Ministry of Finance
Czech Republic

# Convergence Programme
## of the Czech Republic

April 2013

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Ministry of Finance of the Czech Republic
Letenská 15, 118 10 Prague 1

Tel.: +420 257 041 111
E-mail: podatelna@mfcr.cz

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## List of Abbreviations

AWG.................................................... Ageing Working Group of the EPC
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
EPC...................................................... Economic Policy Committee
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
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 25 March 2013 release, fiscal data to the 5 April 2013 release and survey of macroeconomic forecasts of the CR to the 18 April 2013 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 of the Czech Republic for 2013–2016 is exceptional in several ways. At the beginning of May, the Czech Republic (CR) will enter its tenth year of membership in the European Union (EU). It is also the last year taken into account for proper conclusion of the excessive deficit procedure maintained with the CR. Last but not least, this year is important in terms of anchoring economic policy coordination that is the year for finishing preparations, negotiations and approval of the Czech budgetary and fiscal framework reform.

Although institutes were already set up at the end of 2011 by a set of directly applicable regulations of the European Parliament and the Council of the EU to bring about a significant deepening and strengthening of multilateral budgetary surveillance and strengthening the coordination of fiscal, macroeconomic and structural policies in the EU, further progress in the fiscal and budgetary sphere will be achieved next year, when countries of the EU would have to implement the Directive of Requirements for Budgetary Frameworks of the Member States into their national regulations. As of the same date, acceptance of the parameters of budgetary discipline and automatic correction included in the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union is required; although the CR has not accepted the Treaty, it intends to accept the essence of it in the budgetary framework reform.

The submitted update of the Convergence Programme (CP) of the CR was approved by the Government of the CR on 24 April 2013 and is consistent with the National Reform Programme of the CR, approved by the Czech government on 17 April 2013. The CP corresponds to the rules established in the updated Code of Conduct (September 2012) of the Stability and Growth Pact. In April, the document was also presented and discussed with the substantively relevant committees of the Chamber of Deputies and the Senate of the Parliament of the CR.

This update of the CP ensues from the mandate of the current coalition government that set out a number of ambitious reform steps in its Policy Statement from 4 August 2010, including a reform of public finances, enhancing transparency in dealing with public funds, public procurement and restricting corruption. The government also declared its intention to reform the fiscal framework.

Structural reforms aimed at improving long-term sustainability of public finances were prepared or adjusted in accordance with the Annual Growth Survey 2013 (EC, 2012c) and Recommendation of the Council to the Excessive Deficit Removal from 2 December 2009 and with Opinion of the Council to CP from 12 July 2011 and 10 July 2012. Characteristics of structural reforms are included in a number of the CP chapters; nevertheless, fiscal impacts have only been specified for the more important ones among them.

The CP is divided into seven chapters. The first chapter lists the main directions where the CR has been headed in recent years and the future course. The chapter reflects the Excessive Deficit Procedure having been launched with the CR, which recommends the general government to bring the deficit below 3 % of GDP in a credible and sustainable manner in 2013. The relevant committees of the Czech Parliament were informed of all the EU Council's past recommendations.

The CP's macroeconomic scenario is based on data available as of 25 March 2013. Even when political factors are ruled out, future development is encumbered with considerable uncertainties. The main sources of risks result from problems in the euro zone and transmissions of negative external shocks to the Czech economy. For 2013, we currently expect stagnation with an outlook of slight recovery in the following years (for more details – see Chapter 2).

The fiscal forecast discussed in Chapter 3 as well as the economic result which the government sector performance attained in 2012 proceed from the results of the April fiscal notification (closing date for data sources 5 April 2013). We expect the government sector balance for 2013 to amount to −2.8 % of GDP. This year, the general government debt is likely to rise to 48.5 % of GDP. In the coming years, the government is resolved to take care of public finance sustainability, not to procyclically affect the economy by fiscal restriction and to renew confidence in the economy by guaranteeing stability of the business environment.

Chapter 4 follows up with a sensitivity analysis of short-term shocks influencing development of the Czech economy and the government sector. Verification of the CP's macroeconomic framework from forecasts by independent institutions and an explanation of the most important differences compared to the previous year CP update form an equally important part of this chapter.

Chapter 5 monitors long-term impacts of the current pension system. Particular attention is paid to temporary limitation of pension indexation as well as introduction the voluntary fully funded old-age pension pillar. The chapter concludes with an overview of the contingent liabilities.

The final two chapters deal with the qualitative side of public finances. The chapter addresses changes boosting the quality of public finances on both revenue and expenditure side (Chapter 6) and discusses changes in institutional relations and in the system of public administration, including the reform of budgetary framework (Chapter 7).

# 1 Overall Policy Framework and Objectives

The priority of the economic policy for the coming period, in accordance with the Fiscal Strategy (MF CR, 2012a), is to identify such an economic and political mix which minimizes the negative trade-off between economy growth and fiscal consolidation effects in a short-term. Despite the exhausted possibilities of the monetary policy in the CR to accommodate fiscal discretion using standard tools, weaken domestic demand and the external environment, to eliminate the excessive deficit is still desirable. However, setting consolidation pace it is necessary to take into account possible impacts on the output at the same time.

## 1.1 Fiscal Policy

Measures to mitigate the general government deficit for 2010 and 2011 were chosen with the aim of finding a timely solution to fiscal imbalances. In spring 2012, the government adopted an extensive package (MF CR, 2012d), the mission of which was further consolidation of the government sector.

Fiscal and budgetary policies after 2010 have been determined by gradual preparation and implementation of deeper structural reforms in the spheres of diversifying sources of financing old-age pensions, health care system reforms, simplification and greater efficiency of the social benefits system and, last but not least, reduction of administrative burdens by alterations of the tax system and its administration (for more details see Chapters 5, 6 and 7).

In July 2012, the government of the CR resolved (Resolution No. 556/2012) to maintain medium-term fiscal effort in 2012 to 2015, however not to deepen it any further due to weakened domestic demand and the overall state of the economy (see Chapter 2.2). It should ensure both meeting obligations in relation to the EU in terms of an excessive deficit (see Chapter 1.2) and the desirable non-increasing of the procyclical effect of the fiscal policy. At the end of the year it was subsequently decided not to overly volatilize the tax environment with respect to the stability. In April, together with updating the original amounts and determining a new amount of the medium-term expenditure framework for the state budget and state funds, positive fiscal efforts were transformed to the fiscal stimulus, predominantly at the end of the CP horizon by the resolution of the government of the CR (No. 283/2013).

## 1.2 Implementing the Excessive Deficit Procedure

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

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

Considering experience hitherto in adhering to medium-term expenditure frameworks, the CR was urged (apart from the Council, 2009, also the EC, 2012a) to enforce expenditure frameworks more rigorously and to improve monitoring throughout the entire budgetary process.

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

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

i. carry out the planned consolidation in 2011 and adopt lasting measures compensating for revenue shortfalls and planned expenditures excesses;
ii. adopt fiscal measures planned for 2012;
iii. support the general government performance targets for 2013 with specific measures;
iv. avoid cutting growth-enhancing expenditures;
v. increase the efficiency of public investments;
vi. continue shifting the tax burden from labour to consumption; and
vii. improve compliance with tax obligations and reduce tax evasion.

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

Attention was also paid to the long-term sustainability of public finances, as part of both the pay-as-you-go and the fully-fund pillars of the pension system. According to the Council, the CR should focus on further changes to the PAYG pillar so that the system creates no fiscal imbalances in the future. For the pension savings pillar planned at that time, the Council recommended introducing a comprehensive pension reform. It also recommended ensuring that the system is attractive, transparent and involves a low level of administrative costs.

In the last evaluation of the previous year update of the CP (the Council, 2012) the CR was also urged to:

i. ensure the planned progress towards remedying the excessive deficit within the given timeframe;
ii. meet the approved budget for 2012 and specify permanent measures required for 2013;
iii. ensure starting in 2014 the average annual structural effort necessary to achieve the medium-term objective, including meeting the growth rate of adjusted expenditures of the government sector brought by the amended Stability and Growth Pact;
iv. avoid across-the-board cuts;
v. intensify effort to increase efficiency of public expenditures;
vi. shift high labour taxation towards property taxation and environmental taxes;
vii. decrease discrepancy in taxation between employees and self-employed persons; and
viii. adopt measures improving the tax collection, reducing the tax evasion and improving the tax law abiding by introducing the Single Collection Point for all taxes.

Table 1.1 outlines the amount of year-on-year discretionary measures implemented, among others, in accordance with the Council recommendation. It is apparent from the structure that both the revenue and expenditure side have been affected.

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

| | 2010 | 2011 | 2012 |
|---|---|---|---|
| Direct taxes | 0.3 | 0.4 | -0.2 |
| Indirect taxes | 0.8 | 0.0 | 0.3 |
| Other revenues | -0.1 | 0.2 | 0.2 |
| Social benefits | 0.1 | 0.2 | -0.1 |
| Government sector wages | 0.2 | 0.2 | -0.1 |
| GG enhancement of effectiv. | 0.5 | 0.2 | 0.0 |
| Other expenditures | 0.1 | 0.0 | 0.1 |
| **Total impact on balance** | **1.9** | **1.3** | **0.2** |

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

### 1.2.1 Measures for 2010

An increase in both VAT rates and in excise tax rates, doubling of property tax rates and cancellation of some anti-crisis measures ranked as the most important discretionary measures implemented in 2010. In addition, the ceilings for social security contributions were raised. The expenditure side was adjusted by decreasing selected social benefits, freezing pensions, and cutting the wage bill and positions in the government sector. It also involved an overall reduction of expenditures in the individual chapters of the state budget. The total extent of discretionary measures for 2010 amounted to 1.9 % of GDP. Through rigorous implementation of the approved budgets, the structural deficit was improved by 0.5 p.p. year-on-year compared to 2009, thus reducing the government deficit to 4.8 % of GDP.

### 1.2.2 Measures for 2011

In 2011, changes to the extent of approx. 1.3 % of GDP were implemented, evenly distributed between revenues and expenditures. The wage bill in the state administration was reduced by 10 % while 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, across-the-board cuts in certain expenditures of the state budget were made, thus also decreasing current non-mandatory and capital expenditures. On the revenue side, the level of social security contributions was maintained and, for example, motorway toll rates were increased. These measures helped to reduce the structural deficit by a significant 1.4 p.p. to 3.0 % of GDP, resulting in a total deficit of 3.3 % of GDP. In addition to consolidation discretionary changes, crucial acts reforming the pension system (Chapters 5.1.1 and 5.1.2) and the health care system (see e.g. MF CR, 2012c) were adopted.

### 1.2.3 Measures for 2012

The general government in 2012 was influenced to a large extent by one-off expenditure measures, increasing the total deficit by almost 1.8 % of GDP to 4.4 % of GDP (financial compensations of property settlement of the state with churches amounting to 1.5 % of GDP and flat-rate cuts in claims for reimbursement from EU funds to the amount of approx. 0.3 % of GDP). The other discretionary measures had a positive impact overall, however in the end these came close to negating each other. Also due to a deepening negative output gap, the structural balance saw further improvement to −1.7 % of GDP. A more detailed analysis of the general government's performance in 2012 has been provided in the subchapter 3.1.1.

### 1.2.4 Plan and Objectives of Fiscal Consolidation

The government's primary intention is to conclude the excessive deficit procedure based on the 2013 figures, and not to further deepen the procyclical effects of fiscal policy. At the same time, the government is intended, as soon as the situation permits it (probably in 2015 and 2016), to contribute to recovery of the Czech economy in the negative phase of the output gap by introducing a lower tax burden without exceeding the limit of 3 % deficit of GDP once again. The target to balance the total budget in 2016 and achieve the medium-term objective this year at the level of 1 % of GDP of the structural deficit has therefore been postponed until confidence in the economy is restored and sustainable economic growth gets underway once more.

Generally, two opposing factors are encountering in the horizon of the prediction. At the beginning, high cyclical component of the balance and lower discretionary changes play the major role, in the end of the Programme timeframe the gradual closing of the output gap and larger negative discretionary changes will be prevailing. Chapter 3.2 deals with the years of the outlook in more detail.

**Table 1.2: Forecast of Headline Balance**
*(in % of GDP)*

| | 2014 | 2015 | 2016 |
|---|---|---|---|
| **Balance of general government** | **-2.9** | **-2.8** | **-2.8** |

*Note: Balance designates net borrowing of the general government sector by the method applicable for EDP (EDP B.9).*
*Source: MF CR.*

## 1.3 Monetary Policy

The CNB will continue to conduct its monetary policy aided by the inflation-targeting regime. With the inflation target expressed as annual growth in the consumer price index of 2% with a tolerance band of ±1 percentage point, the CNB continues to view its inflation target as medium-term in nature. Therefore real inflation can temporarily divert from the inflation target, for example as a consequence of modifications in indirect taxes the primary impacts of which the monetary policy typically does not react to.

The current low-inflationary environment of the Czech economy and the CNB's strong credibility are reflected in inflation expectations anchored at levels close to the inflation target. The stability of short-term interest rates is consistent with the macroeconomic scenario of the Ministry of Finance of the CR anticipating the recession slowly coming to an end and sub-sequent gradual recovery.

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

The joint document of MF CR and CNB "Assessment of the Fulfilment of the Maastricht Convergence Criteria and the Degree of Economic Alignment of the Czech Republic with Euro–Area", approved by the government on the 20 December 2012, states that the continuing fiscal problems of the euro area together with development of the institutional environment in the EU, do not create an environment favourable for adopting the single currency in the CR at present. As regards the country's level of preparedness to adopt the euro, it is particularly important to continue in the process of consolidating public budgets and to increase flexibility on the labour market. Considering these facts, and in accordance with the approved Updated accession strategy of the CR to the euro area, the government has not yet established a target date for joining the euro area and will not endeavour to enter into ERM II during 2013.

## 1.4 Structural Policies

The CR's priorities and targets in the area of structural policies are described in detail in the National Reform Programme of the CR 2013 (Government Office, 2013a). Here we only include a list of the most important measures and aspects.

### 1.4.1 Labour Market

The CR plans to improve the reconciliation of family and professional life, strengthen public employment services and support the arrival of skilled workers from abroad. In this respect, the CR will extend the range of childcare services for preschool age children, regulate the entry and residence of foreigners in the CR and adopt a number of partial measures to increase the quality and efficiency of employment services.

### 1.4.2 Business Environment

Changes in the business environment particularly focus on modernising and increasing the efficiency of public administration, developing services for business activities and fighting corruption. The act on increasing transparency of joint-stock companies is undergoing approval procedures, which will allow identification of owners of joint-stock companies. In addition, the procurement process will be improved and its transparency increased (see subchapter 6.2.2).

### 1.4.3 Education

The main aim of the reforms is to improve efficiency of the educational system, adjusting this to meet the needs of the Czech economy, which is distinctively oriented to industry and export. The most important measure in this area is the prepared tertiary education reform, which emphasises transparency as well as the quality of tertiary education. The reform especially affects the accreditations, financing and modification of powers of the university authorities.

### 1.4.4 Research, Development and Innovation

The main targets in the area of research, development and innovations include developing conditions for excellent research, developing cooperation between business and research institutions and supporting innovative business activities. The CR is preparing new methodology for evaluating and financing the results of research institutions, on the basis of which public funds will be allocated to organisations. Other measures include programmes for supporting the provision of venture capital and improving the use of industrial property potential.

### 1.4.5 Energy Industry and Climate Change

The CR is actively promoting the target to increase energy efficiency and decrease greenhouse gas emissions. For this purpose, projects contributing to decreasing energy performance of buildings, industrial production and transport will be supported as so far. In terms of renewable sources of energy, the CR is striving to decrease the impacts of their support on the state budget, the business sector and the competitiveness of the Czech economy.

### 1.4.6 Transport Infrastructure

In order to boost the capacities and quality of its transport infrastructure, the CR will focus on completing construction of the backbone transport network and interconnection of the remaining regions and the main industrial centres to core routes and lines. Raising necessary funds and economical use of these will be crucial for the selected projects. In order to bring about more effective planning, the strategic documents on Transport Policy of the CR for 2014–2020 with forecast up to 2050 and Transport Sector Strategy will be approved.

# 2 Economic Outlook

The macroeconomic scenario of the CP has been designed as conservative, trying to balance potential positive and negative shocks to the economic outlook, while applying maximum use of knowledge currently available.

The Czech economy was in recession during the whole the year of 2012. While there is a chance that it the recession would be over as soon as the first half of 2013, the economic recovery should be only gradual. For 2013, we expect to witness the economic growth to stagnate; a slight recovery of economic activity should resume in 2014. Inflation should not differ considerably from the CNB's inflation target. The recession has already hit the labour market; however, we do not envisage any significant worsening in this respect. The current account deficit, as a percentage of GDP, should remain at a sustainable level, posing no risk in terms of macroeconomic imbalances.

## 2.1 World Economy and Technical Assumptions

The current development and outlook for the world economy significantly varies from region to region. In the USA, a slight recovery continues, driven by household consumption. Japan is expected to emerge from re-cession on the back of both fiscal and monetary stimuli. The economies of Brazil, Russia, India and China are also contributing positively to global growth.

The situation is rather different in the EU27 as a whole where GDP decreased by 0.3% in 2012, so that the pre-crisis level has not been reached yet. The main cause for weak performance can be identified as the decline in household consumption (which goes hand in hand with an increase in saving rate), which is affected by on-going fiscal consolidation and an unfavourable situation on the labour market. Economic development in the individual countries of the EU27 remains considerably different.

Compared to the Winter European Economic Forecast (2013a), the CP scenario's assumptions are more cautious. In 2013 we expect the GDP to decrease by 0.2% in the EU27 (compared to growth of 0.1% in the European Economic Forecast). In our opinion, the depressed consumer demand at a still high unemployment rate will strongly hamper the real economy of the EU, the recovery will be thus only very gradual.

In 2012, the average price of Brent crude oil reached 111.7 USD per barrel, an all-time high for crude oil prices. Up to the horizon of the CP, we expect to witness a gradual decrease in oil price to the level of 96 USD per barrel in 2016. For 2013 and 2014, we anticipate a slightly lower oil price than in the Winter European Economic Forecast.

We have chosen an assumption of stability for the USD/EUR exchange rate, around 1.30. In comparison to the Winter European Economic Forecast, resting on an assumption of the exchange rate of 1.35 USD/EUR for 2013 and 2014, we expect a weaker euro exchange rate. After a modest depreciation during 2013, the CZK/EUR exchange rate should slightly appreciate and reach the level of around 24.6 CZK/EUR in 2016. The assumption for short-term interest rates development is consistent with reaching the CNB's inflation target.

**Table 2.1: Exogenous Assumptions of the Scenario**

| | | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|
| **USD/EUR exchange rate** | *annual average* | 1.28 | 1.30 | 1.30 | 1.30 | 1.30 |
| **CZK/EUR exchange rate** | *annual average* | 25.1 | 25.4 | 25.2 | 24.9 | 24.6 |
| **Government bond yield to maturity 10Y** | *in % p.a.* | 2.8 | 2.2 | 2.3 | 2.7 | 3.1 |
| **PRIBOR 3M** | *in % p.a.* | 1.0 | 0.5 | 0.6 | 0.7 | 1.0 |
| **GDP EU27** | *real growth in %* | -0.3 | -0.2 | 0.7 | 1.3 | 1.6 |
| **Oil prices (Brent)** | *USD/barrel* | 111.7 | 108.0 | 102.0 | 98.8 | 95.8 |

*Source: CNB (2013), Eurostat (2013), IMF (2013a). MF CR calculations.*

## 2.2 Actual Developments and Medium-term Scenario

### 2.2.1 GDP and the Demand Side

The economic performance of the CR has not yet reached the peak of the business cycle before the recession at the turn of 2008 and 2009. According to current data, GDP decreased by 1.3% year-on-year in 2012 and the economy was in recession for the duration of 2012. While it is possible that it may emerge from the recession as soon as the first half of 2013, economic recovery is expected to be only gradual. In spite of this, GDP should record a year-on-year stagnation for the year 2013. GDP may increase by 1.2% in 2014, given the positive contribution of both foreign trade and gross domestic expenditure. For the following years, we expect to witness a gradual acceleration up to 2.6% in 2016.

Household consumption is depressed due to the unfavourable income situation, low level of confidence and a deteriorating situation on the labour market. Thanks to a modest economic recovery, consumption could nevertheless recover as soon as 2014. Its growth should gradually accelerate up to 2.5% in 2016.

From 2013 to 2015, the prudent fiscal policy should be reflected in a decrease in real government consumption, which is to be reflected in employment stagnation in the budgetary sphere and in reduction of purchases of goods and services.

We conceive the current development of gross fixed capital formation as the outcome of weak domestic and foreign demand and a low contribution of government investments. These effects should also take place in the forthcoming period. Over a longer period of time, new investments could be stimulated by gradually improving profitability of companies and a more substantial inflow of EU cohesion policy funds in case the difficulties associated with drawing the funds are overcome. This should result in a drop of investments by 0.4% in 2013, followed by slightly accelerating growth up to 3.1% in 2016. We expect to see minor positive contribution of inventories to growth over the CP horizon, related to the slight economic recovery.

At present, foreign trade is the main positive factor for economic development. In 2012, foreign trade contribution to year-on-year GDP growth reached a considerable 1.5p.p. We also expect to observe positive contributions in the course of the entire outlook of the macroeconomic scenario.

**Table 2.2: Economic Output**

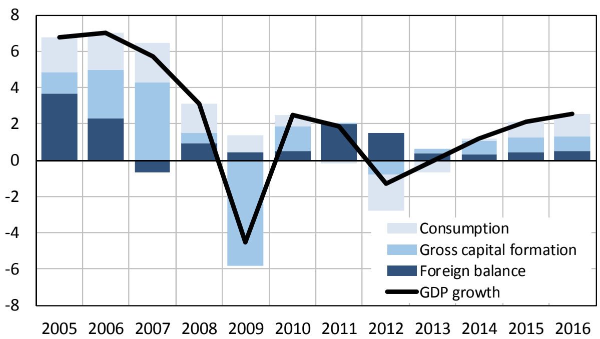
*(level in CZK billion, increases in %, contributions to growth in percentage points)*

| | ESA Code | 2012 *Level* | 2012 | 2013 | 2014 *Rate of change* | 2015 | 2016 |
|---|---|---|---|---|---|---|---|
| **1. Real GDP** | B1*g | **3792** | **-1.3** | **0.0** | **1.2** | **2.1** | **2.6** |
| **2. Nominal GDP** | B1*g | **3843** | **0.1** | **0.4** | **2.1** | **3.6** | **3.7** |
| **Components of real GDP** | | | | | | | |
| **3. Private consumption expenditure** | P.3 | **1881** | **-3.5** | **-1.2** | **1.0** | **2.1** | **2.5** |
| **4. Government consumption expenditure** | P.3 | **785** | **-1.0** | **-0.2** | **-1.7** | **-0.8** | **0.1** |
| **5. Gross fixed capital formation** | P.51 | **902** | **-1.7** | **-0.4** | **0.9** | **2.6** | **3.1** |
| **6. Changes in inventories and net acquis. of valuables** (% of GDP) | P.52+P.53 | **12** | **0.3** | **0.4** | **1.0** | **1.2** | **1.3** |
| **7. Exports of goods and services** | P.6 | **2894** | **3.8** | **1.3** | **3.7** | **4.9** | **5.4** |
| **8. Imports of goods and services** | P.7 | **2681** | **1.9** | **0.9** | **3.5** | **4.7** | **5.1** |
| **Contributions to real GDP growth** | | | | | | | |
| **9. Final domestic demand** | | **-** | **-2.4** | **-0.8** | **0.4** | **1.5** | **2.0** |
| **10. Changes in inventories and net acquis. of valuables** | P.52+P.53 | **-** | **-0.4** | **0.3** | **0.5** | **0.2** | **0.1** |
| **11. External balance of goods and services** | B.11 | **-** | **1.5** | **0.4** | **0.3** | **0.4** | **0.5** |

*Note: Real levels are in 2011 prices. Changes in inventories and net acquisition of valuables on the sixth row express change in inventories as a per cent of GDP in current prices. The increase of the change in inventories and net acquisition of valuables is also calculated from real values.*
*Source: CZSO (2013a), MF CR (2013a).*

**Chart 2.1: Decomposition of GDP Growth**

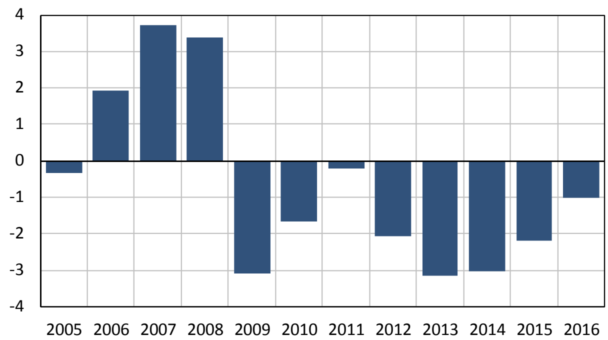
*(contribution to growth in percentage points)*




*Source: CZSO (2013a), MF CR (2013a). MF CR calculations.*

**Chart 2.2: Output Gap**

*(in % of potential product)*




*Source: MF CR calculations.*

### 2.2.2 Potential Product and Position within the Business Cycle

Under current conditions, it is difficult to separate the impact of deepening of the negative output gap and the slowdown of potential product growth, which leads to less plausible decomposition results, which are to be approached with considerable caution.

The recession at the turn of 2008 and 2009 and in 2012 resulted in a considerable slowdown of potential product dynamics, while at the same time plunged the economy in a deeply negative output gap. This is being manifested by a low production capacity utilisation, increased unemployment rate and a small number of job vacancies.

After plummeting further to −3% in 2013 and 2014, the output gap should be gradually closing in line with the economic recovery and may reach −1% in 2016. Thus, complete closure of the gap is expected to occur beyond the CP scenario outlook.

The total factor productivity is the most heavily impacted component of the potential product. Its trend component decreased from the maximum growth of 4.1% in 2005 to zero in 2011. In 2012, total factor productivity even decreased by 0.2%. A decline in investments led to a decrease in the contribution of capital stock growth. From 2010 on, the negative impact of demographics started to weigh on quite strongly in potential growth. On the contrary, the contribution of participation rate has been considerably positive. This is due to effects related to the demographic structure and increased desire of the population for being involved in employment to at least partially balance the de-crease in real disposable income.

According to our calculations, the growth of the potential product dropped below 1% in 2010, though this result probably underestimates the reality.

We assume, however, that a slowdown in economic potential already reached its trough in 2011. In the CP macroeconomic scenario outlook, the potential product growth rate should hover slightly above 1%.

### 2.2.3 Prices

Inflation measured by the harmonized consumer price index reached 3.5% in 2012. The increase in the reduced VAT rate from 10% to 14% accounted considerably for this outcome. Although the previous year's inflation was higher by 0.9 p.p. compared to the EU27 average, the Czech economy can be regarded as a low-inflation economy over the long-term.

Between 2013 and 2015, inflation should fluctuate near the CNB's inflation target (around 2%). For 2016, the scenario expects the growth in consumer prices to slow down to 1.1%: according to the currently valid legislation, VAT rates should be unified at 17.5% as of 1 January 2016.

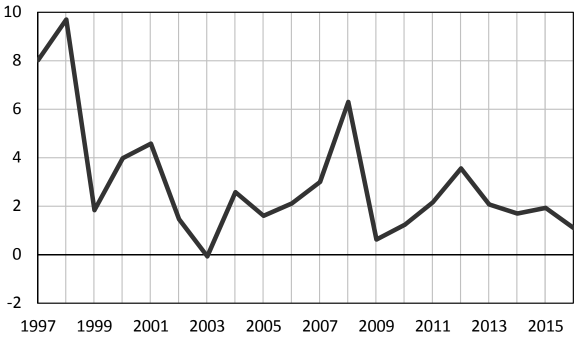
Due to the CNB's high credibility, we suppose that inflation expectations will remain strongly anchored close to the inflation target. A low inflation should be supported by the high level of competition on the internal market, lingering of the Czech economy in the negative output gap area, tendency towards a slight koruna appreciation as well as only gradual growth in unit labour costs.

**Table 2.3: Prices of Goods and Services**
*(indices 2005=100, increases in %)*

| | 2012 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|
| | *Level* | *Rate of change* | | | | |
| **1. GDP deflator** | **107.4** | **1.4** | **0.4** | **0.9** | **1.4** | **1.1** |
| **2. Private consumption deflator** | **113.7** | **2.3** | **1.2** | **1.2** | **1.8** | **1.1** |
| **3. HICP** | **120.3** | **3.5** | **2.1** | **1.7** | **1.9** | **1.1** |
| **4. Public consumption deflator** | **117.2** | **1.5** | **1.4** | **1.2** | **1.3** | **0.9** |
| **5. Investment deflator** | **103.2** | **0.6** | **0.2** | **0.6** | **0.6** | **0.7** |
| **6. Export price deflator (goods and services)** | **96.5** | **3.0** | **1.2** | **0.0** | **0.7** | **0.6** |
| **7. Import price deflator (goods and services)** | **101.7** | **3.6** | **1.7** | **0.3** | **0.7** | **0.5** |

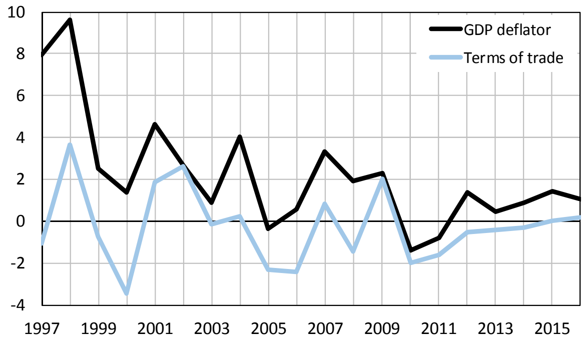
*Source: CZSO (2013a), Eurostat (2013). MF CR calculations.*

**Chart 2.3: Harmonized Index of Consumer Prices**
*(y-o-y growth in %)*




*Source: Eurostat (2013). MF CR calculations.*

**Chart 2.4: GDP Deflator and Terms of Trade**
*(y-o-y change in %)*




*Source: CZSO (2013a). MF CR calculations.*

### 2.2.4 Labour Market and Wages

In spite of the unfavourable economic situation in 2012, employment increased by 0.4%. However, the only the self-employed were of a positive contribution to growth. This likely reflects the high taxation of dependant labour and increased efforts for cost optimisation. The impact on governmental sector revenues is therefore definitely negative.

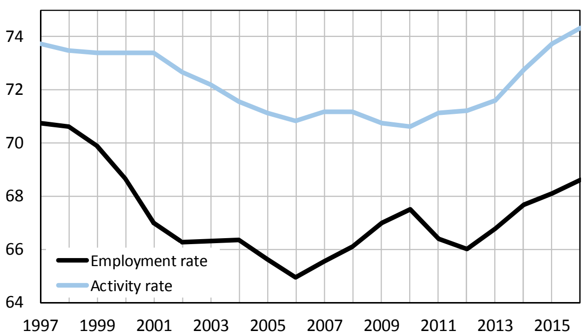
Seasonally adjusted unemployment rate grew throughout 2012, increasing by 0.3 p.p. year-on-year to 7.0%. This development is the cause of decreased ability of short-term unemployed persons to find a job. The anticipated slight decrease in real GDP this year coupled with lagged effects of 2012 should result in a further increase in unemployment rate up to 7.7% in 2014. We expect that the legislation changes from the year 2012 should continue to bear fruits and labour market indicators may improve from 2014 onwards, also despite the relatively low economic growth.

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

Compensation of employees (the sum of the wage bill and social security contributions paid by the employer) increased by 2.0% in 2012 due to a decline in real labour productivity and slight decrease in the number of employees. Even such a low growth rate resulted in the highest growth in unit labour costs since 2002.

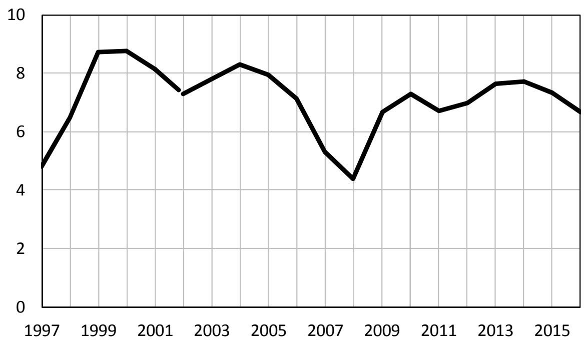
For 2013, we expect to observe low growth in compensation of employees amounting to 1.3%, which can be attributed to the slow improvement of the economic situation in the private sector and wage bill freeze in the budgetary sphere. A non-negligible impact on this year's growth rate would be due to exceptional bonuses paid out already in 2012, which reflect the desire to avoid new taxation above ceilings of social contributions, designed to remove regression in income taxation. On average, compensation of employees is expected to grow by 3.3% in subsequent years, i.e. approximately at the rate of nominal GDP growth.

**Chart 2.5: Employment and Participation Rates**
*(in %)*




*Note: The employment rate from the Labour Force Survey is not comparable between 2001 and 2002 due to changes in methodology.*
*Source: CZSO (2013c). MF CR calculations.*

**Chart 2.6: Unemployment Rate**
*(in %)*




*Note: The unemployment rate from the Labour Force Survey is not comparable between 2001 and 2002 due to changes in methodology.*
*Source: CZSO (2013c). MF CR calculations.*

**Table 2.4: Employment and Compensation of Employees**

*(price levels in common prices, increases in %)*

| | ESA Code | 2012 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|
| | | *Level* | *Rate of change* | | | | |
| **1. Employment, persons** | | **5092** | **0.4** | **-0.2** | **0.0** | **0.1** | **0.2** |
| **2. Employment, hours worked** | | **9.2** | **-1.2** | **-0.3** | **-0.2** | **0.1** | **0.0** |
| **3. Unemployment rate (%)** | | **7.0** | **7.0** | **7.6** | **7.7** | **7.3** | **6.7** |
| **4. Labour productivity, persons** | | **762** | **-1.7** | **0.2** | **1.2** | **2.0** | **2.4** |
| **5. Labour productivity, hours worked** | | **420** | **0.0** | **0.2** | **1.4** | **2.1** | **2.5** |
| **6. Compensation of employees** | D.1 | **1659** | **2.0** | **1.3** | **2.7** | **3.1** | **4.0** |
| **7. Compensation per employee** | | **401** | **2.1** | **1.5** | **2.8** | **3.0** | **3.9** |

*Note: Employment is based on domestic concept of national accounts. Rate of unemployment is based on the methodology of the Labour Force Survey. Labour productivity is calculated as real GDP (in 2011 prices) per employed person or worked hour.*
*Source: CZSO (2013a, 2013c). MF CR calculations.*

## 2.3 External Transactions and Sectoral Balances

In accordance with the requirements of the Code of Conduct, this sub-chapter has been prepared using national account methodology, which allows to divide the surplus or deficit in economic relations with the rest of the world among individual economic sectors without any residue; on the basis of the relation between investments and savings. This method differs from the commonly used balance of payments method in terms of accrualization, categorizing of several items and also by inclusion of several phenomena such as capital transfers.

As far as the change in the net position vis-à-vis the rest of the world is concerned, the Czech economy is experiencing only a very slight deficit. The balance of net lending/borrowing reached −1.4% of GDP in 2012. This is the result of a gradually increasing surplus of the balance of goods and services, a negative balance of primary incomes (outflow of dividends from foreign-owned companies) and current transfers and a positive balance of capital transfers especially due to investment subsidies from the EU budget. No substantial changes should occur in this sphere within the CP outlook period.

From the perspective of sectoral balances, while keeping the government's financial position to GDP ratio more or less constant, the private sector surpluses should gradually decrease and net lending from non-residents should slightly increase.

**Table 2.5: Sectoral Balances**

*(in % of GDP)*

| | ESA Code | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|
| **1. Net lending/borrowing vis-à-vis the rest of the world** | B.9 | **-1.4** | **-1.3** | **-1.2** | **-1.3** | **-1.6** |
| *of which* : Balance on goods and services | | 5.3 | 5.4 | 5.4 | 5.7 | 6.1 |
| *of which* : Balance of primary incomes and transfers | | -7.9 | -7.9 | -7.9 | -8.3 | -9.1 |
| *of which* : Capital account | | 1.3 | 1.3 | 1.4 | 1.4 | 1.4 |
| **2. Net lending/borrowing of the private sector** | B.9 | **3.0** | **1.5** | **1.6** | **1.5** | **1.2** |
| **3. Net lending/borrowing of general government** | EDP B.9 | **-4.4** | **-2.8** | **-2.9** | **-2.8** | **-2.8** |
| **4. Statistical discrepancy** | | **0.0** | **0.0** | **0.0** | **0.0** | **0.0** |

*Source: CZSO (2013a). MF CR calculations.*

## 2.4 Growth Implications of Major Structural Reforms

Impacts of currently prepared or enacted important structural reforms will in most cases take place only in the long run. This is due to the fact that these represent major systemic changes whose aim is to increase the potential product, employment and government sector savings. Over the horizon of the CP, their influence should be manifested only in a confined way. For the aforementioned reasons, it is currently impossible to offer more precise quantifications of effects of main reform measures on economic growth and employment.

# 3 General Government Balance and Debt

The recession at the turn of 2008 and 2009 brought a considerable worsening of the general government sector balance which wasn't restricted to the CR alone. The following two years led to a decrease in both overall and structural deficits in a period of slight economic growth, the determination of the coalition government, the excessive deficit procedure, pressure from international institutions on speedy consolidation, and all of this in an environment of (at times hysterical) sensitivity of the financial markets. The government sector deficit dropped from 5.8% of GDP in 2009 to 3.3% in 2011 due to active interventions and reforms, and if it weren't for the statistical and accounting operation recording the financial compensation of the property settlement between the state and churches, it would have reached 2.8% of GDP in 2012, including the flat-rate corrections of refunds from the EU. In the following period, the deficit will be kept safely below the 3% limit at a relatively stable amount, which will allow using the acquired "cushion" for stimulating the economy especially at the end of the forecast period.

## 3.1 Actual Balances and Updated Budgetary Plans for the Current Year

### 3.1.1 2012 Development

According to preliminary data from the CZSO, in 2012 the governmental sector deficit was 4.4% of GDP. Compared to the previous year this amounts to a considerable deterioration of 1.1 p.p. However, this can be attributed to the capital transfer of CZK 59 billion in connection with passing the act on property settlement with churches and religious companies (see MF CR, 2011a), and further to capital transfer due to flat-rate corrections of non-recognized expenditures co-financed from the EU (MF CR, 2012b) to the amount of approximately CZK 12 billion by 2012. Adjusting the expenditure item of the capital transfers of total amount of CZK 71 billion, the deficit in 2012 would have reached 2.5% of GDP, and compared to 2011, would have translated into improvement of the government sector balance by 0.8 p.p.

Compared to 2011, revenue increased by nearly 1% overall, which is in particular due to the dynamics of tax revenues and social security contributions. The most significant growth was seen in VAT revenues (increase by 3%). Nevertheless, given the increase in the VAT reduced rate of 4 p.p. in 2012, this amounts to only a slight increase attributed to the 1.4% decline in household consumption last year.

By contrast, excise taxes proved to exercise very low elasticity towards fluctuations in household consumption growing by 1.3% despite the drop in consumption. From the perspective of discretionary measures in respect of this tax, only an increase in tobacco tax was introduced with impact slightly exceeding CZK 2 billion. As far as other forms of consumption taxation are concerned, a payment of revenues from lotteries was introduced with the discretionary effect of CZK 7.7 billion. However, in this case it is also necessary to consider the negative impact of the decrease or abolishment of fees for gambling machines (CZK 1.2 billion).

Personal income tax revenues increased by 1.1% in 2012 whereby growth was rather considerably slowed down by discretionary measures of ca. CZK 8 billion (mainly a tax deduction increase of CZK 1.800 per child annually and termination of the temporary decrease of the basic tax deduction per taxpayer). Corporate tax revenues decreased by 0.4%, while no discretionary measures were introduced with a more considerable fiscal impact. Currently, we are only able to present a first estimate of the reality, in particular in the case of corporate taxes, it would be specified in detail in the October Notifications of Government Deficit and Debt based on tax returns filed. Social security contributions increased by 1.3%, and can be basically interpreted as a fully autonomous development.

A sharp decline of capital transfers revenue amounted to 26.1% in 2012. This can be best explained by the year-on-year decrease in investment subsidies by more than CZK 12 billion. It particularly refers to a decrease in the accrual subsidy of funds from the EU which is especially used to finance such investments whereby the final beneficiary is the government sector. The prevailing part (CZK 11 billion) can be accounted for by central government, mainly the Road and Motorway Directorate, and to a lesser extent also the Railway Infrastructure Administration and public universities. These items will subsequently appear as a decrease in government investments. The dynamics of other revenue items was similar to those of 2011.

General government expenditures increased by 3.4% in 2012, brought on by the two aforementioned capital transfers to the total sum of CZK 71 billion. In the event of adjustment, this would amount to a decrease in expenditures by almost 1%.

In 2012 government consumption expenditures increased by just 0.4%, thus underlying efforts made for an austerity policy by the government. The major component of government consumption to increase the most were social benefits in kind (expenses related primarily to health care) which increased by 2.4%, referring predominantly to autonomous development. Several discretionary measures have been approved for this year, including an increase in patients' co-participation and some other changes in the health care system (categorisation for levels of hospital care, outpatient surgery, payments for medicines). However, the positive effect was basically compensated by a growth in the VAT reduced rate and by the increase in doctors' wages. Compared to 2011, the intermediate consumption decreased by 1.8% and was basically equally distributed between central government and local government. Compensations of employees increased by just 0.6% due to several wage adjustments (in particular an increase in the wages of pedagogical employees), a decrease occurred especially at the local level.

The gross capital formation decreased the most significantly from expenditures (more than 15%). The highest drop was in central government (approx. by CZK 10 billion), which highlights the connection with the aforementioned decrease in revenue investment subsidies from the EU. At the central level, it was likely there was a decrease in investments co-financed from European resources, which led to a decrease in national financing requirements. The most significant decrease could be seen in the Road and Motorway Directorate and the Railway Infrastructure Administration and, to a slightly lower extent, in government agencies. There was also an improvement by approximately CZK 3 billion in connection with operations concerning used fixed assets. Newly acquired tangible fixed assets in local government institutions decreased by approximately CZK 6 billion whose investment subsidy from the EU decreased only marginally (approx. by CZK 1 billion). Thus it is very likely that this refers to a decrease in investments predominantly from national resources.

Another item on the spending side which decreased relatively significantly included capital transfers (excluding the two aforementioned one-off capital operations). A decrease of approx. CZK 6.5 billion comprised predominantly of the reduction of contributions for buildings savings scheme amounting CZK 5.5 billion.

With regards to other expenditure items, these mostly develop autonomously. Nevertheless, their lower-than-average dynamics had its roots in the austerity policy. Due to this, budgetary savings across entities were considerable as were across transactions focusing on savings in investments, capital transfers and tax discretions.

#### 3.1.2 2013 Development

In 2013, we expect the deficit to reach 2.8% of GDP which is an improvement by 1.6 p.p. compared to the previous year. After adjusting the 2012 figures of financial compensation to churches and the EU corrections, it has deteriorated by 0.3 p.p., which is given by the cyclical development.

Compared to the previous year, overall incomes should increase by 1.2%, in particular due to tax incomes which should increase by 1.6%. A number of discretionary measures have been reflected in this growth when an increase in both reduced and basic VAT rates of 1 p.p. has the biggest effect, and the total effect of this change should be approx. CZK 15 billion. Higher collection is also expected for personal income tax where the discretionary measures reach almost CZK 7 billion (it mainly concerns cancellation of the tax allowance for working pensioners, a statutory progression of the tax, or restrictions of flat-expense deductions). We also anticipate a positive discretionary change for excise tax (e.g. an increase in the rate on cigarettes) and for property transfer tax (a rate increase by 1 p.p. to 4%). By contrast, a drop in collection due to transferring funds to the pension savings pillar should have a negative impact on social insurance (once updated to the amount of approx. CZK 6 billion).

Compared to the previous year, a slight increase in investment subsidies from EU resources is expected, however in light of the current rather uncertain situation, we have opted for a relatively conservative assumption of approx. 6% growth.

Compared to the previous year, expenditures should decrease by 2.4%, while the aforementioned one-off measures play an important role, after adjusting to these factors, there would be an increase in expenditures of 1.9%. Expenditures on government final consumption should increase by 1.2%, in particular due to growth in intermediate consumption (2.2%) is expected, determined by autonomous development and a change in the VAT rates. Stagnation or a slight autonomous increase is expected for the remaining two major components of government consumption, compensation of employees and social benefits in kind.

After a considerable decrease in gross capital formation for three years in a row, its growth trajectory is expected to recover, approximately by 4%. It is expected that half of this increase will be financed from European resources. Compared to 2009, gross capital formation is already at a very low level in relative terms (ca. 60%), meaning another significant fall in investments is highly unlikely. A fall in the nominal investment amount in the past suggests relatively "unhealthy" use of savings which can lead to creating of implicit debt. If an equivalent investment activity as in the year of the beginning of the crisis had been performed, the deficit would, ceteris paribus, have hovered considerably over 3% of GDP, which can also be said when referring to the years ahead.

On the other hand, it is difficult to quantify the influence of quality of awarding and controlling public contracts reflected in the decrease of nominal investments. Rigorous control could lead to a decrease in tender project prices where pressure would be applied in nominal terms for a decrease in the gross capital formation. However this must be considered as positive, since it means that the real amount of investment is maintained. Another pressure on the price decrease results from the unfavourable situation in the building industry sector, and thus stronger competition. The effects could become more pronounced from this year onwards following on from passing of the new act on public procurement.

In the prediction for 2013 we do not consider the one-off revenue from the auction sale of newly released frequency ranges, as well as the revenue from the sale of emissions allowances, which, if implemented, would improve the balance in 2013. On the other hand, the negative risk for the government sector balance represents additional possible correction in EU funds reimbursements. However, this amount cannot be correctly determined at the moment. Risks of the prediction for this year thus appeared to be balanced.

## 3.2 Medium-term Budgetary Outlook

The medium-term budgetary outlook for 2014–2016 expects a more or less stable share of the general government balance at −2.9% of GDP in 2014 and −2.8% of GDP in the rest of the period. We forecast that this outcome will be achieved even in spite of the expected highly negative output gap in 2013 and 2014 around 3% of potential product (see subchapter 2.2.2), which is at a similar average annual level as in 2009 when the general government deficit almost struck the 6% threshold.

On the one hand, the current setting of fiscal policy is determined by update of the expenditure framework for the state budget and state funds for 2014–2016 approved by the government (24 April 2013) and on the other hand by the assumptions about development of other government sector units using available data sources. A number of measures, which contribute to the form of fiscal policy, have already been adopted in the last years, with the efficiency planned for future years.

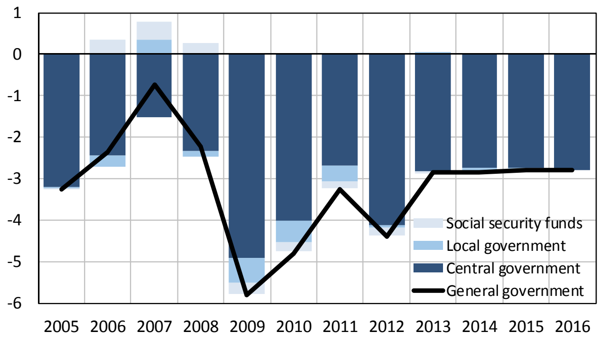
The government balance has always been strongly influenced by central government (Chart 3.1), which most probably will not change in the future. As economic recovery accelerates at the end of the medium-term horizon, we can also expect higher revenues in all units of the governmental institutions sector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

### 3.2.1 Expected Revenue Development

One of the most important changes in the area of government revenues is the intentional absence of tax discretionary changes especially in 2014. The reason this decision was adopted by the government can be particularly attributed to a desire to stabilize the tax environment under the conditions of weak confidence in the economy and the low expectations of economic subjects.

For this reason and in order not to influence the economy by additional restriction measures, some discretionary changes planned as part of the consolidation package from 2012 have been abandoned (MF CR, 2012d) and it has also been decided to leave the current legislative condition in the area of the establishment of the Single Collection Point and the related set of tax measures for 2015.

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




*Note: Years 2012–2013 notification, years 2014–2016 outlook.*
*Source: CZSO (2013b). MF CR calculations.*

Instead of a drop in revenues of approx. CZK 22.4 billion in 2014, this change will bring about an increase of CZK 1.7 billion, as plans to carry out some minor changes in 2014 are already underway. The effect of changing the validity of a part of the package of the Single Collection Point will therefore leave its mark on government sector revenue in 2015 with a fall of CZK 22.8 billion, in 2016 with growth of CZK 8.4 billion. The structure of this package has been shown in the Table 3.1. In total, however, a fall in income taxes especially will be hindered by the package of consolidation measures from 2012 increasing revenues by CZK 2 billion, and decreasing expenditures by CZK 16.5 billion in the same year.

In 2014, revenue of personal income tax should increase at a similar pace as in 2013 (approx. 5%). A half of this increase can be attributed to 2.7% growth in the wage bill in the economy and the rest to minor discretionary changes, such as limitation of tax benefits for children applicable only to residents from the EU, Norway and Iceland to the amount of CZK 2.5 billion and the additional effects of cancelling the basic allowance for working pensioners and introducing a second tax band for incomes above the ceiling for social security contributions. Furthermore, from

2014 onwards recodification of tax laws related to the Single Collection Point exempts dividends from taxation, but the accrual impact of this measure will not be seen until 2015.

In 2015, the personal income tax will be strongly influenced by the direct tax and payments reform in connection with a Single Collection Point. The total decline in revenues due to discretionary measures is estimated at CZK 17.2 billion, which will probably bring about a decrease of nearly 7%. Important factors related to the change will include a different tax base, tax rate and tax deductions, which will have an estimated impact of CZK -26 billion on the balance. By contrast, a positive influence should have the abolition of employees' tax credit to the amount of CZK 10.5 billion, the introduction of which was initially planned by the act related to the Single Collection Point. Last, but not least, the exemption of dividends (see above) should lead to a drop of approx. CZK 2.5 billion.

In 2016, the termination of statutory progression will have a negative influence on nearly year-on-year stagnation of tax revenue (ca. CZK 2.1 billion) and reintroduction of the basic allowance for working pensioners (CZK 2.5 billion).

In terms of the budget, the most important revenue for the government sector in the CR is social security contributions (nearly 39% of overall incomes in 2012). The influence of direct taxation and payment reform will also be reflected here when 2 percentage points of the statutory rate will be shifted from the employer to the employee in 2015. Further, employees' benefits will be burdened, except for luncheon vouchers, which should be reflected in revenue rise by CZK 2 billion. In addition we assume that the transfer of the tax burden from the employer to the employee should have a positive effect on the wage bill growth, which would imply a higher taxation base for income taxes and social security contributions. For the self-employed, the overall tax burden should decrease by CZK 6.4 billion. In 2016, the ceilings for health insurance contributions will be reintroduced (meaning an impact of CZK −1.8 billion). For the whole period, the slightly negative effect of opting out from public pay-as-you-go pillar will also become apparent (approx. CZK 0.7 billion per year on average).

The scenario of this CP update again anticipates revenue from accident insurance provided through the government sector, as the respective act has not yet been cancelled and its effect has been postponed. The revenue should reach CZK 5.3 billion, adjusting the revenues for planned accident insurance benefits the net effect should amount CZK 0.8 billion.

In 2014, corporate income tax will not considerably change (except for modifications with a very small fiscal impact, such as an increase in the limit for gifts to 10% and a deduction for science and research). In 2015, as well as personal income tax is concerned, will be seen the accrual impact of dividends exemption from the previous year (CZK −5.5 billion), which should generate a decrease of 1.4% in revenues. No changes are being considered for 2016.

The value added tax will not deviate significantly due to discretionary interventions in 2014 and 2015. In 2015, there will be a decrease in the registration threshold from CZK 1 million to CZK 750 thousand which should benefit the budget by CZK 2.4 billion in the first year of validity. In the following year both VAT rates should unify at 17.5%, which will alone bring a drop of CZK 16.1 billion. In 2014 and 2015, growth in tax collection will follow the growth in final consumption expenditures of households and the government. At the end of the CP outlook, the revenue should decrease by 1.6%.

For other consumption taxes, only the measures provided in the 2012 package are considered to be more important; this package results in an increase in the rate on cigarettes, abolition of green oil exemption and an increase in cut tobacco taxation to the level of cigarette taxation (with an overall impact of CZK 3.1 billion) in 2014 and termination of electricity payments produced from the sun radiation (CZK 6.2 billion) in the same year. No other discretionary changes in this area are being planned in the outlook period.

Contrary to the previous CP update, for conservative reasons, we are not counting on any revenue from emission allowances, as the price is considerably uncertain in this area. Further, the tax revenue from the prescribed insurance premium outlined in the consolidation package of 2012 and, most recently, the property acquisition tax have not been included. The parameters of these taxes have still not been finalised.

Out of the other measures from the previous year's consolidation package under consideration but subsequently abandoned included an increase to the personal income tax rate by 1 percentage point, natural gas for heating households will continue as tax-exempt in nature while silent wine will not be taxed and excise tax of $CO_2$ will not be introduced. The complete list of the recalculated impact of the package is shown in the Table 3.2.

**Table 3.1: Impact of the 2011 Direct Tax Reform and Its Recodification on the General Government Balance**
*(year-on-year discretional change, in CZK billion)*

| | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|
| **Personal income tax** | **-** | **2.2** | **-17.2** | **-0.6** |
| *of which:* change of tax assessment base, tax rate (19%) and deductions | - | - | -25.8 | -0.6 |
| *of which:* the abolition of employees tax credit | - | - | 10.5 | - |
| *of which:* restriction of the child tax credit only to EU, Norway and Iceland residents | - | 2.5 | - | - |
| **Corporate income tax** | **-** | **-0.5** | **-6.5** | **-** |
| **Social security contributions** | **-** | **-** | **-1.5** | **8.4** |
| **Value added tax** (decrease of mandatory registration limit to CZK 750,000) | **-** | **-** | **2.4** | **0.6** |
| **Tax on lotteries** (including reduction or abolition of some fees) | **0.0** | **-** | **-** | **-** |
| **Savings in compensation of employees** | **-** | **-** | **0.6** | **1.8** |
| **Other savings in administration** | **-** | **2.0** | **0.3** | **0.2** |
| **Total impact on balance** | **0.0** | **3.7** | **-21.8** | **10.4** |
| *% of GDP* | 0.0 | 0.1 | -0.5 | 0.2 |

*Source: MF CR calculations.*

**Table 3.2: Impact of 2012 Consolidation Package on the General Government Balance**
*(year-on-year discretional change, in CZK billion)*

| | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|
| **Personal income tax *** | **7.8** | **1.0** | **0.0** | **-4.6** |
| Abolition of basic allowance for working pensioners | 2.0 | 0.5 | - | -2.5 |
| Tax surcharge of 7% above the social insurance contribution cap | 1.8 | 0.3 | - | -2.1 |
| Reduction of flat-expense deductions for self-employed | 3.5 | - | - | - |
| Increase of the withholding tax against tax havens to 35% | 0.5 | 0.2 | - | - |
| **Social security contributions** | **1.8** | **0.0** | **0.0** | **-1.8** |
| Health insurance cap abolition | 1.8 | - | - | -1.8 |
| **Value added tax and excises** | **17.2** | **3.1** | **0.0** | **-15.1** |
| VAT rates change (reduced rate 15%, basic 21%) | 15.1 | - | - | -15.1 |
| Abolition of the green oil exemption | 0.7 | 1.5 | - | - |
| Increase of cigarette and tobacco taxation | 1.4 | 1.6 | - | - |
| **Other revenues** | **4.3** | **2.0** | **2.0** | **2.0** |
| Increase of real estate transfer tax by 1pp (to 4%) | 2.5 | - | - | - |
| Funds transfer from Forests of the CR, State Enterprise | 1.8 | 2.0 | 2.0 | 2.0 |
| **Social benefits** | **9.5** | **5.9** | **5.7** | **-6.0** |
| Change in pension indexation formula | 9.5 | 5.9 | 5.7 | -6.0 |
| **State administration optimisation** | **12.7** | **0.0** | **10.8** | **-1.1** |
| Simplification of the state administration agendas, elimination of duplicities | - | - | 10.8 | -1.1 |
| Expenditure decrease according to the state budget freeze in 2012 | 12.7 | - | - | - |
| **Other expenditures** | **2.0** | **-2.0** | **0.0** | **0.0** |
| Reduction of renewable energy sources subvention | 2.0 | -2.0 | - | - |
| **Total impact on balance** | **55.3** | **10.0** | **18.5** | **-26.6** |
| *% of GDP* | 1.4 | 0.3 | 0.5 | -0.6 |

*Note: Compared to the original proposal of the Package in CP 2012, following measures were abandoned: increase in the personal income tax rate by 1p.p., abolition of the tax exemption on the natural gas for households, taxation of still wine and introduction of carbon tax. We do not state the fiscal impact of an insurance premium tax, as the parameters of this tax are not known at the moment. In the system of assistance in material need, the cancellation of the supplement for housing was not adopted.*
*Source: MF CR calculations.*

### 3.2.2 Expected Development of Expenditures

Very low expected growth in total expenditures in the years of the outlook (on average by 1.2% per year) will be, in particular, caused by the continuing savings policy inside the general government sector. We continue to predict nominal stagnation of the whole amount of employee compensation within the forecast period. The volume of employee compensation payments has already been decreasing or stagnating for three years in a row. This, by itself, does not mean the average real wage is decreasing, as it is always up to the particular chapter or fund administrator to decide how he or she will optimise the number of jobs.

A considerable part of savings introduced to general government finances should appear in government consumption which will be significantly affected by the planned revision of the agendas of ministries, state funds and a number of other central government offices (more details – see Chapter 6.2.1). Other savings should also be brought by changes in relation to introducing the Single Collection Point (Chapter 6.1.3). These measures should generate savings in government consumption of almost CZK 10 billion from 2014. In spite of the fact that costs of public sector operations are increasing due to changes of indirect taxes, we expect the government intermediate consumption to grow nominally very slowly between 2013 and 2016.

In case of mandatory social expenditures, considerable savings will be made due to a change in the valorisation formula of pensions in 2013–2015 (see Chapter 5.2). As a consequence of this, accumulated expenses for pensions over the forecasting period will decrease by CZK 46 billion. From 2014, the change in the sickness payment regime will have a negative impact on the volume of expenses. Sickness benefit payments issued by the state already from the 15th day of illness (instead of the 22nd day at present) will burden expenses to the amount of CZK 2 billion. No other legislative changes are being considered in the sphere of cash social benefits which would bring about a more significant fiscal impact.

After years of a sizeable fall in the gross fixed capital formation, we expect the investment activity of the government sector to recover. In 2014–2016, year-on-year increases in gross fixed capital formation should reach ca. 4% per year on average. This growth should be driven by both investments from domestic sources and elevating the level of co-financing from the EU funds. We anticipate that the government investment expenditures will continue to be influenced by increasing effectiveness of the public contract system which is expected to be interconnected with the new treasury system. The total savings resulting from these measures is estimated at approximately CZK 5 billion.

Between 2014 and 2016, we expect the expenditure for interest payments to grow approximately by 3% per year on average, which will stabilize the amount of interest costs at the level of 1.5% of GDP. Compared to the previous year update, a decrease was recorded in expected outlays for servicing state debt (e.g. by 0.3% of GDP in 2015) which is caused by the decrease of the forecasted yield curve in every year of the forecast.

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

Despite the fiscal policy intentions outlined in greater detail in Chapter 1.1 highlighting the stabilization function of fiscal policy, in particular in 2015 and 2016, the government still plans on keeping the government sector balance above the reference value of the Stability and Growth Pact.

Table 3.3 illustrates the overall discretionary measures described above in relation to the autonomous development, which means the kind of development that would occur without intentional changes caused by active economic policy measures. The table indicates the situation which would appear under unchanged circumstances, if no discretionary change had been made after 2011. In such a case, in 2013 to 2016 the government sector deficit would most probably significantly exceed 3% of GDP and an excessive deficit procedure could not be concluded with the CR. On average, the balance would be approximately 1.3 p.p. higher than as indicated in this fiscal forecast.

**Table 3.3: Comparison of the No-policy-change Scenario with the Intentions of Fiscal Policy**
*(in % of GDP)*

| | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|
| **Total revenue** | **40.1** | **40.4** | **40.2** | **39.5** | **38.9** |
| Total revenue at unchanged policies | 39.9 | 39.6 | 39.3 | 39.0 | 38.7 |
| Cumulative discretionary revenue measures | 0.3 | 0.8 | 0.8 | 0.4 | 0.1 |
| **Total expenditure** | **44.5** | **43.3** | **43.0** | **42.2** | **41.7** |
| Total expenditure at unchanged policies | 44.4 | 43.7 | 43.8 | 43.1 | 42.4 |
| Cumulative discretionary expenditure measures | 0.1 | -0.4 | -0.8 | -0.8 | -0.7 |
| **Total balance with discretionary measures** | **-4.4** | **-2.8** | **-2.9** | **-2.8** | **-2.8** |
| Total balance without discretionary measures | -4.6 | -4.1 | -4.5 | -4.0 | -3.7 |
| Total cumulative discretionary measures | 0.2 | 1.2 | 1.6 | 1.2 | 0.9 |

*Note: Discretionary measures in this table incorporate all non-autonomous changes, i.e. both those improving and worsening the balance. Discretionary measures in 2012–2016 are represented cumulatively, thus containing effect of changes in previous years.*
*In 2012, the financial compensation of property settlement of state to churches and religious societies is not covered.*
*Source: MF CR calculations.*

## 3.3 Structural Balance, Fiscal Stance

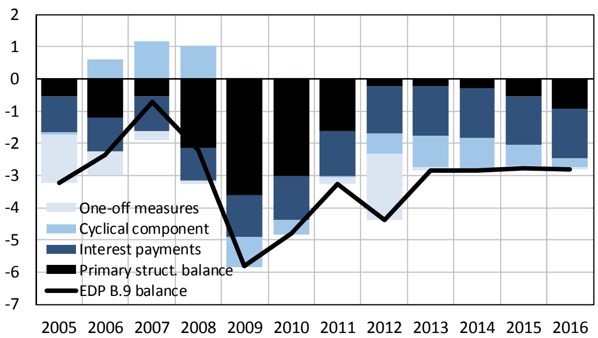
The structural balance in 2012 reached −1.7% of GDP, and we expect to see the same result in 2013. Between 2014 and 2016, it will gradually deteriorate due to transition from the emphasis on economic consolidation to the measures of a stimulating character to −2.4% of GDP. We expect interest expenditures to be constant at 1.5% of GDP through the forecast horizon. As a result of this, the primary structural balance will deteriorate at a similar rate as the structural one.

Among the most important one-off measures in 2012 stands incorporating expenditures related to property settlement with churches, however, these concerned statistical and methodological recording of the operation which has nothing to do with the real outflow of cash funds in the given year; and expenditures as a consequence of the flat-rate cancellation of a refund from EU funds. Throughout the entire forecast period, we also expect to see expenditure capital transfers to non-standard state guarantees to the amount of not more than CZK 2 billion per year and expenditures of interests from state guarantees not exceeding CZK 1 billion per year. As a proportion of GDP, these are practically negligible.

In Chapters 3.1 and 3.2, similarly as here, we do not consider one-off revenue from the auction sale of newly released frequency ranges, the amount of which could reach approx. 0.4% of GDP.

Chart 3.2 (and in greater detail, Table A.5) also indicates the development of the cyclical component of the deficit, i.e. items which are sensitive to the economy position in the business cycle. While in 2012–2013 we expect the negative output gap to deepen (see Chart 2.2), the negative impact of the cyclical component should decrease in 2014–2016 along with gradual economic recovery from −1.0% in 2013 to −0.3% in 2016.

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




*Source: CZSO (2013b). MF CR calculations.*

### 3.3.1 Assessment of the Fiscal Effort

Fiscal effort, defined as a year-on-year change in the structural balance, equates to an average annual value of 0.8 p.p. in the horizon for EDP, i.e. during 2010–2013. Although this does not fulfil the EU Council recommendation (see Chapter 1.2) it will reduce the deficit below the target of 3% of GDP. We have estimated overall fiscal effort in the given period at 3.2 p.p. Despite the government policy focusing on reforms and consolidation, this should thus ensure a decrease in the overall government sector deficit below 3% of GDP in 2013. In subsequent years, fiscal effort will be more lenient as a consequence of the aforementioned termination of fiscally-restrictive period.

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

In order to record the impacts of macroeconomic and structural changes, this method has been applied in 2012–2015 whereby the CP 2012 (MF CR, 2012c) estimates serve as the original estimates of the values and the current CP values serve as the new value estimates. The results of the calculations are indicated in the Table 3.4.

From the table it is apparent that the fiscal effort in 2012 was relatively strong and over the recommended value, which is defined as an average value of 1 p.p. for the 2010–2013 period. After deducting revisions of potential GDP and government revenues, however, the value of adjusted fiscal efforts remains below the Council recommendation. In 2013 and 2014, we expect the fiscal effort to stand at almost zero, moving to a more negative value in 2015. Incorporation of revision of potential GDP growth and government revenue development will be manifested on fiscal effort development in a positive way, since the impact of deteriorated macroeconomic development will prevail over changes in government revenue estimates.

**Table 3.4: Assessment of the Fiscal Effort in 2012–2015**
*(in percentage points)*

| | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|
| **1. Current estimate of fiscal effort** | **1.3** | **-0.1** | **-0.1** | **-0.2** |
| 2. Impact of revisions in potential output growth | -0.4 | -0.9 | -1.1 | -0.8 |
| 3. Impact of revisions on composition of economic growth or of other effects on revenue | 1.0 | 0.8 | 0.4 | 0.5 |
| **4. Adjusted fiscal effort (1 - 2 - 3)** | **0.7** | **0.1** | **0.7** | **0.1** |

*Source: MF CR calculations.*

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

According to the current forecast, we expect to witness growth in the nominal government debt through the entire forecasting period. Considering a slowdown in the consolidation rate and lower GDP growth, we also forecast growth in the debt-to-GDP ratio within the entire CP forecast horizon. This has led to a worsening of the expected development dynamics of the total government debt compared to the last year CP update (MF CR, 2012c). In relative terms to GDP (see Table 3.5), debt should increase from 48.5% in 2013 up to 51.9% in 2016. Contributions of both the primary balance and interest costs to a change in the debt ratio should remain at a practically constant level throughout the period. The forecast does not envisage any privatization revenues, as the government has not yet decided to include any other major entities in the privatization.

When looking at government debt distribution among the individual levels of government (Table 3.5), the decisive share of the sub-sector of central government which made up 94% of total debt in 2012 is apparent, while this share should continue to grow further very marginally. The local government sub-sector accounts for the remaining approximately 6% of total debt, since the indebtedness of social security funds is negligible. Nearly all of the central government debt is subsequently accounted for by state debt, i.e. debt generated by the state budget. Therefore, the sustainable risk structure of the state debt is a crucial stability factor for the debt of the general government sector as a whole.

After adjusting the level of gross government debt by the value of liquid financial assets (currency, deposits and securities including holdings in exchange-listed companies), the so-called net financial debt in 2012 amounted to 56.7% of overall gross debt. In other words, the size of the relatively liquid amount for repayment of the debt if required, would amount to 19.8% of GDP. We expect the ratio of net financial debt to total debt to increase only slightly in the future to approximately 66% in 2016.

When shaping the medium-term state debt and the state issuance strategies (see MF CR, 2012e), main attention has been paid to refinancing and market risk, representing the most significant sources of financing uncertainty. Their stabilisation has been shown to be crucial especially in periods of above-average volatility on international financial markets and increased uncertainty among investors. The key indicator for assessing refinancing risk is the share of short-term state debt (share of debt payable within 1 year in total debt). Over the period, we forecast the share of short-term debt between 18 and 19%, representing a sufficient reserve from the defined limit which, beginning at 2012, has been set at 25%. In addition to short-term debt management, the medium-term state debt (payable within 5 years) has also been actively managed. As of 2012, its maximum contribution to overall 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 state debt (Table 3.6), which has ranged from 6 to 7 years over the past years. In the last three years, the target interval for this ratio was repeatedly shifted downwards. The main reason for these changes is longer lasting uncertainty regarding development in the euro area and the resulting preference of investors to buy state bonds with shorter maturity. At the end of 2012, the average maturity of the state debt reached 5.7 years. For 2013, the target band has been left at 5.0 to 6.0 years for the average period until the maturity of the state debt. In the period of the forecast, we predict the average maturity to remain in the interval of 5 to 6 years with an outlook of the upper part of the interval.

The most important market risk for managing state debt is the interest rate risk. Since 2006 the strategic target for interest refixing of the debt portfolio within 1 year, i.e. the share of debt which is sensitive to interest rate fluctuations the following year, is set each year. For 2013, the interval has been left at the level of 30–40% providing an outlook in the upper half of the interval. This target is in accordance with that of the average period until state debt refixing occurs in the band of 4.0 to 5.0 years. At the end of 2012, refixing of the short-term interest rate debt portfolio (within 1 year) stood at 37.5%.

As far as the interest structure is concerned, the share of state debt with variable interest to total state debt reached 14.9% in 2012. Between 2013 and 2016, the share of state debt with a variable interest in overall state debt should not exceed 17.0%. The effect of derivative transactions on interest rate exposures relates to operations hedging the currency risk of foreign issues.

Another market risk to which the state debt portfolio is exposed is currency risk. Starting from 2011, currency risk is now also being 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 excess due to an unexpected depreciation of the domestic currency). The share of foreign-currency debt at the end of 2012 amounted to 10%. An increase in the ratio of 0.8 p.p. compared to the end of 2011 can be explained by releasing two tranches of the sixth public syndicated foreign issue denominated in the euro currency to the total nominal value of EUR 2.75 billion. We do not expect to observe any significant change to the currency exposure structure in the long-term.

**Table 3.5: General Government Debt by Sub-sector and Net Financial Debt**

*(in % of GDP)*

| | ESA Code | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|
| **General government** | S.13 | **40.8** | **45.8** | **48.5** | **50.3** | **51.2** | **51.9** |
| **Central government** | S.1311 | **38.3** | **43.0** | **45.7** | **47.5** | **48.5** | **49.3** |
| **Local government** | S.1313 | **2.6** | **2.8** | **3.0** | **3.0** | **2.9** | **2.8** |
| **Social security funds** | S.1314 | **0.0** | **0.0** | **0.0** | **0.0** | **0.0** | **0.0** |
| **Net financial debt** 1) | | **23.1** | **25.9** | **29.1** | **31.5** | **33.1** | **34.5** |

*Note: Years 2012–2013 show notification. Years 2014–2016 show outlook.*

*1) Net financial debt is a difference between gross debt and liquid financial assets (monetary gold, Special Drawing Rights, currency and deposits, securities other than shares (consolidated at market value), shares and other equity quoted in stock exchange).*

*Source: CZSO (2013b). MF CR calculations.*

**Table 3.6: The State Debt's Refinancing, Interest and Debt Denominated in Foreign Currency**

| | | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|
| **Refinancing** | | | | | | | |
| **Average maturity** | *years* | **5.8** | **5.7** | **5.6** | **5.6** | **5.8** | **6.0** |
| **Debt due within 1 year** | *% of debt* | **19.3** | **17.9** | **18.2** | **17.9** | **18.2** | **18.7** |
| **Liquidity ratio** 1) | *%* | **18.0** | **18.0** | **35.0** | **33.5** | **33.3** | **32.3** |
| **State Debt's Interest** | | | | | | | |
| **Debt with interest fixation within 1 year** | *% of debt* | **34.5** | **37.5** | **38.0** | **38.2** | **37.1** | **38.3** |
| Fixed interest long-term debt due within 1 year | *% of debt* | 5.4 | 6.5 | 7.2 | 7.2 | 4.9 | 7.3 |
| Variable interest long-term debt | *% of debt* | 14.8 | 14.9 | 15.7 | 15.7 | 16.6 | 14.9 |
| Monetary instruments | *% of debt* | 10.8 | 11.3 | 10.4 | 10.0 | 9.5 | 9.2 |
| Effect of derivative operations | *% of debt* | 3.5 | 4.8 | 4.7 | 5.3 | 6.0 | 6.9 |
| **Foreign Currency Exposition** | | | | | | | |
| **Debt denominated in foreign currency** | *% of debt* | **9.2** | **10.0** | **11.0** | **11.8** | **12.2** | **12.0** |
| Debt denominated in EUR | *% of debt* | 8.0 | 9.0 | 10.1 | 11.0 | 11.4 | 11.2 |

*Note: The state debt here represents debt generated by the state budget financing. Data in the national methodology. The liquidity ratio is defined as a share of the cash reserve to the sum of the short-term state debt, of the deficit of the state budget and of operations of the state financial assets.*

1) *Liquidity ratio is defined as a ratio of financing reserve and the sum of short-term debt, deficit and state financial assets operations.*

*Source: MF CR.*

# 4 Comparison with Previous Update and Sensitivity Analysis

## 4.1 Comparison with Previous Convergence Programme Update

Compared to the scenario of the previous CP, the macroeconomic scenario of the CP provides a less favourable view of economic performance (Table 4.1).

The main source of differences can be found in the escalation of the debt crisis in the euro area in the first half of 2012 which, coupled with fiscal consolidation, resulted in a drop in economic dynamics across all EU countries.

In the CR, a sharp decline in confidence of both consumers and a part of the business sector was reflected in further development. The aforementioned facts led to a drop in economic output in 2012 and a worsening of growth estimates for 2013 and 2014.

The deterioration of estimates for 2013 and 2014 especially concerns household consumption, gross fixed capital formation and foreign trade. A decline in confidence led to extremely cautious consumer behaviour and an increase in the savings rate in the event of a further worsening of the economic situation, which, together with a slowdown in the growth rate of the wage bill, was reflected in a decrease in estimates of real household consumption. Similarly, the business sector is postponing investment decisions due to low confidence, weak domestic demand and low government investments. A lower contribution of foreign trade to GDP growth is subsequently based on a worsening of the outlook of foreign demand for domestic production. Impacts of the lengthy recession have also already started to show on the labour market.

As has been described above, one-off operations of accounting and statistic character were reflected on the government sector balance considerably in 2012 (see subchapter 3.1.1). Without these influences, the balance would have reached −2.5% of GDP and it would have improved, by 0.5 p.p. compared to the CP 2012. For 2013, the estimate of the general government's performance is more or less similar; however for 2014 the constant structural balance is under review as is the constant total balance. The debt reflects the change in the estimate of performance and borrowing needs (see chapter 3.4).

**Table 4.1: Change in the Indicators of the Scenario**

| | | April 2012 CP | | | April 2013 CP | | |
|---|---|---|---|---|---|---|---|
| | | 2012 | 2013 | 2014 | 2012 | 2013 | 2014 |
| **External Assumptions** | | | | | | | |
| GDP growth in EU27 | % | -0.2 | 0.8 | 1.4 | -0.3 | -0.2 | 0.7 |
| Prices of oil (Brent) | USD/barrel | 115.0 | 113.0 | 115.0 | 111.7 | 108.0 | 102.0 |
| Exchange rate USD/EUR | USD/EUR | 1.30 | 1.30 | 1.30 | 1.28 | 1.30 | 1.30 |
| Exchange rate CZK/EUR | CZK/EUR | 25.0 | 24.9 | 24.7 | 25.1 | 25.4 | 25.2 |
| **Real Values** | | | | | | | |
| GDP | change in % | 0.2 | 1.3 | 2.2 | -1.3 | 0.0 | 1.2 |
| Households consumption | change in % | -0.4 | 0.2 | 2.0 | -3.5 | -1.2 | 1.0 |
| Government consumption | change in % | -3.7 | -0.5 | -1.8 | -1.0 | -0.2 | -1.7 |
| Gross fixed capital formation | change in % | -0.5 | 2.1 | 2.8 | -1.7 | -0.4 | 0.9 |
| Contribution of final domestic demand | p.p. | -1.1 | 0.5 | 1.3 | -2.4 | -0.8 | 0.4 |
| Contribution of foreign trade | p.p. | 1.0 | 0.8 | 0.8 | 1.5 | 0.4 | 0.3 |
| Potential product | change in % | 1.1 | 1.4 | 1.5 | 0.7 | 1.1 | 1.1 |
| Output gap | % | -2.0 | -2.1 | -1.4 | -2.1 | -3.1 | -3.0 |
| **Others** | | | | | | | |
| HICP | change in % | 3.5 | 2.3 | 1.9 | 3.5 | 2.1 | 1.7 |
| GDP deflator | change in % | 2.0 | 1.4 | 1.4 | 1.4 | 0.4 | 0.9 |
| Employment | change in % | -0.3 | 0.1 | 0.2 | 0.4 | -0.2 | 0.0 |
| Unemployment rate | % | 7.0 | 7.2 | 7.1 | 7.0 | 7.6 | 7.7 |
| Balance of goods and services | % of GDP | 4.7 | 5.1 | 5.4 | 5.3 | 5.4 | 5.4 |
| Net lending/borrowing | % of GDP | -1.1 | -0.9 | -0.8 | -1.4 | -1.3 | -1.2 |
| **General Government** | | | | | | | |
| Net lending/borrowing (EDP B.9) | % of GDP | -3.0 | -2.9 | -1.9 | -4.4 | -2.8 | -2.9 |
| General government debt | % of GDP | 44.0 | 45.1 | 44.8 | 45.8 | 48.5 | 50.3 |

*Source: MF CR (2012c), MF CR (2013a). MF CR calculations.*

## 4.2 Sensitivity Analysis

In the case of the small and open Czech economy, economic development is largely dependent on external development, in particular within EU countries. Sensitivity analyses thus focus on this aspect and place importance on the effects that worse than expected growth dynamics in the EU have on the domestic economy. In the alternative scenarios, we are considering both a sudden decline in GDP growth in the first year of simulation (2013) as well as a permanent decrease in the performance of European economies. The third scenario simulates impacts of increased interest rates on the Czech economy. The alternative scenarios are derived from the Macroeconomic Forecast (MF CR, 2013a), which forms the baseline for the CP's macroeconomic scenario.

### 4.2.1 Slower Economic Growth in the EU in 2013

The first alternative scenario assumes real GDP growth at 1 p.p. lower in the EU versus the base scenario, occurring only in 2013.

Considering the interdependence of the Czech economy on the EU, this scenario would impact negatively on the real growth in the CR, mainly through exports directed at more than 80% just to the EU countries. Lower foreign demand would lead to a decrease in exports, i.e. a decrease in the business activity. This would partially affect investment activity in terms of the growth rate, which would slow down only slightly at the beginning and subsequently by 0.3, 0.6 and 1.0 p.p. in subsequent years, caused by a certain inertia rate in the case of investment projects and an ongoing, even more moderate, economic drop. In contrast, household consumption would be affected to a lesser extent, as two opposite effects collide here. A decline in output forces wages to decrease (and unemployment to increase). On the other hand, a slowdown in economic growth reduces price level growth. The resulting effect equals to tenths of a percentage point.

The current account deficit in the scenario is caused by fallout of 1 p.p. in exports in the first year and slightly lower decreases in the following years. This is compensated, to a certain extent, by lower imports (rather of investment goods than consumer goods). Lower import activity contributes to stabilization of the current account. In the first year, the balance reaches a worse result compared to the baseline scenario by 0.6 p.p, however in the following years, when the decline in exports is also lower, the current account is practically stabilized.

The general government sector balance would be influenced by lower collection of personal income and corporate taxes. Together with an increase in spending due to a greater amount of unemployment benefits paid out, government deficits would deteriorate by 0.2 p.p. of GDP in the first year and by 0.1 p.p. in the following years. Higher deficits would subsequently accumulate into higher debt, approximately by 1.5 p.p. in the last year of the period monitored.

The Czech economy should gradually recover in line with gradual recovery of foreign demand during the course of 2014.

### 4.2.2 Enduring Lower Economic Growth in the EU

The second scenario also analyses the lower performance of the EU economies, however in this case, it refers to the real GDP growth, which is 1 p.p. lower in each year of the CP scenario forecast.

The mechanism is very similar to that in the previous scenario. But the negative impacts are of a more permanent nature here with respect to recovery of the EU economy beyond the forecast horizon. A higher degree of pessimism can especially be seen regarding investments in respect of which growth would gradually decrease by 1.0 p.p. Once again continuously worsening export activity would be partially compensated within the current account by lower imports, but in this case the balance would have more significant deficits.

In this scenario, wages would also increase more slowly, which will be manifested in a slight decrease in household consumption and at the same time in a higher increase by approximately 0.5 p.p. in the unemployment rate in the individual years.

The government sector would face deficits by 0.2–0.3 p.p. higher than in the baseline scenario. Thus debt would accumulate at a faster rate increasing gradually to 54.1% of GDP in 2016, by approximately 2.2% of GDP higher than as expected in the CP.

### 4.2.3 Increase in the Domestic Interest Rate

The last scenario simulates the impacts of a sharp rise in the domestic interest rate by 0.5 p.p. in 2013.

A higher interest rate makes consumption more expensive, making savings more advantageous. Current consumption would decrease by 0.3 p.p. and be postponed to future, demand would decrease as well as prices. Nevertheless, investment activity would be more significantly affected by an increasing interest rate (due to higher interests on loans), the growth of which would be slowed down in particular in the first two years by approximately 3.0 p.p. Lower investments in the CR along with a slight decrease in domestic prices (and therefore support of domestic consumption to the detriment of imported consumption) would have a positive influence on the current account balance through lower imports. A decrease in domestic demand would lead to a decrease in GDP growth of 0.3 p.p. and to an increase in the unemployment rate also by approximately 0.3 p.p.

In this scenario, lower economic activities would also result in lower tax revenues and, at the same time, lead to higher government expenditures related to unemployment. The government sector balance would show slightly higher deficits, in particular in the first year. However, a higher interest rate would directly influence accumulation of the debt which would reach 55.1% of GDP in the last year of the forecast and would thus be by 3.2 p.p. higher compared to the baseline scenario.

**Table 4.2: Basic Macroeconomic Indicators – Sensitivity Scenarios**

| | | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|
| **Baseline Scenario** | | | | | | |
| Gross domestic product | *Y-o-Y in %* | -1.3 | 0.0 | 1.2 | 2.1 | 2.6 |
| Private consumption | *Y-o-Y in %* | -3.5 | -1.2 | 1.0 | 2.1 | 2.5 |
| Gross fixed capital formation | *Y-o-Y in %* | -1.7 | -0.4 | 0.9 | 2.6 | 3.1 |
| Exports of goods and services | *Y-o-Y in %* | 3.8 | 1.3 | 3.7 | 4.9 | 5.4 |
| Imports of goods and services | *Y-o-Y in %* | 1.9 | 0.9 | 3.5 | 4.7 | 5.1 |
| Current account | *% of GDP* | -2.4 | -2.3 | -2.3 | -2.5 | -2.8 |
| Inflation (HICP) | *Y-o-Y in %* | 3.5 | 2.1 | 1.7 | 1.9 | 1.1 |
| Unemployment rate | *in %* | 7.0 | 7.6 | 7.7 | 7.3 | 6.7 |
| General government balance | *% of GDP* | -4.4 | -2.8 | -2.9 | -2.8 | -2.8 |
| Gross government debt | *% of GDP* | 45.8 | 48.5 | 50.3 | 51.2 | 51.9 |
| **Alternative Scenario I - Lower GDP Growth in EU in 2013** | | | | | | |
| Gross domestic product | *Y-o-Y in %* | -1.3 | -0.5 | 0.9 | 1.9 | 2.4 |
| Private consumption | *Y-o-Y in %* | -3.5 | -1.3 | 1.0 | 2.1 | 2.5 |
| Gross fixed capital formation | *Y-o-Y in %* | -1.7 | -0.4 | 0.6 | 2.0 | 2.1 |
| Exports of goods and services | *Y-o-Y in %* | 3.8 | 0.3 | 3.0 | 4.4 | 5.0 |
| Imports of goods and services | *Y-o-Y in %* | 1.9 | 0.5 | 3.1 | 4.2 | 4.4 |
| Current account | *% of GDP* | -2.4 | -3.0 | -2.6 | -2.5 | -2.5 |
| Inflation (HICP) | *Y-o-Y in %* | 3.5 | 2.1 | 1.7 | 1.9 | 1.1 |
| Unemployment rate | *in %* | 7.0 | 8.2 | 8.1 | 7.5 | 6.8 |
| General government balance | *% of GDP* | -4.4 | -3.0 | -3.0 | -2.9 | -2.9 |
| Gross government debt | *% of GDP* | 45.8 | 48.9 | 51.1 | 52.4 | 53.4 |
| **Alternative Scenario II - Permanently Lower GDP Growth in EU** | | | | | | |
| Gross domestic product | *Y-o-Y in %* | -1.3 | -0.5 | 0.7 | 1.6 | 2.1 |
| Private consumption | *Y-o-Y in %* | -3.5 | -1.3 | 1.0 | 2.0 | 2.4 |
| Gross fixed capital formation | *Y-o-Y in %* | -1.7 | -0.4 | 0.6 | 1.9 | 1.8 |
| Exports of goods and services | *Y-o-Y in %* | 3.8 | 0.3 | 2.7 | 3.8 | 4.3 |
| Imports of goods and services | *Y-o-Y in %* | 1.9 | 0.5 | 3.0 | 3.9 | 4.0 |
| Current account | *% of GDP* | -2.4 | -3.0 | -2.8 | -2.8 | -2.8 |
| Inflation (HICP) | *Y-o-Y in %* | 3.5 | 2.1 | 1.7 | 1.9 | 1.1 |
| Unemployment rate | *in %* | 7.0 | 8.2 | 8.2 | 7.8 | 7.1 |
| General government balance | *% of GDP* | -4.4 | -3.0 | -3.1 | -3.0 | -3.1 |
| Gross government debt | *% of GDP* | 45.8 | 48.9 | 51.2 | 52.7 | 54.1 |
| **Alternative Scenario III - Higher Interest Rate** | | | | | | |
| Gross domestic product | *Y-o-Y in %* | -1.3 | -0.3 | 1.2 | 2.1 | 2.6 |
| Private consumption | *Y-o-Y in %* | -3.5 | -1.6 | 1.0 | 2.1 | 2.5 |
| Gross fixed capital formation | *Y-o-Y in %* | -1.7 | -3.6 | -2.0 | 1.0 | 2.5 |
| Exports of goods and services | *Y-o-Y in %* | 3.8 | 1.3 | 3.7 | 4.9 | 5.4 |
| Imports of goods and services | *Y-o-Y in %* | 1.9 | -0.6 | 1.9 | 3.8 | 4.8 |
| Current account | *% of GDP* | -2.4 | -0.9 | -0.7 | -1.6 | -2.5 |
| Inflation (HICP) | *Y-o-Y in %* | 3.5 | 2.0 | 1.7 | 1.9 | 1.1 |
| Unemployment rate | *in %* | 7.0 | 8.0 | 7.7 | 7.3 | 6.6 |
| General government balance | *% of GDP* | -4.4 | -3.1 | -2.9 | -2.8 | -2.8 |
| Gross government debt | *% of GDP* | 45.8 | 50.7 | 53.4 | 54.4 | 55.1 |

*Source: MF CR calculations.*

## 4.3 Verification of the Macroeconomic Scenario by Other Institutions' Forecasts

Macroeconomic scenario of the CP was also compared with forecasts of other relevant institutions. The enquiry was conducted in April 2013 and its results are based on forecasts of 16 domestic institutions, together with the actual forecasts of the EC (2013a) and the IMF (2013b). However, not all of the forecast cover the whole CP timeframe. Verification of the year 2016, for instance, is based on a sample of only eight respondents.

Key trends of the macroeconomic scenario of the CP 2013 are consistent with the forecasts of other institutions. In 2014–2016, the Czech economy should be gradually recovering, though as far as the growth structure is concerned, there are differences between the CP and forecasts of other institutions. This is most apparent in the case of government consumption, where the difference probably stems from the fact that the CP, unlike the forecasts of other institutions, includes quantification of the impact of the measures described in Chapter 3.2. With a certain lag, economic growth should impact positively on the labour market.

Forecasts for inflation rate confirm that inflation expectations remain well anchored close to the CNB's inflation target. Slowdown in the growth of consumer prices in 2016, envisaged in the CP, derives from the current state of legislation, according to which the VAT rates should be unified at 17.5% with the effect from 1 January 2016.

**Table 4.3: Verification of 2013 Convergence Programme Scenario by Other Institutions' Forecasts**

| | Avearage of Forecasts | | | | April 2013 CP | | | |
|---|---|---|---|---|---|---|---|---|
| | 2013 | 2014 | 2015 | 2016 | 2013 | 2014 | 2015 | 2016 |
| **Growth in Real Terms** | | | | | | | | |
| GDP | -0.1 | 1.5 | 2.2 | 2.5 | 0.0 | 1.2 | 2.1 | 2.6 |
| Households consumption | -0.6 | 0.9 | 1.5 | 2.2 | -1.2 | 1.0 | 2.1 | 2.5 |
| Government consumption | -0.4 | 0.0 | 0.1 | 0.3 | -0.2 | -1.7 | -0.8 | 0.1 |
| Gross fixed capital formation | -0.7 | 1.5 | 2.7 | 3.5 | -0.4 | 0.9 | 2.6 | 3.1 |
| National CPI (aop) | 2.1 | 1.9 | 1.9 | 1.7 | 2.1 | 1.7 | 1.9 | 1.1 |
| GDP deflator (growth) | 1.1 | 1.2 | 1.7 | 1.6 | 0.4 | 0.9 | 1.4 | 1.1 |
| Employment (LFS) | -0.3 | 0.0 | 0.2 | 0.3 | -0.2 | 0.0 | 0.1 | 0.2 |
| Unemployment rate (LFS, level in %) | 7.6 | 7.7 | 7.4 | 7.1 | 7.6 | 7.7 | 7.3 | 6.7 |

*Source: MF CR (2013b).*

# 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 expected demographic development, which over the next few decades will likely dramatically increase the ratio of persons in retirement age to the economically active population.

## 5.1 The Government's Strategy – Reforms

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

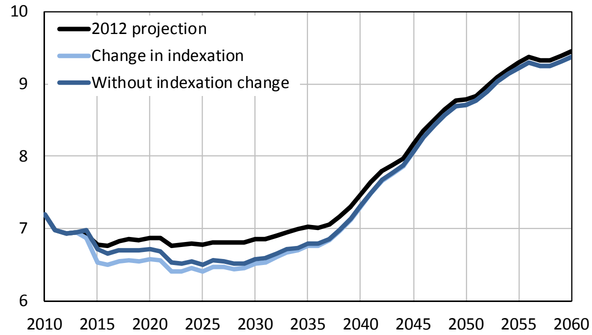
### 5.1.1 Parametric Adjustments

In response to a ruling of the Constitutional Court, which found 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 with effect from the 30 September 2011. These measures were described in the last CP (MF CR, 2012c). It concerns a modification to reduction thresholds in calculating pensions (in a neutral manner in terms of budget) and a shift of the statutory retirement age without the fixed upper limit and, at the same time, removing benefits for women with children (i.e. a uniform retirement age will be applied to all persons born in a certain year). As regards these measures, no change was made in the last year.

Total increase in pensions paid out (regular valorisation) is limited to one third of the consumer price index growth and one third of the real wage growth. From 2016, the valorisation system should return to its original basis and correspond to the consumer price index growth and one third of real wage growth. Valorisation is carried out through an edict based on the rules defined precisely by law. The possibility for the government to raise pensions at its discretion, which has occurred repeatedly in the past, is thus not possible. The effect of the temporary decrease in the pension growth rate is shown in Chart 5.1.

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

**Chart 5.1: The Impact of Change in Indexation Rule on Old-age Pension Expenditures**
*(in % of GDP)*




*Source: MF CR.*

In addition to this, the preretirement scheme as newly established enables those subscribing to additional insurance pension (the 3rd pillar) to draw funds already 5 years before reaching the statutory retirement age without imposing any sanctions. However, the condition is the minimal amount of accumulated funds in the private 3rd pillar which ensures monthly pension minimally at the amount of a third of the average wage. The old-age pension will not be subsequently reduced for the years when the pre-pension is drawn. As to sustainability of the pension system, however, this measure has an absolutely negligible impact.

### 5.1.2 Pension Savings Pillar

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

At the time of initiating the reform, the act has introduced (funded) pension savings pillar with voluntary entry for persons under 35 years of age. Older persons not drawing an old age pension will be allowed to decide about joining the new pillar within half a year after initiating the reform– that is in the first half of 2013. This measure, however, is valid for employed (or self-employed) persons at the time of the reform's initiation, not for the unemployed or economically inactive persons. For such persons, the 6 month period will commence from the time they first become pension insurance payers after initiating the reform. It will not be possible to alter the decision adopted by an insured person in the future.

Financing of pension savings pillar will be provided by funds transferred from participants in the first pillar to the 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 funds. The overall contribution rate thus increases to 30% for persons who have withdrawn, of which 25 p.p. will be directed into the existing PAYG system and the remaining 5 p.p. into the newly created 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: fund of state bonds, conservative, balanced and dynamic. The pay-out phase for accumulated funds from pension savings pillar will be provided by a life insurance company to be selected by the participant. It will be possible to draw paid benefits either in the form of life-long annuity (as an optional alternative, with 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 needs not be the same person entitled to the survivor's pension from the first pillar) or alternatively annuity paid for 20 years (in the case of premature death, the remaining funds will be subject to inheritance).

Fees paid to pension companies are explicitly defined by the Act on Pension Savings (No. 426/2011 Coll., Section 32). Fees are determined for property management in pension funds and appreciation of financial means in pension funds (except for the state bond fund). Participation in the pension savings pillar will understandably have an impact on the sum of the old-age pension, however, not on the amount of other pensions (both the disability and survivor's pension). For old-age pensions, a percentage of the percentage pension assessment will be decreased for participants in the pension saving pillar, when calculating the old-age pension from the 1st pillar, from 1.5% to 1.2% for the years when they subscribed to the pension savings pillar. A specific situation arises when a pension savings pillar's subscriber gains entitlement for a third degree disability pension. In such case, after reaching the retirement age, he or she will have the possibility to ask for the old-age pension to be paid out to the same amount as he or she received the disability pension, and 60% of funds from the pension savings pillar will be transferred to the state budget. This will lead to a situation as if he or she never joined the pension savings pillar, and therefore as if he or she had paid the contribution rate of 28% into the PAYG system, and not 25%.

Creation of pension savings pillar will result in an immediate decrease in revenues for the PAYG first pillar, compensated by lower expenditures in the future. The government will cover this interim period from additional revenues of the higher reduced VAT rate.

#### 5.1.3 Reform of the Health Care Financing System

Topics currently relevant in the health care system particularly include changes to benefit areas, changes to the categorisation for levels of hospital care, and adjustments in the sphere of spa care. In essence, compared to the measures mentioned in last year's update of the CP (Chapter 6.2.3) or in the Government Office (2012, 2013a), no major steps have been taken.

### 5.2 Fiscal Impacts of an Ageing Population

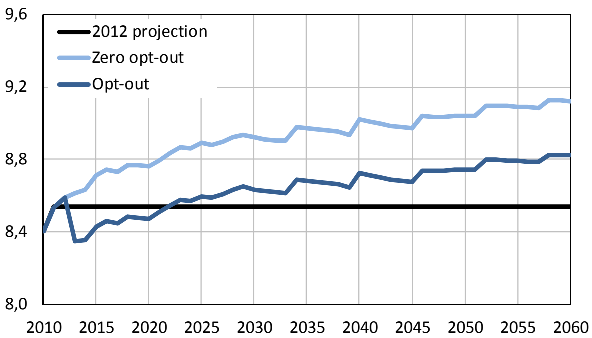
Results from the impacts of ageing are based on long-term projections made in cooperation with the Ageing Working Group (AWG) of the Economic Policy Committee (EPC). Development analyses are based on the assumptions of demographic development (EUROPOP) and the macroeconomic framework consistent for all EU countries. The projections stated do not reflect the current medium-term macroeconomic and fiscal outlooks for the CR. Projections are carried out under the condition of unchanged policies (testifying to the system which is anchored legislatively at the time of projection development). Long-term analyses do not aim to forecast specific values but only display trends and long-term dynamics.

Long-term projections were updated at the beginning of 2013 associated with the introduction of pension savings pillar. The results of the projections were contested by the AWG on the 6 March 2013. In addition to this, projections also take into consideration a temporary change in pension valorisation (see the previous subchapter 5.1).

The results of long-term projections fully adhere to analyses conducted by AWG for the Ageing Report 2012. The year of 2010 is set as the starting year also in this analysis. Therefore the following years are only trend projection which cannot be directly compared to the current data. Demographic and macroeconomic assumptions also remained unchanged. The projections' end is in 2060.

It is necessary to mention that, as a consequence of introducing pension savings pillar, the model approach has also changed. With respect to the voluntary nature of withdrawal, it was necessary to take a certain assumption regarding the impact on the revenue side which had been modelled as a constant percentage in terms of GDP. From now onwards, persons included in the model are to be divided into income deciles. Therefore, it is rather misleading to compare revenue in the last projections with the most current projections, thus it is necessary to consider a change in the model approach. Chart 5.2 thus indicates revenues using the old model approach, in the new model approach with zero withdrawal (i.e. which revenues would be included in the projections in the Ageing Report 2012 if the new method is applied) and finally incomes with the expected number of with-drawing persons.

**Chart 5.2: Modelled Pension Account Revenues**
*(in % of GDP)*




*Note: "Jumps" in revenues are explained by the postponement in statutory retirement age.*
*Source: MF CR.*

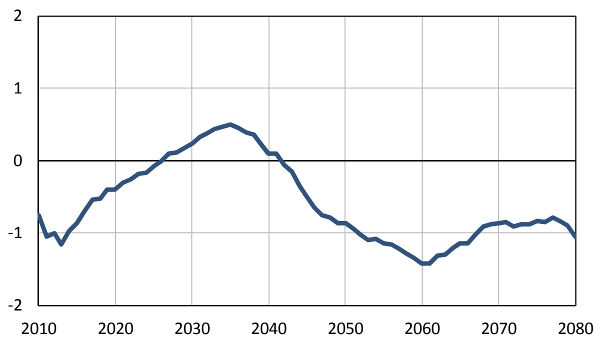
At present, it is very difficult to estimate the number of persons who decide to withdraw and take care of securing their own old age, in addition to the PAYG system, also by pension savings pillar. With respect to the fact that the reform came into effect on the 1st of January 2013 and foreign experience suggests that most people withdraw immediately before the deadline for making the decision expires (i.e. for people older than 35 years the deadline is the 30th of June 2013), the assumption of withdrawing the highest two deciles (it corresponds to approx. 1 million people) was adopted. At present, approximately 15 thousand people have withdrawn. The assumption is based on studies conducted by independent institutions which take into consideration the financial benefits associating with withdrawal. If we assume that the reform will remain valid (the principle of no-policy change), then the financial calculation will probably become one of the main criteria for decision-making on withdrawal and in this case it seems most reasonable to assume the two highest deciles.

From today's viewpoint, the sphere of pensions appears to be the most problematic in terms of the dynamics of expenditure growth (see Table P.7). These will increase from the starting level of 9.1% in 2010 to 11.7% of GDP in 2060, primarily due to changes in the population structure which prevails over other (positive) effects on this share.

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

The sustainability analysis, ensuing from long-term projections, identifies the extent of fiscal consolidation necessary to ensure stability of public finances. The so-called sustainability indicators are calculated, showing the scope of extensive measures required for decreasing expenditures or increasing revenues as a percentage of GDP so that they correspond to the required levels. Currently, this is taken on by the S1 indicator, which expresses the percentage of GDP it is necessary to raise revenues by or permanently reduce expenses by so that the state debt amounts to 60% of GDP in 2030, 0.9% 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 5.4% of GDP. The new S0 indicator, which specifies possible fiscal risks over a short period of time, is at the level of 0.19 for the CR for 2012, a figure placed significantly below the critical limit of 0.44.

**Chart 5.3: The Ministry of Labour and Social Affairs Projection of Pension Account Balances**
*(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.*

With regard to the sustainability analysis, a certain improvement was recorded in relation to the last round of projections, which could however be attributed to influences relating to the current period, i.e. an improvement of the starting budgetary position. The effects of impacts resulting from the pension reform (particularly parametrical changes in PAYG valid from the end of September 2011) are marginal, since the most important impact on the pension system balance will show as late as after the end of the EPC/AWG projection period. Development on the pension account after 2060 has been shown in Ministry of Labour and Social Affairs projections depicted in Chart 5.3. Naturally this aspect also has an impact on the value of the S2 sustainability indicator which, based on the EPC/AWG methodology is being driven upwards.

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

## 5.3 Government Guarantees

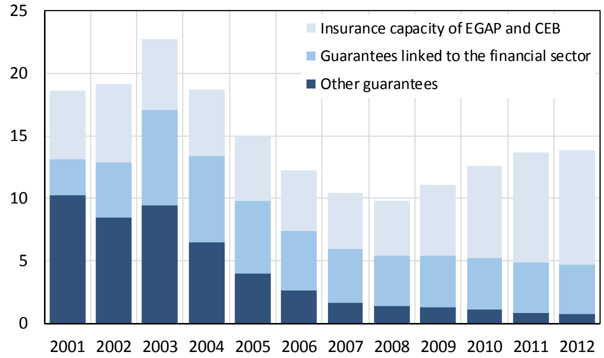
In addition to the fiscal impacts of population ageing on the sustainability of public finances, the state of government guarantees should also be mentioned here. In the Czech Republic, the most important components in this area are loan guarantees for infrastructure projects and investments in railway transport (approximately 0.5% of GDP), guarantees for liabilities of the Export and Guarantee Insurance Company or the Czech Export Bank (around 9% of GDP), and guarantees in relation to the CNB and CSOB ensuing from a resolution of the crisis in 2000 involving the former Czech bank IPB. The last guarantee provided by the government so far was a guarantee for the purchase of vehicles for the Czech Railways in 2007. In 2013, a state guarantee will probably be provided for the CNB's benefit for securing a loan for the International Monetary Fund from the CNB's foreign exchange reserves to the amount of EUR 2.53 billion. In addition to this, on the 6th of March 2013 (government decree no. 170/2013) the government approved an increase in the funds of the Export and Guarantee Insurance Company by CZK 10 billion (thus the total year on year increasing of these funds by CZK 30 billion) to invest in building the Khormala power station in Iraq.

The total amount of guarantees at the end of 2012 amounted to approximately 13.8% of GDP, of which guarantees relating to the former Czech bank IPB represent approximately 4% of GDP. It should be mentioned, however, that the settlement of this guarantee in relation to the CNB and the CSOB bank, which should be paid no later than by 2016, is expected to equate to a fraction of this amount (to date, CZK 5.8 billion has been paid, i.e. approx. 0.2% of GDP). For this reason, CZK 0.4 billion was purposefully paid out in 2012.

In terms of 2013, it is expected that 0.2% of GDP will be paid out in the area of government guarantees.

**Chart 5.4: Government Guarantees**

*(in % of GDP)*




*Note: "EGAP" refers to the Export Guarantee and Insurance Company and "CEB" to the Czech Export Bank.*

*Source: MF CR.*

# 6 Quality of Public Finances – Revenue and Expenditure

The target of domestic fiscal policy is not only consolidation of public finances itself. Emphasis is placed on increasing the efficiency, credibility and quality of public institutions plus the policies contributing to economic growth and rising employment.

## 6.1 Revenue Side

### 6.1.1 Strategy of Tax Policy

In 2008, the tax system was fundamentally changed. The tax system was modified so that it would enhance in previous years already partially initiated shift from labour taxation to consumption taxation. According to many empirical studies, such a setting of the tax system has less of a negative impact on economic growth. In the case of both corporate and personal income taxes, there was a sharp decrease in rates and extension of tax bases. At the same time, most of consumption tax rates were increased significantly.

This trend was also followed by a further increase in excise taxes in 2012 and 2013. In 2013, however, there was a slight increase in the tax burden of some groups of subjects on the labour market. The primary intention of this was to accommodate some non-system exceptions. Generally speaking, it can be stated that in 2013 both tax measures were implemented with a limited effective period, the main purpose of which was to decrease the current amount of government sector debt, and discretionary measures with the intention of eliminating some non-system tax advantages or exceptions.

### 6.1.2 Organization of the Tax Administration

Since the beginning of 2013, the organisational structure of Czech tax administration has been changing. The new organisational structure is considerably flatter. The former 199 tax authorities were replaced by 14 newly created regional tax authorities with deconcentrated territorial workplaces. The second level of the tax administration will fall under the competence of the General Financial Directorate, at the same time all appeal proceedings will be implemented by one financial directorate. The new organisational structure will enable regional tax authorities to deal exclusively with tax administration. To a large extent, economic and technical functions will concentrate on the second level of tax administration. The new organisational model will strengthen effectiveness of tax administration, enable specialization of their employees limited by the size of the existing units, and optimize its performance as well as the fight with tax evasions. The organisational model introduced also represents one of the assumptions for implementing the Single Collection Point.

### 6.1.3 Single Collection Point

With effect from the 1 January 2014, the first phase of the Single Collection Point will be implemented. It is expected to be fully launched one year later. Creation of the Single Collection Point forms an important element of the public finance reform concentrating on making the collection of funds for government sector budgets more effective and decreasing the administrative burden of persons liable to tax. In particular this should be carried out by simplifying communication between persons liable to tax with the respective public administration bodies. At present, persons liable to tax must communicate separately with the tax authorities, social security authorities and health insurance companies. As a consequence of the legal regulation being proposed, this communication will only be carried out in the Single Collection Point. In the first phase, tax legislation will be adjusted by recoding private substantive law. For example, the act on inheritance tax, gift tax and real estate transfer tax will be cancelled. Inheritance tax and gift tax will be integrated in the act on income taxes. The real estate transfer tax will be replaced by a real estate acquisition tax which will be regulated in a new separate act. In relation to carrying out the so called "audit of exceptions", selected tax exemptions are to be cancelled in respect of personal income tax as well as the assessment base of social security contributions or some provisions are to be simplified. Furthermore, the base of personal income tax as a total sum of the gross wage and social security contributions paid by the employer will be cancelled.

Considering budgetary impacts resulting from the above-mentioned measures and considering the tax structure of the proposed changes, the measures presented are likely to have a positive impact on economic growth. Nevertheless, the primary intention of these proposed changes is to make the current tax system more transparent and simpler.

### 6.1.4 Tax Assignment

Since the beginning of 2013, the new system of tax assignment has got underway. The result of this is a permanent increase in shared taxes of municipalities and a decrease in income disproportions per person among the population. For the four biggest cities, separation of the calculation through the so-called recalculating coefficients is still being maintained.

However, compared to the construction of coefficients valid in 2012, their portion in shared taxes has decreased. The weight of the criterion for the overall area of cadastral districts for a municipality does not change, however, it presents a considerable restriction in terms of the extent to which the cadastral district of a municipality is reflected in the calculation. It thus eliminates unjustified extremes in the tax revenues of some municipalities, which benefited from the considerable area of their cadastral districts. Furthermore, the weight of the criterion of the number of population increased while a criterion for the number of pupils at primary schools and kindergartens has been included as a new feature.

### 6.1.5 Fighting Tax Evasions

At present, the challenge and at the same time necessity for most tax administrations is fighting more and more sophisticated forms of tax evasions. From the perspective of estimating the volume and structure of tax evasions, the priority is mainly to implement measures which prevent tax evasions in the area of fuel supplies, furthermore so-called "carousel" frauds in case of value added taxes or problems of transferring prices in the case of direct taxes. These fundamental topics warrant permanent attention from the Czech authorities who are making regular concerted efforts to implement administrative measures targeted on fighting tax evasions.

These efforts also include increasing efficiency of financial administration. The establishment of the Single Collection Point (see above) will result in unification of current information flows into one institution which will be able to react more operatively to any possible attempts at tax evasions.

## 6.2 Expenditure Side

### 6.2.1 Increasing Efficiency in Public Administration

Together with the adoption of a set of measures in 2012 which, through changes in terms of the revenue and expenditure of general government budgets, are to ensure that the deficit is kept below 3% of GDP (more information – see Table 3.2), with its resolution (No. 37/2013) the government also approved a proposal to decrease costs and boost efficiency of state administration performance.

**Table 6.1: Structure of austerity Measures in Public Administration in 2014**
*(in % of GDP)*

| | Savings |
|---|---|
| Reduction of agendas and posts | 0.4 |
| Consolidation of agendas | 2.9 |
| Changes in the system of funding | 1.6 |
| Property sale | 2.7 |
| Total savings | 7.6 |

*Source: The austerity measures proposal on simplification of agendas and removing of duplicities in public administration in 2014. Adjusted by MF CR.*

Simplification of agendas and removing duplicities form part of long-term efforts to reform and optimize work performed within the entire public administration system. This proposal is designed not to impact on the extent or quality of the services provided by central administrative authorities and the institutions subordinated to them. The point of departure for analysis and identification of possible duplicates and non-effectiveness in disposing of public funds is to assign competences to the authorities of various hierarchic levels. Central authorities (especially ministries) are to be responsible for conceptual and managing activities (development of strategies, legislation, methodical management, supervision), while the implementation of adopted policies, concepts and methodological procedures (as standardized activities) should be mainly implemented by the subordinated organisations. Analysing possible sources of savings also focused on the possibilities of rationalisation in using and financing supporting processes in authorities (human resource management, ICT, internal administration) and possibilities of sharing these across individual institutions. In addition to assessing the activities of the institutions concerned, the sale of avoidable property was also considered to be a source of savings. In total 25 central authorities of state administration and 328 subordinated administrative authorities and other units were assessed, while the control conclusions of the Supreme Audit Office, statistical data and annual reports of the individual organisations were used. The current government has also approved it will implement projects of an above-departmental character. Among others, this includes merging ministries, resulting in operational cost-cutting benefits, optimising use of assets, sharing agendas in the sphere of human resource management, information technologies, purchasing and public contracts. It is assumed that synergy will be utilised in the sphere of developing strategies and concepts, including implementation of these, better coordination of investment expenses, as well as effective drawing on finances from European structural funds. Considering the agendas implemented, it has been proposed to merge the Ministry of Industry and Trade with the Ministry of Transport.

For 2014, savings of approx. CZK 11 billion is expected in these spheres (i.e. 0.3% of GDP). In the first stage, savings of approx. CZK 7.6 billion have so far been identified. The structure of these measures is indicated in Table 6.1.

#### 6.2.2 Public Procurement and Anti-corruption Strategy

Definite priorities of the existing government include fighting corruption as socially one of the most seriously perceived problems at present. From analyses made, it is apparent that, as a consequence of the existence of corruption behaviour, only direct costs of Czech general government budgets can reach the level of approx. 1% of GDP per year. Thus it can be said that the fight with corruption takes on an extraordinarily important macroeconomic dimension and curtailing of this, thus also forms one of the ways budgetary responsibility can be enforced. In its Strategy for fighting corruption (Government Office, 2013b), the government has undertaken to take a number of specific measures in 2013–2014 which should lead to limiting corrupt behaviour, and thus reducing costs for the general government budgets.

Continuous works on making the public contract system more transparent and effective should have an immediate effect on public finances, by means of further strengthening of the electronising of tender proceedings above the framework of the current act on public procurements. Extension of the list of common commodities which must be demanded by state administration by awarding public procurements through the electronic marketplace will be considered (now e.g. IT equipment, consumer material, transports services, etc.). In order to award public procurements for commodities which are difficult to standardise (e.g. construction works), the so-called National Electronic Tool will be set up which will enable suppliers to gain equal access to award proceedings and make procedures for the awarding public procurements more effective.

#### 6.2.3 Promotion of Job Creation

In the course of 2013, a programme will be launched which should lead to a decrease in unemployment by introducing (intensifying) financial motivation of employers for increasing (or at least preserving) the number of job positions. Companies will be able to get support for a period up to 1 year when employing young graduates registered with employment agencies. Other supported groups on the labour market will be persons unemployed for a long period of time and mothers with children. Companies will be motivated by an additional financial bonus for creating a higher number of part-time job positions. Better quality advisory services for both employers and unemployed persons will also be backed, while more intensive communication with employers should also ensure more flexible adjustment of the offer for retraining programmes, according to needs of the individual regions. The Ministry of Labour and Social Affairs will also support unemployed persons who decide to set up their own business. This support will include offering education activities and direct financial assistance.

#### 6.2.4 The “Green Light to Savings” Programme

Beginning from 2013, the New Green Light to Savings programme (Government Resolution No. 116/2013) is started, following on from a similar and successful programme operating since 2009. The projects for decreasing energetic demanding character of buildings and operating costs and the related decrease in greenhouse gas emissions will be financed from the programme. Besides the reduction of operating costs for heating, it will increase housing culture and improve appearance of towns and villages. Implementation of the program will also support the economic activity, associated with an increase in employment, particularly in the construction industry and other related fields. Expenses to cover the programme will be sourced from revenues drawn from emission allowance auctions within the European System of Emission Trading. It is expected that the overall allocation of financial means for the programme will reach to CZK 10-28 billion for the period of 2013–2020. The final amount is subject to the development of the carbon market in the coming years and is burdened by the risk of a temporary dysfunction of this market. Out of the total amount, 70% has been reserved for buildings designed for accommodation where public support will range from 30 to 55%, depending on the quality of the project. The programme will stimulate additional private investment and, as a consequence of the dominant involvement of local suppliers will also lead to higher employment.

### 6.3 Composition of Public Expenditure

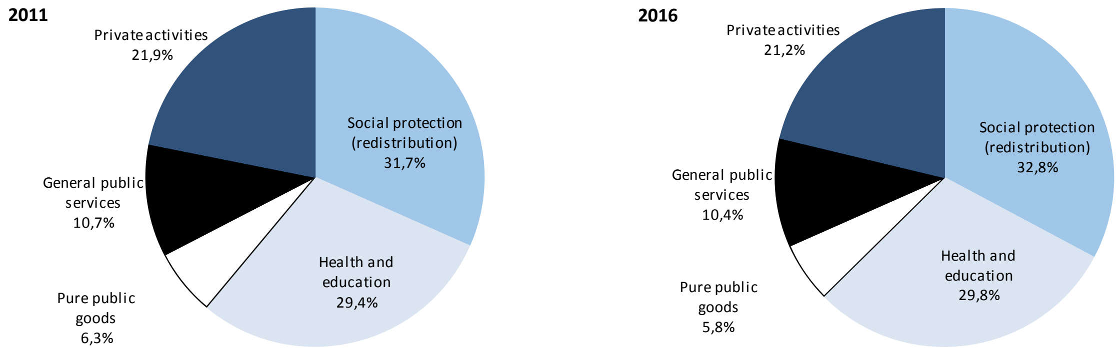
The percentage of total expenditures of the general government sector in GDP increased during the recession up to 44.7% in 2009. In the following years, this percentage fell to 43% in 2011, which is a lower value than the EU27 average by 6 p.p. Between the years 2011 and 2016, we expect only very limited nominal growth in government expenditures – on average 1.2% per year, or 6.3% for the entire 5-year period. Considering the fact that the growth rate of government expenditure will lag behind the expected growth in the nominal product, the share of total expenditure will probably continue to decline up to 41.7% of GDP in 2016. Year-on-year increase in the share of expenditures in GDP in 2012 is especially caused by the methodical posting of the property settlement between state and churches (see above) in the amount of CZK 59 billion. After making adjustments for this operation, 2012 would also confirm the established trend.

From 2009 to 2011, public spending declined in general terms, whereby the only area to record a more significant increase involved environmental protection, education, health care and social affairs. The total decrease in spending in the given period was especially attributed to a fall in the gross capital formation. When looking at the structure of spending in the individual groups in more detail, it is apparent that, together with the area of environmental protection, at least certain nominal growth in investments has been kept only in the area of education.

In the following period, we expect to witness a relative decrease in government expenditure as a share of GDP in almost all categories monitored (see Table P.3 in the annex). The only exception is the area of social affairs where a slight increase in the share of expenditures in GDP will occur. Compared to last year's CP update (MF CR, 2012c), a decrease in the estimate of spending for general public services within the forecast period was recorded. The reason is especially lower expected interest costs from government debt, to a limited extent also savings that should be reached as a consequence of rendering the activities of state administration more effective. Chart 6.1 portrays the composition of government expenditures in 2011 and their expected structure in 2016. During this timeframe, given the relative decrease in total spending, a slight shift will occur from the support of private activities and pure public goods (defence, public order and security) to the redistribution and health care areas.

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

*(in % of total expenditure)*




*Note: The category "Pure public goods" includes "Defence" and "Public Order and Security". The category "Private activities" is a sum of "Economic Affairs", "Environmental Protection", "Housing and Community Amenities", and "Recreation, Culture and Religion". For details about the division see ECB (2009). A 10-figure functional division of general government expenditures can be found in the Annex, Table A.3.*

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

*Source: CZSO (2013d). MF CR calculations.*

# 7 Institutional Features of Public Finances

One of the basic assumptions for implementing successful fiscal consolidation leading to healthy and sustainable general government finances is represented by the strong national institutional framework of fiscal and budgetary policy. The main steps leading to its strengthening can be seen in terms of preparation of the constitutional Act on Fiscal Responsibility and the related Act on Rules of Fiscal Responsibility and in the amendment to the related legal regulations. Implementation of the accounting reform in the area of public finances, launched in 2010 is also continuing successfully, already having made significant headway in terms of increasing transparency.

## 7.1 Constitutional Act on Fiscal Responsibility

In October 2012, the government approved a draft of the constitutional Act on Fiscal Responsibility, which subsequently passed through its first reading in the Chamber of Deputies of the Parliament of the CR. The constitutional Act on Fiscal Responsibility will represent the legal standard covering the national fiscal framework. The standard defines the basic principles and rules for healthy and long-term sustainable general government finances.

The most important parameters of the constitutional act include introducing the duty for government sector institutions to set the budget and medium-term budgetary outlook for the two following years at least, anchoring the rule for setting total expenditure of general government sector and establishment of the National Fiscal Council operating as an independent authority in the area of fiscal and budgetary policy.

Another key element contained in the constitutional act is the fiscal rule applying to the local governments. According to this rule, a municipality or region is to perform economic activities ensuring that the total amount of its gross debt does not exceed 60% of the average of its revenues for the last four years. If the debt of a municipality or region exceeds this level, the state may on an annual basis suspend revenues of taxes, intended for a municipality or region, to the amount of 5% of the difference between the amount of debt and 60% of the average revenues in last four years. Suspended revenues of taxes can be only released for repaying the local government debt obligations made before the year in which the suspension occurred.

The "safety measure" for the event of not respecting operative fiscal rules is referred to as a debt brake. It concerns anchoring the maximal limit of the amount of government debt as a percentage of GDP and other limits of debt that – if exceeded – are subject to automatically activated corrective measures. These measures gradually increase in line with an increase to the debt-to-GDP ratio. The group of mandatory subjects also increases. The rule includes transparent and specifically defined escape clauses. Specific parameters of the debt brake were described in detail in last year's update of the CP (MFCR, 2012c).

## 7.2 Act on Rules of Fiscal Responsibility

With its resolution (No. 253/2012) the government decided to prepare a brief constitutional Act on Fiscal Responsibility and the related Act on Rules of Fiscal Responsibility. The specific way of its approval has been selected to ensure higher stability of the regulation as it requires consent from both Chambers of the Parliament of the CR.

The Act on Rules of Fiscal Responsibility includes, among others, definition of the general government sector consistent with the definition of general government sector according to the European System of National and Regional Accounts ESA 95. At the same time, the legal regulation imposes on the Ministry of Finance the duty to publish basic information required by the Directive of the Council 2011/85/EU of the 18 November 2011 on the requirements for budgetary frameworks of the Member States. It imposes a duty on public institutions to publish proposals and approved budgets and medium-term outlooks for the two following years at least. The current forecast of the Ministry of Finance will be used as preparation material for these. For the purpose of an ex ante evaluation of macroeconomic forecasts and forecasts of general government sector revenues, the Minister shall set up a Committee for Budgetary Forecasts which will assess forecasts at least twice a year. Preparation of the state budget, budgets of state funds and health insurance companies and their middle-term budgetary outlooks results from the macroeconomic forecast and the forecast of revenues identified by the Committee for Budgetary Forecasts as "realistic" or "conservative" in nature. The composition of the Committee for Budgetary Forecast, the method of appointing its members and conduct of the Committee shall be defined by the Ministry of Finance with a regulation. The regulation also imposes on the Ministry of Finance the duty to publish a description of methods used for preparing forecasts, other parameters on which forecasts are based, and the subsequent annual evaluation of their success rate.

The medium-term character of the budgetary process will be strengthened by means of the so-called Budgetary strategy of the general government sector, prepared each year by the Ministry of Finance and discussed by the government. This strategy will include basic parameters of the medium-term budgetary framework required by the aforementioned directive. Total expenditure of the general government sector, among others, will be apparent from it, determined according to the new fiscal rule and expenditure frameworks of the state budget and state funds representing the point of departure for preparing the state budget and budgets of state funds. The strategy will form part of the Convergence Programme of the CR, whereby the fiscal strategy will be clearly linked to the budgetary process. Considering the time framework for preparing budgets of individual public institutions, the Strategy can be considered as the minimal version of the coordination mechanism among the individual levels of the general government sector. Its part will include the financial relations of the state budget to general government sector budgets – especially to local governments and the system of public health insurance.

An important qualitative shift has been brought by the new fiscal rule for determining total expenditure in the general government sector. The rule ensues from a requirement for creating structural balance of the general government sector. Total expenditure is derived from total revenues of the general government sector, adjusted by the impact of the business cycle and one-off or temporary measures. The methodology for determining one-off and temporary measures and adjusting revenues for the impact of the business cycle will be developed by the Ministry of Finance in cooperation with the National Fiscal Council. The rule will be supplemented by a so-called corrective component, which is an automatic correction mechanism taking into account variances of the actual result of performance of the general government sector (published by the Czech Statistical Office) from the total expenditure determined by the rule ex post. This component will be activated once it exceeds the limit of 2% of the previous year's nominal GDP. At this moment, the amount of total expenditure within the general government sector will be decreased by one third of the corrective component exceeding 2% of GDP.

From total expenditure of the general government sector, the expenditure framework of the state budget and budgets of state funds will be derived. Spending of other institutions than of the state budget and state funds will be deducted from total expenditure determined by the fiscal rule, and adjustment will be made from the ESA 95 methodology into the national cash methodology of budget preparation. The determination of the expenditure framework of the state budget and budgets of state funds will be carried out by the Ministry of Finance. The National Fiscal Council will issue its opinion on this, which the Ministry of Finance will be obliged to publish on its websites. The methodology of deducting will again by prepared by the Ministry of Finance in cooperation with the National Fiscal Council.

The Act on Rules of Fiscal Responsibility further includes execution of the numerical fiscal rule for local governments which is anchored in the draft of the constitutional Act on Fiscal Responsibility. Furthermore, it specifies use of the debt brake and outlines exceptions of applying this. Exceptions are limited to the case of a major worsening of the economic development, worsening of the security situation of the state, natural disasters or expenditures resulting from international treaties and other international obligations of the CR.

The element strengthening transparency and credibility of newly introduced tools and rules will be the independent fiscal institution – the National Fiscal Council. The main activities of the Council will include ascertaining and declaring the amount of debt used as part of the debt brake, evaluation of meeting the numerical fiscal rules (incl. submitting the report to the Chamber of Deputies) and evaluation of the results of budgetary management based on the state final account. Furthermore, the Council will create stimuli for strengthening transparency of public institution management, carry out the analysis of long-term sustainability of public finances (incl. evaluation of in what manner it can be influenced by planned government policies), and its opinions on legislative proposals of a fundamental nature and their budgetary impacts. When exercising its competence, the Council will be allowed to require cooperation from other public institutions. The independent character of the Council's activity will be strengthened by the prohibition stipulated by law to accept or require instructions from any entity. The Council will comprise 5 members who will be elected by the Chamber of Deputies of the Parliament of the CR. The act addresses proposing and electing members, requirements put on them, incompatibility with performance of most political functions or termination of the function. The term of the Council's member will be six years, while during the first election the mandate of one member and the first vice-chairman will be shortened to four years and of the other member and the vice-chairman to two years, ensuring a fluid replacement of members strengthening independency from the current political representation. Furthermore, the act regulates remuneration of the Council's members. The tasks related to ensuring the professional, organisational and technical nature of its activities will be performed by the

Office of the Council. It will be led by Head of the Office of the Council appointed and recalled by the Council. The Office's activities will be paid from the Council's budget. The act also regulates financing of the Council and its budget.

## 7.3 The State Treasury

Most modules of the Integrated State Treasury Information System have entered their operational phase. This was preceded with an extensive amendment to budgetary legislation setting out new duties for state organisational components and state semi-budgetary organisations. At the same time, a significant extension was made defining the financial resources of the state treasury.

In January 2012, a pilot operation of the module Budget Implementation and Payment System was started. The first module mentioned, involves 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 components, establishment of budgetary limits, and carrying out their operations with advances.

In July 2012, a Budget Preparation module was launched in which the drafting and approval of the state budget, medium-term outlook and procedure for creating budgetary provisional arrangement are anchored.

The module of Budgetary measures is in its operational phase, which especially includes changes related to maintaining the detailed budgets of state organisational components, approving and implementing budgetary measures, and collecting data for evaluating fulfilment of the state budget, including data on the budgetary provisory.

## 7.4 State Accounting

In 2010, an accounting reform was initiated in the CR in the area of public finances. Its main target is to create conditions for effective ensuring of correct, complete and timely information on the economic situation of the state and other relevant ac-counting units. Specific targets include increasing the quality of accounting methods used in the government sector, their unification and approximation to the principles of the so-called business accounting or obtaining information on potential receivables and payables. Furthermore, the reform concentrates on ensuring reliable information for the purposes of reporting and government financial statistics, at the level of the government sector and partial consolidation units, and receiving continuous information necessary for operative management.

For 2012, some selected accounting units submitted a so-called Auxiliary Analytical Survey to the Central system of accounting information, through which information is ascertained for the purposes of monitoring and managing public finances, including government financial statistics (ESA 95, GFSM 2001 standards, etc.). In 2013, upon agreement between the MF CR and the Czech Statistical Office, the number of municipal accounting units handing the Auxiliary Analytical Survey will remain limited to municipalities whose number of citizens equals to or is higher than 3 thousand as of the 1 January 2012 and semi-budgetary organisations whose net total assets for two immediately preceding accounting periods equal to or are higher than CZK 100 million.

Legislative works are still underway for creating conditions to consolidate individual financial statements for the purpose of drawing up consolidated financial statements for the CR, including the so-called partial consolidation units. For the first time, the consolidated financial statement should be drawn up for the accounting period of 2014.

The Ministry of Finance is also continuing to compile the legislative steps necessary for meeting data requirements resulting from the Directive of the Council 2011/85/EU as defined by the working group of Eurostat established upon request of the General Directorate for Economic and Financial Affairs.

## 7.5 Public Inspection

The process of approving the complex amendment to the act on financial control by the Parliament of the CR is continuing. The main principles strengthened by the amendment were described in last year's update of the CP (MFCR, 2012c).

At the same time, the new act on the management and control system of public administration of the CR is being prepared, which is to be submitted to the government of the CR by the 31 May 2013. The bill structures three pillars of the system, specifically the system of financial management and control, the system of internal audit and the central harmonization of these systems. In the system of financial management and control, it sets out managerial responsibility for public budget administrators, anchors organisational and functional independencies of the system of internal auditing of public budget administrators in accordance with the International Framework of Internal Audit Professional Practice. At the same time, it defines the duties of the Ministry of Finance in the area of central harmonization and performance of supervision over the functionality and effectiveness of the system of financial management and control and the system of internal auditing of the individual administrators of public budgets.

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# Table Annex

### Table A.1a: Macroeconomic Prospects

*(level in CZK billion, growth in %, contributions to growth in p.p.)*

| | ESA Code | 2012 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|
| | | *Level* | | | *Rate of change* | | |
| 1. Real GDP | B1*g | 3792 | -1.3 | 0.0 | 1.2 | 2.1 | 2.6 |
| 2. Nominal GDP | B1*g | 3843 | 0.1 | 0.4 | 2.1 | 3.6 | 3.7 |
| Components of real GDP | | | | | | | |
| 3. Private consumption expenditure | P.3 | 1881 | -3.5 | -1.2 | 1.0 | 2.1 | 2.5 |
| 4. Government consumption expenditure | P.3 | 785 | -1.0 | -0.2 | -1.7 | -0.8 | 0.1 |
| 5. Gross fixed capital formation | P.51 | 902 | -1.7 | -0.4 | 0.9 | 2.6 | 3.1 |
| 6. Changes in inventories and net acquis. of valuables (% of GDP) | P.52+P.53 | 12 | 0.3 | 0.4 | 1.0 | 1.2 | 1.3 |
| 7. Exports of goods and services | P.6 | 2894 | 3.8 | 1.3 | 3.7 | 4.9 | 5.4 |
| 8. Imports of goods and services | P.7 | 2681 | 1.9 | 0.9 | 3.5 | 4.7 | 5.1 |
| Contributions to real GDP growth | | | | | | | |
| 9. Final domestic demand | | - | -2.4 | -0.8 | 0.4 | 1.5 | 2.0 |
| 10. Changes in inventories and net acquis. of valuables | P.52+P.53 | - | -0.4 | 0.3 | 0.5 | 0.2 | 0.1 |
| 11. External balance of goods and services | B.11 | - | 1.5 | 0.4 | 0.3 | 0.4 | 0.5 |

*Note: Real levels are stated in 2011 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 (2013a), MF CR (2013a). MF CR calculations.*

### Table A.1b: Price Developments

*(indices 2005=100, growth in %)*

| | 2012 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|
| | *Level* | | | *Rate of change* | | |
| 1. GDP deflator | 107.4 | 1.4 | 0.4 | 0.9 | 1.4 | 1.1 |
| 2. Private consumption deflator | 113.7 | 2.3 | 1.2 | 1.2 | 1.8 | 1.1 |
| 3. HICP | 120.3 | 3.5 | 2.1 | 1.7 | 1.9 | 1.1 |
| 4. Public consumption deflator | 117.2 | 1.5 | 1.4 | 1.2 | 1.3 | 0.9 |
| 5. Investment deflator | 103.2 | 0.6 | 0.2 | 0.6 | 0.6 | 0.7 |
| 6. Export price deflator (goods and services) | 96.5 | 3.0 | 1.2 | 0.0 | 0.7 | 0.6 |
| 7. Import price deflator (goods and services) | 101.7 | 3.6 | 1.7 | 0.3 | 0.7 | 0.5 |

*Source: CZSO (2013a), Eurostat (2013). MF CR calculations.*

### Table A.1c: Labour Market Developments

*(growth in %)*

| | ESA Code | 2012 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|
| | | *Level* | | | *Rate of change* | | |
| 1. Employment, persons | | 5092 | 0.4 | -0.2 | 0.0 | 0.1 | 0.2 |
| 2. Employment, hours worked | | 9.2 | -1.2 | -0.3 | -0.2 | 0.1 | 0.0 |
| 3. Unemployment rate (%) | | 7.0 | 7.0 | 7.6 | 7.7 | 7.3 | 6.7 |
| 4. Labour productivity, persons | | 762 | -1.7 | 0.2 | 1.2 | 2.0 | 2.4 |
| 5. Labour productivity, hours worked | | 420 | 0.0 | 0.2 | 1.4 | 2.1 | 2.5 |
| 6. Compensation of employees | D.1 | 1659 | 2.0 | 1.3 | 2.7 | 3.1 | 4.0 |
| 7. Compensation per employee | | 401 | 2.1 | 1.5 | 2.8 | 3.0 | 3.9 |

*Note: Employment is based on domestic concept of national accounts. Rate of unemployment is based on the methodology of the Labour Force Survey. Labour productivity is calculated as real GDP (in 2011 prices) per employed person or worked hour.*
*Source: CZSO (2013a, 2013c). MF CR calculations.*

**Table A.1d: Sectoral Balances**

*(in % of GDP)*

| | ESA Code | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|
| **1. Net lending/borrowing vis-à-vis the rest of the world** | B.9 | **-1.4** | **-1.3** | **-1.2** | **-1.3** | **-1.6** |
| *of which* : Balance on goods and services | | 5.3 | 5.4 | 5.4 | 5.7 | 6.1 |
| *of which* : Balance of primary incomes and transfers | | -7.9 | -7.9 | -7.9 | -8.3 | -9.1 |
| *of which* : Capital account | | 1.3 | 1.3 | 1.4 | 1.4 | 1.4 |
| **2. Net lending/borrowing of the private sector** | B.9 | **3.0** | **1.5** | **1.6** | **1.5** | **1.2** |
| **3. Net lending/borrowing of general government** | EDP B.9 | **-4.4** | **-2.8** | **-2.9** | **-2.8** | **-2.8** |
| **4. Statistical discrepancy** | | **0.0** | **0.0** | **0.0** | **0.0** | **0.0** |

*Note: Data from national accounts. Years 2012–2013 notification. Years 2014–2016 outlook.*
*Source: CZSO (2013b). MF CR calculations.*

## Table A.2a: General Government Budgetary Prospects

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

| | ESA Code | 2012 Level | 2012 | 2013 | 2014 In % of GDP | 2015 | 2016 |
|---|---|---|---|---|---|---|---|
| **Net lending (+)/borrowing (-) (EDP B.9) by sub-sectors** | | | | | | | |
| 1. General government | S.13 | -169 | -4.4 | -2.8 | -2.9 | -2.8 | -2.8 |
| 2. Central government | S.1311 | -160 | -4.2 | -2.8 | -2.8 | -2.8 | -2.8 |
| 3. State government | S.1312 | - | - | - | - | - | - |
| 4. Local government | S.1313 | -2 | -0.1 | 0.0 | -0.1 | 0.0 | 0.0 |
| 5. Social security funds | S.1314 | -7 | -0.2 | 0.0 | 0.0 | 0.0 | 0.0 |
| **General government (S.13)** | | | | | | | |
| 6. Total revenue | TR | 1542 | 40.1 | 40.4 | 40.2 | 39.5 | 38.9 |
| 7. Total expenditure [1)] | TE | 1711 | 44.5 | 43.3 | 43.0 | 42.3 | 41.7 |
| 8. Net lending (+)/borrowing (-) | EDP B.9 | -169 | -4.4 | -2.8 | -2.9 | -2.8 | -2.8 |
| 9. Interest expenditure [1)] | EDP D.41 | 57 | 1.5 | 1.5 | 1.5 | 1.5 | 1.5 |
| 10. Primary balance | | -112 | -2.9 | -1.3 | -1.3 | -1.3 | -1.3 |
| 11. One-off and other temporary measures | | -80 | -2.1 | -0.1 | -0.1 | -0.1 | -0.1 |
| **Components of revenues** | | | | | | | |
| 12. Total taxes | | 737 | 19.2 | 19.7 | 19.6 | 18.9 | 18.2 |
| 12a. Taxes on production and imports | D.2 | 460 | 12.0 | 12.4 | 12.1 | 12.0 | 11.4 |
| 12b. Current taxes on income, wealth etc. | D.5 | 276 | 7.2 | 7.3 | 7.5 | 6.9 | 6.8 |
| 12c. Capital taxes | D.91 | 0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| 13. Social contributions | D.61 | 600 | 15.6 | 15.5 | 15.5 | 15.6 | 15.8 |
| 14. Property income | D.4 | 29 | 0.8 | 0.7 | 0.6 | 0.5 | 0.6 |
| 15. Other | | 176 | 4.6 | 4.6 | 4.5 | 4.4 | 4.3 |
| 16. Total revenue | TR | 1542 | 40.1 | 40.4 | 40.2 | 39.5 | 38.9 |
| p.m.: Tax burden | | 1337 | 34.8 | 35.2 | 35.1 | 34.5 | 34.0 |
| **Components of expenditures** | | | | | | | |
| 17. Compensation of employees + Intermediate consumption | D.1+P.2 | 501 | 13.0 | 13.1 | 12.7 | 12.2 | 12.0 |
| 17a. Compensation of employees | D.1 | 281 | 7.3 | 7.3 | 7.2 | 6.9 | 6.7 |
| 17b. Intermediate consumption | P.2 | 220 | 5.7 | 5.8 | 5.5 | 5.4 | 5.3 |
| 18. Social payments | | 767 | 20.0 | 20.2 | 20.3 | 20.2 | 19.9 |
| *of which:* Unemployment benefits [2)] | | 16 | 0.4 | 0.4 | 0.5 | 0.5 | 0.4 |
| 18a. Social transfers in kind supplied via market producers | | 233 | 6.1 | 6.1 | 6.1 | 6.0 | 5.9 |
| 18b. Social transfers other than in kind | D.62 | 534 | 13.9 | 14.1 | 14.2 | 14.2 | 14.0 |
| 19. Interest expenditure [1)] | EDP D.41 | 57 | 1.5 | 1.5 | 1.5 | 1.5 | 1.5 |
| 20. Subsidies | D.3 | 77 | 2.0 | 2.0 | 2.0 | 2.0 | 1.9 |
| 21. Gross fixed capital formation | P.51 | 119 | 3.1 | 3.2 | 3.3 | 3.3 | 3.3 |
| 22. Capital transfers | D.9 | 121 | 3.2 | 1.3 | 1.3 | 1.3 | 1.3 |
| 23. Other | | 68 | 1.8 | 1.8 | 1.8 | 1.8 | 1.7 |
| 24. Total expenditures [1)] | TE | 1711 | 44.5 | 43.3 | 43.0 | 42.3 | 41.7 |
| p.m.: Government consumption (nominal) | P.3 | 795 | 20.7 | 20.9 | 20.3 | 19.7 | 19.2 |

*Note: Years 2012–2013 notification. Years 2014–2016 outlook.*

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

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

*Source: CZSO (2013b). MF CR calculations.*

## Table A.2b: No-policy Change Projections

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

| | 2012 Level | 2012 | 2013 | 2014 In % of GDP | 2015 | 2016 |
|---|---|---|---|---|---|---|
| 1. Total revenue at unchanged policies | 1542 | 40.1 | 39.9 | 39.6 | 39.3 | 39.0 |
| 2. Total expenditure at unchanged policies | 1711 | 44.5 | 43.8 | 43.9 | 43.2 | 42.5 |

*Source: MF CR.*

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

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

| | 2012 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|
| | *Level* | *In % of GDP* | | | | |
| **1. Expenditure on EU programmes fully matched by EU funds revenue** | **56** | **1.4** | **1.4** | **1.4** | **1.3** | **1.3** |
| **2. Cyclical unemployment benefit expenditure** | **-1** | **0.0** | **0.0** | **0.0** | **0.0** | **0.0** |
| **3. Effect of discretionary revenue measures** (year-on-year changes) | **10** | **0.3** | **0.5** | **0.0** | **-0.4** | **-0.3** |
| **4. Revenue increases mandated by law** | - | - | - | - | - | - |

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

### Table A.3: General Government Expenditure by Function

*(in % of GDP)*

| | Code | 2011 | 2016 |
|---|---|---|---|
| **1. General public services** | 1 | **4.6** | **4.3** |
| **2. Defence** | 2 | **0.9** | **0.8** |
| **3. Public order and safety** | 3 | **1.8** | **1.6** |
| **4. Economic affairs** | 4 | **6.0** | **5.5** |
| **5. Environmental protection** | 5 | **1.3** | **1.4** |
| **6. Housing and community amenities** | 6 | **0.8** | **0.7** |
| **7. Health** | 7 | **7.8** | **7.8** |
| **8. Recreation, culture and religion** | 8 | **1.2** | **1.2** |
| **9. Education** | 9 | **4.9** | **4.7** |
| **10. Social protection** | 10 | **13.6** | **13.7** |
| **Total expenditure** | TE | **43.0** | **41.7** |

*Note: Year 2016 outlook.*
*Source: CZSO (2013d), MF CR (2013a). MF CR calculations.*

### Table A.4: General Government Debt Developments

*(in % of GDP, average maturity in years)*

| | ESA Code | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|
| **1. Gross debt** | | **45.8** | **48.5** | **50.3** | **51.2** | **51.9** |
| **2. Change in gross debt ratio** | | **4.9** | **2.8** | **1.8** | **0.9** | **0.6** |
| **Contributions to changes in gross debt** | | | | | | |
| **3. Primary balance** | | **-2.9** | **-1.3** | **-1.3** | **-1.3** | **-1.3** |
| **4. Interest expenditure** | EDP D.41 | **1.5** | **1.5** | **1.5** | **1.5** | **1.5** |
| **5. Stock-flow adjustment** | | **0.5** | **0.1** | **-0.1** | **-0.1** | **-0.4** |
| - Difference between cash and accruals | | -2.6 | 0.5 | 0.1 | 0.0 | -0.2 |
| - Net accumulation of financial assets | | 3.2 | -0.4 | -0.2 | -0.1 | -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** | | **3.2** | **3.1** | **3.1** | **3.0** | **2.9** |
| **6. Liquid financial assets** | | **19.8** | **19.4** | **18.9** | **18.1** | **17.4** |
| **7. Net financial debt** 1) | | **25.9** | **29.1** | **31.5** | **33.1** | **34.5** |
| **8. Debt amortization (existing bonds) since the end of the previous year** 2) | | **3.2** | **3.0** | **3.8** | **3.8** | **4.3** |
| **9. Debt denominated in foreign currency** 2) | | **4.3** | **5.1** | **5.7** | **5.9** | **5.9** |
| **10. Average maturity** 2) | | **5.7** | **5.6** | **5.6** | **5.8** | **6.0** |

*Note: Years 2012–2013 notification. Years 2014–2016 outlook.*
*1) Net financial debt is a difference between gross debt and liquid financial assets (monetary gold, Special Drawing Rights, currency and deposits, securities other than shares (consolidated at market value), shares and other equity quoted in stock exchange).*
*2) Figures only for the state debt. The state debt represents a debt generated by the state budget financing.*
*Source: CZSO (2013b). State debt data MF CR. MF CR calculations.*

## Table A.5: Cyclical Developments

*(growth in %, output gap in % of potential GDP, contributions in p.p., other in % of GDP)*

| | ESA Code | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|
| **1. Real GDP growth (%)** | | **-1.3** | **0.0** | **1.2** | **2.1** | **2.6** |
| **2. Net lending of general government** | EDP B.9 | **-4.4** | **-2.8** | **-2.9** | **-2.8** | **-2.8** |
| **3. Interest expenditure** | EDP D.41 | **1.5** | **1.5** | **1.5** | **1.5** | **1.5** |
| **4. One-off and other temporary measures** | | **-2.1** | **-0.1** | **-0.1** | **-0.1** | **-0.1** |
| **5. Potential GDP growth (%)** | | **0.7** | **1.1** | **1.1** | **1.3** | **1.3** |
| **Contributions:** | | | | | | |
| - labour | | 0.3 | 0.3 | 0.1 | 0.1 | -0.1 |
| - capital | | 0.6 | 0.6 | 0.6 | 0.7 | 0.7 |
| - total factor productivity | | -0.2 | 0.2 | 0.4 | 0.5 | 0.7 |
| **6. Output gap** | | **-2.1** | **-3.1** | **-3.0** | **-2.2** | **-1.0** |
| **7. Cyclical budgetary component** | | **-0.6** | **-1.0** | **-1.0** | **-0.7** | **-0.3** |
| **8. Cyclically-adjusted balance (2 - 7)** | | **-3.8** | **-1.8** | **-1.9** | **-2.1** | **-2.5** |
| **9. Cyclically-adjusted primary balance (8 + 3)** | | **-2.3** | **-0.3** | **-0.4** | **-0.6** | **-1.0** |
| **10. Structural balance (8 - 4)** | | **-1.7** | **-1.8** | **-1.8** | **-2.1** | **-2.4** |

*Note: Years 2012–2013 notification. Years 2014–2016 outlook.*
*Source: CZSO (2013b). MF CR calculations.*

## Table A.6: Divergence from Previous Update

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

| | ESA Code | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|
| **Real GDP growth** | | | | | | |
| **Previous update** | | **0.2** | **1.3** | **2.2** | **2.8** | **-** |
| **Current update** | | **-1.3** | **0.0** | **1.2** | **2.1** | **2.6** |
| Difference | | -1.4 | -1.3 | -1.0 | -0.7 | - |
| **General government net lending** | | | | | | |
| **Previous update** | EDP B.9 | **-3.0** | **-2.9** | **-1.9** | **-0.9** | **-** |
| **Current update** | EDP B.9 | **-4.4** | **-2.8** | **-2.9** | **-2.8** | **-2.8** |
| Difference | | -1.4 | 0.1 | -1.0 | -1.9 | - |
| **General government gross debt** | | | | | | |
| **Previous update** | | **44.0** | **45.1** | **44.8** | **43.4** | **-** |
| **Current update** | | **45.8** | **48.5** | **50.3** | **51.2** | **51.9** |
| Difference | | 1.7 | 3.4 | 5.5 | 7.9 | - |

*Source: MF CR (2012c), MF CR (2013a). MF CR calculations.*

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

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

| | 2010 | 2020 | 2030 | 2040 | 2050 | 2060 |
|---|---|---|---|---|---|---|
| Total expenditure | 45.3 | 38.6 | 40.0 | 41.9 | 45.0 | 47.9 |
| *of which:* Age-related expenditures | 20.2 | 20.0 | 21.0 | 22.1 | 24.0 | 25.4 |
| Pension expenditure | 9.1 | 8.4 | 8.6 | 9.5 | 10.9 | 11.7 |
| Social security pensions | 9.1 | 8.4 | 8.6 | 9.5 | 10.9 | 11.7 |
| Old-age and early pensions | 7.2 | 6.6 | 6.5 | 7.3 | 8.7 | 9.4 |
| Other pensions | 1.9 | 1.8 | 2.0 | 2.2 | 2.2 | 2.3 |
| Occupational pensions | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Health care | 6.9 | 7.3 | 7.8 | 8.1 | 8.4 | 8.5 |
| Long-term care | 0.8 | 0.9 | 1.1 | 1.2 | 1.3 | 1.5 |
| Education expenditure | 3.4 | 3.4 | 3.6 | 3.3 | 3.4 | 3.7 |
| Other age-related expenditures | 25.1 | 18.6 | 19.0 | 19.8 | 20.9 | 22.6 |
| Interest expenditure | 0.9 | 1.5 | 1.9 | 2.7 | 3.8 | 5.5 |
| Total revenue | 40.4 | 35.3 | 35.6 | 35.8 | 35.9 | 36.1 |
| *of which:* Property income | 0.8 | 0.5 | 0.6 | 0.7 | 0.8 | 1.0 |
| *of which:* Pension contributions | 8.4 | 8.8 | 8.9 | 9.0 | 9.0 | 9.1 |
| Pension reserve fund assets | 0.6 | 0.0 | 0.1 | 0.0 | 0.0 | 0.0 |
| *of which:* Consolidated public pension fund assets | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Systemic Pension Reforms [1)] | | | | | | |
| Social contributions diverted to mandatory private scheme | - | - | - | - | - | - |
| Pension expenditure paid by mandatory private scheme | - | - | - | - | - | - |
| Assumptions | | | | | | |
| Labour productivity growth | 2.2 | 2.0 | 1.8 | 1.8 | 1.7 | 1.5 |
| Real GDP growth | 2.3 | 1.8 | 1.7 | 1.5 | 1.1 | 1.2 |
| Participation rate of males (aged 20–64) | 85.1 | 86.9 | 86.1 | 85.5 | 86.8 | 87.3 |
| Participation rate of females (aged 20–64) | 66.5 | 68.7 | 68.8 | 68.4 | 70.9 | 71.7 |
| Total participation rate (aged 20–64) | 75.9 | 77.9 | 77.6 | 77.1 | 79.0 | 79.7 |
| Unemployment rate | 7.1 | 6.2 | 6.0 | 5.9 | 5.9 | 5.9 |
| Population aged 65+ over total population | 15.4 | 19.8 | 22.1 | 25.1 | 28.8 | 30.6 |

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

**Table A.7a: Contingent Liabilities**

*(in % of GDP)*

| | 2012 | 2013 |
|---|---|---|
| Public guarantees | 14.0 | 16.4 |
| *of which:* Linked to the financial sector | 4.0 | 5.6 |

*Source: MF CR.*

**Table A.8: Basic Assumptions**

*(interest rates and growth in %)*

| | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|
| Short-term interest rate (CZ) (annual average) | 1.0 | 0.5 | 0.6 | 0.7 | 1.0 |
| Long-term interest rate (CZ) (annual average) | 2.8 | 2.2 | 2.3 | 2.7 | 3.1 |
| Nominal effective exchange rate (2010=100) | 99.5 | 98.2 | 99.3 | 100.4 | 101.6 |
| Exchange rate CZK/EUR (annual average) | 25.1 | 25.4 | 25.2 | 24.9 | 24.6 |
| World excluding EU, GDP growth | 3.4 | 3.7 | 4.1 | 4.7 | 5.1 |
| EU27 GDP growth | -0.3 | -0.2 | 0.7 | 1.3 | 1.6 |
| Growth of relevant foreign markets | 0.9 | -0.1 | 2.1 | 3.1 | 4.9 |
| World import volumes, excluding EU | 4.2 | 4.5 | 5.1 | 5.7 | 6.1 |
| Oil prices (Brent, USD/barrel) | 111.7 | 108.0 | 102.0 | 98.8 | 95.8 |

*Source: CNB (2013), Eurostat (2013), IMF (2013a). MF CR calculations.*

**Ministry of Finance of the Czech Republic**
Letenská 15
118 10 Prague 1

http://www.mfcr.cz