated in 2011 in connection with the update of demographic and macroeconomic assumptions. The projection results were discussed within AWG during October 2011.

The stated projections do not reflect the current medium-term macroeconomic and fiscal outlooks for the Czech Republic. The projections assume unchanged policies (corresponding to the system legislatively anchored at the time of their creation), and therefore the reported numbers in no way reflect amendments approved after November 2011.

The outcomes of the long-term projections are fully in accordance with the analyses prepared by AWG for the forthcoming report on long-term projections. In this analysis, 2010 is set as the base year. The following years, therefore, show only a trend projection which cannot be directly compared with the current data. The projections end in 2060. Long-term analyses do not aim to forecast specific values but only display the trends and long-term dynamics.

From today's viewpoint, the pension area appears to be the most problematic in terms of the dynamics of expenditure growth (see Table A.7a). Spending will rise from the current level of 9.1% of GDP to 11.8% in 2060 due to changes in the population structure.

Growth in outlays, for among others those depending on demographic changes, will also be seen in expenditures for health care, which will rise by 1.7 p.p. by the end of the projection period. Expenditures for long-term care will rise fastest, as their volume will approximately double. In volume terms, however, these constitute by far the lowest expenditure item.

The sustainability analysis, which proceeds from the long-term projections, identifies the extent of fiscal consolidation necessary to ensure stability of public finances. So-called sustainability indicators are calculated and show what measures would need to be carried out to decrease expenditures or increase revenues as a percentage of GDP so that they correspond to the required levels. Currently, the S1 indicator, which expresses by what percentage of GDP it is necessary to raise revenues or reduce expenses so that the state debt at the end of the projection horizon (i.e. in 2060) is 60% of GDP, comes to 3.8% of GDP. The S2 indicator, which specifies the amount of fiscal effort necessary for reaching parity of discounted revenues and expenditures on an infinite horizon, stands at 6.1% of GDP.

The sustainability analysis has improved to a certain degree in relation to the last round of projections. This can be attributed to reform measures carried out in the pension system, and in particular the increase in the retirement age.

The current fiscal position is a negative factor for long-term development, resulting in faster accumulation of debt due to the unfavourable macroeconomic situation and debt crisis as well as to the relatively high deficits. This will lead to significant growth in interest costs.

5.2 The Government's Strategy – Reforms

Reform measures in the pension and health care systems have recently been implemented, aiming, on the one hand, to improve long-term sustainability and, on the other, to diversify the risks of allocating funds to ensuring living standards in old age.

5.2.1 Parametric Adjustments

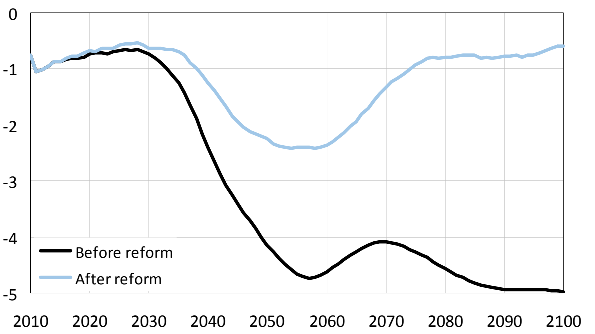
In response to a ruling of the Constitutional Court finding a part of the provisions of the act on pension insurance stipulating the calculation of pension entitlement (in particular the section on the amount of reduction thresholds) to be unconstitutional, a set of parametric changes to the pension system was approved effective from 30 September 2011.

The proposed solution changes the design of the pension calculation by "binding" the reduction thresholds to the average wage; the first reduction threshold on 44% and the second reduction threshold on 400% of the average wage, reducing the contribution between the first and second reduction thresholds to 26%, decreasing the contribution above the second reduction threshold to 0%,[5] and progressively extending the decisive period to be lifelong. The stated measures were designed so that they have no effect on the state budget.

The retirement age for men will continue to rise at the current pace, i.e. by 2 months per year, even after reaching the age limit of 65 years. For women, the rate of increasing the retirement age for those born in 1956 and after should rise 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 months, without limitation. The automatic rise in the statutory retirement age and the rate thereof approximately correspond to life expectancy, which, among others, was also one of the Council's recommendations (2011). A benefit of this indirect linking mechanism is that it makes predicting the age limit easy.

The overall rise in pensions paid (regular valorisation) will, as it has until now, correspond to growth in the consumer price index and to one-third of growth in real wages.[6] Valorisation will be carried out, however, by a decree in accordance with specifically established rules. Thus would end the possibility for the government to raise pensions at its discretion, which has occurred repeatedly in the past.

Chart 5.1: Projection of a Pension Account Balance Before and After the 2011 PAYG Reform
(in % of GDP)



Note: The dissimilarities in balances from the EPC/AWG are explained by different macroeconomic assumptions.
Source: Ministry of Labour and Social Affairs.

The penalty for early retirement was increased, thereby reducing the attractiveness of retiring before reaching the legal retirement age.

The stated measures should significantly strengthen the stability of the pension system (see Chart 5.1). Although the balance will likely remain in deficit for the entire period, this still constitutes a substantial improvement compared to the scenario without the parametric changes. Only in the critical period of 2045–2064 should the pension system deficit fluctuate around 2.4% of GDP. The pension account deficit at the end of the projection, after parametric changes, is estimated at around 0.6% of GDP, as compared to ca 5% of GDP without the reform. The scope of the parametric adjustments thus demonstrates the difference in pension account deficits at the close of the projected horizon, which is ca 4.4% of GDP.

5.2.2 Pension Reform

Reform of the pension system comprises introduction of pension savings pillar. The Czech Parliament approved the reform in November 2011 and the pension savings pillar should start to operate from the beginning of 2013.

The act introduces the (capital) pension savings pillar with voluntary entry for persons under 35 years of age at the time of initiating the reform. Persons who are older than 35 years at the time of reform's initiation and are not old-age pension receivers will be allowed to decide about joining the pension savings pillar within half a year after the reform's initiation – that is the first half of 2013. This measure, however, is valid only for those employed (or self-employed) at the time of the reform's initiation, not for persons unemployed or economically inactive. For such persons, the period of 6 months will begin running from the time they first become pension insurance payers after the reform's initiation. It will not be possible in future to change the decision taken by an insured person.

Financing of the pension savings pillar will be provided by funds transferred from participants in the first pillar in an amount of 3 p.p. from the total contribution rate of 28% (the employee pays 6.5 p.p. and the employer 21.5 p.p.). In addition to this, each insured person will have to pay an additional 2 p.p. from his or her own sources. The total contribution rate is thus increased to 30%, of which 25 p.p. will be directed into the existing PAYG system and the remaining 5 p.p. into the new pension savings pillar.

In the accumulation phase, the funds will be administered by pension companies, which will be obliged to offer their clients four funds with varying levels of risk: government bonds, conservative, balanced and dynamic. The pay-out phase for the saved funds from the pension savings pillar will be provided by a life insurance company selected by the participant. It will be

[5] Thus, the system in fact has a ceiling at 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] The government recently approved a temporary change in the valorisation model for the period 2013–2015 to one-third of the growth of real wages and one-third of the consumer price index.

possible to draw the paid benefit either in the form of a life-long annuity (optionally, as an alternative, with an agreed payment of a survivor's pension for 3 years from the death of the participant to a person designated by the participant in the pension insurance contract, and who need not be the same person entitled to the survivor's pension from the first pillar) or an annuity paid for 20 years (in case of earlier death, the remaining funds will be subject to inheritance).

Fees paid to pension companies are explicitly defined by the Act on Pension Savings (No. 426/2011 Coll., Section 32). Fees are established for managing assets in pension funds and for growing the assets in the pension funds (except for government bond funds).

Participation in the pension savings pillar will of course have an impact on the old age pension amount, but not on the amounts of other pensions (disability and survivor's).

For old age pensions, the percentage used in calculating the pension from the first pillar will be reduced for participants of pension savings pillar from 1.5% to 1.2% regarding the time they are employed.

Creation of the pension savings pillar will result in an immediate decrease in revenues for the PAYG first pillar, compensated by lower expenditures in future. The government will cover this temporary period using additional revenues from the higher reduced VAT rate (see Chapters 3.2.1 and 6.1.1). It should be mentioned that if the revenue connected explicitly with the pension system would be insufficient, analyses of long-term sustainability would not be able to take this component into consideration.

It is not possible at present to determine the specific impact of the reform, as any such estimate would be a pure speculation. Because participants will begin to commit themselves only after the reform's initiation and to a certain extent everything depends on confidence in the reform, as well as on, for example, the informational campaign, no qualified assumption can be made at the present time.

5.2.3 Reform of the Health Care Financing System

Now relevant in the health care system are in particular changes in the benefits area, changes in categorisation for levels of hospital care, and adjustment in the amounts of regulatory fees and co-payments. Detailed information about reforms in the health care sector is presented in Chapter 6.2.2.

5.2.4 Government Guarantees

In addition to the fiscal impacts of an aging population on the sustainability of public finances, the state of government guarantees should also be mentioned. In the Czech Republic, the most important components in this area are loan guarantees for infrastructure projects and investments in railway transport (approximately 0.6% of GDP), guarantees for liabilities of the Export Guarantee and Insurance Corporation and the Czech Export Bank (around 9% of GDP), and guarantees in relation to CNB and CSOB ensuing from resolution of the crisis in 2000 involving the former Czech bank IPB. The last guarantee that the government had provided was one for the purchase of coaches for Czech Railways in 2007. Altogether, these guarantees totalled ca 13.8% of GDP at the end of 2011, of which the guarantees related to IPB represent approximately 4.1% of GDP. It should be mentioned, however, that the settlement of the latter guarantee in relation to CNB and the bank CSOB, which has a payment date at latest by 2016, is expected to be only a fraction of that amount (to date, CZK 5.7 billion has been paid, i.e. ca 0.1% of GDP). For 2012, 0.2% of GDP is expected to be paid out in the area of government guarantees.

6 Quality of Public Finances

Within the years of the outlook, both the revenue and expenditure sides of public finances will undergo significant changes. Long-term planned reform measures, such as the pension system reform (effective from 2013) and the reform of direct taxes and levies in relation to the creation of a Unified Revenue Collection Agency (expected to be in effect from 2014), were supplemented by a number of components which should prevent a rise in public finance deficits due to economic growth that is lower than expected. The range of consolidation measures, some of which are only planned as temporary, is extensive and, through changes in the tax system and in the public expenditures area, affects all parts of the population.

6.1 Changes on the Revenue Side

6.1.1 Value Added Tax

Starting from 2012, the reduced VAT rate was raised by 4 p.p. to 14%, while the base rate remained unchanged at 20%. In connection with continuing efforts to consolidate public finances, both rates are planned to go up by an additional 1 p.p. as from 2013. This adjustment is intended to be only temporary, with validity through the end of 2015. Unification of the two rates at 17.5%, which was originally planned for the start of 2013, would not occur until 2016.

From 2014, the level of turnover for mandatory VAT registration will be cut from CZK 1 million to CZK 750,000. Starting from 2012, the list of activities for which the reverse charge regime will be used upon fulfilling given conditions was expanded to include construction and assembly works. Pilot introduction of the reverse charge mechanism has been in place already since April 2011.

6.1.2 Personal Income Tax

The basic tax exemption per taxpayer returned to its 2010 level in 2012 (i.e. CZK 24,840 annually) and will remain there in the coming period. A 1-year decrease of the exemption had been designed so that income from this operation could be used for covering and correcting the impacts of flood damage. The Concept of Reform of Direct Taxes and Levies, however, assumes that from 2014 this basic exemption will be provided only to the taxpayers with income up to four times the monthly average wage. As compensation for the increase in the reduced VAT rate, starting from 2012 the tax benefit for having a child was increased from CZK 11,604 to CZK 13,404 annually and the maximum limit for the total annual amount of tax benefit for having children rose by CZK 8,100 to CZK 60,300. Cancellation of the basic allowance for working pensioners has also been proposed for the period 2013–2015 (i.e. a return to the situation valid until 2007), and cancellation of the employees tax credit has been proposed for 2014 and 2015.

The statutory personal income tax rate should rise to 19% starting from 2014. The tax base, on the other hand, should decrease and constitute only the gross wage, not the gross wage inclusive of social security contributions paid for the employee by the employer. Nevertheless, the set of temporary consolidation changes considered for 2013–2015 counts upon a 1 p.p. increase in the rate to 20% for 2014–2015. Starting from 2016, the rate should fall back to the aforementioned 19%. Introduction of a statutory progression component in the personal pension tax structure has also been proposed. This would create a sort of solidarity surcharge of 7% of income above the ceiling for social insurance.

For self-employed persons, the application of certain limitations on using flat-expense deduction is being considered. The individual levels of the deductions will be preserved. For activities included under the deductions of 40% and 30%, however, the amount of income for applying the flat-expense deduction will be limited to CZK 2 million. Thus not all persons benefiting from these deductions will be able to apply certain tax exemptions, i.e. items deductible from the tax base and items decreasing the tax (with the exception of the basic tax credit per taxpayer, tax credit for people with physical disabilities, and certain others). Starting from 2013, the withholding tax on income of foreign tax residents of all countries and jurisdictions with which the Czech Republic has not yet concluded an agreement on preventing double taxation will also be increased.

Deduction of mortgage interest also will be restricted within the years of the outlook, while the ceiling for exemption from the tax on income from employers' contributions to supplementary pension insurance and life insurance will be raised (from CZK 24,000 to CZK 30,000 per year). A tax exemption for income from profit sharing and dividends will be newly introduced.

6.1.3 Corporate Income Tax

The exemption of incomes from lotteries and similar games was abolished as from 2012. At the same time, an income tax of 20% was introduced for the difference between amounts wagered and winnings paid out. Important changes related to the corporate income tax will occur as from 2014 in relation to the act already adopted on a Unified Revenue Collection Agency (changes planned already in CP 2011). In addition to the exemption of dividends and increase in the limit for gifts to 10%, the rate for investments and pension funds will be annulled.

6.1.4 Excise Taxes

The tax rate on cigarettes, cigars and cut tobacco increased as from January 2012. A further increase of the excise tax is planned from the beginning of 2014 in order to conform to the European regulation (minimum excise tax EUR 90 per 1,000 cigarettes).

Starting from 2014, an emission component of the excise tax on fuel oils and solid fuels (the so-called "carbon tax") should be introduced. The proposed tax rate amounts to €15/t of CO_2. Natural gas used for household heating, which is currently exempt from excise tax, will be newly subject to taxation. "Green diesel fuel", i.e. the excise tax exemption on mineral oil for agricultural producers, will also be abolished. Taxation of non-sparkling wine is being considered, as well, at a possible rate of CZK 10 per 1 litre.

6.1.5 Social and Health Insurance

The range of mandatory insured persons was expanded from 2012. Employees working on the basis of a contract for services now participate in social and health insurance. Social and health insurance contributions are not paid for contracts under CZK 10,000 per month (in the case of multiple contracts from a single employer, the amounts are added together).

Participation in health and pension insurance will be newly established, for example, for members of collective bodies of legal entities, liquidators and company secretaries (if their income for performing activities in these bodies is regarded as income from employment). The range of health-insured persons has also been expanded to include other employed persons who hitherto only participated in pension insurance. Such persons include, for example, partners and statutory executives of limited liability companies and limited partners in limited partnership companies.

The contribution on public health insurance for 2012 is capped at six times the average wage, while this ceiling is expected to be completely eliminated for the period 2013–2015. Contribution payments for social insurance are limited to a ceiling of four times the average wage as from 2012. Starting from 2014, both the social insurance and the public health insurance contribution rate will be set at 6.5% for employees. The same rate will be applied for self-employed persons – the total rate will be 13%, while their assessment base for social and public health insurance will be 100% of gross income.

The base for calculating social and health insurance is expected to be broadened starting from 2014 to include benefits previously exempt from these payments provided by the employer to its employees.

6.1.6 Inheritance, Gift and Real Estate Transfer Tax

After 2012, the gift tax will no longer apply to emission permits, as they will be transferred to applicants by means of auctions (replacing the current transfer at no charge).

A 1 p.p. increase in the real estate transfer tax to 4% is proposed with effect as from 2013.

6.1.7 Other Taxes

According to the proposal, a new indirect tax on insurance premiums should be introduced. Specific parameters, such as the rate, individual insurance types and extent of the tax assessment base and exemptions, are currently under discussion.

6.2 Changes on the Expenditure Side

6.2.1 Unemployment Benefits

The amount of unemployment benefits and duration of their payment remain the same as last year, though certain conditions for entitlement to unemployment compensation have changed as from 2012. The period over which it is necessary to obtain at least 12 months of pension insurance has been shortened from three years to two.

The primary change concerns the offer of up to 20 hours of public service per week for job seekers listed in the Labour Office's register for over 1 year without interruption, listed in the register for a total of more than 1 year over the last 3 years, or for whom there is reasonable suspicion of performing illegal work or deceptive registration. If the job seeker refuses this offer without a serious reason, he or she will be removed from the register of job seekers.

Starting from 2012, job applicants may choose for themselves a specific requalification course to complete. The selection is subject to approval by the Labour Office, which also sets the maximum limit for reimbursing the cost of requalification. If this limit is exceeded, the job seeker must cover the price difference.

6.2.2 Pensions

One step which should prevent a more significant increase in public budget deficits in the years of the outlook is a temporary adjustment of the pension valorisation mechanism. During 2013–2015, pensions should be raised by 1/3 of the growth in prices and by

1/3 of the growth in real wages. Thus the current 100% reflection of growth in the price level will be limited.

Two fundamental adjustments were made in the pension system in 2011. The parameters of the current PAYG system were significantly modified (see Chapter 5.2.1) and, at the same time, laws enabling the creation of a capital pension savings pillar were approved (main features are presented in Chapter 5.2.2).

6.2.3 Health Care System Reform

A number of reform laws became effective in the health care system during 2012, thereby adjusting the conditions for providing health care services and the activities of emergency medical service.

An above-standard, more costly, variant of care has now been defined. If a patient opts for this variant of treatment, he or she will be obliged to pay the difference between the actual cost and the standard amount paid by the health insurance company. The currently limited list of activities defined as above-standard will be expanded in the coming years.

As a result of the implemented reform, patients' contribution to covering the cost of health care will slightly increase. Patients will pay from their own funds for all medicaments available without a prescription, regardless of price. The fee for one day's treatment at a hospital is increased from CZK 60 to CZK 100 from 1 December 2011.

As part of efforts to rationalise the provision of health care, a portion of acute care beds will be terminated in the coming period and transformed into beds for follow-up and social care, with lower personnel and financial demands. This restructuring will be accompanied by development of so-called one-day surgery.

A new act on health insurance companies, currently in preparation, is planned to take effect from 2014. The act will clearly define insurance companies as non-profit institutions and will reinforce the Ministry of Health's supervisory role over their finances. A collection of new acts should also facilitate the introduction of two-component insurance. In addition to the basic insurance tied to the insured person's income and subject to redistribution, there will be also a second component the amount of which will differ between individual insurance companies in accordance with the products and services they offer. As a result of defining above-standard care, and in connection with the planned insurance companies act, more substantial commercial development of health care insurance should occur after 2014.

6.2.4 State Social Support and Benefits in Case of Material Need

A new adjustment of parental benefits will facilitate flexible selection of length and amount, depending on a family's current social situation. Up to CZK 220,000 may be drawn in total until a child reaches 4 years of age. The maximum amount of parental benefits is limited by the amount of support provided during maternity, and it cannot exceed CZK 11,500 monthly.

As from 2012, benefits for aid in case of material need and state social support benefits are paid by labour offices from the single payment point. Cancellation of the housing supplement in the system of material need is thus planned as from 2013, as this constitutes a supplement to the housing contribution from the state social benefits support system. The two-level assessment of entitlement to financial housing support is therefore no longer justified.

6.2.5 Public Procurement

An amended act on public tenders took effect on 1 April 2012. The new act should significantly improve transparency and reduce potential for corruption in this area. For example, it abolishes the majority of qualification conditions making it possible to tailor a tender to the characteristics of a specific supplier. Moreover, a procurement process must be cancelled if in the last round only one bid remains to be considered. It is now possible to open a tender without competition only with a significantly reduced performance ceiling for such tender. With certain exceptions, the possibility to reduce the number of contenders by lottery was eliminated. The procurer may now define in advance in the tender documentation what activities must be performed by the supplier directly and not by a sub-supplier. The procurer is now obliged to publish procurement documentation on its website. Timetables were also adjusted. For example, a short deadline for submitting offers when reasons of urgency do not permit adherence to the standard timetable was eliminated.

6.2.6 Simplification of Agendas

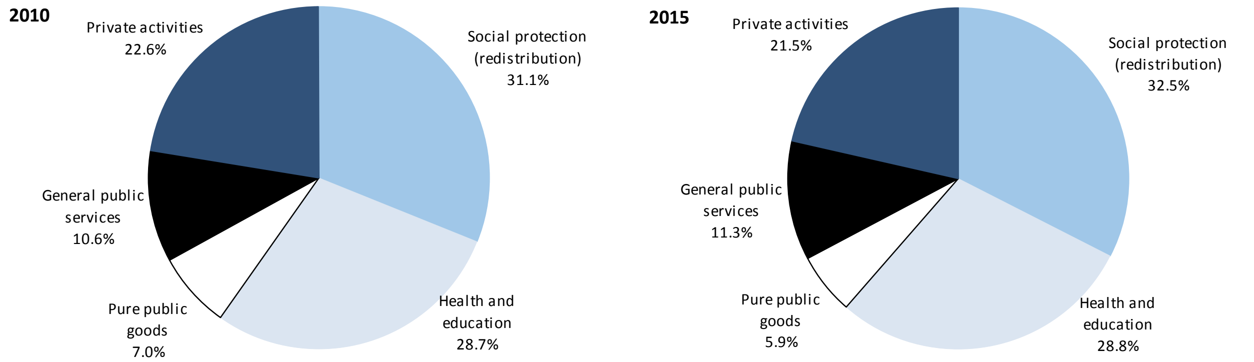
Steps for simplifying agendas and creating savings without reducing quality are proposed based on the results of process modelling for public administration agendas, their interconnectedness, expenses, revenues, risks and necessity. Based on the analysis, state funds and the Agriculture and Forestry Support and Guarantee Fund should be integrated while selected ministries should be merged.

6.3 Composition of Public Expenditure

Between the years 2010 and 2015, we expect very limited nominal growth in government expenditures (5.6% for the entire period). As a proportion of GDP, total expenditures will decrease from 44.1% in 2010 to 41.1% in 2015. Public spending will decline almost in all observed categories in relative terms (see Table A.3 in the appendix). The only exception is the area of environmental protection, where we expect significant growth of expenditures in connection with ongoing removal of environmental damage from the past. Expenditures for general public services will record fast nominal growth and only a marginal decrease in relative terms, due exclusively to increasing outlays for servicing the state debt. A significant spending decrease in the category of economic affairs is expected, both due to savings generated by further increasing the efficiency of the public procurement system (see 6.2.5) and to limiting inefficient public investments as part of austerity measures.

Chart 6.1 portrays the composition of public outlays in 2010 and the expected structure of expenditures in 2015. A slight shift of funds towards the redistribution area is apparent, especially at the expense of expenditures for private activities and pure public goods (defence, public order and security). The share of social expenditures in total public expenditures will grow especially due to the ongoing changes in population structure. Moreover, the space for consolidation measures is more limited than in other areas of the public sector due to the mandatory nature of these expenditures.

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 (2012d). MF CR calculations.

7 Institutional Features of Public Finances

The government's fundamental priorities also include institutional changes to reinforce the domestic fiscal and budgetary framework and to support healthy, transparent and responsible general government sector financing sustainable over the long term. In particular, this involves submission of the constitutional act on budgetary discipline and responsibility and creation of the independent National Budgetary Council. The measures being prepared should limit the tendency towards use of deficit financing, support anti-cyclical fiscal policy, limit information asymmetries, and support credibility and transparency of published indicators on general government finances. Steps for implementation of the Directive on Requirements for Budgetary Frameworks of the Member States are also gradually implemented in connection thereto.

7.1 Fiscal Framework Reform

In the first half of this year, the government will prepare a legislative proposal defining the principles of budget discipline and responsibility and covering the fiscal framework. The main pillars of the constitutional act on budgetary discipline and responsibility will include ensuring consistent coverage of the entire government sector by numeric fiscal rules, anchoring the maximum limit for the amount of government debt, tightening budgetary rules for the local governments, establishing transparency rules for publishing selected information and establishing the National Budgetary Council.

The current "deficit" rule of fiscal targeting will be replaced with an expenditure rule consisting in stipulation of an expenditure ceiling, e.g. maximum growth in modified nominal outlays of the central government and health insurance companies. The development of total nominal expenditures, net of predefined items not under the government's direct control or not affecting achievement of the medium-term budgetary target, will be harmonised with the average growth of potential product increased by the GDP deflator. If the government sector does not achieve the medium-term budgetary target, the average growth of nominal expenditures will automatically be further decreased. Nominal spending will be derived from the adjusted nominal expenditures and expenditure growth rates for the following 3 years. Total nominal expenditure framework for the following three budgetary periods will be derived by adding the predefined expenditure categories and, as appropriate, deducting discretionary measures decreasing revenues. The proposed expenditure rule will take into account the economy's growth potential and will support orientation of the fiscal policy toward a medium-term budgetary target using automatic correctional mechanisms. Its flexibility leaves room for automatic fiscal stabilisers. The rule reflects the so-called pay-as-you-go principle, i.e. newly created expenditures and measures decreasing revenues must be compensated. This will ensure that expenditures do not grow faster than revenues in the medium and long term.

The new legislation will restrict regional self-governing bodies' use of financing from long-term loans exclusively to investments in fixed tangible assets, repairing damage caused by natural or other disasters, and financing of projects co-financed by the EU. The clause declaring that the central government does not secure and is not responsible for insolvency of municipalities and regions will be reinforced. On the other hand, the state will be obliged to provide adequate financial compensation whenever delegating competence to local authorities. A new fiscal rule for local government institutions requiring that budgetary financing of a municipality, region or association of municipalities always be in balance or in surplus for all eight previous budgetary periods will also be introduced. If a local government institution does not fulfil this requirement, it will be obliged to do so within 3 years. Insufficient consolidation efforts to repair an accumulated imbalance will be penalised by withholding a portion of shared taxes or by sanctions.

In the case of not adhering to the operative numerical fiscal rules, the system will be further supplemented by the so-called debt brake, which will automatically be activated at the point when government debt exceeds 40% of GDP. Upon crossing this threshold, automatic corrective measures will be gradually initiated and the government as well as local authorities and health insurance companies will be obliged to fulfil them. The debt brake will be divided into three phases, and the measures will be gradually expanded. In the first phase, the government will present to the Chamber of Deputies measures to reduce the debt ratio at minimum to the amount determined after consulting the independent National Budgetary Council and Ministry of Finance. In the next phase, the government will not be permitted to present the Chamber of Deputies with proposals for the state budget, state funds budgets and insurance plans of health insurance companies containing a year-on-year nominal increase in expenses. In this phase, regional self-governing bodies will approve their budgets for the following budgetary year with maximum expenditures in the same amount as those in the previous budget. Wages of institutional officials will also be decreased and the wage base of state administration employees will be frozen. In the next phase, the government will, in addition to the previous measures, not be permitted to present deficit proposals for the state budget, state funds budgets and health insurance plans of health insurance companies. Local authorities will only approve balanced or surplus budgets for the following budgetary year. If government debt reaches 50% of GDP, the government will request a vote of confidence from the Chamber of Deputies. The debt brake will not be put into operation in the case of escape clauses which will be analogous to the expenditure rule. These will correspond to a significant year-on-year decrease in GDP and expenditures related to repairing the after-effects of disasters and catastrophes, settlements ensuing from international agreements, and pronounced changes in the price level.

The reform of the fiscal framework will be assisted by the independent National Budgetary Council through its support in preparing, evaluating and monitoring fiscal policy. Its establishment will strengthen the enforceability of fiscal rules and the transparency and credibility of the basic pillars of the national fiscal framework. The Council's basic competencies will include monitoring the transparency of fiscal policy and the budgetary process, evaluating the fulfilment of numerical fiscal rules, and presenting a report on the long-term sustainability of public finances. In addition to its basic competencies, it also will provide ad hoc opinions on the budgetary impacts of legislative proposals, important systemic adjustments and reforms. Financing of the Council's activities will be conceived so as to ensure its independence from the government.

7.2 Tax Administration

The government was presented with an amendment to the act on budgetary determination of taxes. Its main principles include strengthening the shared taxes of municipalities and decreasing the disproportion in per capita incomes among municipalities. The proposal increases the proportion of shared taxes of municipalities at the expense of state-wide subsidy programmes from the state budget. The second stated target is intended to be fulfilled not only by increasing shared taxes generally, but also by decreasing them for the largest cities, for which partial compensations are expected in connection thereto in the following four years. The proposal also contains an amendment of the criteria applied in redistributing shared taxes. The weight of the population criterion is increased and inclusion of a criterion for number of pupils in primary schools and kindergartens has been proposed. The amendment is proposed to become effective from 1 January 2013.

At present, taxes are managed by financial offices, social security contributions by regional social security authorities, and public health insurance contributions by health insurance companies. The material and procedural legislation is also different for each type of payment. The purpose of introducing the Unified Revenue Collection Agency (see e.g. MF CR, 2010) is to unify legislation and to transfer the administration of insurance contributions to financial offices. This will lead to a decrease in administrative costs for both the state and payers and will improve the efficiency of administration. The appropriate legislation has already been approved, but additional legislative adjustments are expected – in particular, creation of a single law replacing the existing legal arrangement, facilitating closer unification of legal regulations and moving the effectiveness date from 2015 to 2014.

The payment of benefits in the case of material need, state social benefits, and unemployment benefits (i.e. more than 20 different types of social benefits) will now be performed by labour offices from a single payment point. This measure will complete the process of switching the payment and administration of non-insurance social transfers to direct performance of the state administration. The implemented changes will also significantly improve the quality of the information-data environment.

7.3 The State Treasury

The Integrated State Treasury Information System project is entering its final phase. Its main purpose is to create an effective tool for efficiently achieving government priorities and targets by means of an automated, integrated and transparent environment. At the same time, its basic intention is to secure high-quality, timely and coherent information necessary for properly objective management of state finances. Toward this end, an extensive amendment was prepared of the budgetary legislation setting out new duties for the state organisational components and state semi-budgetary organisations included in the Budgetary Information System. It incorporates several relevant areas (e.g. budget preparation, budgetary measures and the payment system).

In the area of budget preparation, prerequisites for better prioritisation and evaluation of individual expected budgetary tasks when preparing the state budget will be created. This module incorporates the necessary development in the area of the budgetary system for drawing up and approving the state budget, the medium-term outlook, the procedure for creating a provisional budget, as well as amendments to the state budget act. This constitutes an intuitive budgetary system which maximally takes into account the demands for ease of use and administration.

The part of the module on budgetary measures includes especially changes related to maintaining detailed budgets of state organisational units, approving and implementing budgetary measures, and collecting data for evaluating fulfilment of the state budget, including data on the provisional budget. The data should ensure balanced (in the accounting sense) budget reports at all times, allow concurrent processing of multiple documents as a single unit (concurrent entry of chronological data, common reporting, etc.) and approval of changes in the Employment Regulation, and manage the Integrated State Treasury Information System as the primary system for recording budgetary measures.

The payment system module comprises the most significant changes in the budget implementation phase. These relate especially to reserving state budget funds, verification of such reservations for accepting payment orders from CNB, processing of data on payments executed by CNB, structures of accounts of state organisational units, establishment of budgetary limits, and their operations with advances.

The payment system module will enable efficient management of state finances and will foster transparency in spending of state funds. It will also make possible partial realisation of state fiscal policy targets, efficient preparation and transparent implementation of the state budget, and, last but not least, ex-ante and ex-post controls over outlays.

The central accounting information system will ensure conditions enabling the acceptance of accounting records from accounting units via a defined transfer channel as well as implementation of processes leading to compilation of consolidated accounting and statistical reports.

The purposes of the Integrated State Treasury Information System are to support and implement processes and activities of the State Treasury consisting in open planning; recording and realisation of state revenues and expenditures; investment, non-investment and financial accounting for state property; immediate accounting recording of any movement in the handling of state assets and liabilities; introducing automated financial and administration controls when spending state budget funds; and reporting on the state's financial management. All of this will be fully automated and in real time.

7.4 State Accounting

Implementation of an accounting reform in the area of public finances was initiated on 1 January 2012. As part of efforts required to unify the collection of information from accounting units managing public budget funds within the Central State Accounting Information System, on 1 January 2012 the use of certain accounting methods was refined and the format of transferred information was unified.

In order to secure information for the purposes of monitoring and managing public finances (including international reporting in the area of government financial statistics: ESA 95 and GFS 2001) based on requirements stemming from European directives on the European System of National and Regional Accounts in the Community, as well as directives on application of the Protocol on the Excessive Deficit Procedure attached to the Treaty establishing the European Community, the transfer of the Auxiliary Analytical Overview by selected accounting units was introduced.

Another reason for the adjustments in legal regulations in the accounting area was the creation of prerequisites for consolidation of individual financial statements for the purpose of compiling consolidated financial statements for the Czech Republic, including the state's so-called consolidation units. Further improvements will continue in the following years.

7.5 Supreme Control Office

The proposal of a constitutional act amending the Constitution of the Czech Republic and the Supreme Control Office Act entered into a second reading in the Chamber of Deputies. The new legislation would authorise the Supreme Control Office to conduct control activities not only in relation to state property and the state budget, as is currently the case, but also in relation to the property of regional self-governing bodies (including their budgets) and other legal entities of a public nature (health insurance companies, public research institutions, associations of municipalities, semi-budgetary organisations of regional self-governing bodies, regional councils of the cohesion regions, Czech Television, Czech Radio, public universities, CNB). The broadening of the Supreme Control Office's control competence to include other public legal entities and their operations with public funds is an important development, despite the fact that for regional self-governments, the CNB and universities only the lawfulness and not the purposefulness and economy in use of public fund expenditures will be controlled. Control competence over funds provided to the state from abroad would also be added into the Constitution.

7.6 Act on Financial Supervision

A proposal for a comprehensive amendment of the act on financial supervision in public administration was presented at a meeting of the government. The amendment will ensure unification of national legislation with EU law, fulfilment of the functions of the national supervisory authority and the auditing authority for verifying the appropriateness of drawing other foreign funds, and implementation of the directive on requirements for budgetary frameworks of the member states. The reasons for adopting the amendment are also evident in the effort to divide and separate the responsibility of public budget administrators for financing administration and control systems and for audit within their competencies. A two-level system will thus be created in the Czech Republic's public administration. Current public control will be divided institutionally and in terms of content into control performed as part of financial administration within the authority and responsibility of the administrative and executive structures and audit in public administration performed within the authority and responsibility of a department that is organisationally and functionally separated from the management and executive structures. In relation to the State Treasury, the act will define incontestable obligations and responsibilities of the individual officials.

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Table Annex

Table A.1a: Macroeconomic Prospects

(level in CZK billion, growth in %)

	ESA Code	2011 Level	2011	2012	2013 Rate of change	2014	2015
1. Real GDP	B1*g	3842	1.7	0.2	1.3	2.2	2.8
2. Nominal GDP	B1*g	3809	0.9	2.1	2.7	3.7	4.4
Components of real GDP							
3. Private consumption expenditure	P.3	1891	-0.5	-0.4	0.2	2.0	2.8
4. Government consumption expenditure	P.3	814	-1.4	-3.7	-0.5	-1.8	-0.2
5. Gross fixed capital formation	P.51	928	-1.2	-0.5	2.1	2.8	3.2
6. Changes in inventories and net acquis. of valuables (% of GDP)	P.52+P.53	23	0.5	0.8	0.7	0.9	1.0
7. Exports of goods and services	P.6	2600	11.0	3.2	3.7	4.8	5.1
8. Imports of goods and services	P.7	2415	7.5	2.1	2.8	4.1	4.8
Contributions to real GDP growth							
9. Final domestic demand		-	-0.8	-1.1	0.5	1.3	2.2
10. Changes in inventories and net acquis. of valuables	P.52+P.53	-	-0.1	0.3	0.0	0.2	0.2
11. External balance of goods and services	B.11	-	2.6	1.0	0.8	0.8	0.5

Note: Real levels are stated in 2010 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 (2012a), MF CR (2012a). MF CR calculations.

Table A.1b: Price Developments

(indices 2005=100, growth in %)

	2011 Level	2011	2012	2013 Rate of change	2014	2015
1. GDP deflator	105.3	-0.7	2.0	1.4	1.4	1.5
2. Private consumption deflator	112.2	1.8	3.3	2.3	1.8	2.0
3. HICP	116.2	2.1	3.5	2.3	1.9	2.1
4. Public consumption deflator	114.6	-0.2	2.0	1.3	1.7	1.6
5. Investment deflator	103.7	-0.1	1.3	1.4	1.1	1.3
6. Export price deflator (goods and services)	92.9	0.3	2.3	1.1	0.4	0.2
7. Import price deflator (goods and services)	99.1	2.7	2.9	1.5	0.7	0.4

Source: CZSO (2012a), Eurostat (2012). MF CR calculations.

Table A.1c: Labour Market Developments

(growth in %)

	ESA Code	2011 Level	2011	2012	2013 Rate of change	2014	2015
1. Employment, persons		5067	0.3	-0.3	0.1	0.2	0.4
2. Employment, hours worked		9.0	-0.9	-1.0	-0.2	0.0	0.1
3. Unemployment rate (%)		6.7	6.7	7.0	7.2	7.1	6.9
4. Labour productivity, persons		760	1.4	0.5	1.2	2.0	2.5
5. Labour productivity, hours worked		423	2.6	1.2	1.5	2.3	2.7
6. Compensation of employees	D.1	1599	1.4	1.4	2.8	3.7	4.4
7. Compensation per employee		387	1.6	2.5	2.9	3.6	4.1

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 2010 prices) per employed person or worked hour.
Source: CZSO (2012a, 2012c). MF CR calculations.

Table A.1d: Sectoral Balances

(in % of GDP)

	ESA Code	2011	2012	2013	2014	2015
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	**-1.5**	**-1.1**	**-0.9**	**-0.8**	**-0.8**
of which : Balance on goods and services		4.1	4.7	5.1	5.4	5.6
of which : Balance of primary incomes and transfers		-7.7	-7.7	-8.0	-8.2	-8.4
of which : Capital account		1.8	1.8	1.9	1.8	1.8
2. Net lending/borrowing of the private sector	B.9	**1.6**	**1.9**	**2.0**	**1.1**	**0.1**
3. Net lending/borrowing of general government	EDP B.9	**-3.1**	**-3.0**	**-2.9**	**-1.9**	**-0.9**
4. Statistical discrepancy		**0.0**	**0.0**	**0.0**	**0.0**	**0.0**

Note: Data from national accounts. Years 2011–2012 notification. Years 2013–2015 outlook.
Source: CZSO (2012b). MF CR calculations.

Table A.2a: General Government Budgetary Prospects

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

	ESA Code	2011	2011	2012	2013	2014	2015
		Level			*In % of GDP*		
Net lending (+)/borrowing (-) (EDP B.9) by sub-sectors							
1. General government	S.13	-118	-3.1	-3.0	-2.9	-1.9	-0.9
2. Central government	S.1311	-101	-2.6	-2.7	-2.7	-1.8	-0.9
3. State government	S.1312	-	-	-	-	-	-
4. Local government	S.1313	-10	-0.3	-0.2	-0.2	0.0	0.0
5. Social security funds	S.1314	-8	-0.2	-0.1	-0.1	0.0	0.0
General government (S.13)							
6. Total revenue	TR	1534	40.3	40.2	40.2	40.4	40.2
7. Total expenditure [1)]	TE	1652	43.4	43.2	43.1	42.2	41.1
8. Net lending (+)/borrowing (-)	EDP B.9	-118	-3.1	-3.0	-2.9	-1.9	-0.9
9. Interest expenditure [1)]	EDP D.41	53	1.4	1.5	1.6	1.7	1.8
10. Primary balance		-65	-1.7	-1.5	-1.3	-0.1	0.8
11. One-off and other temporary measures		-5	-0.1	-0.3	-0.1	0.0	0.0
Components of revenues							
12. Total taxes		727	19.1	19.5	20.2	20.3	20.2
12a. Taxes on production and imports	D.2	439	11.5	12.1	12.4	12.4	12.4
12b. Current taxes on income, wealth etc.	D.5	284	7.5	7.4	7.7	7.9	7.8
12c. Capital taxes	D.91	4	0.1	0.1	0.0	0.0	0.0
13. Social contributions	D.61	592	15.5	15.4	14.8	15.2	15.4
14. Property income	D.4	28	0.7	0.6	0.5	0.4	0.4
15. Other		187	4.9	4.7	4.6	4.4	4.2
16. Total revenue	TR	1534	40.3	40.2	40.2	40.4	40.2
p.m.: Tax burden		1319	34.6	34.9	35.0	35.5	35.6
Components of expenditures							
17. Compensation of employees + Intermediate consumption	D.1+P.2	501	13.2	12.7	12.2	11.5	11.0
17a. Compensation of employees	D.1	278	7.3	7.2	7.1	6.8	6.5
17b. Intermediate consumption	P.2	223	5.9	5.5	5.2	4.8	4.4
18. Social payments		759	19.9	20.0	19.9	19.6	19.2
of which: Unemployment benefits [2)]		22	0.6	0.5	0.5	0.5	0.4
18a. Social transfers in kind supplied via market producers		228	6.0	5.8	5.7	5.6	5.5
18b. Social transfers other than in kind	D.62	531	14.0	14.2	14.1	14.0	13.7
19. Interest expenditure [1)]	EDP D.41	53	1.4	1.5	1.6	1.7	1.8
20. Subsidies	D.3	77	2.0	1.9	1.9	1.8	1.8
21. Gross fixed capital formation	P.51	139	3.6	3.6	3.6	3.6	3.7
22. Capital transfers	D.9	90	2.4	2.5	2.7	2.7	2.5
23. Other		33	0.9	1.0	1.2	1.3	1.3
24. Total expenditures [1)]	TE	1652	43.4	43.2	43.1	42.2	41.1
p.m.: Government consumption (nominal)	P.3	793	20.8	20.0	19.6	18.9	18.4

Note: Years 2011–2012 notification. Years 2013–2015 outlook. 1) Data are adjusted for interest from swap operations so that it holds total revenues less total expenditures are equalled to net lending/borrowing in EDP B.9 terms.
Source: CZSO (2012b). MF CR calculations.

Table A.2b: Breakdown of Revenue

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

	2011	2011	2012	2013	2014	2015
	Level			*In % of GDP*		
1. Total revenue at unchanged policies	1505	39.5	39.0	38.5	38.0	37.9
2. Discretionary revenue measures	29	0.8	1.3	1.7	2.4	2.3

Source: MF CR.

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

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

	2011	2011	2012	2013	2014	2015
	Level	In % of GDP				
1. Expenditure on EU programmes fully matched by EU funds revenue	63	1.6	1.6	1.5	1.4	1.2
2. Expenditure fully matched by mandated revenue increases	16	0.4	0.3	0.3	0.0	0.0
3. Non-discretionary changes in unemployment benefit expenditure	3	0.1	0.0	0.0	0.0	0.0

Source: MF CR.

Table A.3: General Government Expenditure by Function

(in % of GDP)

	Code	2010	2015
1. General public services	1	4.7	4.6
2. Defence	2	1.0	0.8
3. Public order and safety	3	2.0	1.7
4. Economic affairs	4	6.6	5.7
5. Environmental protection	5	1.0	1.1
6. Housing and community amenities	6	0.9	0.9
7. Health	7	7.8	7.5
8. Recreation, culture and religion	8	1.4	1.2
9. Education	9	4.8	4.4
10. Social protection	10	13.7	13.4
Total expenditure	TE	44.1	41.1

Note: Year 2015 outlook.
Source: CZSO (2012d), MF CR (2012a). MF CR calculations.

Table A.4: General Government Debt Developments

(in % of GDP, state debt denominated in foreign currency in % of total state debt, average maturity in years)

	ESA Code	2011	2012	2013	2014	2015
1. Gross debt		41.2	44.0	45.1	44.8	43.4
2. Change in gross debt ratio		3.1	2.9	1.0	-0.3	-1.5
Contributions to changes in gross debt						
3. Primary deficit		1.7	1.5	1.3	0.2	-0.8
4. Interest expenditure	EDP D.41	1.4	1.5	1.6	1.7	1.7
5. Stock-flow adjustment		0.4	0.7	-0.7	-0.5	-0.5
- Difference between cash and accruals		1.1	1.1	-0.4	-0.4	-0.3
- Net accumulation of financial assets		-0.9	-0.4	-0.3	-0.2	-0.1
- Privatisation proceeds		0.0	0.0	0.0	0.0	0.0
- Valuation effects and other		0.1	0.0	0.0	0.0	0.0
p.m.: Implicit interest rate on debt		3.4	3.4	3.5	3.8	4.0
6. Liquid financial assets		15.7	15.0	14.2	13.5	12.8
7. Net financial debt 1)		25.4	29.1	30.9	31.3	30.5
8. Debt amortization (existing bonds) since the end of the previous year 2)		2.7	3.2	2.7	3.2	3.1
9. Percentage of debt denominated in foreign currency 2)		9.2	11.4	12.0	12.0	12.0
10. Average maturity 2)		5.8	5.5	5.3	5.1	5.1

Note: Years 2011–2012 notification. Years 2013–2015 outlook. 1) Net financial debt is a difference between gross debt and liquid financial assets. 2) Figures only for the state debt. The state debt represents a debt generated by the state budget financing.
Source: CZSO (2012b). MF CR calculations.

Table A.5: Cyclical Developments

(in % of GDP)

	ESA Code	2011	2012	2013	2014	2015
1. Real GDP growth (%)		**1.7**	**0.2**	**1.3**	**2.2**	**2.8**
2. Net lending of general government	EDP B.9	**-3.1**	**-3.0**	**-2.9**	**-1.9**	**-0.9**
3. Interest expenditure	EDP D.41	**1.4**	**1.5**	**1.6**	**1.7**	**1.8**
4. One-off and other temporary measures		**-0.1**	**-0.3**	**-0.1**	**0.0**	**0.0**
5. Potential GDP growth (%)		**0.8**	**1.1**	**1.4**	**1.5**	**1.8**
Contributions:						
- labour		-0.2	-0.1	0.1	0.1	-0.1
- capital		0.6	0.7	0.7	0.8	0.8
- total factor productivity		0.4	0.5	0.5	0.6	1.0
6. Output gap		**-1.1**	**-2.0**	**-2.1**	**-1.4**	**-0.3**
7. Cyclical budgetary component		**-0.3**	**-0.6**	**-0.7**	**-0.4**	**-0.1**
8. Cyclically-adjusted balance (2 - 7)		**-2.8**	**-2.4**	**-2.3**	**-1.4**	**-0.8**
9. Cyclically-adjusted primary balance (8 + 3)		**-1.4**	**-0.8**	**-0.7**	**0.3**	**0.9**
10. Structural balance (8 - 4)		**-2.6**	**-2.1**	**-2.2**	**-1.4**	**-0.8**

Note: Years 2011–2012 notification. Years 2013–2015 outlook.
Source: CZSO (2012b). MF CR calculations.

Table A.6: Divergence from Previous Update

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

	ESA Code	2011	2012	2013	2014	2015
Real GDP growth						
Previous update		**1.9**	**2.3**	**3.3**	**4.0**	**-**
Current update		**1.7**	**0.2**	**1.3**	**2.2**	**2.8**
Difference		-0.2	-2.1	-2.0	-1.8	-
General government net lending						
Previous update	EDP B.9	**-4.2**	**-3.5**	**-2.9**	**-1.9**	**-**
Current update	EDP B.9	**-3.1**	**-3.0**	**-2.9**	**-1.9**	**-0.9**
Difference		1.1	0.5	0.0	0.1	-
General government gross debt						
Previous update		**41.4**	**42.4**	**42.8**	**42.0**	**-**
Current update		**41.2**	**44.0**	**45.1**	**44.8**	**43.4**
Difference		-0.2	1.7	2.2	2.8	-

Source: MF CR (2011c), MF CR (2012a). MF CR calculations.

Table A.7a: 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	45.4	44.5	46.1	47.9	51.0	54.1
of which: Age-related expenditures	17.9	20.2	20.3	21.3	22.3	24.2	25.5
Pension expenditure	7.8	9.1	8.7	8.9	9.7	11.0	11.8
Social security pensions	7.8	9.1	8.7	8.9	9.7	11.0	11.8
Old-age and early pensions	7.1	7.2	6.9	6.9	7.5	8.8	9.5
Other pensions	0.7	1.9	1.8	2.1	2.2	2.2	2.3
Occupational pensions	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Health care	6.2	6.9	7.3	7.8	8.1	8.4	8.5
Long-term care	0.2	0.8	0.9	1.1	1.2	1.3	1.5
Education expenditure	3.5	3.4	3.4	3.6	3.3	3.4	3.7
Other age-related expenditures	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Interest expenditure	1.1	1.4	1.5	2.1	3.0	4.3	6.1
Total revenue	42.0	40.4	40.9	40.9	40.9	40.9	40.9
of which: Property income	0.8	0.8	0.7	0.7	0.7	0.7	0.7
of which: Pension contributions	8.6	8.4	8.6	8.6	8.6	8.6	8.6
Pension reserve fund assets	0.4	0.6	0.0	0.0	0.0	0.0	0.0
of which: Consolidated public pension fund assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Systemic Pension Reforms [1]							
Social contributions diverted to mandatory private scheme	-	-	-	-	-	-	-
Pension expenditure paid by mandatory private scheme	-	-	-	-	-	-	-
Assumptions							
Labour productivity growth	4.1	2.2	2.0	1.8	1.8	1.7	1.5
Real GDP growth	5.1	2.3	1.8	1.7	1.5	1.1	1.2
Participation rate of males (aged 20–64)	85.2	85.1	86.9	86.1	85.5	86.8	87.3
Participation rate of females (aged 20–64)	66.9	66.5	68.7	68.8	68.4	70.9	71.7
Total participation rate (aged 20–64)	76.1	75.9	77.9	77.6	77.1	79.0	79.7
Unemployment rate	5.4	7.1	6.2	6.0	5.9	5.9	5.9
Population aged 65+ over total population	14.4	15.4	19.8	22.1	25.1	28.8	30.6

Note: 1) The fully-funded pillar in the Czech Republic is based on optional entry system.
Source: EC (2009). MF CR calculations.

Table A.7b: Contingent Liabilities

(in % of GDP)

	2011	2012
Public guarantees	13.8	-
of which: Linked to the financial sector	4.1	-

Source: MF CR.

Table A.8: Basic Assumptions

(interest rates and growth in %)

	2011	2012	2013	2014	2015
Short-term interest rate (CZ) (annual average)	1.2	1.2	1.2	1.3	1.5
Long-term interest rate (CZ) (annual average)	3.7	3.4	3.5	4.0	4.4
Nominal effective exchange rate (2005=100)	103.1	101.3	101.9	102.5	103.2
Exchange rate CZK/EUR (annual average)	24.6	25.0	24.9	24.7	24.6
World excluding EU, GDP growth	4.2	3.8	4.1	4.5	5.2
EU27 GDP growth	1.5	-0.2	0.8	1.4	1.9
Growth of relevant foreign markets	6.9	1.9	2.8	3.3	4.2
World import volumes, excluding EU	7.4	6.2	6.7	7.5	8.0
Oil prices (Brent, USD/barrel)	111.0	115.0	113.0	115.0	115.3

Source: CNB (2012), Eurostat (2012), IMF (2012). MF CR calculations.

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