Ministry of Finance
Czech Republic

Convergence Programme
of the Czech Republic

May 2016

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ISSN 1804-798X

Issued annually, free distribution

Electronic archive:
http://www.mfcr.cz/CoPr

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List of Abbreviations

CNB .... Czech National Bank
COFOG .... Classification of the Functions of Government
CP .... Convergence Programme of the Czech Republic
CZK .... Czech koruna currency code
CZSO .... Czech Statistical Office
EC .... European Commission
ERM II .... Exchange Rate Mechanism II
ESA 2010 .... European System of National and Regional Accounts from year 2010
EU, EU28 .... European Union containing 28 countries
EUR .... euro currency code
GDP .... gross domestic product
LFS .... Labour Force Survey
MF CR .... Ministry of Finance of the Czech Republic
PAYG .... pay-as-you-go system
pp .... percentage point
PPS .... Purchasing Power Standard
USD .... US Dollar currency code
YoY .... year-on-year

Symbols Used in Tables

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

Cut-off Date for Data Sources

Macroeconomic data used pertain to the 1 April 2016 release, fiscal data to the 11 May 2016 release and survey of macroeconomic forecasts of the CR to the 15 April 2016 release. Notification of general government deficit and debt was approved by Eurostat on 21 April 2016.

Note

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

Introduction

In the sphere of fiscal policy, several exceptional events occurred in 2015. In spite of record-breaking investment and the compensation of austerity cuts, the lowest general government sector deficit in the modern history of the CR was achieved. The amount of general government sector investment was the highest since at least 1995, that year being the earliest year the relevant data are available for comparison. Even when the lease of the JAS-39 Gripen aircraft is included, the value of investment exceeded the highest pre-crisis level by CZK 4 billion. Quicker utilisation of resources from EU funds made a significant contribution. The second extraordinary phenomenon were the record-breaking low yields of government bonds. On 28 August 2015, medium-term state bonds were sold on the primary market for the first time in the history of the CR with negative yields. Since then, a further ten auctions of medium-term state bonds have been held on the primary market with negative yields. Government treasury bills have continually achieved negative interest yields on the primary market more or less since September 2015. On the secondary market, average monthly rates for medium-term bonds with a residual maturity of 2 years got into negative values for the first time in April 2015 and have remained there continuously since August 2015. Since October 2015 (except for an interlude in January 2016), a negative average monthly rate has also been recorded continually on the secondary market for bonds with a residual maturity of 5 years.

The submitted update of the Convergence Programme (CP) for the period 2016–2019 was approved by the Government of the CR on 11 May 2016 and is consistent with the National Programme of Reforms of the CR approved by the Government of the CR on the same day. The CP is fully in line with the rules defined in the updated opinion of the Economic and Financial Committee of the Council on the content and format of the Programmes of Stability and the Convergence Programmes (EFC, 2012). In April 2016, the CP was also presented and discussed with the relevant committees of the Chamber of Deputies and the Senate of the CR.

CP is divided into seven interconnected chapters. Chapter 1 sets out the economic and political intentions and targets of the Government of the CR in the sphere of fiscal policy and the basic elements of structural reforms, as well as the monetary policy framework.

The macroeconomic scenario of the CP, based on the April Macroeconomic Forecast of the MF CR (2016a), is detailed in Chapter 2. The economy was stimulated by several exceptional factors in 2015: a positive supply shock resulting from low oil prices and fiscal expansion, reflecting - among other factors - the effort towards maximal absorption of resources from EU funds from the financial perspective 2007–2013. As a result, the economy accelerated considerably and real GDP increased by 4.2% for the whole year. In 2016, we expect a slowdown in real GDP growth to 2.5%. The year 2016 should be characterised by inflation staying extremely low and by a further reduction in the unemployment rate.

The economic policy in 2015, the forecast for 2016, as well as the fiscal strategy of the government in future years are discussed in Chapter 3. This Chapter is based on the results of the Deficit and Debt Notification approved by Eurostat on 21 April 2016, and on the now more precise economic-policy intentions of the Government (closing date for data sources was 11 May 2016). For 2015, the general government sector deficit of 0.4% of GDP and government debt of 41.1% of GDP were notified. The forecast estimates the general government sector deficit of 0.6% of GDP in 2016 with a subsequent decrease to 0.5% of GDP in the whole horizon of the outlook. The structural balance should stay at around −1% of GDP in the same period, i.e. at the level of the medium-term budgetary objective of the CR. In 2015, the EU Council recommended that the CR should realise fiscal effort from 2015 to 2016 at a level of 0.5 pp, whereby it should return to the medium-term budgetary objective. From the perspective of current results, we can consider the given recommendation to have little point now, since in both these years as well as in the years of the outlook the CR should meet its medium-term budgetary objective.

Macroeconomic and fiscal scenarios are verified in Chapter 4 by comparison with the forecasts of other public and private independent institutions, including an evaluation of the macroeconomic forecast by a panel of independent experts. Moreover, the scenario is supplemented with a sensitivity analysis in which the impacts of alternative scenarios of economic development are simulated. These alternatives encompass different interest rates, lower economic growth of the main economic partners in the EU and a higher oil price. An equally important part of the chapter is also the analysis of the variances between the current scenario and the scenario from the last update of the CP.

In Chapter 5, some aspects of long-term sustainability are monitored. The chapter provides information on the pension scheme and the public health insurance scheme, including reform measures. In terms of long-term sustainability, the updated pension projections in the Ageing Working Group of the Economic Policy Committee (EPC/AWG) are also described. This chapter also examines the size and structure of general government sector guarantees.

Chapter 6 addresses the qualitative side of general government sector revenues and expenditure. At present, priority is given to a description of planned and implemented changes in the tax system which should result in preventing tax evasion and improving tax collection. Measures for rationalising government expenditure are also presented here.

The last section, Chapter 7, deals with already implemented or planned changes in the institutional environment, the transparency of public finances and strengthening their efficiency. Special emphasis is paid to issues around strengthening the fiscal and budgetary framework.

1 Overall Policy Framework and Objectives

The intention of the current Government of the CR is to support and develop "a socially and environmentally oriented market economy" (Policy Statement of the Government, 2014). The aim of the economic and political mix is to increase the competitiveness of the economy and strengthen the country's social and regional cohesion through long-term sustainable economic growth. The priority is to identify and implement growth-supporting measures across different spheres of the economy. From the perspective of fiscal policy, the government has also expressly declared that it will take pains to ensure that development of the general government deficit will remain at a safe level below the reference value of 3% of GDP. In monetary policy, in November 2013 the CNB began to use the exchange rate as an additional monetary policy instrument after the possibilities of using the traditional channel of interest rates were more or less exhausted. According to the CNB's current statement, this regime of a one-sided exchange rate commitment with a lower limit of 27 CZK/EUR is to be used at least until 2017; the CNB Bank Board considers it probable that the commitment will end nearer to mid-2017.

1.1 Fiscal Policy

In the area of fiscal policy, the Government of the CR has set out several main objectives. The most important of these can be identified as the improved collection of taxes, more effective and transparent government expenditure and improvement of the absorption and drawdown of resources from EU funds.

In the first year of the government's term of office, an audit was conducted in order to implement measures aimed at increasing the effectiveness of public administration. The following year 2015 was characterised by a high increase in tax revenues, including social contributions, which increased by CZK 95 billion in accrual terms. In addition to macroeconomic development, measures resulting in more effective financial and customs administration (e.g. the extension of the reverse charge system of value-added tax, the introduction of a nationwide control system for carousel frauds, a new tax annex to the corporate income tax allowing better supervision of transfer pricing or the squad Kobra at the general and regional level) were also reflected in a better tax collection. At present, measures aimed at increasing the effectiveness of tax collection are being introduced. The electronic VAT report came into effect on 1 January 2016, and fiscalisation of cash payments will come into force at the end of 2016 (see subchapter 6.1). Both aforementioned measures should result in improvement of the revenue side that would enable the financing of government priorities on the expenditure side or reduce the tax burden in the future.

Measures in the social area work in the opposite direction, either in government final consumption concerning increased expenditure of health insurance companies and growth in the wage bill in the general government sector, or in the area of social benefits. In 2015, the government carried out extraordinary indexation of pension benefits by 1.8% as compensation for the cuts of previous governments in this area. In February 2016, a one-off benefit of CZK 1,200 was paid out to each pensioner due to the low increase in pensions given by the calculation of the indexation formula in which the low inflation is reflected. For following years, the Government of the CR has approved the reintroduction of discretion into the indexation system (Government Resolution No. 146/2016), which will enable it in future to respond exactly to these types of situations with low inflation (more detail – see Chapter 5). Another aspect of the expenditure policy is an increase in the wage bill in the general government sector, where we estimate the compensation of employees to increase by approximately 4%. Undoubtedly, the national security is also an expenditure priority. In reaction to the current situation, both in connection with the migration crisis and terrorist attacks in Europe, the government has decided to increase expenditure in the area of the interior, defence and foreign affairs.

In 2015, the CR exceeded its medium-term budgetary objective (corresponding to a structural balance of −1% of GDP for the CR) when the structural balance reached −0.3% of GDP. Since 2014, when the medium-term budgetary objective had been met exactly, a positive fiscal effort of 0.7 pp was achieved. This outcome has been achieved even in spite of a reduction in the rate of value added tax for medicines, books and essential child nutrition, the reintroduction of tax credit for working pensioners, extraordinary pension indexation, increase in tax credit for families with more than one child or the gift tax returns on emission allowances. One of the primary factors of the YoY positive fiscal effort is the successful drawdown of the European resources from the financial perspective 2007–2013. With the gradual start of the new perspective, we again expect an increase in investment from national resources that should lead to a gradual deterioration of the structural balance to the value of the medium-term budgetary objective, where it should last until the end of the outlook horizon (Table 1.1).

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

	2017	2018	2019
General government balance	**-0.5**	**-0.5**	**-0.5**
Structural balance	-1.0	-1.0	-1.0
Primary structural balance	0.1	0.0	0.0

Source: MF CR.

In the area of state debt management, the main objective has been the optimisation and increased efficiency of the system of asset management in the state treasury system: this has acted as a significant brake on the increase in general government debt (in 2014, it even decreased by approx. CZK 21 billion in absolute terms). In 2015, the share of general government debt in GDP continued its decline to 41.1% of GDP, whereas in 2016 stabilisation of this share is expected. Considering the planned performance of the general government sector in the following years and the macroeconomic outlook, we expect a decrease in general government debt to a value of around 39% of GDP (more detail – see subchapter 3.4).

1.2 Monetary Policy

The monetary policy of the CNB is unwaveringly conducted as an inflation-targeting regime. Since 1 January 2010, a new medium-term inflation target has been set, defined as a YoY increase in the consumer price index of 2% with a tolerance range of ±1 pp. Actual inflation can therefore temporarily deviate from the inflation target, for example due to modifications of indirect taxes, the primary impacts of which the CNB typically does not react to at all, concentrating only on their secondary manifestations.

Considering the fact that the undershooting of the inflation target continued in spite of a decrease in interest rates to the technical minimum, in November 2013 the CNB decided to further relax the monetary conditions and started using the exchange rate as an additional monetary policy instrument. This has taken the form of an asymmetric commitment not to allow any strengthening of the exchange rate below 27 CZK/EUR. Although this regime is to be used at least until 2017, in fact the CNB Bank Board considers its termination of the commitment to be probably closer to mid-2017.

Considering the potential accession of the CR to the euro zone, the Government of the CR stated, on the basis of the joint document of the MF and CNB "Assessment of the Fulfilment of the Maastricht Convergence Criteria and the Degree of Economic Alignment of the Czech Republic with the Euro Area" (MF CR, CNB, 2015), that the situation in the Euro Area is still not yet creating conditions sufficiently favourable for the future adoption of the single European currency in the CR. Regarding the country's actual level of preparedness to adopt the euro, it is necessary to solve in particular the issue of the long-term sustainability of public finances, to reduce administrative barriers to business and increase labour market flexibility in certain aspects. Considering these facts, the government has not yet established a target date for joining the Euro Area and will not endeavour to enter the ERM II during 2016.

1.3 Structural Policies

In its Policy Statement, the government committed itself to enforcing an economic programme based on support for business, an effective labour market, a functioning and transparent state administration, a long-term sustainable pension scheme, investment in education, science and research and social harmony across society.

In this context, a number of measures and reforms have already been taken or are being prepared. The most important of them include a decrease in the tax burden on the labour of pensioners and families with children, or relaxing the conditions for providing material support for creating new jobs in the investment incentive system. In the business environment, the Act on Public Procurement will increase transparency and reduce the administrative requirements of the procurement process. As far as the fight against tax evasion is concerned, the government has introduced the electronic VAT report and the Act on Fiscalisation of Cash Payments will come into effect on 1 December 2016 (see subchapter 6.1). In the area of science and research, a draft of long-term budget of national expenditure on research, development and innovation to 2021 is currently prepared. The budget should contribute to strengthening the assurance and long-term stability of the research, development and innovation system, within the meaning of Government Resolution no. 1067/2015, after the end of the financial perspective of 2007–2013. Strengthening of the assurance and long-term stability of the research, development and innovation is also addressed in the National policy of research, development and innovation of the CR for the years 2016–2020, approved by the Government Resolution no. 135, of February 17, 2016.

The CR's priorities and targets in the sphere of structural policies are detailed in the National Reform Programme of the Czech Republic 2016 (Government Office, 2016).

2 Economic Outlook

The macroeconomic scenario of the Convergence Programme of the CR is based on the April Macroeconomic Forecast of the MF CR (2016a). Its verification by an independent panel of experts and comparison with other forecasts is provided in Chapter 4.

The Czech economy is in the boom phase of the business cycle; in 2016 we expect real GDP to grow by 2.5%. Economic growth should be driven primarily by domestic demand. The year 2016 should still be characterised by low inflation due to a marked decrease in crude oil prices. The economic recovery is also reflected in the labour market, where the unemployment rate is decreasing and employment is growing. These favourable tendencies should also continue in the next few years. The external position of the Czech economy in the form of net lending/borrowing vis-à-vis the rest of the world should remain balanced.

2.1 World Economy and Forecast Assumptions

The global economic situation and the outlook in individual regions of the world are gradually getting slightly worse. The economic growth rate in both developed and emerging economies is slowing down and some large economies, such as Russia and Brazil, are going through a deep recession. The impact of low prices for crude oil and other commodities differs in individual regions. Whereas in oil-importing countries it can be considered as an important supply stimulus, countries exporting oil face a number of economic and social problems.

For 2015, GDP of the EU28 showed growth of 1.9%. The economic recovery during the year was mainly caused by private consumption due to the improving labour market situation and low energy prices. In contrast, the growth of exports was unfavourably influenced by foreign demand dynamics and net exports dampened economic growth.

We expect GDP of the EU28 to increase by 1.7% in 2016 (versus growth of 1.9% in the EC Winter Forecast, 2016a); for 2017 we expect growth of economic performance of 1.9% (versus growth of 2.0% in the Winter Forecast of the EC, 2016a). Growth should continue to be driven especially by private consumption expenditure supported by the improving labour market situation. Conversely, economic growth will be mitigated by the worsened global outlook or the high debt level of some economies.

Other assumptions of the CP scenario are comparable with the assumptions of the 2016 Spring Forecast of the EC.

In 2015, the average price of Brent crude oil was 52 USD per barrel, while its decrease in the period 2014–2016 surpassed all expectations. In the forecast horizon of the CP we expect a gradual price rise to 54 USD per barrel in 2019; for 2016 and 2017 we expect the crude oil price to be similar to that assumed in the Spring Forecast of the EC, i.e. approx. 41 and 47 USD per barrel, respectively.

Based on the recent development of the USD/EUR exchange rate, we made a technical assumption for an exchange rate stability of 1.10 USD/EUR for 2016–2019. This scenario has a slightly stronger EUR/USD exchange rate compared to the assumptions of the Spring Forecast of the EC, which expects an identical exchange rate of 1.09 USD/EUR for both years.

The CNB will continue to use the CZK exchange rate as an additional monetary policy instrument (more detail – see also Part 1.2). Therefore, the assumption of exchange rate stability at 27 CZK/EUR was adopted for the period until the second quarter of 2017. In line with the CNB's statement, we expect the CZK to again strengthen slightly against the euro after the exchange rate commitment is abandoned.

Considering the outlook for inflation, even in the medium-term horizon we cannot expect any marked tightening of the CNB's monetary policy, and nor therefore any marked growth in interest rates either, which have been hovering at extremely low values since the end of 2012.

Table 2.1: Exogenous Assumptions of the Scenario

		2015	2016	2017	2018	2019
USD/EUR exchange rate	*annual average*	1.11	1.10	1.10	1.10	1.10
CZK/EUR exchange rate	*annual average*	27.3	27.0	26.9	26.2	25.6
Government bond yield to maturity 10Y	*in % p.a.*	0.6	0.6	0.8	1.2	1.6
PRIBOR 3M	*in % p.a.*	0.3	0.3	0.3	0.3	0.5
GDP EU28	*real growth in %*	1.9	1.7	1.9	2.0	2.0
Oil prices (Brent)	*USD/barrel*	52.4	40.9	47.4	51.4	54.0

Source: CNB (2016a), EIA (2016), Eurostat (2016). MF CR calculations.

2.2 Actual Developments and Medium-term Scenario

2.2.1 GDP and the Demand Side

In 2015, the real GDP growth accelerated to 4.2%. However, a number of one-off factors contributed to this dynamic economic growth, in particular strengthened investment activity due to the ending of the financial perspective 2007–2013 and decline in crude oil prices. In 2016, the first factor will expire while the second should continue, but now to a more limited extent. GDP growth should slow to 2.5% in this year and should also fluctuate around this level in the following years.

Improving household incomes, growing employment with low inflation and increasing consumer confidence all resulted in an acceleration of household consumption growth to 2.8% in 2015. In 2016, these favourable factors should cause household consumption growth to further accelerate to 3.1%. In the CP horizon, due to gradually accelerating inflation, we expect real household consumption to slow to 2.3%, with growth in the nominal wage bill being relatively similar.

The trajectory of real expenditure of the general government sector on final consumption is based on the proposal of the medium-term expenditure framework and the approved deficit amount for the 2017 state budget. The growth rate of this general government expenditure should gradually decrease from 2.8% in 2015 to 1.3% in 2019. All the most important components of general government sector consumption in terms of volumes will participate in a real slowdown, i.e. intermediate consumption, social benefits in kind and compensation of employees, where we expect employment growth to gradually decline in this sector.

In 2015, the dynamics of gross fixed capital formation were strongly supported by investment of the general government sector, the impact of which culminated thanks to the final opportunity to use resources from EU funds for the previous financial perspective and also due to the inclusion of the financial lease of the JAS-39 Gripen aircraft in investment expenditure in the ESA 2010 methodology. The increase in investment activity also corresponded to growing domestic and foreign demand and, together with the favourable development of firms’ own resources for financing investment projects, was in response to a growth in capacity utilisation. Once the financial perspective 2007–2013 is terminated, we expect a one-off slowdown in gross fixed capital formation growth to 0.6% in 2016. In the following years of the outlook, we can expect investment to grow by approximately 3%.

The contribution of foreign trade to YoY growth of real GDP in 2015 reached −0.2 pp, in particular due to import growth caused by the high dynamics of domestic demand. Considering the expected development on export markets and the forecasted slowdown of domestic demand, the contribution of foreign trade to economic output should be slightly positive in the next few years.

2.2.2 Potential Product and Position within the Business Cycle

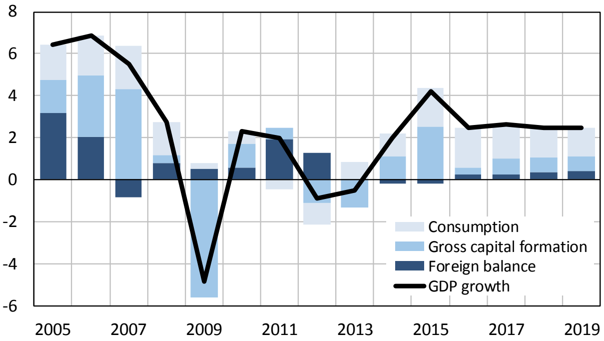
Due to a long period of recessions and the sluggish economic growth in 2011–2013, growth of potential product has slowed considerably; the biggest contribution stemmed from the trend in total factor productivity. Since 2014, growth accelerated up to 1.8% in 2015 alongside the growth in total factor productivity. The decrease or only slight growth in gross fixed capital formation in 2008–2013 has led to a drop in the contribution of capital stock. Moreover, from 2010 on, the negative impacts of demographic changes have started to manifest themselves quite strongly. The decline in the working-age population, however, is compensated by an increase in the participation rate. Considering that regular working time is being shortened and that the CR is approaching the standards of more developed economies, the contribution of the number of worked hours to potential product growth still tends towards the negative.

In the next few years, bound up with stable growth in the economy, growth in potential product could hover above 2%. Most of this growth can be ascribed to total factor productivity growth, and to a lesser extent also to growth in capital stock contribution.

The output gap, reaching up to −3.5% of potential product during the culmination of the recession in 2013, closed during 2015. At the end of the CP horizon, we expect a positive output gap of around 1%.

Chart 2.1: Decomposition of GDP Growth

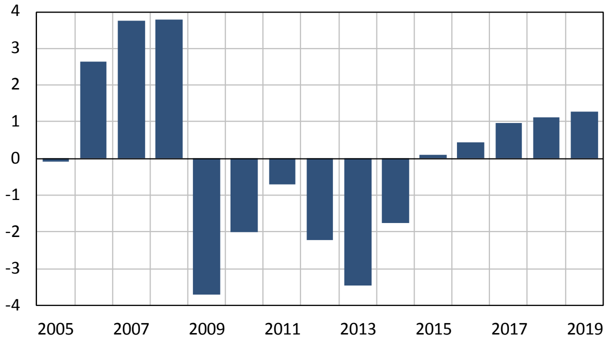
(growth in %, contributions to growth in percentage points)



Source: CZSO (2016a), MF CR (2016a). MF CR calculations.

Chart 2.2: Output Gap

(in % of potential product)



Source: MF CR calculations.

Table 2.2: Economic Output

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

	ESA Code	2015 *Level*	2015	2016	2017 *Rate of change*	2018	2019
Real GDP	B1*g	**4440**	**4.2**	**2.5**	**2.6**	**2.4**	**2.4**
Nominal GDP	B1*g	**4472**	**5.0**	**3.5**	**4.0**	**4.1**	**4.2**
Components of real GDP							
Private consumption expenditure	P.3	**2128**	**2.8**	**3.1**	**2.7**	**2.4**	**2.3**
Government consumption expenditure	P.3	**851**	**2.8**	**2.1**	**1.6**	**1.4**	**1.3**
Gross fixed capital formation	P.51g	**1143**	**7.3**	**0.6**	**3.0**	**3.1**	**3.1**
Changes in inventories and net acquis. of valuables (% of GDP)	P.52+P.53	**39**	**0.9**	**1.0**	**0.9**	**0.8**	**0.7**
Exports of goods and services	P.6	**3822**	**7.0**	**5.5**	**5.9**	**6.0**	**6.0**
Imports of goods and services	P.7	**3544**	**7.9**	**5.6**	**6.1**	**6.1**	**6.1**
Contributions to real GDP growth							
Final domestic demand		**-**	**3.7**	**2.1**	**2.4**	**2.2**	**2.1**
Changes in inventories and net acquis. of valuables	P.52+P.53	**-**	**0.7**	**0.1**	**0.0**	**0.0**	**0.0**
External balance of goods and services	B.11	**-**	**-0.2**	**0.2**	**0.2**	**0.3**	**0.4**

Note: Real levels are in 2014 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 (2016a), MF CR (2016a).

2.2.3 Prices

Inflation measured by the harmonised consumer price index reached 0.3% in 2015, i.e. it was the second lowest in the available time series (since 1997). Factors in the external environment participated strongly in the very low inflation. These included especially the aforementioned marked fall in crude oil and energy prices and the related decrease of the producer prices in the euro zone. Domestic economic development, characterised by growing demand against the backdrop of a closed output gap and low unemployment rate, had a pro-inflationary effect, but the development of unit labour costs mitigated these effects. Administrative measures contributed to consumer price growth only very slightly.

In 2016, inflation rate should reach 0.6%. In the first three quarters of 2016, YoY growth of consumer prices should remain low, though a more significant acceleration can be expected as late as in the fourth quarter of 2016, when YoY growth in the CZK crude oil price will probably become positive. In addition to the crude oil price, the main factors in price developments in 2016 will likely have a nearly neutral (CZK/EUR exchange rate) or a pro-inflationary effect (growing demand in connection with a slightly positive output gap, and rising unit labour costs). The contribution of administrative measures should be similarly as low as it was in 2015.

In 2017, inflation should increase further to 1.5%, while similar factors as those at the end of 2016 should take effect. In the years of the outlook, the harmonised consumer price index growth should fluctuate below 2%.

Table 2.3: Prices of Goods and Services

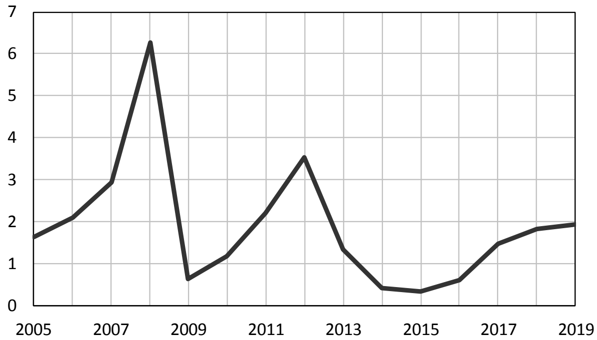
(indices 2010=100, rate of change in %)

	2015 Level	2015	2016	2017 Rate of change	2018	2019
GDP deflator	105.9	0.7	1.0	1.3	1.6	1.8
Private consumption deflator	105.5	0.1	0.5	1.4	1.8	1.9
Harmonised index of consumer prices	108.0	0.3	0.6	1.5	1.8	1.9
Public consumption deflator	104.2	1.2	1.2	2.0	1.0	1.1
Investment deflator	103.9	0.9	0.9	1.3	1.5	1.7
Export price deflator (goods and services)	108.7	-1.1	-1.7	-0.6	0.0	0.2
Import price deflator (goods and services)	107.8	-1.5	-2.3	-0.6	-0.2	0.0

Source: CZSO (2016a), Eurostat (2016). MF CR calculations.

Chart 2.3: Harmonised Index of Consumer Prices

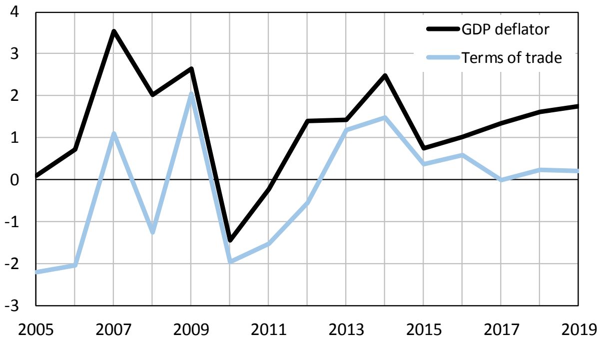
(y-o-y growth in %)



Source: Eurostat (2016). MF CR calculations.

Chart 2.4: GDP Deflator and Terms of Trade

(y-o-y change in %)



Source: CZSO (2016a). MF CR calculations.

2.2.4 Labour Market and Wages

High economic growth in 2015 resulted in favourable development for the main labour market aggregates. Employment based on national accounts methodology increased by 1.2%, which was the highest figure since 2008.

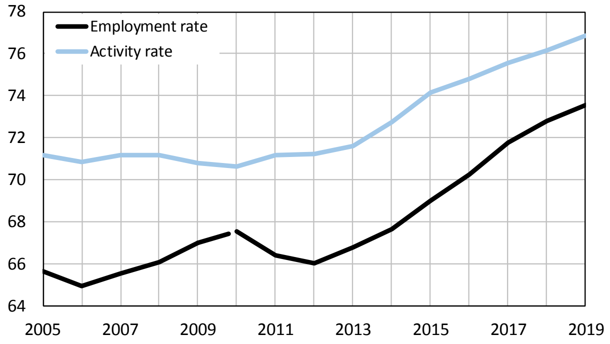
In spite of relatively dynamic economic growth, in the CP horizon we are expecting a somewhat gradual increase in employment, which will be reflected, however, in more considerable growth in the employment rate due to the falling working-age population. The unemployment rate should decrease gradually to 4.2% in 2019.

A problematic aspect of the Czech labour market is the high proportion of long-term unemployed persons, which will prevent any more significant increase in employment or any decrease in the total unemployment rate. A barrier to more significant improvement of labour market aggregates will also be increasing friction in the market, i.e. the shortage of qualified employees especially in technical professions. This aspect can be largely interpreted as structural, though at present it is also accented by the position of the Czech economy in the business cycle.

The participation rate in the CR has a counter-cyclical character. The improving position of the Czech economy in the business cycle brings about pressures towards lowering the participation rate. Structural factors should counteract such pressures, however. The most important of these include the rise in statutory retirement age, which should also manifest itself in the increasing effective retirement age, and the favourable change in the demographic structure. In the CP horizon the share of population in age groups with a naturally high participation rate is increasing (especially those aged 40–49); after including the impact of the development in all age groups, the demographic effect will be positive.

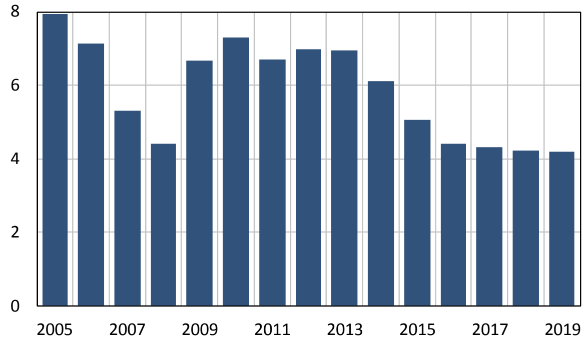
For 2016, we expect an increase in the compensation of employees by 4.5%, whereby several tendencies will impact wage development in the CP horizon in opposite directions. In particular in 2016, nominal wage growth should be dampened by low inflation. The aforementioned shortage of qualified workers in some professions or regions should, on the contrary, further increase pressures on wage growth. With stable economic growth, a decrease in the number of less well remunerated jobs in the grey economy can also be expected.

Chart 2.5: Employment and Participation Rates
(in %)



Source: CZSO (2016c). MF CR calculations.

Chart 2.6: Unemployment Rate
(in %)



Source: CZSO (2016c). MF CR calculations.

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

	ESA Code	2015	2015	2016	2017	2018	2019
		Level	*Rate of change*				
Employment, persons		**5170**	**1.2**	**0.5**	**0.1**	**0.1**	**0.1**
Employment, hours worked		**9.2**	**1.8**	**0.7**	**0.1**	**-0.2**	**-0.2**
Unemployment rate (%)		**5.1**	**5.1**	**4.4**	**4.3**	**4.2**	**4.2**
Labour productivity, persons		**793**	**3.0**	**1.9**	**2.5**	**2.4**	**2.4**
Labour productivity, hours worked		**441**	**2.3**	**1.7**	**2.5**	**2.7**	**2.7**
Compensation of employees	D.1	**1787**	**4.4**	**4.5**	**4.6**	**4.6**	**4.6**
Compensation per employee		**405**	**2.4**	**3.3**	**4.4**	**4.5**	**4.5**

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 2014 prices) per employed person or worked hour.
Source: CZSO (2016a, 2016c). MF CR calculations.

2.3 External Transactions and Sectoral Balances

This subchapter has been prepared using the national accounts methodology, which allows - based on the relationship between investment and savings - the surplus or deficit in economic relations vis-à-vis the rest of the world to be completely divided among individual economic sectors. The difference from the analogous and commonly used balance of payments methodology lies, for example, in the method of processing data sources or classifying certain items.

In 2015, the Czech economy recorded positive net lending/borrowing vis-à-vis the rest of the world of 1.1% of GDP, i.e. it once again became a net exporter of capital, as it had been in 2013.

The surplus in the balance of goods and services reached 6.4% of GDP. The YoY decrease of 0.3 pp was caused by domestic demand dynamics and the inclusion of the lease of the JAS-39 Gripen aircraft. The long-term deficit balance of primary incomes, which is influenced predominantly by the distributed income of companies under foreign control, achieved a negligible improvement of 0.1 pp to −7.7% of GDP. The balance of current transfers showed a slight deficit of −0.7% of GDP. The surplus of capital transfers reached a record-breaking value of 3.1% of GDP due to accelerated use of funding from the financial perspective 2007–2013.

In 2016, the balance of net lending/borrowing should return to a deficit of approx. −0.4% of GDP, especially due to a lower surplus in the balance of capital transfers. In the next few years, net lending/borrowing vis-à-vis the rest of the world as a percentage of GDP should fluctuate around the value of zero, with a slightly increasing tendency while keeping the current structure of individual balances.

In terms of sectoral balances, with the given trajectory of the percentage of the general government sector deficit in GDP, the balance of the private sector should fluctuate below 1% of GDP.

Table 2.5: Sectoral Balances
(in % of GDP)

	ESA Code	2015	2016	2017	2018	2019
Net lending/borrowing vis-à-vis the rest of the world	B.9	**1.1**	**-0.4**	**-0.3**	**0.0**	**0.3**
Balance of goods and services		6.4	6.8	6.7	6.9	7.2
Balance of primary incomes and transfers		-8.4	-8.5	-8.4	-8.4	-8.5
Capital account		3.1	1.3	1.4	1.5	1.6
Net lending/borrowing of the private sector	B.9	**1.5**	**0.2**	**0.2**	**0.5**	**0.7**
Net lending/borrowing of general government	B.9	**-0.4**	**-0.6**	**-0.5**	**-0.5**	**-0.5**
Statistical discrepancy		**0.0**	**0.0**	**0.0**	**0.0**	**0.0**

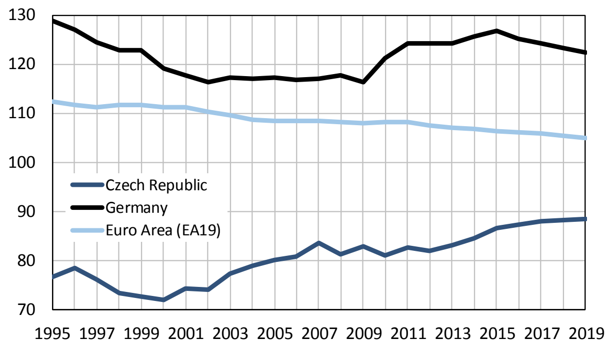
Note: National Accounts Methodology. Net lending/borrowing of general government for 2015–2016 notification, years 2017–2019 outlook.
Source: CZSO (2016a). MF CR calculations.

2.4 Convergence

According to the preliminary estimate, the economic level of the CR, expressed in terms of GDP per capita adjusted by current purchasing power parity, reached approximately 24,400 PPS in 2015, corresponding to 86% of the EA28 economic level or 68% of the economic level of Germany. Thanks to strong economic growth, the relative economic level of the CR in comparison with the EA28 countries increased by 11 pp in 2000–2007. Subsequently, however, due to periods of recession and sluggish economic growth, the convergence process stopped (see Chart 2.7). In 2008–2013, the economic level of the CR fluctuated between 81% and 83% of the EA28 average. Economic recovery in 2014 and strong growth the following year has resulted in renewal of the convergence process that should also continue gradually in the next few years.

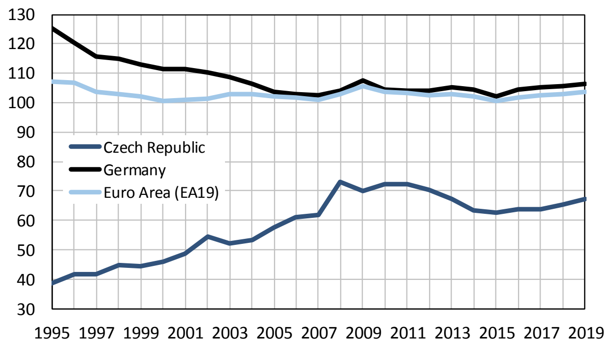
As far as a comparison of price levels is concerned, the price level in the CR increased almost continuously from 1995 to 2008, when it reached 73% of the EU28 average (Chart 2.8). In 2009–2013, there followed a period of relative stability in the price level at around 70% of the EU28 average. Subsequently, the comparative price level decreased due to a strong weakening of the CZK/EUR exchange rate as a result of monetary policy, specifically to 63% of the EU28 average in 2015, which assisted in improving the price competitiveness of the Czech economy in the aforementioned period. In the following years, the price level of the CR should again start approaching the EU28 average owing to a slight strengthening of the exchange rate, although we estimate that now the rate will be slower than it was before 2008.

Chart 2.7: GDP per Capita – Using Current Purchasing Power Parities
(EU28=100)



Source: CZSO (2016a), Eurostat (2016). MF CR calculations.

Chart 2.8: Comparative Price Level of GDP
(EU28=100)



Source: : CZSO (2016a), Eurostat (2016). MF CR calculations.

3 General Government Balance and Debt

The general government sector deficit in 2015, at −0.4% of GDP, was the record-breaking lowest, both absolute and relative, in the history of the CR. The deficit was unequivocally the lowest, despite a number of discretionary measures that either reduced income or increased expenditure. Expenditure co-financed from EU funds played a substantial role in how 2015 actually turned out. We estimate utilisation of 96% of the total allocation for the recently finished programming period 2007–2013. Another very positive impact includes conditions on the financial markets, which even allow state bonds to be issued with negative yields, bringing additional income to the state budget. The objective of the Government of the CR in the years of the outlook is to implement its priorities while keeping the general government sector performance at the level of the medium-term budgetary objective.

3.1 Actual Balances and Updated Budgetary Plans for the Current Year

3.1.1 Development in Year 2015

According to data published by the CZSO, the general government sector deficit in 2015 was 0.4% of GDP. In comparison with 2014, this is a considerable improvement of 1.5 pp, while in structural terms it is a decrease of 0.7 pp. Approximately half the improvement can be attributed to the development of the business cycle (closing the negative output gap) and one-off measures; nevertheless, in spite of this it has been the best result in the available time series, even surpassing the existing record-breaking deficit low in 2007 (0.7% of GDP). That, however, was largely caused by an extremely positive output gap.

The total growth of incomes reached 8.5% in 2015. Incomes from taxes and social security contributions increased by 6.5%, while revenues from indirect taxes amounted to the highest increases. In relative terms, total revenues reached 42.2% of GDP. The composite tax burden increased by 0.5 pp to 34.6%. However, this value was not caused by an increase in statutory tax rates, which actually fell in 2015, but by improved tax collection.

The collection of indirect taxes increased by more than 9%, especially due to VAT revenues and at the same time due to a very high increase in excise duties on tobacco products. During 2014, a measure introducing the time limitation on the additional sale of tobacco stamps with the immediately preceding rate was approved. The motive for stockpiling was thereby reduced considerably, resulting in a steep decline in tax revenues in 2014 and at the same time their returning to the current level a year later, as dictated by real consumption of tobacco products. This extraordinary fluctuation considerably accelerated the dynamics of accrual tax revenues in 2015. To a lesser extent, the increased rate of tax on tobacco products also contributed to the increase in tax revenues.

Despite weaker VAT collection in the first quarter of 2015, its annual revenues grew by 4.3%, far in excess of household consumption dynamics. Tax revenues were also dampened by the introduction of the second reduced rate for medicines, books and irreplaceable child nutrition.

Direct tax revenues increased by 4.3% compared to 2014, mainly due to corporate income tax (growth of 6.8%) that reflected the fast pace of economic growth. In contrast, slower development was apparent in personal income tax, which only increased by 2.0%. However, the result was caused by discretionary influences that supported selected groups of households, such as reintroduction of the basic personal tax credits for working pensioners and support for families with more children, and others. The development in social security contributions was also a dynamic that increased by 5.5% YoY, while additional revenues due to an increase in the payment for state insured persons were only slight.

However, the biggest contribution to growth of the revenue side stemmed from accrual capital transfers from EU funds, which increased by more than 84% compared to 2014. The development was caused by the successful effort to draw down the remaining resources from the programming period 2007–2013. Because of the n+2 rule, 2015 was the last year possible to draw down funds. Such transaction has a direct impact on the expenditure side, since investment expenditure of the general government sector is being increased in tandem. Current subsidies were also increasing relatively strongly in annual terms, again due to the drawdown of European funds, although in this case for non-investment projects, which was mainly reflected in intermediate consumption and compensation of employees on expenditure.

Total expenditure increased by 4.6%, thus reaching 42.6% of GDP in relative terms.

The nominal final consumption expenditure of general government increased by 4.8% in 2015, thus contributing to nominal GDP growth relatively strongly. The development of general government sector expenditure was mainly driven by an increase in salaries in public administration, due partly to increased payment tariffs and partly to the wage bill co-financed from the EU funds (growth of 4.8%). A similar development was also apparent in intermediate consumption; its growth of 4.2% was also largely determined by European projects. In contrast, a YoY slowdown could be seen in the social transfers in kind that represent payments of health insurance companies for health-care to health facilities that are not part of the general government sector.

Expenditure on financial social benefits increased by 2.3%. Discretionary influences of approximately 0.1% of GDP were reflected in the dynamics; these mainly included an extraordinary pension indexation of 1.8% as compensation for decreased indexation in the previous years that reduced the real purchasing power of pension benefits (see also Chapter 5).

Investment activity of the general government sector increased by approximately 30% YoY. Investment reached the highest value in the whole time series so far since 1995. In particular, the increase in investment went to EU projects and therefore has only a limited impact on the deficit in the amount of Czech financing. It was possible to generate a substantial fiscal impulse for the economy with relatively small costs for Czech public finances. Investment was also increased by the inclusion of the lease of the JAS-39 Gripen aircraft, which is included as one-off expenditure in the fourth quarter of 2015. Resources for purely national projects were slightly mitigated, which resulted in improvement of the balance of the general government sector.

A very favourable development could be seen in the interest costs of debt servicing. Their decrease by nearly CZK 8 billion was caused by state debt stability, a decline in the whole revenue curve of state bonds, the time-restricted regime of foreign exchange interventions by the CNB and confidence in the government's fiscal policy.

The expenditure side was also influenced by the gift tax returns on emission allowances amounting to CZK 4.5 billion. In reality, the tax return was paid out from the corporate income tax account, but according to the ESA 2010 methodology it is accounted for as capital transfers to non-financial corporations.

3.1.2 Development in Year 2016

In 2016, we expect a slight increase in the deficit to 0.6% of GDP, but with the structural balance still above the medium-term budgetary objective. A negative fiscal effort of 0.3 pp is primarily due to a change in the structure of investment expenditure financing.

In 2016, revenues should decrease by 0.4% to 40.6% of GDP due to a decrease in the use of funding from the EU. Nevertheless, the decrease will be dampened by incomes from taxes and social security contributions, which should increase by 3.6%.

Indirect tax revenues should increase by approximately 3.2%, mainly due to VAT collection. The expected growth of VAT revenues of 6.2% in 2016 is based on additional incomes from measures that should lead to a considerable reduction in tax evasion. In 2016, the impact of electronic VAT reporting should be the main manifestation of these measures. A limited dynamics is expected in excise duties, where a negative effect is expected in relation to the so-called Anti-Smoking Act currently being approved, as a consequence of which we expect a reduction in tobacco product consumption.

Direct taxes should increase by 2.9% compared to 2015. Their development should be determined by the increasing of personal income tax and social security contributions, which amount to approximately 4%, a similar amount as the forecasted growth of the wage bill. The termination of the 2nd pillar will be reflected in the social security contributions; specifically in the amount of approximately CZK 0.9 billion (see Chapter 5). We expect a lower growth of approximately 2% in corporate income tax due to the moderate dynamics of the development of gross operating surplus compared to 2015.

Once the possibility to use money from the old financial perspective 2007–2013 is finished, we expect a decrease in both current and especially capital accrual subsidies. The introduction of the new programming period is not fully able to compensate for the termination of the old perspective. At the same time, we assume that the time pattern of drawdown will be more fluid and uniform in this period than in the previous one.

Expenditure of the general government sector should stagnate compared to 2015, reaching 41.2% of GDP. It will therefore continue to decline as a percentage of GDP.

After its relatively high growth in 2015, expenditure on government final consumption should slow to 3.4%. We expect the highest growth of government consumption in social transfers in kind (4.5%), due to legislative changes in health-care (support for spa care, etc.). We also forecast relatively higher growth of compensation for employees of 3.9%, where the implemented growth of wages in state administration should be reflected. For intermediate consumption we expect a slowdown to 3.1% due to lower drawdown of current money from the EU funds compared to 2015.

Cash social benefits should increase by 2.3%. In addition to current statutory indexation, the extraordinary contribution of CZK 1,200 to pensioners paid out in February 2016 is reflected in their growth.

Interest costs should decrease again, although more slightly this time, due to the continuing favourable condition in the given segment of the financial market and the interest in Czech state bonds strengthened by the CNB's exchange rate policy.

Total subsidies and transfers should increase by more than 3%, and they should reflect an increase in contributions of the state to renewable energy sources.

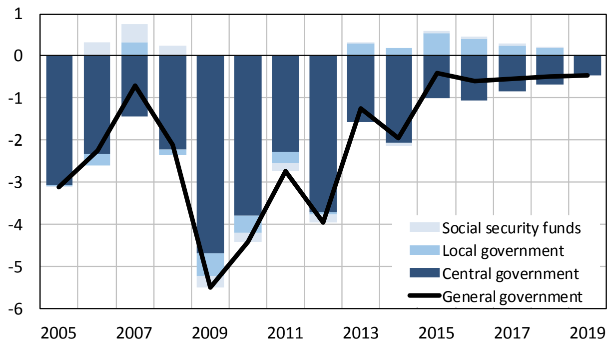
Investment activity of the government sector should be lower compared to 2015 for the aforementioned reason of the transition to the EU financial perspective 2014–2020. However, this decline is partially compensated by an increase in Czech investment that, in contrast to European projects, has full influence on the balance of the general government sector. In YoY comparison, investment expenditure is also decreased by the basis for comparison, which was increased by the extraordinary lease of the JAS-39 Gripen aircraft that was accounted for in 2015.

3.2 Medium-term Budgetary Outlook

For the period of the medium-term outlook, we expect balances of the general government sector to stabilise at −0.5% of GDP. This development implies maintaining structural balances at the level of the medium-term budgetary objective.

The current setting of fiscal policy is determined on the one side by the state budget deficits approved by the Government of the CR and by the draft of the medium-term expenditure framework for 2017–2019, and on the other side by assumptions regarding the development of other general government sector units. General government sector performance has always been strongly influenced by the central general government balance (Chart 3.1), which is unlikely to change in the future. The positive output gap should extend relatively slowly, which implies that the weight of items sensitive to the business cycle will play a relatively small role in annual terms.

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



Note: Years 2015–2016 notification, years 2017–2019 outlook.
Source: CZSO (2016b). MF CR calculations.

3.2.1 Expected Development of Revenue

The main strategy of the CR's budgetary policy on the revenue side is the fight against tax evasion and the increased effectiveness of tax collection. However, as far as these measures are concerned, the MF CR is aware of risks related, for example, to the technical implementation of the fiscalisation of cash payments. The materialisation of such risks would affect implemented revenues. We do not expect an increase in the tax burden in the period 2017–2019 through any growth of statutory tax rates. The only exception is growth of tobacco products taxation.

Higher tax collection in 2015 led to a more optimistic revision of the forecasted revenues of the general government sector compared to the last update of the CP. Their increase is due to both development of the macroeconomic bases directly influencing tax revenues on the one hand and to the increased effectiveness of tax collection and more effective prevention of tax evasion on the other. In the years of the outlook, we expect a stronger YoY growth on the revenue side in tax revenues (including social security contributions), which should exceed 4% on average. The following text briefly sets out the specific budgetary impacts of measures being prepared in 2017–2019. A more detailed description of them is included in subchapters 6.1 and 6.2.

The collection of personal income tax should be influenced positively by the development of the wage bill in the domestic economy, which is expected to be 4.6% on average in the years of the outlook. Due to the introduction of the fiscalisation of cash payments, we expect an increase in revenues from personal income taxes of those doing business in the affected sectors by approx. CZK 4.8 billion in 2017, by another approx. CZK 2.2 billion in 2018 and by CZK 0.2 billion in 2019, in line with the gradual introduction of the obligation to record sales on-line in the individual sectors. Having an effect in the reverse direction will be the one-off tax credit of CZK 5,000 for all personal income tax payers who become obliged to record sales in the given year. The tax credit was approved in order to compensate for initial costs incurred by tax payers in connection with the effect of the Act. Its impact is calculated as a one-off amount of CZK 1 billion, distributed over the period 2016 and 2017. The forecast for discretionary measures in connection with the effect of the Act on Fiscalisation of Cash Payments and amendments to accompanying acts has been modified compared to the last update of the CP due to the later date of the legislation becoming effective.

In terms of social security contributions, which in budgetary terms is the most important item for the general government sector, we expect development in line with growth in the wage bill in the economy and the expected development of payments for state insured persons. The average growth of yields is forecasted at 4.6% in the years of the outlook. An increase in the tax assessment base for persons doing business due to the introduction of the fiscalisation of cash payments is also to contribute to its growth. In connection with the effect of the Act on Fiscalisation of Cash Payments and the gradual involvement of additional sectors, we expect discretionary measures for social security contributions to be approx. CZK 4.3 billion in 2017, CZK 2.0 billion in 2018 and another CZK 0.2 billion in 2019.

Table 3.1: Impact of Measures Fighting Tax Evasions
(year-on-year discretional change, in CZK billion)

	2016	2017	2018	2019
Electronic evidence of sales	**0.5**	**15.7**	**8.3**	**0.7**
Personal income tax	-	4.2	3.0	0.2
Corporate income tax	0.1	1.9	0.9	0.1
Social security contributions	0.2	4.3	2.0	0.2
Value added tax	0.2	5.3	2.4	0.2
VAT reporting	**10.0**	**2.0**	**3.0**	**-**
Value added tax	10.0	2.0	3.0	-
Total	**10.5**	**17.7**	**11.3**	**0.7**

Source: MF CR.

The forecasted economic growth will also manifest itself positively in revenues from corporate income tax. Collection of this tax item should also increase slightly in connection with the introduction of the fiscalisation of cash payments (by approx. CZK 1.9 billion in 2017, CZK 0.9 billion in 2018 and an additional CZK 0.1 billion in 2019). Considering the absence of other negative discretionary changes, in 2017–2019 we expect an average growth of corporate income tax revenues of 4.9% per year.

For value added tax revenues, we expect an acceleration in the dynamics to 4.8% in the years of the outlook. Growth of household consumption, increased effectiveness of tax collection and key measures in the fight against tax evasion will have a positive impact that should finally result in making the business environment fair. The introduction of measures in the fight against tax evasion is also expected for 2017–2019 in line with the gradual involvement of entities in the obligation, in the case of the fiscalisation of cash payments, to immediately record sales on-line, or the obligation to submit an electronic VAT report. With the introduction of electronic VAT reporting, we expect an impact only on VAT revenues. In 2016, from this item we expect a YoY increase in VAT collection by CZK 10 billion, by another CZK 2.0 billion in 2017 and by yet another CZK 3.0 billion in 2018. Considering its effectiveness from 1 December 2016, the impact of the Act on Fiscalisation of Cash Payments will manifest itself primarily in 2017–2019. We estimate a discretionary impact on the increase in VAT collection to be CZK 5.8 billion in 2017, CZK 2.4 billion in 2018 and an additional CZK 0.2 billion in 2019. Alongside the Act on Fiscalisation of Cash Payments, an amendment to Act No. 235/2004 Coll., on Value Added Tax (Act No. 133/2016 Coll.), was also approved. The amendment reduced, among other changes, the tax rate for food services from 21 to 15%, except for alcoholic beverages, from the moment when the Act on Fiscalisation of Cash Payments comes into effect. This measure, which has an impact of CZK 0.5 billion, is aimed at compensating possible pressure to increase prices, which was assessed as a risk factor in this sector.

Excise duties will be influenced by active measures for tobacco product taxation. The amendment to the Act on Excise Duties (Act No. 315/2015, Coll.) sets out a trajectory for increasing the tax burden on tobacco products in compliance with European legislation until 2018. The effects on YoY growth in excise duty revenues should be approx. CZK 1.1 billion in 2017 and CZK 1.4 billion in 2018. We take into consideration a negative additional impact on excise duty revenues in connection with the approval of the government bill on health protection against the harmful effects of addictive substances (the so-called Anti-Smoking Act, Chamber of Deputies Print No. 508). When it comes into effect, a reduction in tobacco product consumption is expected, the effect of which on consumption tax collection should be a decrease of CZK 0.3 billion in 2017 and another CZK 1.4 billion in 2018.

As far as other revenues are concerned, we expect growth of investment subsidies in 2017–2019 in line with the gradual increase in the drawdown of resources from EU funds in the programming period 2014–2020.

For the period of the medium-term outlook, we do not forecast any one-off revenues for general government sector budgets.

3.2.2 Expected Development of Expenditure

In 2017–2019, we expect an average YoY growth in general government expenditure of 3.7%, which is less than the forecasted growth of nominal GDP. In 2017, expenditure in relative terms should stagnate at 41.2% of GDP. In the following two years of the outlook, we forecast a slight decrease to 40.6% of GDP. On the expenditure side, we do not expect any legislative changes in the medium-term outlook that would have an important impact on the general government sector deficit. Nevertheless, here we do identify risks, mainly in the security sphere in connection with the migration crisis, threat of terrorism or in the sphere of export subsidies that could possibly require an increase in expenditure in the respective chapters of the state budget.

Government final consumption expenditure should be driven by growth in expenditure on social transfers in kind (nearly 5%), compensation of employees (approx. 4.0%) and intermediate consumption, for which an increase of approx. 3% on average is expected. An important change in government final consumption is a change in the definition of this sector. This mainly applies to health-care, where a number of entities were transferred to the general government sector in 2015. The transfer had a considerable impact on the forecast for social transfers in kind, the intermediate consumption and compensation of employees since here we can see reflected the assumption of balanced finances for the social security subsector. Expenditure in this subsector should grow in line with its revenues, which are determined by an increase in the wage bill.

Growth dynamics will be mainly driven by pension benefits. On 17 February 2016, the government approved the amendment to the Act on Pension Insurance (Chamber of Deputies Print No. 725), amending the pension indexation system. Now the government will be able to adjust indexation up to 2.7%, if the indexation amount is lower according to the standard rule. It has been decided that the value of indexation for 2017 would be 1.7% (CZK 200). The current macroeconomic forecast (MF CR, 2016a) implies an impact in every year of the outlook. The impact in 2017 is estimated to approximately CZK 1 billion, in 2018 to approximately CZK 2 billion and in 2019 to approximately CZK 0.5 billion. The approval of the amendment to the Act on Social Services (Chamber of Deputies Print No. 689) will also have an impact on expenditure on cash social benefits. The amendment increases the contribution for care by 10% with effect from 1 August 2016, thus reacting to a decrease in the real value of the contribution. The discretionary growth of expenditure due to the introduction of this measure is expected to be CZK 2 billion in total, of which an impact of CZK 1.2 billion will occur in 2017. The forecast also takes into account the amendment (approved by the Government) of act on health insurance with a discretionary impact of CZK 1.9 billion in 2017.

Considering the termination of the financial perspective 2007–2013 at the end of 2015 and the gradual introduction of the new period, we expect a systematic increase in investment activity in 2017–2019 with YoY growth of approx. 4.5%. At present, the Government of the CR is negotiating with the EC in connection with the transition to the new standard for assessing the effects of structures on the environment (Environmental Impact Assessment, EIA). The result of this negotiation will impact the amount of drawdown of European resources in the first years of the outlook, the amount of investment of the general government sector and, through the component of Czech financing, also its balance. We also expect growth in investment financed from national resources. Such expectation takes into account both the relatively lower level of investment from the EU funds and also the expected and gradual increase in investment activity of local governments.

Considering the continuing favourable conditions on the financial markets, the expected gradual termination of the foreign exchange interventions regime, and only a slow increase in interest rates in the economy in connection with the expected inflation rate, the outlook expects expenditure on debt servicing to stabilise at 1.0% of GDP. In nominal terms, for the period 2017–2019 we expect a growth of expenditure on interest payments of approx. 2.3% per year due to the expected increase in general government debt and the increase in interest rates on newly issued debt. The subchapter 3.4 deals with these issues in detail.

Table 3.2: Structure of Discretionary Measures in 2016–2019
(year-on-year discretional change, in CZK billion)

	2016	2017	2018	2019
Revenue Discretioanry Measures	**21.4**	**24.4**	**11.3**	**0.7**
Personal income tax	0.5	4.6	3.0	0.2
Corporate income tax	-0.4	1.8	0.9	0.1
Social security contributions	6.6	11.4	2.0	0.2
Value added tax	10.2	7.3	5.4	0.2
Consumption taxes	2.2	0.8	-	-
Tax on lotteries	1.8	-	-	-
Other revenue measures	0.5	-1.4	-	-
Expenditure Discretionary Measures	**-12.8**	**-22.4**	**-0.1**	**-**
Cash social benefits	-4.5	-0.6	-	-
Compensation to employees	-14.1	-15.6	-0.1	-
Health care	-8.3	-6.1	-	-
Other expenditure measures	14.1	-0.1	-	-
Total	**8.7**	**2.0**	**11.2**	**0.7**
% of GDP	0.2	0.0	0.2	0.0

Source: MF CR.

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

The intentions of economic policy compared to the autonomous scenario, i.e. the scenario in which only the currently valid situation is taken into consideration, are presented in Table 3.3.

On the revenue side, major measures have been approved for more effective tax collection, i.e. electronic VAT reporting and the fiscalisation of cash payments. Electronic VAT reporting has been valid since 1 January 2016 while the fiscalisation of cash payments, approved in the first quarter of 2016, will come into force on 1 December 2016. We already include these measures in the autonomous scenario. The only measures being currently discussed with a more significant impact on the revenue side are the so-called Anti-Smoking Act and an act on gambling tax. On the expenditure side, we take into consideration the proposal to increase state social support (contribution to care), the proposal of compensation for employees of the OKD company, the proposal of amendment of act on health insurance, the proposal to minimal pension indexation and increase the wage bill in the government sector by approx. 4%. This also has an impact on revenues and partially compensates the negative impact on expenditure.

Assuming that these measures are not approved, government sector revenues would be lower by 0.1% of GDP in 2016, by 0.2% of GDP in 2017, by 0.3% of GDP in 2018 and by 0.4% of GDP in 2019. The measures have a negligible impact on the expenditure side in 2016, but they further increase expenditure by 0.5% of GDP in 2017, by 1.0% of GDP in 2018 and finally by 1.3% of GDP in 2019. The general government sector deficit would be, without the discretionary measures, 0.4% of GDP lower in 2017, 0.6% of GDP lower in 2018 and 0.9% of GDP lower in 2019. We also get a similar picture after adjusting the whole balance for the business cycle and one-off measures.

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

	2016	2017	2018	2019
Total revenue	**40.6**	**40.7**	**40.5**	**40.2**
Total revenue at unchanged policies	40.5	40.5	40.2	39.7
Cumulative discretionary revenue measures	0.1	0.2	0.3	0.4
Total expenditure	**41.2**	**41.2**	**41.0**	**40.6**
Total expenditure at unchanged policies	41.2	40.7	40.1	39.3
Cumulative discretionary expenditure measures	0.0	0.5	1.0	1.3
General government balance with discretionary measures	**-0.6**	**-0.5**	**-0.5**	**-0.5**
General government balance without not yet approved discretionary measures	-0.6	-0.2	0.1	0.4
Total cumulative discretionary measures	0.0	-0.4	-0.6	-0.9

Note: Autonomous scenario does not consider any additional government measures, i.e. it takes into account the current legal state and thus measures approved in the past may be included. The scenario with discretionary measures takes into account the prepared measures which are part of the outlook and fiscal strategy of the government. Discretionary measures in this table incorporate all non-autonomous changes, i.e. both those improving and worsening the balance. Discretionary measures in 2016–2019 are represented cumulatively, thus containing effect of changes in previous years.
Source: MF CR.

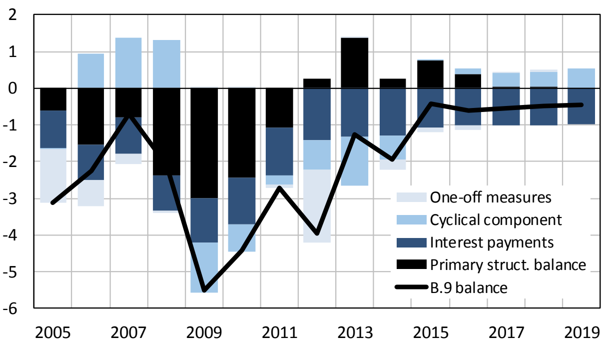
3.3 Structural Balance, Fiscal Stance

The structural balance in 2015 reached −0.3% of GDP, and it should decrease to −0.6% of GDP in 2016. In 2017, we expect a further decrease in the structural balance to −1.0% of GDP and it will probably also stay at this level in 2018 and 2019. Interest expenditure should, after a slight decrease, stabilise at 1.0% of GDP. As a consequence, in the years of the outlook the primary structural balance will be balanced and will develop similarly to the structural balance.

In 2015, the most important one-off revenue was the revenue of the Deposit Insurance Fund from bankruptcy proceedings and settled disputes amounting to CZK 5.2 billion. The most important one-off expenditure in 2015 was the inclusion of the principal of the lease of JAS-39 Gripen aircraft, accounted for in the amount of CZK 9.9 billion, and further the tax returns on emission allowances amounting to CZK 4.5 billion. In 2016, we expect one-off revenues from the auction sale of frequency bands to mobile operators of CZK 1.3 billion. The one-off contribution to pensioners amounting to CZK 3.5 billion is included on the expenditure side in 2016, furthermore expenditure on interest from state guarantees in 2016–2017, which, however, will not exceed CZK 0.5 billion per year.

Chart 3.2 (and in more detail, Table A.5) records the development of the cyclical component of the deficit, i.e. the impact of items which are clearly sensitive to the position of the economy in the business cycle. Since the second half of 2013, the negative output gap had been closing in tandem with the gradual economic recovery (see Chart 2.2); this process was concluded in 2015. For 2016–2018, we expect a slow extension of the positive output gap and that, as a consequence, the cyclical component of the balance will rise from 0.0% of GDP in 2015 to 0.5% of GDP in 2019.

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



Source: CZSO (2016b). MF CR calculations.

3.3.1 Fiscal Effort and the Expenditure Rule of the Stability and Growth Pact

The values for the structural balance and fiscal effort in 2015–2019 are shown in Table 3.5. The positive fiscal effort in 2015 was related to financing investment of projects co-financed by the EU from the programming period 2007–2013. Replacement of these resources by investment financed from national resources will probably result in a deterioration of fiscal effort in 2016 and 2017, and therefore also of the structural balance. The latter should not, however, drop under the value of the medium-term budgetary objective. In 2018 and 2019, we expect a neutral fiscal policy in order to maintain the medium-term budgetary objective.

The view of fiscal effort and structural balance in 2017–2019 is also supplemented by the expenditure rule of the Stability and Growth Pact, which compares the growth of the adjusted real expenditure of the general government sector with the average growth of potential product. If a country is not in line with its medium-term budgetary objective, the average growth of potential product (1.6% for the CR) is decreased by the convergence clause (1.2 pp for the CR), which provides an improvement in the structural balance of 0.5 pp per year; however, at present the CR is in line with its medium-term budgetary objective. The comparison is shown in Table 3.4.

Table 3.4: Adjusted Real Expenditures Growth and the Expenditure Benchmark of the Stability and Growth Pact
(growth in %)

	2017	2018	2019
Adjusted Real Expenditures	1.9	1.4	0.7
Expenditure Benchmark (SGP)	1.6	1.6	1.6

Source: EC (2016a). MF CR calculations.

Table 3.5: Structural Balance and Fiscal Effort
(% of GDP, pp of GDP)

		2015	2016	2017	2018	2019
General government balance	*% of GDP*	**-0.4**	**-0.6**	**-0.5**	**-0.5**	**-0.5**
Structural balance	*% of GDP*	**-0.3**	**-0.6**	**-1.0**	**-1.0**	**-1.0**
Fiscal Effort	*pp of GDP*	**0.7**	**-0.3**	**-0.3**	**0.0**	**0.0**

Source: Source: CZSO (2016b). MF CR calculations.

Box 1: Comparison of structural balances according to the methods of the MF CR and EC

Table 3.6: Differences in Potential Product Estimates by MF CR and EC Methods

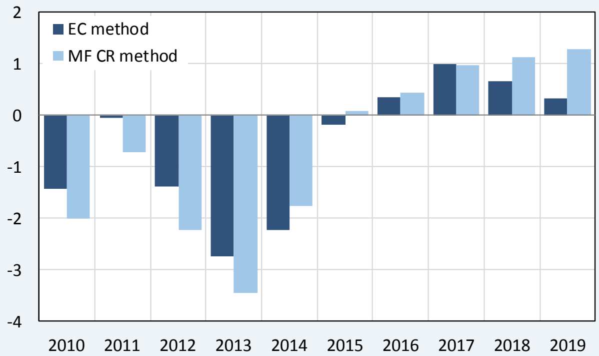
	MF CR Method	EC Method
Methodological differences		
Potential indicator	Gross Value Added	Gross Domestic Product
Production function parameters	Parameter alpha calculated as a ratio of compensations of employees to the sum of compensations of employees and the gross operating surplus (net of the mixed income)	Parameter alpha fixed at 0.65
Medium-term horizon	t+3	The output gap linearly converges to zero (between t+3 and t+5).
Filters used	HP filter (for the total factor productivity); moving averages	HP filter (for the capital, hours worked and rates of participation); Kalman filter (for the NAWRU and the total factor productivity)
Data differences		
Data periodicity	Quarterly	Annual
Unemployment	Labour Force Survey	Labour Force Survey
Participation rates	Ratio of the labour force (regardless of age) to the active population 15–64	Active population 15–64
Hours worked	Labour Force Survey	National Accounts
Stock of capital	National Accounts	National Accounts

Source: Lang and Mareš (2015). MF CR adjustments.

Budgetary supervision in the EU is based not only on monitoring the amount of the total balance and debt of the general government sector as a percentage of GDP, but also on monitoring the structural balance, its changes and growth of adjusted real expenditure (“expenditure benchmark”). To calculate the structural balance of expenditure first requires that the position of the economy in the business cycle be determined. A number of methods are used. For the Fiscal Outlooks of the CR, the Macroeconomic Forecasts of the CR and the Convergence Programmes of the CR, the MF CR uses the modified method of the EC (Havik *et al.*, 2014) for estimating potential product (MF CR, 2013). Both methods are based on a similar production function; nevertheless, their parameters, estimates of trend components, sources used, definitions of individual data categories and assumptions about the end of the forecast horizon, all differ. Their brief differences are summarised in Table 3.6.

If calculations are to be used for budgetary planning, we consider the assumption of the behaviour of the output gap at the end of the forecast horizon to be crucial. The EC method considers that the output gap will gradually close during the years of the outlook. In contrast, the MF CR forecasts a slight extension of the positive output gap (see Chart 3.3).

Chart 3.3: Output Gap according to MF CR and EC
(in % of the potential product)

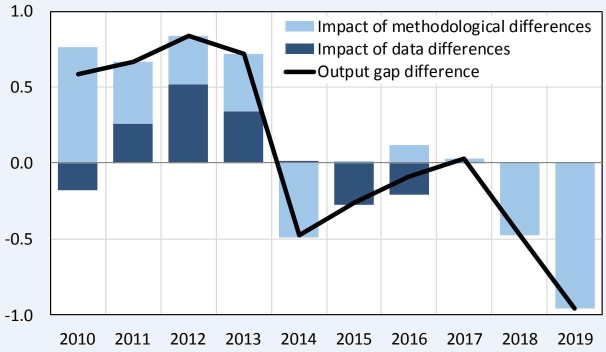


Source: MF CR.

The assumption of the EC is purely technical and has its justification for the purpose of long-term projections. Although both calculation methods are made on the same macroeconomic forecast, they differ at the end of the forecast horizon not only in relation to growth of potential products, but also with estimates of real GDP. Unlike the MF CR method, the EC method adjusts the estimate of real GDP growth in the years t+3 to t+5 so that the output gap is closed. As shown in Chart 3.4, whereas there are generally no differences between the results of the methods in 2017, at the end of the horizon the differences are already noticeable and originate precisely from the different methodologies.

From the perspective of setting fiscal policy, the assumption of a closed output gap at the end of the forecast horizon is highly disputable. In 2016, the general government sector in the CR should perform within the band above the medium-term budget-

Chart 3.4: Difference between EC and MF CR Method
(in pp)



Source: MF CR.

ary objective. Considering the EU requirements to maintain the structural balance at the medium-term budgetary objective as the very minimum once it has been achieved, the closing of the output gap during the forecast horizon implies relaxing of the budgetary position and expansionary fiscal policy. The size of the enabled expansion is the determined by the starting position of the economy in the cycle from which the production gap was closed.

Table 3.7 shows the calculated cyclical component of the balance after the application of the different methods for estimating the output gap. If we take into account the one off measures, we get the structural balances of the general government sector. The EC technique enables fiscal policy to be set in a more expansionary manner without the necessity of having any economically justifiable reason for doing so.

Table 3.7: Cyclical Component and Structural Balance according to EC and MF CR Methods
(in % of GDP)

	2013	2014	2015	2016	2017	2018	2019
Cyclical component of balance							
EC method	-1.2	-1.0	-0.1	0.1	0.4	0.3	0.1
MF CR method	-1.3	-0.7	0.0	0.2	0.4	0.4	0.5
Structural balance							
EC method	0.0	-0.8	-0.2	-0.7	-1.0	-0.8	-0.7
MF CR method	0.1	-1.0	-0.3	-0.6	-1.0	-1.0	-1.0

Note: One-off measures for the EC 2013–2015 from the EC (2016d) database. One-off measures for the EC 2016–2019 and for the MF CR 2013–2019 according to the actual CP.
Source: EC (2016d), MF CR. MF CR calculations.

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

In 2016, we expect the nominal value of general government debt to be 41.1% of GDP. General government debt would thus remain unchanged as a percentage of GDP compared to 2015.

In comparison with the update of the CP in 2015, public hospitals and all remaining allowance institutions have been included in the general government sector (see MF CR, 2015c); other institutions were further included in 2016, such as public-service media. The impact of this change on debt is negligible; it was less than 0.1% of GDP in 2016.

Looking at the trend, the relative debt rate of the general government sector in recent years has been improving considerably, and with the given setting of fiscal policy we expect this trend to continue. In 2014 a decrease in the debt quota was recorded for the first time since 2007. In total, general government debt decreased in relative terms by 4.1 pp in 2013–2015. The CR is still relatively one of the least indebted countries in the EU. The debt quota level is at a safe distance both from the debt reference value given by the Maastricht Convergence Criteria and the Stability and Growth Pact, and below the limit of the proposal of the national debt rule included in the government bill on budgetary responsibility rules (see Chapter 7.1). We also forecast a decrease in the debt quota in 2017–2019, in total by approx. 1.5 pp to 39.3% of GDP (YoY decrease is shown in Table 3.8). The contributions of interest expenditure to the debt quota change should stabilise at 1.0% of GDP in 2017–2019. The decrease in the relative amount of interest expenditure is caused by the concurrence of state bond revenues being at the historical minima and a decrease in the debt quota. The record-breaking low revenues on state bonds in all maturity segments have been achieved thanks to the positive perception on the financial markets of financial discipline of the CR, the surplus of available liquidity on the interbank markets, the effect of which has been to relax the CNB's and ECB's monetary policies, and due to the time-restricted regime of foreign exchange interventions. At the end of August 2015, for the first time in the history of the CR medium-term state bonds were sold on the primary market with negative yields. Since September 2015, the MF CR has been regularly achieving negative yields to maturity in auctions of medium-term and long-term state bonds with a time to maturity of 5 years; negative yields are also achieved in auctions of treasury bills.

The current forecast does not envisage any significant privatisation revenues according to Act No. 92/1991 Coll., on the conditions of transfer of the state assets to other persons, as amended. However, if such incomes are realised and it will be used to finance government expenditure, it should have a positive impact on further slowdown of growth in a debt.

After adjusting the level of gross government debt by the value of liquid financial assets (defined in ESA 2010 as currency, deposits and securities, including holdings in exchange-listed companies), net financial debt at the end of 2015 amounted to 27.9% of GDP. In other words, the size of the liquid amount for repayment the debt, if required, would amount to 13.1% of GDP. The development of this liquid amount has been impacted partly by more effective management and administration of assets in the state treasury system in financing the state budget deficit, and partly by the surplus performance of the local government subsector. Possibilities for the use of disposable liquidity in the next few years will depend on the amount of financial assets on state treasury accounts. The central government subsector has the biggest share in general government debt (see Table 3.8). In 2016, it is expected to reach a value of CZK 1,800.6 billion, i.e. a 95% share in total general government debt. The debt of the local government subsector represents the remaining 5% of the share in total debt; in 2016 we forecast it to amount to CZK 108.5 billion. Its value should decrease gradually in 2017–2019 due to the expected surplus of this subsector (among other reasons, due to more effective tax collection and an increase in revenues from shared taxes according to the amendment to Act No. 243/2000 Coll., on Tax Assignment). The subsector of social security funds shows a long-lasting negligible debt rate.

Since most of the central government subsector debt consists of state debt, it is very important to focus on its sustainability and stability in terms of key risk indicators. Their stabilisation and management were fundamental in the period of above-average volatility on the international financial markets, which occurred in relation to events of the debt crisis, and they continue to help ensure a prudent approach to debt sustainability and increasing the country's transparency on the state bond market. At present, a debt management strategy is also fundamental due to the possibility of using the situation on the primary market to receive additional revenues for the state budget by issuing state bonds with negative yields. When drafting the medium-term strategy for state debt management, emphasis has been given to refinancing, interest rate and currency risks as the most important sources of uncertainty in its management.

Table 3.8: General Government Debt by Sub-sector and Net Financial Debt
(in % of GDP)

	ESA Code	2014	2015	2016	2017	2018	2019
General government	S.13	**42.7**	**41.1**	**41.1**	**40.7**	**40.2**	**39.3**
Central government	S.1311	40.2	38.9	38.9	38.8	38.3	37.6
Local government	S.1313	2.7	2.5	2.3	2.2	2.1	2.0
Social security funds	S.1314	0.0	0.0	0.0	0.0	0.0	0.0
Net financial debt 1)		**27.6**	**27.9**	**28.4**	**28.1**	**27.9**	**27.3**

Note: Years 2015–2016 show notification. Years 2017–2019 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 (2016b). MF CR calculations.

Primarily in connection with sufficient liquidity and the relatively stable balances in the state treasury system, the MF CR has adopted a new concept for refinancing and interest rate risk management. Strategic objectives and limits will be announced from 2016 in the medium-term horizon, i.e. in the outlook for the 3 years from the beginning of drafting the strategy for the current year. Where conditions for issue are advantageous and would mainly result in a decrease in expenditure on state debt servicing, there can be a short-term deviation of these objectives and limits. Issuing activity will be planned so that objectives and limits set in the medium-term horizon are met. The reason for the partial change in strategy is a flexible response to short-term market conditions and possible specific demands of investors.

The key indicators for assessing re-financing risk include the share of short-term debt, the share of medium-term debt and the average time to maturity of state debt. The share of short-term debt (i.e. debt payable within 1 year) in total state debt reached 16.4% at the end of 2015, representing a YoY increase of 1.5 pp, and it fluctuated below the limit of 20% of total state debt. The increase is exclusively caused by the higher demand for state debt financing due to the relatively high repayments of bond principals in 2016. The same limit is also set in the medium-term horizon. In addition to the short-term debt, medium-term debt (defined as debt payable within five years) is also managed actively. Its upper limit is set at 70% of total state debt. At the end of 2015, the value of the share of medium-term debt was 59.4%, meaning its share had increased by 3.7 pp. Medium-term debt is also managed by the indicator for the share of state debt payable within three years, the value of which was 41.1% in 2015 (YoY growth of 5.4 pp). Another indicator used in re-financing risk management is the average time to maturity of state debt, which is crucial for determining the timing and volume structure of state bond issues. With the new risk management concept, its limit value has been set for the medium-term horizon at a level of 6.0 years with the possibility of a deviation of 0.25 year. At the end of 2015, the average time to maturity of state debt reached 5.1 years (YoY decrease of 0.3 year). The indicator level decreased due to MF CR's flexible response to the current market conditions. There was an increase of issues of medium-term and long-term bonds with a relatively short time to maturity in auctions for negative yields.

Replacing part of the payable principals of state bonds by issuing state bonds with a shorter time to maturity and with negative average interest revenues, has enabled the state treasury to collect extraordinary incomes.

The most important market risk for managing state debt is the interest rate risk. Prudent management of this risk can help mitigate the impact of fluctuating interest rates on the financial markets. With the new risk management concept, the value of the indicator is newly set at 4.0 years in the medium-term horizon. The target is set with regard to optimising the costs of state debt and the risks resulting from re-fixing interest rates. The monitored indicator for the average time to the re-fixing of state debt recorded a decrease of 0.3 year to 4.0 years at the end of 2015. The value of the average time to re-fixing lies within the target band of 4–5 years valid for the given year. The decrease in the value is in line with a decrease in the average time to maturity of the debt portfolio during 2015. Another monitored indicator concerning interest rate risk is the re-fixing of interest on the debt portfolio within 1 year, i.e. the share of debt which is sensitive to interest rate fluctuations on the financial market in the following year. For the medium-term horizon, the target band is set at 30–40% of total state debt. The value at the end of 2015 is nearly in the middle of the target band at 33.7% (YoY decrease of 1.7 pp). As far as the interest structure is concerned, the share of state debt with variable interest to total state debt reached 19.9% in 2015. In 2016–2019, this indicator should fluctuate around 20% (see Table 3.9). The effect of derivative transactions on interest rate exposures relates to operations hedging the currency risk during foreign issues.

Another market risk assessed as part of state debt management is currency risk related to exchange rate fluctuation. MF CR actively manages net foreign-currency exposure. This represents the value of that part of foreign-currency debt that is exposed to exchange rate movement after adjustment for the foreign-currency exposure of state financial assets. The exposure level can be influenced by derivative operations, thus securing part of foreign-currency debt against unfavourable fluctuation of exchange rates.

The explicit limit of 15% + 2 pp has been set for the share of net foreign-currency exposure in total state debt. Exceeding the 15% limit in any sustained manner is not possible, and the limit may only be overstepped in the short term, i.e. in the case of sudden domestic currency depreciation, by 2 pp at most. At the end of 2015, this indicator reached 10.9% of total state debt and was safely below its limit value. The dominant part of net foreign-currency exposure has been for a long time the euro. At the end of 2015, the share of net foreign-currency exposure of state debt denominated in euros reached 89.8% in net foreign-currency exposure. In the medium-term horizon, an increase in the share of debt denominated in euros in net foreign-currency exposure is evident (Table 3.9) due to maturity of state bonds denominated in Swiss francs in 2016. The share of foreign-currency state debt in total state debt at the end of 2015 was 13.6%. Compared to the end of 2014, there was a decrease of 0.8 pp due to repayment in 2015 of the first issue of euro bonds, totalling EUR 0.3 billion, and its replacement by state bonds in the domestic currency. The MF CR did not carry out any issue of state bonds on foreign markets in 2015. The reason was the government's low borrowing requirement and the higher potential expenditure related to such issue compared to an issue of state bonds in the domestic currency.

The targets and limits, set according to requirements resulting from a prudent approach to risk management in minimising costs in the long-term horizon, are in line with best international practice. The declared targets and limits were fulfilled in 2015 and the values of individual indicators for 2016–2019 meet the given strategic targets declared in the medium-term horizon.

Table 3.9: The State Debt's Refinancing, Interest and Debt Denominated in Foreign Currency
(in % of debt, average maturity in years)

		2014	2015	2016	2017	2018	2019
Refinancing							
Average maturity	*years*	**5.5**	**5.1**	**5.3**	**5.7**	**6.0**	**6.0**
Debt due within 1 year	*% of debt*	**14.9**	**16.4**	**16.6**	**16.5**	**14.9**	**14.8**
State Debt's Interest							
Debt with interest fixation within 1 year	*% of debt*	**35.5**	**33.7**	**33.0**	**35.9**	**36.3**	**30.9**
Fixed interest long-term debt due within 1 year	*% of debt*	7.5	6.3	10.2	13.9	12.3	5.5
Variable interest long-term debt	*% of debt*	18.7	19.9	17.1	16.3	18.3	19.7
Monetary instruments	*% of debt*	6.6	5.2	3.4	3.3	3.2	3.2
Effect of derivative operations	*% of debt*	2.5	2.4	2.3	2.4	2.5	2.5
Foreign Currency Exposition							
Foreign-currency exposition of the state debt[1)]	*% of debt*	**10.4**	**10.9**	**10.8**	**11.0**	**10.5**	**10.9**
EUR exposition	*% of debt*	9.4	9.8	10.4	10.7	10.2	10.5

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

4 Comparison with Previous Update and Sensitivity Analysis

4.1 Comparison with Previous Convergence Programme Update

In 2015, economic activity increased much faster compared to the CP scenario of April 2015, while GDP growth was driven exclusively by domestic demand. The economic recovery was also favourably reflected in the labour market development. Considering the continuing decline in the oil price, the inflation rate only reached a very low value (for more details – see Chapter 2.2).

In contrast, estimates of indicators for 2016 and 2017 remain relatively stable. Only the view of the structure of the GDP use components has changed. In particular we expect higher growth of household consumption and general government sector consumption. Household consumption will be supported by a good labour market situation, growth of real disposable income, a decrease in the savings rate and consumers' optimistic expectations. In contrast, investment growth in 2016 will be appreciably slowed by the general government sector investment, which is caused by the transition to the new financial perspective 2014–2020 of the EU funds as well as by the high comparative base of 2015.

The foreign trade contribution to GDP growth should already be positive in 2016. Low oil prices are reflected positively in an improvement of terms of trade and represent a positive supply shock, not only for the domestic economy, but also for economies of the main trading partners of the CR.

With regard to the aforementioned facts, the forecast for the development of GDP as a whole compared to the forecast in the previous CP is roughly the same.

As described above in subchapter 3.1, there has been a considerable improvement in the general government sector balance compared to the previous CP. Impacts in the future should come not only from higher economic growth, but also from measures contributing to more effective tax collection (for more details – see subchapters 3.2 and 6.1).

Table 4.1: Change in the Indicators of the Scenario

		April 2015 CP			April 2016 CP		
		2015	2016	2017	2015	2016	2017
External Assumptions							
GDP growth in EU28	%	1.6	1.9	2.1	1.9	1.7	1.9
Prices of oil (Brent)	USD/barrel	60.2	68.3	73.5	52.4	40.9	47.4
Exchange rate USD/EUR	USD/EUR	1.07	1.05	1.05	1.11	1.10	1.10
Exchange rate CZK/EUR	CZK/EUR	27.5	27.5	27.2	27.3	27.0	26.9
Real Values							
GDP	change in %	2.7	2.5	2.3	4.2	2.5	2.6
Households consumption	change in %	2.8	2.3	2.2	2.8	3.1	2.7
Government consumption	change in %	1.7	1.6	1.5	2.8	2.1	1.6
Gross fixed capital formation	change in %	5.3	4.2	3.2	7.3	0.6	3.0
Contribution of final domestic demand	p.p.	3.0	2.5	2.2	3.7	2.1	2.4
Contribution of foreign trade	p.p.	-0.3	0.0	0.1	-0.2	0.2	0.2
Output gap	%	0.1	0.9	1.2	0.1	0.4	1.0
Others							
Nominal GDP	CZK bn.	4467	4644	4816	4472	4629	4812
Harmonised index of consumer prices	change in %	0.2	1.4	1.8	0.3	0.6	1.5
GDP deflator	change in %	1.9	1.4	1.4	0.7	1.0	1.3
Employment	change in %	0.7	0.2	0.1	1.2	0.5	0.1
Unemployment rate	%	5.7	5.5	5.4	5.1	4.4	4.3
Balance of goods and services	% of GDP	7.8	8.0	8.0	6.4	6.8	6.7
Net lending/borrowing	% of GDP	2.1	1.0	0.9	1.1	-0.4	-0.3
General Government							
General government balance (B.9)	% of GDP	-1.9	-1.2	-0.8	-0.4	-0.6	-0.5
General government debt	% of GDP	40.9	40.9	40.7	41.1	41.1	40.7

Source: CNB (2016a), CZSO (2016a), EIA (2016), Eurostat (2016), MF CR (2015a).

4.2 Sensitivity Analysis

The sensitivity analysis is calculated by means of dynamic stochastic general equilibrium model, developed by the MF CR. The alternative scenarios focus on several current questions concerning possible future development. Considering the high level of openness and the dependence of the Czech economy on the external environment, the first scenario shows the importance of the impact of worse than expected growth dynamics in the EU on the domestic economy. Another alternative scenario evaluates a potential sudden increase in the currently very low interest rates. The last analysis is in response to uncertainty regarding future oil price developments, and analyses what would happen during a sharp price increase. All alternative scenarios are derived from the baseline scenario of the CP described in Chapters 2 and 3.[1]

4.2.1 Slower Economic Growth in the EU in 2016

The first scenario is based on the assumption that GDP growth in the EU will be by approximately 2 pp lower in 2016 than in the baseline scenario. This difference corresponds to the amount of standard deviation of growth for the period of 2000–2015.

Considering the significant interdependence of the Czech economy with the EU, this scenario would impact negatively on real growth in the CR, mainly through exports, more than 80% of which head directly to EU countries. Lower foreign demand would lead to a decrease in export activity and a deterioration of the current account balance; however, this would be partially compensated by lower imports. A worse result of foreign trade would be negatively reflected in real GDP growth, which would consequently increase more slowly, by 0.6 pp in 2016 and by approx. 0.2 pp in 2017.

Lower export performance would be negatively reflected in the investment activity of firms, the growth rate of which would slow by 0.8 pp in 2016 and 0.4 pp in 2017 compared to the baseline scenario. The total production of firms would also be lower, which would lead to a downward pressure on the growth rate of wages and a rise in unemployment. This effect would be most marked in 2016.

Greater uncertainty on the labour market would be reflected in the household consumption, which would record a decrease in its growth rate of approx. 0.6 pp. In addition to the aforementioned effect of slower wage growth, a CZK exchange rate depreciation would have a negative effect on consumption, making imports of consumer goods more expensive.

The impacts on inflation appear rather small, since two opposing effects would be at work here: (i) wage pressures would diminish due to lower production in the Czech economy, dampening inflation; (ii) on the other hand, the deterioration of the current account balance would have a depreciating influence on the Czech koruna, thus increasing prices paid by companies for imported inputs and consumer goods for households. Depreciation would as a consequence partially compensate a decrease in exports, which would, however, not reverse the resulting effect, and prices would increase by 0.4% in 2016 compared to 0.6% in the baseline scenario. Their subsequent growth in the following years of the outlook would be slower by 0.3–0.4 pp compared to the baseline scenario.

The general government balance would be influenced by a lower collection of income taxes. Together with an increase in spending due to a greater amount of social benefits paid, government deficits would deteriorate by 0.2 pp in the first two years of the outlook. Higher deficits would subsequently accumulate into higher debt, approximately by 0.7 pp in the last year of the monitored period.

The Czech economy would gradually recover in line with the gradual recovery of foreign demand during the course of 2017.

4.2.2 Rise in the Domestic Interest Rate

The second scenario assumes a 1.5 pp higher domestic interest rate in 2016, also corresponding to the standard deviation of its development in 2000–2015.

Higher interest rates suppress domestic demand, in particular investment. Investment would increase by approximately 0.1 pp slower due to higher costs as a result of higher rates for corporate loans. The growth rate of household consumption would also gradually decrease as the problems of firms are transferred to households through lower growth in wages. Due to higher interest rates, people with higher incomes could see an increase in their share of savings to the detriment of consumption. In contrast, a slightly lower domestic price level would work favourably for consumption. Considering a delay of 4–6 quarters within the monetary-political horizon, this domestic price level would increase more slowly by approx. 0.3 pp. Thus household consumption would ultimately slow growth by 0.3–0.2 pp in the years of the outlook.

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[1] In the alternative scenarios we assume a development different from the baseline scenario, always starting from the second quarter of 2016.

Table 4.2: Basic Macroeconomic Indicators – Sensitivity Scenarios

		2015	2016	2017	2018
Baseline Scenario					
Gross domestic product	*Y-o-Y in %*	**4.2**	**2.5**	**2.6**	**2.4**
Private consumption	*Y-o-Y in %*	2.8	3.1	2.7	2.4
Gross fixed capital formation	*Y-o-Y in %*	7.3	0.6	3.0	3.1
Exports of goods and services	*Y-o-Y in %*	7.0	5.5	5.9	6.0
Imports of goods and services	*Y-o-Y in %*	7.9	5.6	6.1	6.1
Harmonised index of consumer prices	*Y-o-Y in %*	**0.3**	**0.6**	**1.5**	**1.8**
Unemployment rate	*in %*	**5.1**	**4.4**	**4.3**	**4.2**
General government balance	*% of GDP*	**-0.4**	**-0.6**	**-0.5**	**-0.5**
Gross government debt	*% of GDP*	**41.1**	**41.1**	**40.7**	**40.2**
Alternative Scenario I - Lower GDP Growth in EU in 2016					
Gross domestic product	*Y-o-Y in %*	**4.2**	**1.9**	**2.4**	**2.4**
Private consumption	*Y-o-Y in %*	2.8	2.5	2.3	2.4
Gross fixed capital formation	*Y-o-Y in %*	7.3	-0.2	2.3	3.0
Exports of goods and services	*Y-o-Y in %*	7.0	4.1	5.5	6.0
Imports of goods and services	*Y-o-Y in %*	7.9	4.9	5.8	6.0
Harmonised index of consumer prices	*Y-o-Y in %*	**0.3**	**0.4**	**1.1**	**1.5**
Unemployment rate	*in %*	**5.1**	**5.0**	**4.4**	**4.2**
General government balance	*% of GDP*	**-0.4**	**-0.8**	**-0.7**	**-0.5**
Gross government debt	*% of GDP*	**41.1**	**41.3**	**41.3**	**40.9**
Alternative Scenario II - Higher interest rates					
Gross domestic product	*Y-o-Y in %*	**4.2**	**2.0**	**2.2**	**2.3**
Private consumption	*Y-o-Y in %*	2.8	2.8	2.4	2.2
Gross fixed capital formation	*Y-o-Y in %*	7.3	0.5	2.9	3.0
Exports of goods and services	*Y-o-Y in %*	7.0	5.5	5.9	6.0
Imports of goods and services	*Y-o-Y in %*	7.9	5.4	6.0	6.0
Harmonised index of consumer prices	*Y-o-Y in %*	**0.3**	**0.5**	**1.3**	**1.7**
Unemployment rate	*in %*	**5.1**	**4.9**	**4.9**	**4.6**
General government balance	*% of GDP*	**-0.4**	**-0.7**	**-0.7**	**-0.6**
Gross government debt	*% of GDP*	**41.1**	**41.2**	**41.2**	**40.9**
Alternative Scenario III - Higher oil prices					
Gross domestic product	*Y-o-Y in %*	**4.2**	**2.1**	**2.6**	**2.4**
Private consumption	*Y-o-Y in %*	2.8	2.6	2.7	2.4
Gross fixed capital formation	*Y-o-Y in %*	7.3	0.5	2.9	3.0
Exports of goods and services	*Y-o-Y in %*	7.0	4.8	5.9	6.0
Imports of goods and services	*Y-o-Y in %*	7.9	5.0	6.0	6.1
Harmonised index of consumer prices	*Y-o-Y in %*	**0.3**	**0.9**	**1.6**	**1.8**
Unemployment rate	*in %*	**5.1**	**4.7**	**4.3**	**4.2**
General government balance	*% of GDP*	**-0.4**	**-0.7**	**-0.6**	**-0.5**
Gross government debt	*% of GDP*	**41.1**	**41.2**	**40.9**	**40.3**

Source: CZSO (2016a), EIA (2016), Eurostat (2016), MF CR calculations.

This scenario would also have negative impacts on foreign trade, where the effect of a slight CZK appreciation[2] would manifest itself, followed by a certain decrease in the volume of exports. On the other hand, a slightly stronger CZK exchange rate would retard the decrease in consumption through its impact on import prices.

In total, the aforementioned effects would be reflected in decreased GDP growth of approximately 0.4–0.5 pp and correspondingly higher unemployment.

As in the case of lower GDP growth in the EU, but to a lesser extent, general government revenue would be influenced by a lower collection of taxes, both from businesses and from individuals. With higher unemployment, general government expenditure would also rise. Subsequently, deeper deficits of 0.1–0.2 pp

[2] However, the effect of an exchange rate appreciation would not mean that the exchange rate would fall considerably below the limit of 27 CZK/EUR, set by the CNB until approximately first half of 2017. As an average of the individual years 2016 and 2017, the exchange rate would be at 27.0 CZK/EUR (*as in the baseline scenario*) and 26.8 CZK/EUR (*versus 26.9 CZK/EUR in the baseline scenario*).

would again be reflected in the accumulation of debt, on which higher interest rates would also impact. As a result, the debt level at the end of the outlook would reach 40.9% of GDP, i.e. a level 0.7 pp higher than the baseline scenario expects.

Table 4.3: Assumptions of Alternative Scenario of Higher Oil Prices

		2015	2016	2017	2018
Baseline					
Deflator of imports	*average 2010=100*	**107.8**	**105.3**	**104.7**	**104.4**
	growth in %	-1.5	-2.3	-0.6	-0.2
Crude oil Brent	*USD/barrel*	**52.4**	**40.9**	**47.4**	**51.4**
Alternative Scenario III - Higher oil prices					
Deflator of imports	*average 2010=100*	**107.8**	**107.1**	**106.5**	**106.2**
	growth in %	-1.5	-0.6	-0.6	-0.2
Crude oil Brent	*USD/barrel*	**52.4**	**53.2**	**61.7**	**66.8**

Source: CZSO (2016a), EIA (2016), MF CR calculations.

4.2.3 Higher Oil Prices

The last scenario considered shows the possible impacts of an alternative development in oil prices compared to the baseline scenario. Here we assume that the current, still very low, oil price is only a temporary phenomenon and that already during 2016 there could be a sharp increase of 30%.[3] The oil price during 2016 would be 53.2 USD per barrel on average (instead of the 40.9 USD per barrel considered in the baseline scenario). For 2017–2018, we then consider the YoY increase in the oil price at the level of the baseline scenario. The increase in the oil price (or its smaller decrease) in 2016 on average would manifest itself mainly in an increase in the import price index, as shown in Table 4.3. A higher oil price would also be reflected in the lower growth of export markets. Therefore, we also expect weakening foreign demand (GDP growth rate in the EU) approximated by lower growth in the EU of approx. 0.1 pp in 2016.

The effects of both aforementioned shocks, i.e. the increase in oil prices and lower growth of foreign demand, would impact negatively on the Czech economy, in particular in 2016. In the following years of the outlook, they would only manifest themselves marginally.

The primary effect of higher oil prices would be an increase in import prices, which would be reflected by a direct decrease in the volume of imports and by a slightly positive impact on net exports. Subsequently, however, there would be a decrease in the volume of exports due to a growth of export prices and a decrease in foreign demand. Growth of household consumption would be slower (by approx. 0.5 pp) due to the relatively higher prices of foreign and domestic goods, while investment in fixed capital would also grow 0.1 pp more slowly in 2016−2018. The total impact on real GDP growth in 2016 would be around −0.4 pp.

Due to negative changes in the economy, the expected production of firms would decrease, which could lead to downward pressures on wages and an unemployment rate approximately 0.3 pp higher than in the baseline scenario. In this case, the growth of import input prices would have a positive impact on the increase in the price level (meaning its higher growth); on the other hand, the decrease or slighter growth of wages would have a negative impact. As a result, the inflation rate would be 0.3 pp higher than in the baseline scenario.

Due to a lower collection of taxes caused by lower consumption dynamics, lower production of firms and also a decrease in the growth rate of wages, the general government balance would record a negative impact of –0.1% of GDP. This would also be ultimately reflected in the accumulation of debt, which would be slightly higher compared to the baseline scenario.

[3] Technically, we assume in this scenario that the oil price will be 30% higher in each year of the outlook (starting from 2016) compared to the baseline scenario.

4.3 Verification of the Macroeconomic Scenario by Other Institutions' Forecasts

Macroeconomic scenario of the CP was also compared with forecasts of other relevant institutions. The survey was conducted in April 2016 and its results are based on forecasts of 20 domestic institutions, together with the latest forecasts of the EC (2016a) and the International Monetary Fund (IMF, 2016). However, the whole CP timeframe is at least for some indicators covered by forecasts of only 13 institutions.

Key trends of the macroeconomic scenario of the CP 2016 are consistent with the average of forecasts of other institutions. The growth of the Czech economy, which could reach around 2.5% in 2016–2019, should be driven by the domestic demand, composed by both consumption (of households and government) and gross fixed capital formation. The positive contribution of net exports should gradually decrease, while in 2019 the foreign trade balance should even slightly dampen the GDP growth.

The inflation rate should remain very low also this year, mostly due to a counter-inflation impact of the oil price. Despite the presumed acceleration of consumer price growth in 2017, the inflation should remain in the lower half of the tolerance range of the CNB's inflation target. Modest growth of consumer prices should continue also in 2018 and 2019.

Economic growth should have a positive impact on the labour market. Thus, the unemployment rate should gradually decrease, while the employment should conversely increase.

Individual respondents of the survey from the ranks of institutions independent on the government were also asked to evaluate the CP macroeconomic scenario on a scale of conservative–realistic–optimistic. Of the 17 institutions addressed (3 out of 20 survey respondents are government-dependent institutions) 13 institutions evaluated the macroeconomic scenario, of which 12 institutions deem it as realistic and 1 institution as conservative. Based on the external evaluation of government-independent experts, it is possible to consider the CP macroeconomic scenario as realistic.

Table 4.4: Verification of 2016 Convergence Programme Scenario by Other Institutions' Forecasts

	Avearage of Forecasts				April 2016 CP			
	2016	2017	2018	2019	2016	2017	2018	2019
Growth in Real Terms								
Gross domestic product	**2.5**	**2.7**	**2.5**	**2.3**	**2.5**	**2.6**	**2.4**	**2.4**
Households consumption	3.0	2.8	2.6	2.7	3.1	2.7	2.4	2.3
Government consumption	2.3	1.9	1.7	1.9	2.1	1.6	1.4	1.3
Gross fixed capital formation	1.8	3.4	4.1	4.0	0.6	3.0	3.1	3.1
National consumer price index (aop)	**0.7**	**1.7**	**1.8**	**1.9**	**0.6**	**1.4**	**1.8**	**1.9**
GDP deflator (growth)	**1.1**	**1.6**	**1.7**	**1.7**	**1.0**	**1.3**	**1.6**	**1.8**
Employment (LFS)	**0.8**	**0.4**	**0.4**	**0.4**	**0.5**	**0.1**	**0.1**	**0.1**
Unemployment rate (LFS, level in %)	**4.6**	**4.5**	**4.4**	**4.4**	**4.4**	**4.3**	**4.2**	**4.2**

Source: MF CR (2016a, 2016b).

5 Sustainability of Public Finances

Long-term sustainability has consistently been one of several significant challenges for Czech public finances. The most serious risk lies in the projected demographic development, i.e. the expected considerable increase over the next several decades of the ratio of persons in retirement age to the economically active population. This risk continues despite the last demographic projection of the EC (2014a) being more optimistic than the previous one.

5.1 The Government's Strategy – Reforms

After seeking to address the long-term sustainability of the pay-as-you-go public pension system (PAYG) by adjusting the parameters of the pension insurance system in 2011, measures have been taken in the area of pension security and the public health insurance system, primarily aimed at short-term or medium-term consolidation of public finances.

5.1.1 Status Quo of the Public Pay-as-you-go Pension Scheme

In response to a ruling of the Constitutional Court (published as Regulation No. 135/2010 Coll.), which found part of the provisions of the Act on Pension Insurance stipulating the calculation of pension entitlement (in particular the section on the amount of reduction thresholds) to be unconstitutional, a set of parametric changes to the pension system was approved with effect from 30 September 2011 (for more details – see MF CR, 2012). These involve modifying reduction thresholds when calculating pensions (in a budget-neutral manner) and moving from a statutory retirement age to one without a fixed upper limit and, at the same time, removing benefits for women with children (i.e. a uniform retirement age will be applied to all persons born in a certain year). The government approved in March 2016 that a limit on retirement age will be reintroduced, however, this would be subject to the regular revisions according to demographic projections. The concrete value of the limit (either 65, or 67) is still being discussed.

For 2013–2015, the total increase in pensions paid out (regular indexation) was originally limited to one third of the consumer price index growth and one third of real wage growth. However, the government approved an amendment to Act No. 155/1995 Coll. (Act No. 183/2014 Coll.) according to which the validity of the reduced indexation was shortened by one year and an extraordinary indexation of 1.8% (calculated for the average old-age pension) was effective for 2015. Since 1 January 2016, the indexation formula has reverted to the total sum of full consumer price growth and one third of real wages growth; moreover, an extraordinary benefit of CZK 1,200 was paid out in February 2016.

On 17 February 2016, the government approved (Government Resolution No. 146) a change in the pension indexation system, partially returning the possibility of discretion to the government. The government hereby reacted to the currently very low inflation values and subsequent low indexations. If a situation occurred whereby an increase in the average pension would not reach 2.7% according to the standard indexation formula, then the government would be authorised by this regulation to increase the percentage assessment of the pension up to the value of 2.7%. If the indexation value equals or is higher than 2.7%, the government is not authorised to use its discretion. This modification should have impact on the long-term sustainability based on EPC/AWG projections amounting to 0.2 pp, taking into account the latest assumptions on the consumer price index and real wages. It means that the expenditure on pension would be 9.9 % of GDP in 2060. At the same time, the period decisive for calculation of inflation used in indexation formula will both start and end two months earlier.

Since 2010, the penalty for early old-age retirement has been increased, thus reducing the attractiveness of retiring before reaching the statutory retirement age. Specifically, the penalty rate was increased from 0.9% to 1.2% for the period from the 361st day to the 720th day before reaching the statutory retirement age. The percentage assessment of earnings-related old-age pension subsequently decreases by this percentage for every whole 90-day period.

In addition, there exists a so-called preretirement scheme, which enables those subscribing to the supplementary pension savings scheme (the 3rd pillar) to already draw funds 5 years before reaching the statutory retirement age without any sanctions being imposed. However, preretirement is conditional upon having an amount of accumulated funds in the private 3rd pillar so as to provide a monthly pension amounting to at least a third of the average wage. The old-age pension is not subsequently reduced for the years when the pre-pension is drawn. Before the end of 2015 the opportunity to draw preretirement was taken up by only 1,125 persons, who received an average benefit of CZK 9,498. As to the sustainability of the pension system, the impact of this measure is absolutely negligible.

5.1.2 Termination of the Pension Savings Pillar

Reform of the pension system consisted in the introduction of a pension savings pillar. The Parliament of the CR first approved the reform in November 2011 and, following a veto by the President, it was approved in its final form in November 2012. The pension savings pillar was launched on 1 January 2013. For more detailed information on this system see the MF CR (2014).

As of 31 December 2015, 84,680 persons were registered in the pension savings pillar. The amount of transfers (i.e. the sum of contributions debited from the pay-as-you-go public system and contributions paid from the participant's savings) to pension companies for 2015 was more than CZK 1.4 billion. Out of this amount, nearly 92% is paid by employees and only approx. 8% is paid by self-employed persons. The share of voluntary payers is absolutely negligible. The amount taken out of the 1st pillar accounts for a 60% share in the total volume, i.e. it is approx. CZK 0.9 billion.

The pension savings pillar was cancelled as of 1 January 2016 and the winding up process will last until the end of 2016 (Act No. 376/2015 Coll.). Before 31 March 2016, pension companies informed participants of the termination of the pension savings pillar. Funds accumulated in this system will be returned to participants either by transferral to their accounts within the system of the additional pension insurance system with state contribution, or the supplementary pension savings system (the 3rd pillar), or else they will be paid into their bank accounts or in cash. Pension companies will pay out money to participants according to the selected method in the period from 15 October 2016 to 31 December 2016. According to the estimate of MF CR, cancelling the pension savings pillar could reach up to CZK 1 billion in costs, which will be covered by the state budget.

5.1.3 Changes in the Healthcare System

Within the public health insurance system, in 2016 it is planned to distribute to medical facilities using the reimbursement mechanism (Decree No. 273/2015 Coll.) CZK 252.0 billion (i.e. 5.4% of GDP) for medical services provided through health insurance companies. This figure is approx. CZK 8.3 billion more than in 2015 (i.e. the planned YoY growth of expenditure on health care is 3.4%). An increase in expenditure is ensured in all healthcare segments by a sufficient increase in payments to cover increased personal costs, amounting to 5% of the increase in payment tariffs in 2016. The biggest increase in health-care expenditure is planned in the hospital care segment, namely CZK 5.3 billion. Out of this amount, CZK 4.3 billion is allocated to an increase in payments to health-care providers, which will compensate the expected increase in wages and at the same time cover an increase in the production of predominantly specialised workplaces, and approx. CZK 1 billion is attributed to the natural growth of medical products and foods for special medical purposes. In the outpatient care segment, growth in expenditure of approx. CZK 2.2 billion is planned. The reason for the rise lies predominantly in the natural growth of this segment and an increase in the volume of care influenced by cancellation of regulatory fees for clinical examinations (Act No. 256/2014 Coll.). The last important item is growth of expenditure on prescription medicines, where growth of approx. CZK 1 billion is expected, primarily caused by the market launch of new medicines and utilising the whole potential of savings. In 2016, the total balance of the public health insurance system is planned with a negligible surplus (according to health insurance schemes, the estimated balance is approx. CZK 0.5 billion, which is an improvement of CZK 0.3 billion compared to 2015). A nearly balanced balance of the system is enabled thanks to the correlative expected YoY growth in the collection of social contributions for public health insurance of approx. CZK 6.1 billion (i.e. of approx. 3.2%) due to an increase in the wage bill and a decrease in the unemployment rate. Since 1 January 2016, the assessment base for health insurance premium has been increased for so-called state insured persons to CZK 6,444 (Government Resolution No. 158/2015). The monthly payment of the state for a state insured person increased by CZK 25 to CZK 870 (impact of approx. CZK 1.8 billion).

At present, several models of the indexation of payments for a state insured person are being discussed, the intention of which is to achieve an anti-cyclical character of payments for state insured persons in relation to economic growth and also ensure the long-term sustainability of the public health insurance system. Further, the government plans to introduce a new model for redistributing social contributions for public health insurance in order to take into consideration the chronic diseases of insured persons in this system, and the related increased costs of health services. Scheduled to take effect from 1 January 2017, health insurance premium should be redistributed among individual health insurance companies according to new cost groups. This is the date when the two current demographic indicators (age and gender) will be supplemented with an indicator of the average annual consumption of certain medicines by the insured person, who will be included in the so-called Pharmacy-based Cost Groups (PCG) model.

In 2016, the implementation of the project DRG Restart (payments for case-based lump-sum amounts) continues. Its introduction will result in re-setting the system of payments for acute hospital care. The objective is to create a certain number of clinically and economically defined groups according to cases of acute hospitalisation and enable comparisons between the relative expensiveness of the cases included in these groups. The DRG system should reflect the real prices of outputs which will subsequently manifest themselves in the payments of health insurance companies. Following the introduction of the DRG system it is expected that greater efficiency will be achieved in financing hospital care thanks to the better use of money for some specialised outputs that are not fully paid for at present by health insurance companies. The necessity for implementation of this project is the amendment to Act No. 372/2011 Coll., on Health Services (approved by the Senate of the Parliament of the CR on 20 April 2016), by means of which it will be possible to build up a National Health Information System that will provide an overview of the availability and quality of health care. An important part of this system will be the National Register of Medical Staff, which should increase the effectiveness of health service provision by means of monitoring the demographic structure of employees and the development of capacities in health care.

5.2 Fiscal Impacts of a Population Ageing

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

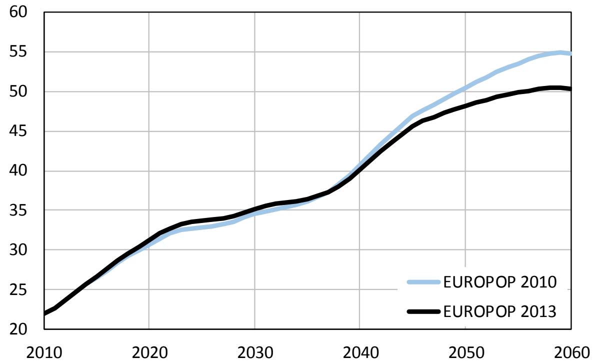
Long-term projections were updated for the last time in autumn 2014 (EC, 2014a) in connection with the Ageing Report 2015 (EC, 2015).

From today's viewpoint, the biggest problem appears to be health-care expenditure from the public health insurance system (see Table A.7). This will increase from a starting level of 5.7% of GDP in 2013 to 6.7% of GDP in 2060. Long-term care expenditure (0.7% of GDP in 2013) rises the fastest, with its volume likely to double. In volume terms, however, this constitutes quite a small expenditure item.

As far as pension expenditure is concerned, which has been most important so far in terms of expenditure increases, it should increase from the current 9.0% of GDP in 2013 to 9.7% of GDP in 2060. Although demographic development remains a negative factor, the current demographic projection is more favourable for the CR than the projection in previous rounds. From this perspective, the share of the working-age population has been improving in relation to numbers of pensioners (see Chart 5.1). Such improvement also brings with it a more positive macroeconomic outlook thanks to a more favourable labour market development.

Chart 5.1: Dependency Ratio (65+/15–64)

(in %)

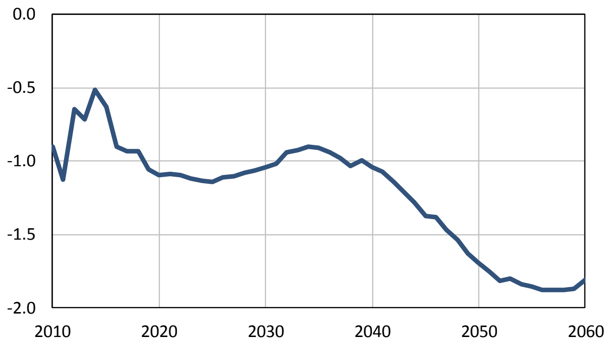


Source: EC (2011), EC (2014).

The resulting projection for the balance of the pension system (see Chart 5.2) also considers, in addition to the aforementioned pension expenditure, revenues from social contributions. These are at a level of 7.9% of GDP in all years of the projection. This assumption results from the contribution rate for pension insurance being considered unchanged over time, as well as from the assumption of a relatively constant share of employee compensation in GDP, built into the macroeconomic scenario. We expect that the balance will be relatively stable, around −1% of GDP, until 2040. In the following period, there will be an unfavourable demographic development for nearly two decades and the balance will drop to nearly −2% of GDP before the end of the projection horizon. It will reach its minimum in 2057 and the deficit will start to decrease in the following years.

Chart 5.2: The Ministry of Finance Projection of Pension Account Balances

(in % of GDP)



Source: Years 2010–2015 based on the State Final Account. Years 2016–2060 projections of MF CR and the Ageing Working Group of the Economic Policy Committee.

A similar development is apparent in practically all projected pension expenditure components. Maximal values are always reached just before the end of the monitored period (in 2057), which indicates a reversal and subsequent decrease in expenditures beyond the projection horizon (after 2060). Naturally this aspect also has an impact on the value of the S2 sustainability indicator (see below) which, based on the Ageing Working Group methodology (EC, 2016c), is driven upwards at the end of the projection in 2060. Under its current conditions and setting, the pension insurance system is basically sustainable with regard to stabilisation at the end of the forecast horizon.

In contrast, the course of other projected components of expenditure that are dependent on age structure (health care, long-term care, education) shows a systematic increasing trend across the whole projection horizon.

5.3 Sustainability Analysis

The sustainability analysis, based on long-term projections, identifies the extent of fiscal consolidation necessary to ensure the stability of public finances. So-called sustainability indicators are calculated, showing the scope of measures required for decreasing expenditure or increasing revenues as a percentage of GDP in order that they correspond to the required levels.

The European Commission typically publishes three sustainability indicators (see EC, 2016c). The S1 indicator expresses generally the percentage of GDP by which it is necessary to permanently improve the structural primary balance of the general government sector so that government debt amounts to 60% of GDP in 2030. At present, this indicator reaches −0.6% of GDP (an improvement from 0.1% of GDP) for the CR.

The S2 indicator specifies the amount of fiscal effort necessary for achieving parity between discounted revenues and expenditures on an infinite horizon. According to the last Report on Fiscal Sustainability of the EC (2016c), this indicator stands at 3.2% of GDP (an improvement from 5.5% of GDP).

Last but not least, the S0 indicator indicates possible fiscal or financial competitiveness risks over the short term. It is a composite leading indicator composed of macro-financial and fiscal indicators that have proved to be relevant in the past for detecting fiscal risks in the near future. It is different in nature from the other two indicators S1 and S2, which define necessary fiscal consolidation; in contrast, S0 quantifies the rate of risk. For the CR, the value of the S0 indicator is currently around 0.11, which is far below the critical limit of 0.43.

At present, in the area of long-term sustainability of public finances the CR is assessed as a medium-risky country. The reason is the value of the S2 indicator, although the values of the indicators S0 and S1 correspond more to low risk. This confirms the fact that the CR should take further measures aimed at strengthening long-term sustainability. With regard to the results of projections in subchapter 5.2, measures should be primarily focused in the health-care system.

Table 5.1: Sustainability Indicators S1 and S2 for the Czech Republic
(in % of GDP)

	S1	S2
Cost of Ageing	0.7	2.4
Initial budgetary position	0.2	0.8
Impact of current debt	-1.5	
Total	**-0.6**	**3.2**

Source: EC (2015).

5.4 Government Guarantees

In terms of the long-term sustainability of public finances, in addition to the impacts of the ageing population we also focus on the status of guarantees provided by the general government sector. They represent a growth in general government outlay at the moment when debtors are not able to repay their liabilities for which the guarantee is provided. The total amount of guarantees at the end of 2015 was 3.9% of GDP.

The majority share in general government sector guarantees is taken by state guarantees, in particular the guarantee for the banking sector, specifically in the case concerning the takeover of the IPB by ČSOB (3.4% of GDP). Based on ČSOB's unilateral declaration, maturity for this guarantee is assumed in 2016 and the repayment of only a fraction of its value is expected. So far, an amount of CZK 5.8 billion has been paid; however, no financial compensation was paid in this regard in 2015. Another important part of the total value of the state guarantees is the infrastructure development item, amounting to 0.2% of GDP. However, this has been constantly decreasing because the financing of infrastructure development has been secured since 2001 using loans from the European Investment Bank that are directly reflected in general government debt. Further, a guarantee for securing the CNB's loan from the foreign exchange reserves on behalf of the International Monetary Fund has also been included in state guarantees, of which the utilised loan framework is nearly CZK 0.4 billion at the end of 2015. Its amount is dependent on specific drawdown in the given year, whereby the promised value from the CNB is CZK 2.53 billion.

In 2015, no new state guarantee was provided.

Compared to the previous CP, the status of government guarantees has decreased due to inclusion of all state-funded institutions and public medical facilities in the general government sector. Government guarantees provided to these entities have been consolidated in the sector. The impact on the status of government guarantees is CZK −0.2 billion.

Beyond the framework of state guarantees, we expect guarantees amounting to 0.2% of GDP in the general government sector. The most important of these include a guarantee provided to the Prague Public Transit Company for postponed repayments of CZK 6.7 billion in 2015 to purchase trams and also guarantees provided by local municipalities for loans related to housing needs (CZK 0.7 billion).

For 2016, 0.1% of GDP is expected to be paid out in the area of state guarantees, while a fall to 3.6% of GDP in the status of recorded state guarantees is expected, due to the payment of due amounts and loan repayments. A loan to the European Investment Bank intended for financing construction of the 2nd railway corridor of the Railway Infrastructure Administration and a loan intended for purchase and modernisation of the railway rolling stock of Czech Railways will be fully repaid.

In 2016, no new provision of a state guarantee is expected.

6 Quality of Public Finances – Revenue and Expenditure

The government of the CR is focusing on rationalisation and increasing how effectively the general government sector works, removing various forms of wastage, and increasing transparency. Meeting these objectives is shown, for example, by the introduction of the central register of contracts or in the draft act on the monitoring and management of public finances. For environmental commitments, tenders were opened for most public small-scale contracts and thereby prices were reduced. In terms of public finances, the clear priority is larger amounts of collected tax without needing to increase the tax burden on the revenue side, and the ability to provide a greater volume of public goods without the need to increase total expenditure.

6.1 Tax Policy Outlook for 2016–2019

6.1.1 Tax Policy Fundamentals

The starting point of tax policy strategy is the Policy Statement of the Government. One of the main priorities is the fight against tax evasion and increasing tax collection efficiency. The central belief behind introducing measures to this effect is not only their positive impact on tax incomes without having to increase statutory rates or tax bases, but also making the market environment fair. The expected increase in tax revenues can also provide the government with additional room to reduce taxes or tax payments in future. In addition to these measures, also the work on the amendment to the Act on Income Tax has begun.

6.1.2 Planned and Implemented Measures against Tax Evasion

The key measures in the fight against tax evasion include the introduction of electronic VAT reporting and the fiscalisation of cash payments. Electronic VAT reporting came into effect on 1 January 2016 and it is targeted at fraud based on illegitimately claimed excessive deductions. In the first quarter of 2016, the Act on the fiscalisation of cash payments was approved (Act No. 112/2016 Coll.). This legislation aims at preventing the concealment of taxable incomes. Compared to electronic VAT reporting, the fiscalisation of cash payments will have a much wider impact, and, in addition to revenues from VAT, it will also apply to both personal and corporate income taxes and the collection of social security contributions. In connection with the introduction of the fiscalisation of cash payments, a change in the Act No. 586/1992 Coll., on Income Taxes, has been approved. This introduces a one-off income tax credit for persons doing business obliged to record sales in the given year. Alongside the Act on the fiscalisation of cash payments, the reclassification of food services from the basic to the reduced tax rate, i.e. from 21% to 15%, was approved as an additional compensation measure (amendment to Act No. 235/2004 Coll., on Value Added Tax). Partial fiscal impacts are set out in subchapter 3.2.1.

During 2015, the application of the mechanism for the transfer of tax duty (the so-called reverse charge) for selected types of goods and services was extended, specifically to mobile phones, laptops, game consoles, precious metals, as well as selected cereals and technical crops, including oil seeds and sugar beet. Since 1 January 2016, the reverse charge mechanism has been used for real estate, and since 1 February 2016 it has also been extended to supplies of natural gas and electricity.

In spring 2015, the CR – together with three other EU member states – sent the EC an application for exemption concerning the general use of the reverse charge (all taxable supplies exceeding EUR 10,000). However, the application was rejected due to its failure to comply with the valid EU legislation. With regard to the published VAT Action Plan (EC, 2016b), the CR will strive for derogation that would make it possible to introduce reverse charge to taxable supplies exceeding EUR 10,000.

Proving the origin of property

With the approval of the government bill on amending the act in connection with proving the origin of property (Chamber of Deputies Print No. 504), mechanisms will be introduced that will improve ability of tax administrators to reveal any non-declared or concealed incomes and subsequently tax them. The act will enable the tax administrator to ask a taxpayer to prove their incomes if there is a major difference between an increase in the taxpayer's property, their consumption or other spending and incomes shown in the tax return. The payer will be obliged to prove that their property has been financed from revenues that were duly taxed or that are not subject to taxation. If the taxpayer is unable to bear the burden of evidence, their tax base or tax will be assessed in a special manner according to certain aids. At the same time, the tax administrator will assess a penalty from the amount of the determined tax in an increased amount of 50% or 100%, if the taxpayer's failure to provide cooperation has seriously hampered or prevented the determination of the tax. In defined cases, the tax administrator can also demand the filing of a property declaration if the value of the taxpayer's property exceeds, according to a preliminary conclusion, CZK 10 million.

International exchange of information on financial accounts

In 2015, automatic exchange of information on financial accounts was carried out for the first time according to the so-called FATCA Agreement, concluded between the CR and the United States of America. In 2016, exchange of information on the foreign accounts of Czech citizens will be extended to include several dozens of other countries. Thus, Czech Financial Administration will have at its disposal each year detailed information on balances on accounts of Czech taxpayers abroad, without the need to make individual applications. This should result in the acceleration and increasing effectiveness of some tax proceedings.

Central Account Register

At the beginning of February 2016, the government approved the bill of the MF CR and CNB to establish the Central Account Register. The Register will be administered by the CNB and the existing accounts of both individuals and legal entities opened with commercial banks and cooperative savings banks will be recorded there. In the case of any well-founded suspicion of criminal activity, the Customs Administration and the General Financial Directorate will be authorised to ask for recorded information as part of efforts to uncover serious tax evasion and other criminal activity. When fighting against criminal activity, prosecutors, judges, the intelligence services and the Financial Analytical Department of the MF CR will also be authorised to ask for this information. Quick retrieval of information should help improve the fight against tax evasion, money laundering or financing terrorism. The Register is scheduled to be launched 16 months after the date when the Act comes into force.

6.1.3 Tax Collection Streamlining

Measures to simplify the tax system are targeted at increasing the effectiveness of financial administration and greater computerisation of the circulation of tax documents in order to reduce administrative costs and accelerate the tax administrator's ability to react to immediate threats of tax evasion. Specifically, efforts have been focused on introducing the duty of all VAT payers, since 1 January 2016, to submit their tax declarations only electronically, which generates the possibility of reacting more quickly to any possible tax fraud and preventing it more effectively. The duty to submit electronic tax declarations has also been introduced since 2015 for most entities subject to corporate income tax, while the possibility to submit electronic tax declarations also applies to other taxes. On the Tax Administration portal, tax declarations are accessible for this purpose and offer the possibility to check entered data on-line. Computerisation decreases costs both on the part of the administrator and the tax entity.

Another measure in this sphere is the possibility to change the local jurisdiction of the tax administrator from the virtual address of the tax entity to the place of the entity's real economic activity. This measure makes searching activities and control procedures more effective right across the CR, helps for a more effective distribution of personnel capacities, and thus also for improving services for taxpayers. The possibility to change the local jurisdiction of the tax administrator came into effect on 1 January 2015. The aforementioned measures, in combination with the newly introduced electronic VAT reporting, will enable greater concentration of tax control on problematic entities that fail to duly fulfil their tax obligations.

6.1.4 Future Outlook

The main prerequisite for the future setting of tax policy is successful application of measures against tax evasion. If they were to be fully effective in the economy, we expect they would bring in additional tax incomes annually equalling approx. CZK 20 to 30 billion. According to the statement of the government of the CR these additional funds could be used for further decreases in the tax burden. With regard to the interval between the introduction of all the measures against tax evasion, their full effect and their impact evaluation, we can assume that any changes in the tax burden will not be made before the next general election.

At present, work is under way on the new act on income taxes. This will comprehensively address issues of the "super-gross" wage, solidarity surcharge and more generally the taxation of self-employed persons and employees. Alongside preparations for the new act on income tax, the concept of so-called self-assessment is under preparation. Primarily, it should mean simplification of the tax administration process, strengthening legal certainty and decreasing administrative burden on the part of tax administrators and tax entities. The principle of the project is the automatic determination of tax at the amount which the tax entity writes in their tax declaration. Self-assessment should bring considerable reduction in administration and the possibility to use personnel capacities in control activities.

6.2 Other Aspects of Tax Policy

Due to better tax collection and the effective struggle against tax evasion, additional room was also created in 2016 for decreasing the tax burden of selected groups of citizens. In order to support families with children, the tax credit for a second child was increased by CZK 100 per month and for a third and any additional child by CZK 300 per month in comparison with the figures valid for 2015.

Further, the conditions have been extended in 2016 for providing tax credits for placing a child in statutorily defined child-care facilities for preschool children. A taxpayer may claim expenditure for placing a child in child-care facilities for preschool children, including kindergarten up to the amount of the minimum wage.

The governmental bill on gambling tax (Chamber of Deputies Print No. 579) increases the current rate and extends the group of taxable items. The act also legalises gambling business for foreign entities in the CR, in particular the possibilities of using the Internet for intermediating games, which will enable their proper taxation and increase the effectiveness of lottery tax collection.

Indirect taxes should rise due to a gradual increase in the rates of excise duty on tobacco products in 2016–2018. In 2016, in the area of tobacco products, taxation on tobacco for smoking and on cigars has increased more than for cigarettes.

6.3 Tax Assignment

Effective since 1 January 2016, the latest amendment to Act No. 243/2000 Coll., on Tax Assignment (Act No. 391/2015 Coll.), has increased the share of the regions in VAT revenues from 7.86% to 8.92% of nationwide revenues (a return to the value valid until 2011). Due to this modification, we expect an increase in revenues of the regions (and a corresponding decrease in revenues of the state budget) of approx. CZK 3.5 billion. With effect from 1 January 2017, the share of municipalities in the nationwide gross VAT revenues will be increased from the current 20.83% to 21.4%. This change should bring an additional amount of CZK 2.1 billion to the budgets of municipalities. In contrast, the 30% share of municipalities in personal income tax revenues from business activity will be cancelled from the same date, which will decrease revenues of municipalities by CZK 1.2 billion. In total, revenues of municipalities will increase by approx. CZK 0.9 billion from 1 January 2017.

6.4 Rationalisation of General Government Expenditure

In its Policy Statement, the government has identified one of its main priorities to be much greater rationalisation of state finances and an audit of state property, as well as ensuring that systematic records of the latter are kept (Policy Statement of the Government, 2014). In accordance with the Policy Statement of the Government, due diligence was performed during 2014 for selected ministries' finances. Based on this audit, the MF CR has prepared its bill on the monitoring and management of public finances. The bill defines the duty to determine the responsibility of specific persons in the system for the management and monitoring of public finances, thereby limiting duplication in subsidy controls. Establishing audit committees at individual ministries and at government level should make the quality and independence of internal audits more effective. Together with that, rules for project evaluation and for applying international auditing standards will also be defined clearly.

According to Resolution of the Government No. 924/2014, since 2016 the purchase of specific commodities has started through the state central purchasing system. Participation in this system is obligatory (respecting certain limitations) for central bodies of state administration and their subordinate organisations. Based on knowledge of the structure of selected ministries' expenditure and analyses of best practice in the area of central purchases in five countries of the EU, a list of commodities included in state central purchasing has been drawn up under Resolution of the Government No. 289/2015. The financial volume of commodities to which central purchasing should relate in 2016–2020 is approx. CZK 13 billion.

As of 1 July 2016, Act No. 340/2015 Coll., on the Contracts Register, comes into force. Its objective is to increase transparency in the use of public sector funds, limit the potential for corruption and contribute ultimately to a decrease in the costs of purchasing goods and services. All authorities as well as state firms whose shares are not quoted on a stock exchange will have a duty to publish in the information system of public administration any contracts concluded with a performance higher than CZK 50,000, excl. VAT. Contracts, agreed after the 1st July 2017, will not be effective unless it is not published and written into a register within 3 months from its agreement. If it is not done, the contract would be cancelled from the beginning.

More economical use of the state's real estate is ensured by using the Central Registry of Administrative Buildings. At present, it registers all administrative buildings owned by the state. The system provides state institutions with a better picture of the vacant and occupied administrative buildings owned by the state, thus helping to optimise the deployment of government institutions and identify unnecessary property, which is subsequently offered for sale. More effective use of state property should also result from the amendment to the Act on Property of the Czech Republic (implemented by the Act No. 51/2016 Coll.) that came into effect on 1 March 2016. The amendment strengthens, among other things, the competences of the Office for Government Representation in Property Affairs under which unnecessary state real estate is transferred and it allows to use its own staff for selling this state property through the public auctions, thereby saving the considerable costs related to the auction with using contractual auctioneer.

A considerable decrease in prices has been achieved by making the method of public procurement related to environmental services more transparent. By introducing new rules ensuring the contractors are selected exclusively in open tenders, contract prices are reduced by approximately half compared to the tender prices of bidders winning so-called Ekotendr. This method has saved expenditure of CZK 1 billion for all contracts so far awarded.

6.5 Composition of General Government Expenditure

In 2009–2014, a decrease or stagnation in the total volume of general government expenditure in relation to GDP was a clear trend. The exception was 2012. In 2012, the total amount of expenditure was influenced by growth of expenditure in the category General public services, which was due to the one-off recording of financial compensation as part of the property settlement with churches and religious societies (impact of 1.5% of GDP) and to the flat-rate correction of refunds from the EU (0.3% of GDP). In 2015, change in the total volume of general government expenditure (so far calculated by the CZSO only until 2011) was due to its extension to include public medical facilities having the form of trade companies, the remaining state-funded institutions and some other entities having the characteristics of government institutions (for more details – see MF CR, 2015c). This extension also resulted in a change in the volume of expenditure in individual categories according to the COFOG classification (in particular related to expenditure on Health, Social protection and Private activities).

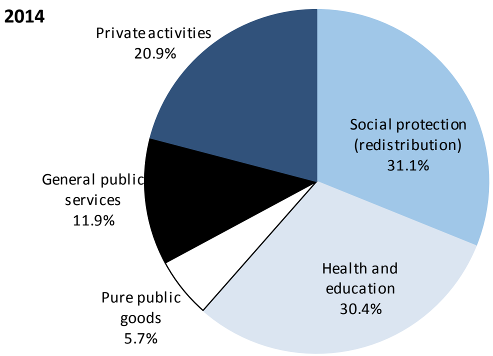
In spite of the decreasing tendency of the total volume of general government expenditure in relation to GDP, it increased by approx. 2% on average in absolute terms in 2009–2014. On average, the biggest contribution to expenditure growth stemmed from expenditure on Social protection and expenditure on Health and education.

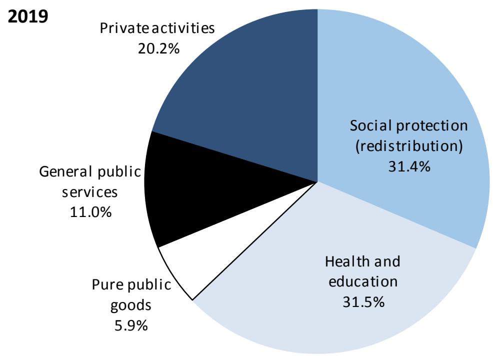
In the years of the outlook, we expect the decreasing trend in the volume of general government expenditure in relation to GDP to continue. Compared to 2014, general government expenditure should decrease by 2.1 pp in 2019. We expect that in 2019 the share of general government expenditure on social and health security of citizens will be at the level of 50.1% of the total expenditure of the sector (i.e. 20.4% of GDP). Compared to 2014, this would mean keeping similar relations both in the share in GPD and in the share in the total expenditure.

Chart 6.1 indicates the structure of general government expenditure in 2014 and its expected structure in 2019. The projection for the given period only shows a decrease in the shares of expenditure on General public services and Private activities, counterbalanced by an increase in expenditure on Health and education and expenditure on Pure public goods.

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).

Notice: The chart depicts a medium-term projection of expenditure structure based on current and planned government discretionary measures, rather than a forecast.

Source: CZSO (2016d). MF CR calculations.

7 Institutional Features of Public Finances

A high-quality and credible national institutional framework of fiscal and budgetary policy represents a basic prerequisite for healthy and sustainable public finances. In this connection, the government has discussed and approved proposals concerning regulations on fiscal responsibility, and at the same time steps have been taken aimed at strengthening tax administration and reducing tax evasion, as well as a number of measures aimed at ensuring the transparency and effectiveness of the public finances system in the CR.

7.1 Budgetary Responsibility and Government Finance Statistics

In February 2015, the government approved a set of proposals for regulations in the area of fiscal responsibility (Chamber of Deputies Print No. 411, 412 and 413). These proposals were subsequently discussed by the Chamber of Deputies of the Parliament of the CR. One of the tasks of the aforementioned regulations is to transpose Council Directive No. 2011/85/EU on requirements for budgetary frameworks of the member states into the legal order of the CR. The content of the regulations was already described in detail in the update of the CP submitted in 2015 (MF CR, 2015a), therefore only a summary of the main parameters of the proposed regulation is provided in this version, including selected temporary measures aimed at strengthening the national budgetary framework taken since the governmental proposals came into effect.

7.1.1 Forecasts and Medium-term Budgetary Framework

An independent expert Committee for Fiscal Forecasts will be established to evaluate the probability of the fulfilment of the forecasts used for the purpose of drafting the state budget, budgets of state funds and health insurance companies, and their medium-term outlooks. Before the fiscal responsibility legislation is approved and becomes effective, since April 2016 the role of the Committee has been played by the existing expert panel (the so-called “Colloquium”), composed of experts from national institutions engaged in forecasting national economic development. These experts are asked by the MF CR for a qualitative assessment of the character of its macroeconomic forecasts used for the budgetary purposes. The assessment is subsequently published in budgetary documents. The result of this assessment is provided in Subchapter 4.3.

7.1.2 Independent Fiscal Institution

As an independent expert body working in the area of fiscal and budgetary policy, a National Budgetary Council will be established (hereinafter referred to as the “Council”). Among other tasks, the Council will evaluate whether or not the numerical fiscal rules have been met. The Chamber of Deputies of the Parliament of the CR and the public will be informed of the results of this evaluation in the Council’s report. Further, the Council will draw up a report on the long-term sustainability of public finances. In its activity, the Council will be authorised to request information and cooperation from individual public institutions. The Council will have three members elected by the Chamber of Deputies of the Parliament of the CR, and membership in the Council will not be compatible with any function in the executive or legislature or, among other proscriptions, with membership in any political party or movement. For carrying out tasks related to providing professional, organisational, administrative, personnel and technical support for the Council’s activity, a new state organisational unit will be established – the Office of the Council. Expenditure on the activity of the Council and the Office of the Council will be reimbursed from a separate chapter of the state budget.

7.1.3 Numerical Fiscal Rules

This proposal introduces three numerical fiscal rules. They include two so-called operative fiscal rules that will function permanently and one rule related to a possible increase in the share of general government debt in GDP above the defined limit. A key role in the national fiscal framework will be played by the expenditure rule, which will derive the maximal volume of general government expenditure in particular from the structural part of this sector’s revenues increased by 1% of GDP (the currently defined medium-term budgetary objective) – see Box 2 for more details. The expenditure framework will be derived from the aggregate level of general government expenditure serving as the starting point for drawing up draft state budgets and draft budgets of state funds. The rule is supplemented with an automatic correction mechanism, reflecting in a retrospective manner the evaluated difference between the real expenditure level and the expenditure level defined by the rule. Fulfilment of the rule will be monitored by the independent Council, which will also be involved at the methodological level. For individual local government units, a rule regulating the so-called prudent level of the use of external resources will be introduced. It will be set at the level of 60% of the average of total revenues of a specific local government unit for the last four years. If this level is exceeded, a minimal tempo for debt reduction will be defined by law. If the level is not decreased as required, a part of the shared tax revenues of the local government unit will be withheld at the amount of the statutorily defined reduction that was not performed. Should the effectiveness of the rules described above prove to be insufficient, which would be reflected in an increase in the share of general government debt above 55% of GDP after adjusting for the cash reserve intended for state debt financing, then stricter requirements defined by law will be applied to the finances of individual general government sector entities which should help ensure sound and sustainable public finances once again. All rules are accompanied by precisely defined escape clauses.

Box 2: Proposed Numerical Fiscal Rules

Total general government expenditure for the year t+1 will be derived in the following manner:

$$\overline{G}_{t+1} \leq \sum_i E_t\left(R_{i,t+1}\right)\cdot E_t\left(\frac{Y^*_{t+1}}{Y_{t+1}}\right)^{\varepsilon_i} + E_t\left(OR_{t+1}\right) - k_{t+1} - E_t\left(M_{t+1}\right) + E_t\left(U_{t+1}\right) + 0{,}01\cdot E_t\left(Y^N_{t+1}\right),$$ where

$E_t\left(R_{i,t+1}\right)\cdot E_t\left(\frac{Y^*_{t+1}}{Y_{t+1}}\right)^{\varepsilon_i}$ represents revenues sensitive to the output gap development in the year t+1 as predicted in the year t.

Y^* is the potential product and ε_i represents sensitivity of the i-th category of revenues to the output gap development. $E_t\left(OR_{t+1}\right)$ are revenues not sensitive to the output gap development expected in the year t+1. $E_t\left(Y^N_{t+1}\right)$ is the nominal gross domestic product expected in the year t for the year t+1. M represents one-off or temporary measures (in sum of the revenue and expenditure of the state budget) and U is additional expenditure enabled by escape clauses. Finally, the term k in the equation represents in the year t+1 the requested correction of previous errors in the forecast, the so-called corrective component.

Debt rule for local government units

$$0{,}6 \geq \frac{D_{t-1}}{\left(\sum_{i=t-4}^{i=t-1} R_i\right)/4}$$, where

D_{t-1} represents the debt of a municipality of region as at the balance sheet date of the year t−1 and $\left(\sum_{i=t-4}^{i=t-1} R_i\right)/4$ is the average of revenues of a local government unit for the last four budgetary years.

Debt rule for the general government sector

$$0{,}55 \geq \frac{\left(D^{VS}_{t-1} - R_{t-1}\right)}{Y^N_{t-1}}$$, where

D_{t-1} is gross consolidated general government debt in the nominal value and R_{t-1} represents the cash reserve in state debt financing (borrowed resources that have not yet been used for financing).

7.1.4 Government Finance Statistics and Reporting

Act on the collection of selected data for the purposes of monitoring and managing public finances

The process of transposing and implementing Council Directive No. 2011/85/EU on requirements for budgetary frameworks of the member states is to be completed by two new legal regulations in the area of statistics and the comprehensiveness of these budgetary frameworks, specifically by the act on the collection of selected data for the purpose of monitoring and managing public finances and by its implementing decree. At the same time, the current non-systematic character in the Czech legal order will be remedied by transferring a part of a related legal regulation from accounting legislation to these two new statutes. As far as the material aspect is concerned, the MF CR will receive selected input data on a cash basis on the finances of some entities or accounting units that are included in the general government sector in accordance with the ESA 2010 methodology. This is a very heterogeneous group of institutions from whom the MF CR does not yet receive any data according to the valid legal order, or else the data it does receive are completely insufficient for the purpose of meeting obligations ensuing from membership in the EU. Data relating to revenues, expenditure, government guarantees and public and private sector partnership projects will be required, whereby they will be used for compiling and publishing output fiscal data for the MF CR's own requirements, with full coverage of the general government sector according to EU secondary law as well as according to the Act on the Rules of Fiscal Responsibility. Input data will also be used by the

CZSO as part of the state statistical service. Other potential users can also be the CNB or Supreme Audit Office, in the performance of their activities. The government bill is currently being discussed at the Chamber of Deputies of the Parliament of the CR (Chamber of Deputies Print No. 746) and it is scheduled to come into force on 1 January 2017. The current fiscal and statistical data defined by the aforementioned directive are presented, including methodological descriptions in Czech and English versions, on the website of the MF CR (see MF CR, 2016c).

SDDS Plus

On 4 April 2016, the CR joined eight other developed countries which meet the requested criteria of the highest standard of statistical reporting of the International Monetary Fund. The standard SDDS Plus (Special Data Dissemination Standard Plus) represents transparent economic and financial data with international comparability. The complete set of data under SDDS Plus for the CR is presented on the CNB's website (see CNB, 2016b).

GFS 2014

In the area of government financial statistics, the MF CR is currently preparing its transition to the updated manual of the International Monetary Fund of 2014 (GFS 2014). This will replace the methodology regulated by the manual of 2001 (GFS 2001) in which the MF CR publishes data for public budgets of the CR. This step does not essentially change the current principles of recording financial and non-financial operations; however, it does mean closer alignment with the System of National Accounts of 2008 or the ESA 2010 methodology.

7.2 Increasing Transparency and Effectiveness of Public Finances

7.2.1 Involving Further Available Liquidity of Institutions of the General Government Sector under State Treasury Accounts maintained by the CNB

Based on the amendment to the Act No. 218/2000 Coll., on Budgetary Rules, the General Health Insurance Company, other health insurance companies, health insurance company unions and the Railway Infrastructure Administration will subordinate their accounts to the state treasury, and thus will only be maintained by the CNB. Local government units, voluntary unions of municipalities and regional councils of cohesion regions will now receive subsidies and refundable financial assistance from the state budget, state funds or the National Fund only to accounts subordinated to the state treasury. State-funded institutions established by state organisational units will have to transfer all their deposits to accounts subordinated to the state treasury within 9 months from the date when the amendment comes into effect. The objective is to rationalise the use of state cash resources. This will lead, in the long term, to budgetary savings from the interest costs on state debt and to a further increase in the effectiveness of the state's issuing activity. The possibility to use resources freely maintained on selected accounts will not be restricted by this amendment.

7.2.2 Access to Invoices for the Public

The portal "Opendata of the Ministry of Finance of the Czech Republic" (MF CR, 2015d) launched in 2015, where numerical data in a machine-legible format are published in concentrated form and a well-arranged manner, has been extended to include new data from surveys of municipality economic management. The application "Supervisor—pop-up expenditure of the MF" has also been recently launched, visualising data from the Summary of Invoices of the MF CR. According to categories, it is possible to find individual information from invoices – amount, supplier, invoice subject, and other information.

7.2.3 Transparency Amendment to the Act on Public Health Insurance

The government also intends to increase the economic stability, effectiveness and transparency of the healthcare system. In 2015, the so-called transparency amendment to the Act on Public Health Insurance (Act No. 200/2015 Coll.) was approved, binding the government to strengthen state supervision over health insurance cashflows and performance. It imposes, among other obligations, the duty to publish contracts between health service providers and health insurance companies and regulates the provision of health insurance company data to the Ministry of Health and the MF CR.

7.2.4 Financial statements for the Czech Republic

In 2016, financial statements will be drawn up for the CR for the first time. The first statements will relate to a limited number of accounting units (approx. 7,000) for 2015. Specifically, they will include e.g. municipalities, regions and state organisational units. In 2017, financial statements for the CR for 2016 will already be drawn up by all accounting units (approx. 19,000), i.e. including state enterprises, health insurance companies, public research institutions and important trade corporations in which the state or local government units exercise their influence over monitoring and management.

References

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Act No. 155/1995 Coll., on Pension Insurance, as amended.

Act No. 243/2000 Coll., on the Tax Assignment of the Revenues of Some Taxes to Local Governments and Some State Funds (Act on Tax Assignment).

Act no. 235/2004 Coll., on Value-Added Tax, as amended.

Act no. 372/2011 Coll., on Health Services and Conditions of their Provision (Health Services Act), as amended.

Act No. 183/2014 Coll., amending the Act on Pension Insurance.

Act No. 256/2014 Coll., the Amendment to the Act on Public Health Insurance and on Changes and Supplementing of Some Related Acts, and the amendment to other related acts.

Act no. 200/2015 Coll., the Amendment to the Act on Public Health Insurance and amending and supplementing Some Related Acts, the Act on General Health Insurance Company of the Czech Republic, the Act on Ministry, Branch, Company, and Other Health Insurance Companies and the Act on Public Health Insurance.

Act no. 391/2015 Coll., Amending Act no. 243/2000 Coll., On the Tax Assignment of Certain Tax Revenues for Municipalities and Some State Funds (the Act on Tax Assignment), as amended.

Act No. 400/2015 Coll., on State Budget of the Czech Republic for 2016.

Act No. 112/2016 Coll., on Evidence of Sales.

Act No. 113/2016 Coll., amending Some Acts in Relation to the Approval of the Act on Evidence of Sales.

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Table Annex

Table A.1a: Macroeconomic Prospects

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

	ESA Code	2015 *Level*	2015	2016	2017 *Rate of change*	2018	2019
Real GDP	B1*g	**4440**	**4.2**	**2.5**	**2.6**	**2.4**	**2.4**
Nominal GDP	B1*g	**4472**	**5.0**	**3.5**	**4.0**	**4.1**	**4.2**
Components of real GDP							
Private consumption expenditure	P.3	**2128**	**2.8**	**3.1**	**2.7**	**2.4**	**2.3**
Government consumption expenditure	P.3	**851**	**2.8**	**2.1**	**1.6**	**1.4**	**1.3**
Gross fixed capital formation	P.51g	**1143**	**7.3**	**0.6**	**3.0**	**3.1**	**3.1**
Changes in inventories and net acquis. of valuables (% of GDP)	P.52+P.53	**39**	**0.9**	**1.0**	**0.9**	**0.8**	**0.7**
Exports of goods and services	P.6	**3822**	**7.0**	**5.5**	**5.9**	**6.0**	**6.0**
Imports of goods and services	P.7	**3544**	**7.9**	**5.6**	**6.1**	**6.1**	**6.1**
Contributions to real GDP growth							
Final domestic demand		**-**	**3.7**	**2.1**	**2.4**	**2.2**	**2.1**
Changes in inventories and net acquis. of valuables	P.52+P.53	**-**	**0.7**	**0.1**	**0.0**	**0.0**	**0.0**
External balance of goods and services	B.11	**-**	**-0.2**	**0.2**	**0.2**	**0.3**	**0.4**

Note: Real levels are stated in 2014 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 (2016a), MF CR (2016a). MF CR calculations.

Table A.1b: Price Developments

(indices 2010=100, growth in %)

	2015 *Level*	2015	2016	2017 *Rate of change*	2018	2019
GDP deflator	**105.9**	**0.7**	**1.0**	**1.3**	**1.6**	**1.8**
Private consumption deflator	**105.5**	**0.1**	**0.5**	**1.4**	**1.8**	**1.9**
Harmonised index of consumer prices	**108.0**	**0.3**	**0.6**	**1.5**	**1.8**	**1.9**
Public consumption deflator	**104.2**	**1.2**	**1.2**	**2.0**	**1.0**	**1.1**
Investment deflator	**103.9**	**0.9**	**0.9**	**1.3**	**1.5**	**1.7**
Export price deflator (goods and services)	**108.7**	**-1.1**	**-1.7**	**-0.6**	**0.0**	**0.2**
Import price deflator (goods and services)	**107.8**	**-1.5**	**-2.3**	**-0.6**	**-0.2**	**0.0**

Source: CZSO (2016a), Eurostat (2016). MF CR calculations.

Table A.1c: Labour Market Developments

(growth in %)

	ESA Code	2015 *Level*	2015	2016	2017 *Rate of change*	2018	2019
Employment, persons		**5170**	**1.2**	**0.5**	**0.1**	**0.1**	**0.1**
Employment, hours worked		**9.2**	**1.8**	**0.7**	**0.1**	**-0.2**	**-0.2**
Unemployment rate (%)		**5.1**	**5.1**	**4.4**	**4.3**	**4.2**	**4.2**
Labour productivity, persons		**793**	**3.0**	**1.9**	**2.5**	**2.4**	**2.4**
Labour productivity, hours worked		**441**	**2.3**	**1.7**	**2.5**	**2.7**	**2.7**
Compensation of employees	D.1	**1787**	**4.4**	**4.5**	**4.6**	**4.6**	**4.6**
Compensation per employee		**405**	**2.4**	**3.3**	**4.4**	**4.5**	**4.5**

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 2014 prices) per employed person or worked hour.
Source: CZSO (2016a, 2016c). MF CR calculations.

Table A.1d: Sectoral Balances

(in % of GDP)

	ESA Code	2015	2016	2017	2018	2019
Net lending/borrowing vis-à-vis the rest of the world	B.9	**1.1**	**-0.4**	**-0.3**	**0.0**	**0.3**
Balance of goods and services		6.4	6.8	6.7	6.9	7.2
Balance of primary incomes and transfers		-8.4	-8.5	-8.4	-8.4	-8.5
Capital account		3.1	1.3	1.4	1.5	1.6
Net lending/borrowing of the private sector	B.9	**1.5**	**0.2**	**0.2**	**0.5**	**0.7**
Net lending/borrowing of general government	B.9	**-0.4**	**-0.6**	**-0.5**	**-0.5**	**-0.5**
Statistical discrepancy		**0.0**	**0.0**	**0.0**	**0.0**	**0.0**

Note: Data from national accounts. Net lending/borrowing of general government for 2015–2016 based on notification, for 2017–2019 outlook.
Source: CZSO (2016b). MF CR calculations.

Table A.2a: General Government Budgetary Prospects

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

	ESA Code	2015 Level	2015	2016	2017 In % of GDP	2018	2019
Net lending (+)/borrowing (-) (B.9) by sub-sectors							
General government	S.13	**-19**	**-0.4**	**-0.6**	**-0.5**	**-0.5**	**-0.5**
Central government	S.1311	-45	-1.0	-1.1	-0.8	-0.7	-0.5
State government	S.1312	-	-	-	-	-	-
Local government	S.1313	25	0.5	0.4	0.2	0.2	0.0
Social security funds	S.1314	2	0.0	0.1	0.0	0.0	0.0
General government (S.13)							
Total revenue	TR	**1886**	**42.2**	**40.6**	**40.7**	**40.5**	**40.2**
Total expenditure	TE	**1905**	**42.6**	**41.2**	**41.2**	**41.0**	**40.6**
Net lending (+)/borrowing (-)	B.9	**-19**	**-0.4**	**-0.6**	**-0.5**	**-0.5**	**-0.5**
Interest expenditure	D.41	48	1.1	1.0	1.0	1.0	1.0
Primary balance		30	0.7	0.4	0.5	0.5	0.5
One-off and other temporary measures		**-6**	**-0.1**	**-0.1**	**0.0**	**0.0**	**0.0**
Components of revenues							
Total taxes		**887**	**19.8**	**19.8**	**19.9**	**19.8**	**19.7**
Taxes on production and imports	D.2	558	12.5	12.4	12.4	12.3	12.1
Current taxes on income, wealth etc.	D.5	329	7.4	7.3	7.5	7.6	7.6
Capital taxes	D.91	0	0.0	0.0	0.0	0.0	0.0
Social security contributions	D.61	**663**	**14.8**	**14.9**	**15.1**	**15.2**	**15.2**
Property income	D.4	**37**	**0.8**	**0.8**	**0.7**	**0.7**	**0.7**
Other		**300**	**6.7**	**5.1**	**5.0**	**4.8**	**4.7**
Total revenue	TR	**1886**	**42.2**	**40.6**	**40.7**	**40.5**	**40.2**
p.m.: Tax burden		**1550**	**34.6**	**34.7**	**34.9**	**35.0**	**34.8**
Components of expenditures							
Compensation of employees + Intermediate consumption	D.1+P.2	**684**	**15.3**	**15.3**	**15.3**	**15.2**	**15.1**
Compensation of employees	D.1	398	8.9	8.9	9.0	9.0	8.9
Intermediate consumption	P.2	286	6.4	6.4	6.3	6.2	6.2
Social payments		**712**	**15.9**	**15.8**	**15.7**	**15.6**	**15.5**
of which: Unemployment benefits [1)]		20	0.4	0.4	0.3	0.3	0.3
Social transfers in kind supplied via market producers	D.632	144	3.2	3.2	3.3	3.3	3.3
Social transfers other than in kind	D.62	568	12.7	12.6	12.4	12.3	12.2
Interest expenditure	D.41	**48**	**1.1**	**1.0**	**1.0**	**1.0**	**1.0**
Subsidies	D.3	**102**	**2.3**	**2.3**	**2.3**	**2.3**	**2.3**
Gross fixed capital formation	P.51g	**232**	**5.2**	**4.0**	**4.0**	**4.1**	**4.1**
Capital transfers	D.9	**32**	**0.7**	**0.7**	**0.8**	**0.8**	**0.6**
Other		**95**	**2.1**	**2.0**	**2.0**	**2.0**	**2.0**
Total expenditures	TE	**1905**	**42.6**	**41.2**	**41.2**	**41.0**	**40.6**
p.m.: Government consumption (nominal)	P.3	**890**	**19.9**	**19.9**	**19.8**	**19.5**	**19.2**

Note: Years 2015–2016 notification. Years 2017–2019 outlook.
1) Includes cash benefits (D.621 and D.624) and in kind benefits (D.631) related to unemployment benefits.
Source: CZSO (2016b). MF CR calculations.

Table A.2b: No-policy Change Projections

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

	2015 Level	2015	2016	2017 In % of GDP	2018	2019
Total revenue at unchanged policies	**1886**	**42.2**	**40.5**	**40.5**	**40.2**	**39.7**
Total expenditure at unchanged policies	**1905**	**42.6**	**41.2**	**40.8**	**40.2**	**39.5**

Source: MF CR.

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

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

	2015	2015	2016	2017	2018	2019
	Level	*In % of GDP*				
Expenditure on EU programmes fully matched by EU funds revenue	**103**	**2.3**	**1.3**	**1.3**	**1.3**	**1.2**
Non-investment expenditure	14	0.3	0.4	0.4	0.3	0.3
Investment expenditure	90	2.0	0.9	0.9	0.9	0.9
Cyclical unemployment benefit expenditure	**0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Effect of discretionary revenue measures (year-on-year changes)	**-8**	**-0.2**	**0.5**	**0.4**	**0.2**	**0.0**
Revenue increases mandated by law	-	-	-	-	-	-

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

Table A.3: General Government Expenditure by Function

(in % of GDP)

	Code	2014	2019
General public services	1	**5.1**	**4.5**
Defence	2	**0.7**	**0.8**
Public order and safety	3	**1.7**	**1.6**
Economic affairs	4	**5.8**	**5.5**
Environmental protection	5	**1.1**	**1.1**
Housing and community amenities	6	**0.9**	**0.8**
Health	7	**7.7**	**7.6**
Recreation, culture and religion	8	**1.2**	**0.9**
Education	9	**5.3**	**5.2**
Social protection	10	**13.3**	**12.8**
Total expenditure	TE	**42.8**	**40.6**

Note: Year 2019 outlook.
Source: CZSO (2016d), MF CR (2016a). MF CR calculations.

Table A.4: General Government Debt Developments

(in % of GDP, average maturity in years, contributions in % of debt)

	ESA Code	2015	2016	2017	2018	2019
General government gross debt		**41.1**	**41.1**	**40.7**	**40.2**	**39.3**
Change in gross debt ratio		**-1.6**	**0.0**	**-0.3**	**-0.5**	**-0.9**
Contributions to changes in gross debt						
Primary balance		**0.7**	**0.4**	**0.5**	**0.5**	**0.5**
Interest expenditure	D.41	**1.1**	**1.0**	**1.0**	**1.0**	**1.0**
Stock-flow adjustment		**0.0**	**0.8**	**0.7**	**0.6**	**0.3**
Difference between cash and accruals		-0.4	0.0	0.0	0.0	0.0
Net accumulation of financial assets		0.4	0.8	0.7	0.6	0.3
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		**2.6**	**2.5**	**2.5**	**2.5**	**2.5**
Liquid financial assets		**13.1**	**12.7**	**12.6**	**12.3**	**12.0**
Net financial debt 1)		**27.9**	**28.4**	**28.1**	**27.9**	**27.3**
Debt amortization (existing bonds) since the end of the previous year 2)		**3.0**	**4.0**	**4.7**	**4.9**	**4.1**
Foreign-currency exposition of the state debt 2) 3)		**4.1**	**4.1**	**4.1**	**3.9**	**3.9**
Average maturity 4)		**5.1**	**5.3**	**5.7**	**6.0**	**6.0**

1) Net financial debt is a difference between gross debt and liquid financial assets (monetary gold, Special Drawing Rights, currency and deposits, securities other than shares (consolidated at market value), shares and other equity quoted in stock exchange).
2) Figures only for the state debt. The state debt represents a debt generated by the state budget financing.
3) The foreign-currency exposure of the state debt is debt denominated in foreign currency, which is exposed in term of foreign-currency Exchange rate movement after being adjusted for the foreign-currency exposure of state financial assets.
Source: CZSO (2016b). State debt data MF CR. MF CR calculations.

Table A.5: Cyclical Developments

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

	ESA Code	2015	2016	2017	2018	2019
Real GDP growth (%)		**4.2**	**2.5**	**2.6**	**2.4**	**2.4**
Net lending of general government	B.9	**-0.4**	**-0.6**	**-0.5**	**-0.5**	**-0.5**
Interest expenditure	D.41	**1.1**	**1.0**	**1.0**	**1.0**	**1.0**
One-off and other temporary measures		**-0.1**	**-0.1**	**0.0**	**0.0**	**0.0**
Potential GDP growth (%)		**1.8**	**2.1**	**2.1**	**2.3**	**2.3**
contribution of labour		0.0	-0.1	-0.1	0.0	-0.1
contribution of capital		0.5	0.6	0.6	0.6	0.6
total factor productivity		1.3	1.6	1.6	1.7	1.8
Output gap		**0.1**	**0.4**	**1.0**	**1.1**	**1.3**
Cyclical budgetary component		**0.0**	**0.2**	**0.4**	**0.4**	**0.5**
Cyclically-adjusted balance		**-0.4**	**-0.8**	**-0.9**	**-0.9**	**-1.0**
Cyclically-adjusted primary balance		**0.6**	**0.3**	**0.1**	**0.1**	**0.0**
Structural balance		**-0.3**	**-0.6**	**-1.0**	**-1.0**	**-1.0**

Note: Years 2015–2016 notification. Years 2017–2019 outlook.
Source: CZSO (2016b). MF CR calculations.

Table A.6: Divergence from Previous Update

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

	ESA Code	2015	2016	2017	2018	2019
Real GDP growth (%)						
Previous update		**2.7**	**2.5**	**2.3**	**2.3**	**-**
Current update		**4.2**	**2.5**	**2.6**	**2.4**	**2.4**
Difference		1.5	0.0	0.3	0.2	-
General government net lending (% of GDP)						
Previous update	B.9	**-1.9**	**-1.2**	**-0.8**	**-0.6**	**-**
Current update	B.9	**-0.4**	**-0.6**	**-0.5**	**-0.5**	**-0.5**
Difference		1.4	0.6	0.3	0.1	-
General government gross debt (% of GDP)						
Previous update		**40.9**	**40.9**	**40.7**	**40.2**	**-**
Current update		**41.1**	**41.1**	**40.7**	**40.2**	**39.3**
Difference		0.1	0.2	0.0	0.0	-

Source: MF CR (2015a, 2016a). MF CR calculations.

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

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

	2013	2020	2030	2040	2050	2060
Total expenditure	**41.9**	**40.6**	**41.2**	**41.5**	**42.9**	**43.8**
of which: **Age-related expenditures**	**18.9**	**19.4**	**20.1**	**20.3**	**21.5**	**22.0**
Pension expenditure	**9.0**	**9.0**	**9.0**	**9.0**	**9.6**	**9.7**
Social security pensions	**9.0**	**9.0**	**9.0**	**9.0**	**9.6**	**9.7**
Old-age and early pensions	**7.3**	**7.5**	**7.5**	**7.4**	**8.0**	**8.1**
Other pensions	**1.7**	**1.5**	**1.5**	**1.6**	**1.6**	**1.6**
Occupational pensions	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Health care	**5.7**	**5.9**	**6.2**	**6.5**	**6.6**	**6.7**
Long-term care	**0.7**	**0.9**	**1.0**	**1.2**	**1.2**	**1.4**
Education expenditure	**3.4**	**3.6**	**3.9**	**3.7**	**4.0**	**4.1**
of which: **Non-age-related expenditures**	**22.1**	**21.2**	**21.2**	**21.2**	**21.4**	**21.9**
of which: **Unemployment benefits**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**
of which: **Interest expenditure**	**1.3**	**1.2**	**1.2**	**1.2**	**1.4**	**1.9**
Total revenue	**40.8**	**39.9**	**39.9**	**39.9**	**39.9**	**39.9**
of which: **Pension contributions**	**7.9**	**7.9**	**7.9**	**7.9**	**7.9**	**7.9**
of which: **Property income**	**0.9**	**0.7**	**0.7**	**0.7**	**0.7**	**0.7**
Pension reserve fund assets	**0.6**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
of which: **Consolidated public pension fund assets**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Systemic Pension Reforms						
Social contributions diverted to mandatory private scheme	-	-	-	-	-	-
Pension expenditure paid by mandatory private scheme	-	-	-	-	-	-
Assumptions						
Labour productivity growth	**0.9**	**1.8**	**1.9**	**1.8**	**1.7**	**1.5**
Real GDP growth	**-0.9**	**1.6**	**1.9**	**1.6**	**1.5**	**1.7**
Participation rate of males (aged 20–64)	**86.1**	**87.6**	**86.8**	**86.1**	**87.8**	**88.7**
Participation rate of females (aged 20–64)	**69.5**	**72.2**	**72.4**	**71.9**	**74.8**	**76.0**
Total participation rate (aged 20–64)	**77.9**	**80.0**	**79.7**	**79.2**	**81.4**	**82.5**
Unemployment rate	**7.0**	**6.3**	**6.0**	**6.0**	**6.0**	**6.0**
Population aged 65+ over total population	**17.1**	**20.2**	**22.3**	**24.7**	**27.5**	**28.2**

Source: EC (2014, 2015). MF CR calculations.

Table A.7a: Contingent Liabilities

(in % of GDP)

	2015	2016
General government sector guarantees	**3.9**	**3.6**
of which: Linked to the financial sector	3.6	3.3

Source: MF CR.

Table A.8: Basic Assumptions

(interest rates and growth in %)

	2015	2016	2017	2018	2019
Short-term interest rate (CZ) (annual average)	**0.3**	**0.3**	**0.3**	**0.3**	**0.5**
Long-term interest rate (CZ) (annual average)	**0.6**	**0.6**	**0.8**	**1.2**	**1.6**
Nominal effective exchange rate (2010=100)	**92.5**	**93.7**	**94.6**	**97.1**	**99.2**
Exchange rate CZK/EUR (annual average)	**27.3**	**27.0**	**26.9**	**26.2**	**25.6**
World excluding EU, GDP growth	**3.2**	**3.4**	**3.7**	**3.9**	**4.0**
EU28 GDP growth	**1.9**	**1.7**	**1.9**	**2.0**	**2.0**
Growth of relevant foreign markets	**5.5**	**4.7**	**5.6**	**5.8**	**6.1**
World import volumes, excluding EU	**0.8**	**2.2**	**3.5**	**3.9**	**4.1**
Oil prices (Brent, USD/barrel)	**52.4**	**40.9**	**47.4**	**51.4**	**54.0**

Source: CNB (2016a), EIA (2016), Eurostat (2016). MF CR calculations.

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ISSN 1804-798X