Ministry of Finance

Czech Republic

Convergence Programme

of the Czech Republic

April 2015

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List of Abbreviations

CNB	Czech National Bank
CP	Convergence Programme of the Czech Republic
CZK	Czech koruna currency code
CZSO	Czech Statistical Office
EC	European Commission
ERM II	Exchange Rate Mechanism II
ESA 95	European System of National and Regional Accounts from year 1995
ESA 2010	European System of National and Regional Accounts from year 1995
EU, EU28	European Union containing 28 countries
EUR	euro currency code
GDP	gross domestic product
LFS	Labour Force Survey
MF CR	Ministry of Finance of the Czech Republic
PAYG	pay-as-you-go system
pp	percentage point
USD	US Dollar currency code
YoY	year-on-year

Symbols Used in Tables

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

Cut-off Date for Data Sources

Macroeconomic data used pertain to the 1 April 2015 release, fiscal data to the 29 April 2015 release and survey of macroeconomic forecasts of the CR to the 17 April 2015 release. Notification of general government deficit and debt was approved by Eurostat on 21 April 2015.

Note

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

Introduction

This submitted update of the Convergence Programme of the Czech Republic (CP) for the period 2015–2018 was approved by the Government of the Czech Republic on 29 April 2015 and is consistent with the National Reform Programme of the Czech Republic approved by the Government of the Czech Republic on the same day. The CP is fully consistent with the rules on the content and format of stability and convergence programmes (EFC, 2012). In April 2015, the CP was also presented and discussed with the relevant committees of the Chamber of Deputies and the Senate of the Czech Republic.

This year's CP update is the second in a row describing the aims of the current coalition government, which was formed following the early election in 2013. Based on the last year's CP, the EU Council decided to abrogate the excessive deficit procedure, explaining that the excessive deficit had been removed in the Czech Republic in a permanent and credible manner (EU Council, 2014a). The European Commission assessed the CP both with regard to its importance for sustainable fiscal and social and economic policies in the Czech Republic and to its compliance with EU rules. On this basis, the EU Council expressed its viewpoint in the following recommendations: "Following the correction of the excessive deficit, preserve a sound fiscal position in 2014. Significantly strengthen the budgetary strategy in 2015 to ensure that the medium-term objective is achieved and remain at the medium-term objective thereafter. Prioritise growth-enhancing expenditure to support the recovery and improve growth prospects. Adopt and implement measures to strengthen the fiscal framework, and in particular establish an independent fiscal institution to monitor fiscal policies, introduce fiscal rules for local and regional governments and improve coordination between all layers of government." (EU Council, 2014b) The individual elements of this Recommendation are discussed in the respective chapters of the CP.

The Convergence Programme is divided into seven chapters. Chapter 1 sets out the economic and political intentions and targets of the Government of the Czech Republic in the spheres of fiscal policy and basic elements of structural reforms, as well as the description of the monetary policy framework.

The macroeconomic scenario of the CP is detailed in Chapter 2. In 2014, the Czech economy continued the recovery started in the first half of 2013, and real GDP increased by 2.0% for the whole year. The economy is being stimulated by several one-off factors in 2015: by the positive supply shock resulting from low oil prices and by fiscal stimulation, partially reflecting the effort to draw down maximum possible resources from the EU funds of the 2007–2013 financial perspective. In 2015, we expect a quicker growth of real GDP of 2.7%. The year 2015 should be characterised by a very low inflation, a reduction in the unemployment rate, employment growth and closing the output gap.

The economic policy in 2014 and 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 Notifications approved by Eurostat on 21 April 2015, and on the now more precise economic-policy intentions of the Government (closing date for data sources was 29 April 2015). For 2014, a government sector deficit of 2.0% of GDP and government debt of 42.6% of GDP were notified. The forecast estimates a government sector deficit of 1.9% of GDP in 2015 with a subsequent gradual decrease to 0.6% in 2018. The structural balance should develop positively in the same period, from −1.7% of GDP in 2015 to −1.1% of GDP in 2018, i.e. to a level close to the medium-term budgetary objective of the Czech Republic. General government debt as a percentage of GDP culminated at 45.0% in 2013, for 2015 we expect it to decrease to 40.9% of GDP, i.e. by more than 4 pp compared to 2013. The primary reason is the integration of liquidity from the state treasury system. In 2018, government debt should fluctuate around the level of 40% of GDP.

Macroeconomic and fiscal scenarios are verified in Chapter 4 by comparing them with the forecasts of other public and independent private institutions. Moreover, the scenario is supplemented with a sensitivity analysis, in which the impacts of alternative scenarios of economic development are simulated based on different interest rates, lower economic growth of the main economic partners in the EU and a higher price of oil. 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, 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 update of pension projections in the Ageing Working Group of the Economic Policy Committee (EPC/AWG) of autumn 2014 is also presented. This chapter also examines the size and structure of guarantees of the general government sector.

Chapter 6 addresses the qualitative side of government sector revenues and expenditure. At present, priority is given to a description of planned changes in the tax system which should result in preventing tax evasion and improving tax collection.

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 Czech Republic is to support and develop "a socially and environmentally oriented market economy" (Policy Statement of the Government, 2014). The aim of the economic and political mix is to increase the competitiveness of the economy and strengthen the country's social and regional cohesion through long-term sustainable economic growth. The priority is to identify and implement growth-supporting measures across different spheres of the economy. From the perspective of fiscal policy, the government also expressly declared that it will take pains to ensure that the development of general government sector finances will remain at a safe level below the reference deficit value of 3% of GDP. In monetary policy, in November 2013 the Czech National Bank (CNB) began to use the exchange rate as an additional monetary policy instrument after the possibilities afforded by the traditional channel of interest rates were more or less exhausted. This regime of a one-sided exchange rate commitment with a lower limit of 27 CZK/EUR is to be used at least until the second half of 2016.

1.1 Fiscal Policy

Since 2009, the Czech Republic has taken a number of steps towards decreasing the government sector deficit, despite a relatively deep negative output gap. This resulted in the abrogation of the excessive deficit procedure with the Czech Republic on 20 June 2014. However, the relatively strong consolidation manifested itself in a recurrent deepening of the negative output gap to −3.0% of GDP in 2013. Since 2014, the restrictive fiscal policy has been abandoned, a turnaround that has occurred even during a situation of a highly accommodative currency policy, i.e. nearly zero interest rates, supplemented since November 2013 by foreign exchange intervention (see below). Growth of government investment, which had been systematically decreasing in the previous four years, has been started. Investment growth is also continuing in 2015.

In the area of final consumption, the efforts of the present government to rationalise purchases of goods and services are having a positive effect: intermediate consumption in 2014 was basically increasing by a third of the rate compared to 2013, and we also expect a similar development in 2015. Social measures are following the opposite direction, whether in government final consumption in the increase in health insurance company expenditure, growth in the government sector wage bill, or in the sphere of social benefits. Here the mechanism of pension benefit indexation that was valid until 2012 returned as of 1 January 2015, with an exceptionally increased indexation for 2015 (after 2013 the pension indexation had been temporarily reduced by the Nečas' government as part of consolidation measures). On the one hand, all these measures have been resulting in a deterioration of the structural deficit, which should culminate in 2015 at the level of 1.7% of GDP, but on the other hand they are supporting domestic demand and economic growth. This will contribute to closing the output gap already in 2015.

The current government has focused in the first year of its mandate on auditing and increasing the efficiency of public administration. The priority in fiscal policy for the next few years is increasing the effectiveness of tax collection. The main measures should include electronic VAT reporting, fiscalisation of cash payments and increasing the effectiveness of the financial administration (see Chapter 6.1). Measures in the tax sphere are considered as the main factor in the positive fiscal effort[1] in the forecast horizon. The expected deficit should decrease from 1.9% of GDP in 2015 to 0.6% of GDP in 2018. The decrease implies a decline in the deficit adjusted for the business cycle and one-off and temporary measures from 1.5% of GDP in 2016 to 1.1% of GDP in 2018 (Table 1.1). We expect that the medium-term budgetary objective will be more or less achieved at the end of the forecast horizon. This corresponds for the Czech Republic to a structural balance of −1.0% of GDP. Fiscal policy will again fulfil its function as a counter-cyclical stabiliser.

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

	2016	2017	2018
General government balance	**-1.2**	**-0.8**	**-0.6**
Structural balance	-1.5	-1.3	-1.1
Primary structural balance	-0.4	-0.2	0.1

Source: MF CR.

In the sphere of state debt management, the main target has become the optimisation and effective use of available liquidity from the state treasury system. At the end of 2014, state debt and government sector debt were even reduced by approx. CZK 20 billion. Government debt as a percentage of GDP was reduced to 42.6% of GDP in 2014. In 2015, a decline in relative terms to 40.9% of GDP due to the inclusion of state treasury funds is expected. With regard to the planned consolidation of government sector finances in the following years, we expect a decrease in government debt to a value around 40% of GDP (regarding the government sector – see subchapter 3.4 for more detail).

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

1.2 Monetary Policy

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

With respect to the fact that disinflation continued even after the reduction of interest rates to the technical minimum in November 2012, the CNB began to further relax the monetary conditions in November 2013. In order to prevent the long-term undershooting of the inflation target, the CNB started using the exchange rate as an additional monetary policy instrument. Intervention on the foreign exchange market (in the volume of approximately EUR 7.5 billion) was only carried out in November 2013; since then, the mere existence of the exchange rate commitment and the declared resolution of the CNB to meet this commitment have been enough to maintain the exchange rate above the level of 27 CZK/EUR.

The joint document of MF CR and CNB "Assessment of the Fulfilment of the Maastricht Convergence Criteria and the Degree of Economic Alignment of the Czech Republic with the Euro Area" (MF CR, CNB, 2014), approved by the government on 15 December 2014, states that important institutional changes in the functioning of the monetary union and related additional conditions and commitments arising for the Czech Republic from its possible membership in the Euro Area have been implemented in recent years. As regards the country's level of preparedness to adopt the euro, it is necessary, even in spite of certain improvement, to ensure the long-term sustainability of public finances, in particular in connection with the ageing population (see Chapter 5), and it is also advisable to adopt measures that would reduce administrative barriers to business and increase labour market flexibility. Considering these facts, and in accordance with the Updated Accession Strategy of the Czech Republic to the Euro Area, the government has not yet established a target date for joining the Euro Area and will not endeavour to enter ERM II during 2015 (in accordance with the Updated Accession Strategy of the Czech Republic to the Euro Area the length of stay there should be minimal).

1.3 Structural Policies

The Czech Republic's priorities and targets regarding structural policies are described in detail in the National Reform Programme of the Czech Republic (Government Office, 2015). Here, we only include a list of the most important ones.

1.3.1 Labour Market

In the labour market, the Czech Republic is working to create suitable conditions for employment sustainable over the long run. In this regard, changes in competences of labour offices together with an increase in the number of employees in these institutions will result in a more effective implementation of the active labour market policies. The reform of the investment incentive system will increase investors' motivation to create jobs in regions with structural deficiencies. The introduction of childcare within child groups will enable parents to better balance their professional, family and personal lives.

1.3.2 Business Environment

Measures in the business environment focus in the long term on reducing administrative and regulatory burden of entrepreneurs. Also of small- and medium-sized enterprises are supported and exports facilitated. In this regard a number of measures is being implemented that should result in a reduction of administrative burden, while plans to reduce the cost of founding a company are underway. The export client centre will help Czech entrepreneurs to expand into foreign markets.

1.3.3 Education

Reforms in the education system are targeted in particular at an increasing quality of education and reconciling secondary and university education with labour market requirements. The prepared amendment to the Higher Education Act introduces a new system to evaluate quality of universities and regulates the system of accreditation of study programmes. At the same time, a system for students' testing at the national level is been under development and the framework for the comprehensive evaluation of the quality of schools is being prepared.

1.3.4 Research, Development and Innovation

The main targets of the Czech Republic in the area of research, development and innovation include improving the conditions for excellent research, strengthening of cooperation between business and research organisations and the development of so-called start-ups. In this regard, a number of programmes are being implemented. At the same time, the amendment to the methodology for evaluating research organisations is being prepared, together with a new regulation of the status and financing of research infrastructure.

1.3.5 Energy Industry and Climate Change

Over the long run, the Czech Republic has been striving for a long time towards an effective transition to a competitive low-carbon economy and reduced dependence on fossil fuels. For this purpose, the Climate Protection Policy in the Czech Republic and the further updating of the National Renewable Energy Action Plan of the Czech Republic are being prepared.

1.3.6 Transport Infrastructure

In the field of transport, the Czech Republic is focusing in particular on effective completion of backbone transport infrastructure and connecting the remaining regions and important industrial centres to core routes. The already approved strategic document Transport Policy of the Czech Republic for 2014–2020, with an outlook to 2050 is a basis for the partial strategies that outline detailed solutions and financing methods in individual areas.

2 Economic Outlook

The recovery of the Czech economy has gradually intensified: in 2015 we expect real GDP to grow by 2.7%. Economic growth should be driven exclusively by domestic demand. The year 2015 should be characterised by very low inflation due to a marked decrease in oil price. 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 years. Net lending/borrowing vis-à-vis the rest of the world should remain positive.

2.1 World Economy and Forecast Assumptions

The economic situation and outlook differ considerably in individual regions. While economic growth should accelerate further in the USA, mainly due to household consumption dynamics, only moderate recovery occurred after the technical recession in Japan and the outlook reflects poor performance of the economy. The economic growth of developing economies has slowed, but still maintains its high dynamics. The impact of low oil prices differs in individual regions, but can be viewed generally as an important stimulus for the world economy.

For the whole of 2014, GDP of the EU28 showed growth of 1.3%, thus overtaking the level of 2008. The economic recovery during the year was mainly caused by private consumption due to the improving labour market situation and increasing consumer confidence. Improved situation was also apparent in some economies in the south of the Euro Area.

We expect GDP of the EU28 to increase in 2015 by 1.6% (versus growth of 1.7% in the Winter Forecast of the EC, 2015a); for 2016 we expect growth of economic output of 1.9% (versus 2.1% in the Winter Forecast of the EC, 2015a). We expect further improvement in consumer and business sentiment. In the outlook, private investment and consumption should remain the principal drivers of growth. Strengthening foreign demand and the weakened euro will support exports.

Other assumptions of the CP scenario are comparable with the assumptions of the 2015 Spring Forecast of the EC.

In 2014, the average price of Brent crude was 99 USD per barrel, while a decrease in the price below 60 USD per barrel at the end of the year surpassed expectations. In the forecast horizon of the CP we expect a gradual price growth to 78 USD per barrel in 2018; for 2015 and 2016 we expect the oil price to be practically identical to that assumed in the Spring Forecast of the EC, i.e. approx. 60 and 68 USD per barrel, respectively.

Based on the recent development of USD/EUR exchange rate, we selected the level of 1.07 USD/EUR for 2015 and a technical assumption of an exchange rate stability of 1.05 USD/EUR for 2016–2018. This is a scenario with a weaker EUR/USD exchange rate compared to the assumptions of the Spring Forecast of the EC, which expects an exchange rate of 1.11 USD/EUR and 1.10 USD/EUR for 2015 and 2016, respectively.

The CNB will continue to use the CZK exchange rate as an additional monetary policy instrument. This rate should fluctuate, according to our expectations, around 27.50 CZK/EUR until the end of 2016. Thereafter the CZK should again start strengthening against the euro (the expected abandonment of the CNB's exchange rate commitment), although with more moderate impacts on nominal values than would otherwise correspond to a long-term trend. Considering the CNB's loose monetary policy, even in the medium-term horizon we cannot expect any marked growth in interest rates, which have been hovering at extremely low values since the end of 2012.

Table 2.1: Exogenous Assumptions of the Scenario

		2014	2015	2016	2017	2018
USD/EUR exchange rate	*annual average*	**1.33**	**1.07**	**1.05**	**1.05**	**1.05**
CZK/EUR exchange rate	*annual average*	**27.5**	**27.5**	**27.5**	**27.2**	**26.8**
Government bond yield to maturity 10Y	*in % p.a.*	**1.6**	**0.6**	**0.8**	**1.2**	**1.8**
PRIBOR 3M	*in % p.a.*	**0.4**	**0.3**	**0.3**	**0.4**	**0.5**
GDP EU28	*real growth in %*	**1.3**	**1.6**	**1.9**	**2.1**	**2.3**
Oil prices (Brent)	*USD/barrel*	**99.0**	**60.2**	**68.3**	**73.5**	**77.3**

Source: CNB (2015), EIA (2015), Eurostat (2015). MF CR calculations.

2.2 Actual Developments and Medium-term Scenario

2.2.1 GDP and the Demand Side

In 2014 the Czech economy carried on with the recovery that started in the first half of 2013, and real GDP increased by 2.0% for the whole year. In 2015, growth should accelerate to 2.7% thanks to the effect of one-off factors[2] . In the following years, after these factors expire, the growth rate should slow slightly to 2.5% in 2016 and 2.3% in 2017 and 2018. Up to the horizon of the CP, growth should be driven solely by domestic demand.

Improving household incomes, growing employment coinciding with low inflation and increasing consumer confidence resulted in an acceleration of household consumption growth to 1.7% in 2014. In 2015, these favourable factors will cause the household consumption growth further accelerate up to 2.8%. In the CP horizon, due to the moderation of economic output and accelerating inflation, we expect the household consumption growth to gradually slow to 2.1%.

The current setting of government expenditure is given by the draft of the expenditure framework for the state budget and state funds for 2016–2018 and by approved state budget deficit for 2016. The growth of government expenditure should gradually decrease from 2.3% in 2014 to 1.3% in 2018 (see Chapter 3).

In 2014, the dynamics of gross fixed capital formation was supported by an improvement in the draw-down of funds from the EU financial perspective 2007–2013. The same effect should also manifest itself in 2015, when we expect a 5.3% growth of investment in fixed capital. An increase in investment activity corresponds to growing domestic and foreign demand and, together with the favourable development of firms' own resources for financing investment projects, reacts to growth of capacity utilisation. Once the financial implementation of the perspective EU 2007–2013 is terminated and the fiscal stimulus fades away, we expect the gross fixed capital formation growth to slow to 3.2%.

The development of foreign trade is strongly influenced by the slump in oil prices as well as the exchange rate development. The increase in the foreign trade surplus in current prices that occurred in 2014 was accompanied by a considerable improvement in the terms of trade. In contrast, in terms of volumes imports were growing faster than exports. The contribution of foreign trade to year-on-year growth of real GDP in 2014 reached −0.1 pp. The aforementioned factors should also take effect in 2015. Considering the expected development on export markets and the development of domestic demand, the effect of foreign trade on economic output should be broadly neutral in the next few years.

The economic level of the Czech Republic, expressed in terms of GDP per capita using purchasing power parity, reached approximately 83% of the EU28 average in 2014. After a period of convergence during the years 2000 to 2007 when the relative economic level of the Czech Republic compared to the EU28 countries increased from 72 to 84%, there has been stagnation since then or even a slight decline. Due to the differential of GDP growth, the relative economic level of the Czech Republic is assumed to remain at around 84% of the EU28 average in 2018.

2.2.2 Potential Product and Position within the Business Cycle

Due to long periods of recession and sluggish economic growth, the growth of potential product has slowed considerably, down to 0.7% in 2014; the biggest contribution stemmed from total factor productivity. The long-lasting and deep slump in gross fixed capital formation has led to a drop in the contribution of capital stock. From 2010 on, the negative impact of demographic changes has also started to depress potential growth quite severely. 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 Czech Republic is approaching the standards of more developed economies, the contribution of the number of worked hours to potential product growth has been negative for a long period of time.

In the following years, growth of potential product could accelerate in connection with economic recovery and exceed the level of 2% in 2018. Total factor productivity, and to a lesser extent also the growth of capital stock, should contribute most to potential product growth.

The output gap decreased from −3.0% at the recession trough in 2013 to −1.2% in 2014. It should close during 2015 in line with the ongoing economic recovery. At the end of the CP horizon, we expect a positive output gap of around 1% (see Chart 2.2**Chyba! Nenalezen zdroj odkazů.**).

[2] The positive supply shock by means of a decrease in the price of oil, the fiscal stimulus and efforts to use the maximum allocation of EU funds from the financial perspective 2007–2013 until the end of 2015.

Table 2.2: Economic Output

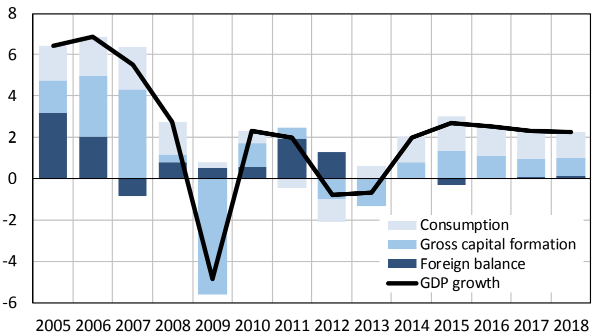
(level in CZK billion, increases in %, contributions to growth in percentage points)

	ESA Code	2014 Level	2014	2015	2016 Rate of change	2017	2018
Real GDP	B1*g	**4168**	**2.0**	**2.7**	**2.5**	**2.3**	**2.3**
Nominal GDP	B1*g	**4266**	**4.4**	**4.7**	**4.0**	**3.7**	**3.8**
Components of real GDP							
Private consumption expenditure	P.3	**2061**	**1.7**	**2.8**	**2.3**	**2.2**	**2.1**
Government consumption expenditure	P.3	**820**	**2.3**	**1.7**	**1.6**	**1.5**	**1.3**
Gross fixed capital formation	P.51g	**1065**	**4.5**	**5.3**	**4.2**	**3.2**	**3.2**
Changes in inventories and net acquis. of valuables (% of GDP)	P.52+P.53	**-11**	**-0.2**	**-0.2**	**-0.2**	**-0.2**	**-0.2**
Exports of goods and services	P.6	**3431**	**8.8**	**5.7**	**6.0**	**6.1**	**6.1**
Imports of goods and services	P.7	**3198**	**9.5**	**6.6**	**6.6**	**6.6**	**6.6**
Contributions to real GDP growth							
Final domestic demand		-	**2.4**	**3.0**	**2.5**	**2.2**	**2.1**
Changes in inventories and net acquis. of valuables	P.52+P.53	-	**-0.3**	**0.0**	**0.0**	**0.0**	**0.0**
External balance of goods and services	B.11	-	**-0.1**	**-0.3**	**0.0**	**0.1**	**0.1**

Note: Real levels are in 2013 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 (2015a), MF CR (2015a).

Chart 2.1: Decomposition of GDP Growth

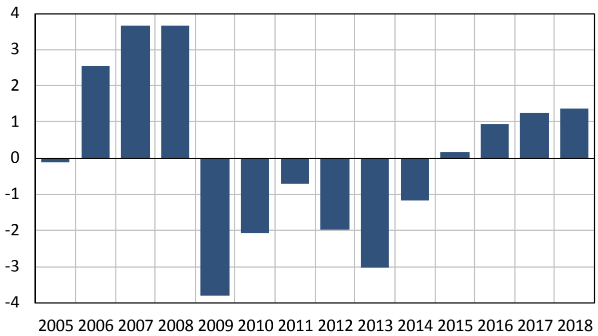
(growth in %, contributions to growth in percentage points)



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

Chart 2.2: Output Gap

(in % of potential product)



Source: MF CR calculations.

2.2.3 Prices

Inflation measured by the harmonised consumer price index reached 0.4% in 2014, i.e. it was the second lowest inflation in the history of the independent Czech Republic. This was in part a manifestation of the abnormal negative contribution of administrative measures, specifically of regulated prices, where a decrease in the electricity price had the biggest impact. At the end of the year the considerable fall in oil prices also contributed to the slow growth of consumer prices. In 2014, the only significant pro-inflationary factor was the exchange rate.

The year 2015 should also be characterised by very low inflation, in particular due to a favourable supply shock in the form of a decrease in the oil price. Administrative measures should have an almost neutral impact on inflation. The exchange rate should have a pro-inflationary effect (however, less than in 2014), together with the growth of unit labour costs and the improving position of the economy in the business cycle.

Once the favourable supply oil shock has receded, inflation should accelerate in 2016. The main factors should impact inflation either neutrally (exchange rate, regulated prices) or have a pro-inflationary effect (growing demand due to the increasing positive output gap, growth in the oil price and unit labour costs). Introduction of fiscalisation of cash payments should have insignificant impact on the inflation (up to a maximum of 0.1 pp) due to the demand counter-effect. In the next few years, growth of the harmonised consumer price index should approach 2%.

Table 2.3: Prices of Goods and Services

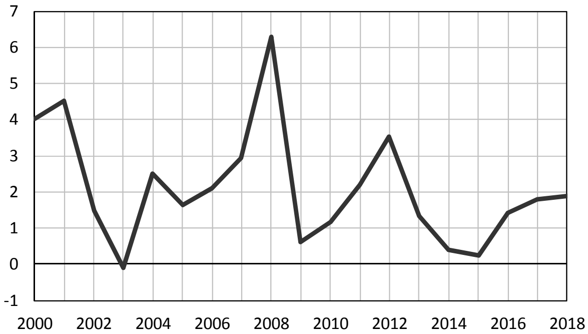
(indices 2010=100, rate of change in %)

	2014	2014	2015	2016	2017	2018
	Level	*Rate of change*				
GDP deflator	**105.3**	**2.4**	**1.9**	**1.4**	**1.4**	**1.5**
Private consumption deflator	**105.6**	**0.3**	**0.2**	**1.5**	**1.8**	**1.9**
Harmonised index of consumer prices	**107.7**	**0.4**	**0.2**	**1.4**	**1.8**	**1.9**
Public consumption deflator	**102.6**	**1.8**	**0.5**	**0.3**	**0.8**	**0.8**
Investment deflator	**103.5**	**1.6**	**0.7**	**0.9**	**0.9**	**0.9**
Export price deflator (goods and services)	**109.9**	**4.0**	**0.9**	**0.4**	**0.6**	**0.6**
Import price deflator (goods and services)	**109.4**	**2.4**	**-1.0**	**-0.2**	**0.4**	**0.3**

Source: CZSO (2015a), Eurostat (2015). MF CR calculations.

Chart 2.3: Harmonised Index of Consumer Prices

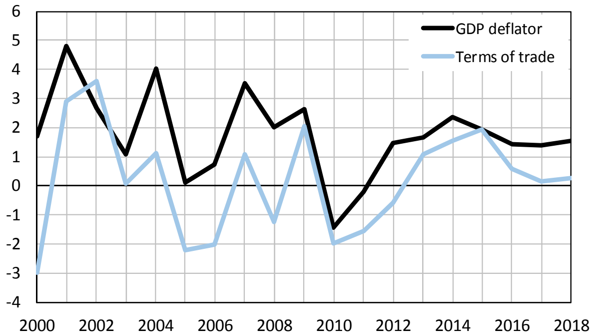
(y-o-y growth in %)



Source: Eurostat (2015). MF CR calculations.

Chart 2.4: GDP Deflator and Terms of Trade

(y-o-y change in %)



Source: CZSO (2015a). MF CR calculations.

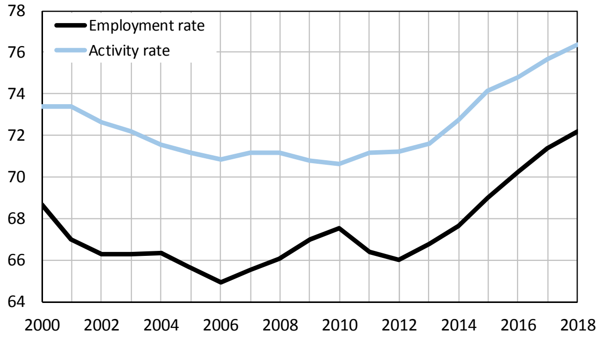
2.2.4 Labour Market and Wages

The relatively favourable economic situation in 2014 manifested itself in employment growth, the number of worked hours per person increased slightly after two years considering its procyclicality. In the CP horizon, we are inclined to forecast a gradual increase in employment, which due to the decreasing working-age population will manifest itself in a considerable increase in the employment rate. Even though the economic growth necessary for maintaining the unemployment rate constant lies presently far below the long-term average (around 3%), the unemployment rate should decrease gradually to 5.3% in 2018. A problematic aspect of the Czech labour market is the high proportion of long-term unemployed persons that continues to prevent any significant decrease in the total unemployment rate.

The participation rate in the Czech Republic has a counter-cyclical character. The so-called "additional worker effect" is predominant within the Czech economy, whereby households react to a deterioration of their financial situation by increasing labour supply. The effects with an impact in the opposite direction (earlier retirements, extension of parental leaves or studies, etc.) are less important. The improving position of the Czech economy in the business cycle brings about pressures towards lowering the participation rate. Structural factors should effectively counteract such pressures, however. The most important of these include the increasing 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 aged 40–49); after including the impact of the development in all age groups, the demographic effect will be positive.

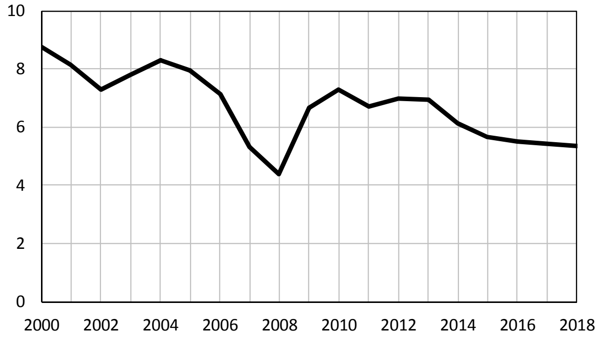
For 2015, we forecast an increase in compensation of employees by 4.0%, whereby several tendencies will impact wage development in the CP horizon in opposite directions. In particular in 2015, nominal wage growth should be dampened by low inflation. The rapidly falling short-term unemployment rate could lead, however, to a shortage of qualified workers in some professions or regions, which would further increase pressures on wage growth. With gradual economic recovery, a decrease in the number of less remunerated jobs in the grey economy can be expected.

Chart 2.5: Employment and Participation Rates
(in %)



Source: CZSO (2015c). MF CR calculations.

Chart 2.6: Unemployment Rate
(in %)



Source: CZSO (2015c). MF CR calculations.

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

	ESA Code	2014	2014	2015	2016	2017	2018
		Level	*Rate of change*				
Employment, persons		5105	0.4	0.7	0.2	0.1	0.1
Employment, hours worked		9.1	1.0	0.2	-0.3	-0.2	-0.2
Unemployment rate (%)		6.1	6.1	5.7	5.5	5.4	5.3
Labour productivity, persons		793	1.6	2.0	2.3	2.2	2.2
Labour productivity, hours worked		441	1.0	2.5	2.8	2.5	2.5
Compensation of employees	D.1	1711	3.2	4.0	4.1	4.4	4.1
Compensation per employee		399	3.0	3.2	3.9	4.2	4.0

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 2013 prices) per employed person or worked hour.
Source: CZSO (2015a, 2015c). MF CR calculations.

2.3 External Transactions and Sectoral Balances

In accordance with the EFC (2012), this subchapter has been prepared using national accounts methodology, which allows 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, commonly used balance of payments methodology lies, for example, in accrualisation and classification of some items.

In 2014, the Czech economy recorded, for the first time in the history of the independent Czech Republic, positive net lending/borrowing vis-à-vis the rest of the world of 1.0% of GDP. Czech Republic thus became an exporter of capital.

The steady improvement in the balance of goods and services continued, with the surplus rising to 6.9% of GDP. The long-term deficit balance of primary incomes, which is influenced predominantly by the distributed income of companies under foreign control, achieved a slight improvement of 0.4 pp to −7.7% of GDP. The balance of current transfers showed a slight deficit of −1.0% of GDP and the surplus of capital transfers reached to 1.8% of GDP.

In 2015, the surplus of net lending/borrowing should increase to approx. 2.1% of GDP due to two favourable one-off factors: low oil prices should contribute to a further increase in the surplus of the balance of goods, while efforts to maximise the use of EU funding from the financial perspective 2007–2013 will probably lead to a higher surplus of the balance of capital transfers.

In the next few years, the surplus of the balance of net lending/borrowing vis-à-vis the rest of the world as a percentage of GDP should fluctuate around 1% of GDP, with slightly decreasing tendency. We expect a further expansion of surpluses in the balance of goods and services and deficits in the balance of primary incomes.

In terms of sectoral balances, with the decreasing percentage of the deficit of the general government sector in GDP, surpluses of the private sector should reach 4.0% of GDP in 2015, and then decrease gradually to 1.4% of GDP in 2018.

Table 2.5: Sectoral Balances

(in % of GDP)

	ESA Code	2014	2015	2016	2017	2018
Net lending/borrowing vis-à-vis the rest of the world	B.9	**1.0**	**2.1**	**1.0**	**0.9**	**0.8**
Balance of goods and services		6.9	7.8	8.0	8.0	8.1
Balance of primary incomes and transfers		-7.7	-7.9	-8.2	-8.4	-8.7
Capital account		1.8	2.2	1.2	1.3	1.5
Net lending/borrowing of the private sector	B.9	**2.9**	**4.0**	**2.3**	**1.7**	**1.4**
Net lending/borrowing of general government	B.9	**-2.0**	**-1.9**	**-1.2**	**-0.8**	**-0.6**
Statistical discrepancy		**0.0**	**0.0**	**0.0**	**0.0**	**0.0**

Note: National Accounts Methodology. Net lending/borrowing of general government for 2014–2015 notification, years 2016–2018 outlook.
Source: CZSO (2015a). MF CR calculations.

3 General Government Balance and Debt

Following the abrogation of the excessive deficit procedure, the government has focused on supporting economic growth. This is contributing to the gradual closing of the output gap. One of the main stimuli in 2015 should also be a fiscal impulse supported by the additional drawing down of the EU funds from the programming period 2007–2013. The implementation of these funds accelerated considerably in 2014 and a similar development is also expected this year. After closing the output gap, the government expects a strategy of gradual consolidation and the de facto fulfilment of the medium-term budgetary objective at the end of the CP horizon.

3.1 Actual Balances and Updated Budgetary Plans for the Current Year

3.1.1 Development in Year 2014

According to preliminary data from the CZSO, the government sector deficit in 2014 was 2.0% of GDP; in comparison with 2013 this is a deficit higher by 0.8 pp. The resulting balance was strongly influenced by newly included financial institutions of the government sector (in 2014 the Deposit Insurance Fund disbursed CZK 14.7 billion in compensation to clients of bankrupt cooperative savings banks), by a considerable one-off accrual drop in excise duties and due to kickstarting investment activity. Fiscal effort was approx. −1.5 pp, since most of the aforementioned impacts are reflected in the structural balance.

The total growth of revenue reached 2.6% in 2014. Tax revenues and social security contributions increased by 2.4%, while direct taxes increased most as far as purely tax revenues are concerned. The share of total revenues to GDP decreased by 0.7 pp to 40.1% of GDP.

Indirect taxes revenues as a whole developed unfavourably (a decrease of 1.7%) due to the development of excise taxes on tobacco products. During 2014, the measure introducing a limitation on the additional sale of tobacco stamps with the immediately previous rate was approved, thereby considerable reducing any motive for stockpiling. As excise tax on tobacco products is due approx. 2 months from ordering the tobacco stamps, there is a shift back by these 2 months when revenues from this tax are being accrued. Therefore the very favourable months of January and February 2014 when considerable stockpiling was apparent in collection, were moved to the revenues of 2013. Conversely, the first two months of 2015, which were considerably worse in annual terms (by nearly CZK 17 billion), were included in 2014. The total accrual drop in revenues from this tax was approximately CZK 24 billion. However, this was a one-off effect that should disappear in 2015. Other measures influencing the development of excise taxes by approx. 0.1% of GDP were, first, the reduction of payment from energy produced from solar radiation when the rate was reduced and the validity period for measures was extended, and second, the return of excise tax from mineral oils for agricultural primary producers.

In contrast, there was a very favourable development of value added tax revenues. Here the YoY increase exceeded 5% and thus reflected the newly begun trend of higher tax collection due to the gradual introduction of measures against tax evasion.

The collection of direct taxes compared to 2013 increased by 7.2%, mainly due to the very favourable development of corporate income tax that reflected the economic recovery. Personal income tax revenues increased by 4%. Balance in 2014 was considerably encumbered by the refunds of basic personal tax credits for working pensioners based on a ruling of the Constitutional Court (impact of approx. 0.2% of GDP). Other discretionary influences were less important and largely compensated each other.

An increase in social security contributions of 3.6% was largely influenced by an increase in the payment for state insured persons of an amount exceeding CZK 6 billion. This is expenditure of the state budget and at the same time revenue of the subsector of social security funds (health insurance companies). Only the payment of health insurance companies to health facilities for care has any impact on the balance as such.

In annual terms, revenue capital transfers saw the greatest relative increase (by 25.4%) due to a considerable increase in investment from European sources. In terms of actual size, this is an item several sizes of magnitude smaller than income taxes. The total balance is influenced only by a part of Czech financing. This is accrual revenue, reflecting the volume of invested European sources in the given year. The revenues of 2014 were positively influenced by yield from the sale of licences for frequency bands to mobile operators of CZK 8.5 billion.

Total expenditure increased by 4.7%, thus reaching 42.0% of GDP, which represents a slight increase compared to the result in 2013.

Nominal final consumption expenditure of general government increased by 3.3%. This growth was mainly driven by the development of social transfers in kind (particularly the payments of health insurance companies for health care), which increased by more than 6% compared to 2013. Insurance companies used funds increased by payments for state insured persons and compensated medical facilities for a drop in revenues in connection with the cancellation of regulatory fees in health care. Expenditure on payment for hospital care was also increased. Compensation of employees increased by 3.5%, with the increase in the wages of state administration also having an impact on this rise (an impact of approx. 0.1% of GDP). Intermediate consumption (purchases of goods and services of the government sector) developed moderately compared to 2013, its growth reaching only 1.7%.

Expenditure on financial social benefits increased slightly (approx. 2%) with the aforementioned increase in the payment for state insured persons in the public health insurance system. In particular, the very limited pension indexation had an impact here.

Government investment increased by more than 17%. The rise primarily occurred in local government institutions (although there was also investment growth in central government), financed both from European and national sources.

Expenditure subsidies (mainly capital transfers and subsidies for production) also increased considerably. In the case of subsidies for production, this involved an increase in subsidies for renewable sources of 0.1% of GDP and, as far as capital transfers are concerned, the already mentioned expenditure of the Deposit Insurance Fund to clients of bankrupt cooperative savings banks, with a total effect amounting to approx. 0.3% of GDP.

Despite the one-off considerable fall in tobacco taxes and the compensation of the Deposit Insurance Fund (in total 0.9% of GDP), in the light of factors mentioned above 2014 can still be assessed positively. Without these impacts, the result would otherwise have been better than in 2013. The deficit was kept safely below 3% of GDP and investment activity was kickstarted. Following a decline lasting several years after 2009, such activity has again increased, achieving the level of 2011, in spite of a considerably better structural balance.

3.1.2 Development in Year 2015

In 2015, we expect the government sector deficit to improve slightly to 1.9% of GDP. Last year's negative fiscal effort should be reduced considerably to −0.3 pp.

In 2015, we expect revenues to accelerate by 5.2% to 40.3% of GDP, which represents a slight increase compared to the previous year. Tax revenues and social security contributions should increase by 3.8%.

Collection of indirect taxes should grow by 3.5% due to the sharp increase in excise duties on tobacco products. After the 2014 slump these duties should return to the value of their long-term trend, which mirrors the volume of tobacco product consumption. Value added tax revenues should increase more moderately by 1.5%. In 2015 this is dampened by the introduction of the second reduced rate of 10% for medicines, books and irreplaceable child nutrition.

Collection of direct taxes should increase by 3.4% compared to 2014, and as in 2014 it should be driven primarily by the revenues of corporate income taxes, with an expected growth of around 5%. Social security contributions will probably increase by more than 4%, thereby largely reflecting the increase in the wage bill in the economy.

We also expect an increase of more than 16% in property income due to an increase in revenues from state-owned companies. Revenues from the transfer of profits from the company Lesy ČR, s. p. should also be higher compared to 2014.

Similarly as in 2014, we expect the sharpest jump in revenue transfer items, thanks to a more than 45% increase in capital transfers from the EU due to European investment.

According to the forecast, government sector expenditure will increase compared to 2014 by 4.9%, reaching 42.1% of GDP. As a percentage of GDP, it will more or less stagnate.

Final consumption expenditure growth should slow to 2.2%, while the 3.7% increase in the wage bill in the government sector should contribute most to its dynamics. Social transfers in kind will considerably slow their dynamics to 2.8% YoY. In 2015, these expenditures are again strengthened by compensation of revenues to health facilities in connection with the abolition of regulatory fees in health care; on the other hand, their development should be slowed by the reduced rate of VAT for medicines. Intermediate consumption should increase by 1.5%, i.e. it should grow at a similarly slow pace to that in 2014.

Social benefits should increase at a quicker pace (4.3%) compared to 2014, the cause of which is higher pension indexation.

Interest expenditure of the government sector should decrease significantly, thanks partly to stabilisation of government sector debt and partly to the reduction of Czech government bonds yields, reflecting, among other causes, the positive manner in which the Czech Republic is perceived in the financial markets and the liquidity surplus. Mature bonds are gradually being replaced by bonds with lower interest rates.

A decrease should also occur in subsidy and transfer expenditure items, mainly due to capital transfers, which had a high comparison base in 2014 due to the expenditure of the Deposit Insurance Fund on payments for bankrupted cooperative savings banks.

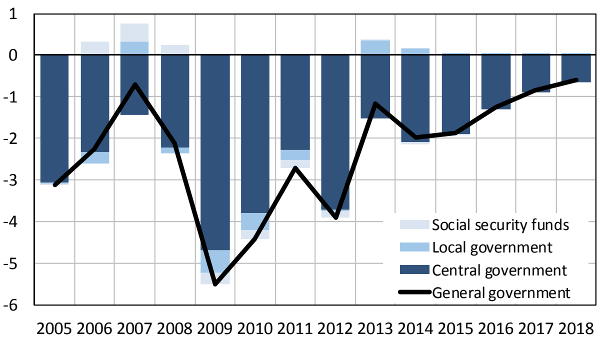
As in 2014, the high dynamics of government investment is also expected in 2015, in particular from the European sources. Gross fixed capital formation should increase by approx. 29% and will reflect efforts to draw down as much money as possible from the programming period 2007–2013, which must be done in connection with the rule N+2 by the end of 2015. Investment expenditure in 2015 also includes a one-off imputation of CZK 10.5 billion due to the lease of the JAS-39 Gripen supersonic aircrafts; both deficit and debt are influenced by this amount.

3.2 Medium-term Budgetary Outlook

For the period of the medium-term outlook, we expect the government sector to attain considerably better results and a decrease in the deficit from 1.2% of GDP in 2016 to 0.6% of GDP in 2018. We expect this trend based on the positive government fiscal effort and the expected improving macroeconomic situation, manifesting itself in the positive contributions of the cyclical component of the balance.

The current setting of fiscal policy is determined on the one side by the approved state budget deficit for 2016 and by the draft of the expenditure framework for the state budget and state funds for 2016–2018, and on the other side by the assumptions regarding the development of other government sector units. Government sector performance has always been strongly influenced by the central government balance (Chart 3.1), which most probably will not change in future. In connection with the assumption of a gradual extension of the positive output gap in the years of the outlook, higher revenues in general government sector units can also be expected from a collection of taxes sensitive to the business cycle.

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



Note: Years 2014–2015 notification, years 2016–2018 outlook.
Source: CZSO (2015b). MF CR calculations.

3.2.1 Expected Development of Revenues

The Government of the Czech Republic does not expect an increase in the tax burden in the period of the outlook through any growth of statutory tax rates. The only exceptions will be a growth of tobacco products taxation as well as the planned increase in gambling taxation. The dynamic YoY growth of tax revenues (including social security contributions), which should exceed 4% on average in the years of the outlook, will be primarily driven by autonomous growth of the respective macroeconomic bases, supported by increasingly effective tax collection and more effective prevention of tax evasion. The following text briefly sets out the specific expected fiscal impacts of measures being prepared; their more detailed description is included in subchapter 6.1.

The collection of personal income tax will be influenced positively by the expected development of the wage bill in the domestic economy. Of discretionary measures, tax credit for families with more than one child has increased since the beginning of 2015. Tax relief for families with children will be further deepen in 2016, when the tax credit for a second child will be increased by CZK 1,200 per year and for a third and any additional child by CZK 3,600 per year in comparison with the currently valid figures. This regulation will have a negative effect on tax revenue of approx. CZK 1 billion per year.

Due to the introduction of fiscalisation of cash payments, we expect an increase in the volume of reported incomes of natural persons doing business in the affected sectors. In the prediction, we expect an increase in the collection of personal income tax of approx. CZK 3 billion in 2016 and by another approx. CZK 2 billion in 2017 in line with the gradual introduction of the obligation to record sales on-line in the individual sectors.

In terms of contributions for social security and health insurance, which in budgetary terms is the most important item for the government sector, we expect revenues to grow by 4.1% on average in the years of the outlook, de facto mirroring the forecast for wage bill growth. A slight increase in revenues (of CZK 1–1.5 billion from 2016) is expected due to an increase in the tax base for persons doing business following the introduction of fiscalisation of cash payments. From 2016 the pension savings pillar (see Chapter 5) is to be cancelled, which will increase revenues from pension insurance by approx. CZK 0.8 billion.

The scenario of the updated CP expects revenues from accident insurance which from 2017 will be provided through the government sector. In the first year, revenues from this item should reach CZK 5.8 billion, and CZK 0.9 billion after adjustment for planned expenditure for accident insurance benefits.

Higher dynamics of the domestic economy will also manifest positively in revenues from corporate income tax, where we expect increases of 4–5% per year. Collection of this tax should also slightly increase in connection with the introduction of the fiscalisation of cash payments (by approx. CZK 1.2 billion in 2016 and an additional CZK 0.8 billion in 2017). From 2016, collection of corporate tax will be slightly negatively influenced by the establishment of the National Resolution Fund into which all banks will have to pay financial contributions according to their portfolio risk profiles. Due to this measure, the tax base of banks will decrease and their payment of corporate income tax will drop by approx. CZK 0.5 billion. Except for two other measures with an entirely marginal fiscal effect (tax recognisable expenditure for the establishment and operation of employer kindergartens, and the restriction on the opportunity to use the 5% rate for investment fund taxation), no other legislative measures with any impact on the revenues of this tax have been proposed.

For value added tax revenues, we expect acceleration to an average pace of 5.5% in the period 2016–2018. In addition to a positive impact in the form of the stable growth of domestic consumption, the collection of value added tax will be influenced mostly by new government measures.

In 2016, i.e. in the first year during which two key measures in the fight against tax evasion will be functioning, we expect an increase in value added tax collection of CZK 10 billion due to the introduction of the obligation for electronic VAT reporting and of approx. CZK 3.8 billion thanks to the institute of fiscalisation of cash payments. We also expect a gradual effect resulting from these measures on government budgets in the next years of the outlook. In 2017, we predict a discretionary growth of revenues of CZK 4.2 billion (with an approximately even distribution between both measures mentioned) and in 2018 growth of an additional CZK 3 billion due to the obligation for electronic VAT reporting. Therefore, in the period 2016–2018 we expect a cumulative increase in value added tax collection of approx. CZK 53 billion as a result of the increased effectiveness of tax collection.

In connection to the proposal for the introduction of the fiscalisation of cash payments, a proposal for transferring catering services from the basic VAT rate to the 15% reduced VAT rate will also be discussed. This would be possibly aimed at compensating potential upward pressure on prices, which was assessed as a risk factor in this segment.

For other excise duties, we expect active measures on tobacco product taxation. The government draft of the amendment to the Act on Excise Duties sets a trajectory for increasing the tax burden of tobacco products (in accordance with European legislation) until 2018. The effects on YoY growth in excise duties revenues should be approx. CZK 3.3 billion in 2016 and CZK 1–1.5 billion in each of the other two years of the outlook. Considering the absence of other discretionary changes, we expect an average growth of excise duties revenues of 1% in 2016–2018.

The government is also preparing a set of measures for gambling taxation which should lead to an increase in government sector revenues of CZK 2.5 billion, starting from 2016. For the period of the medium-term outlook we do not expect any one-off revenues of the general government sector budgets.

3.2.2 Expected Development of Expenditures

In 2016, with the slight nominal decrease in the total volume of government expenditure, we expect a 1.7 pp decrease in its share in GDP to 40.5% of GDP. We also predict a slight decrease in the share in the following two years of the outlook. On the expenditure side, we do not expect any legislative changes in the years of the outlook that would have any important impact on the government sector deficit.

We expect a growth of government final consumption expenditure slightly exceeding 2% on average in 2016–2018, i.e. similar dynamics as in 2015. Expenditure growth will be driven mainly by social transfers in kind where, after removing the restrictions of the previous government, we expect them to grow in excess of 3.5% and to maintain a constant share of GDP.

After what might be termed, from the perspective of development post-2009, the above standard growth of funds for compensating employees in 2014 and the forecast for 2015, we expect YoY increase of wages in public administration in 2016 by 3% as approved by the government. Expenditure on cash social benefits should grow at the average annual pace of 2.9%, which will cause a decrease in their share in GDP. Dynamics will be driven mainly by pension benefit expenditure. After the higher indexation in 2015, pensions are indexed in the following years according to the formula valid until 2012: growth in consumer prices will be fully reflected, as will a third of the growth in real wages, without government discretion to increase these expenditures above the minimum statutory limit.

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

	2015	2016	2017	2018
Personal income tax	-	3.1	1.9	-
Corporate income tax	-	1.2	0.8	-
Social security contributions	-	1.0	0.5	-
Value added tax	-	13.8	4.2	3.0
Total	**-**	**19.1**	**7.4**	**3.0**

Source: MF CR.

Table 3.2: Structure of Discretionary Measures in 2015–2018
(year-on-year discretional change, in CZK billion)

	2015	2016	2017	2018
Revenue Discretioanry Measures	**-9.0**	**25.2**	**14.0**	**4.4**
Personal income tax	-3.6	2.4	1.9	-
Corporate income tax	0.1	0.7	0.7	-
Social security contributions	3.6	3.6	6.4	-
Value added tax	-4.2	13.5	4.0	3.0
Consumption taxes	2.8	3.3	1.1	1.4
Tax on lotteries	-	2.5	-	-
Other revenue measures	-7.7	-0.8	-0.1	-
Expenditure Discretionary Measures	**-12.3**	**-5.5**	**-5.1**	**-0.1**
Cash social benefits	-5.7	-0.1	-5.0	-
Compensation to employees	-8.4	-5.4	-0.1	-0.1
Health care	-4.1	-	-	-
Other expenditure measures	6.0	-	-	-
Total	**-21.3**	**19.7**	**8.8**	**4.3**
% of GDP	-0.5	0.4	0.2	0.1

Source: MF CR.

Considering the expected positive development of the domestic economy and increasing employment, we expect in the forecast the lower growth of other, non-pension social benefits compared to the previous period.

In 2016, we expect a considerable decrease in expenditure on gross fixed capital formation (of approx. 22% YoY), which will be caused both by the one-off imputation of the lease of the JAS-39 Gripen aircraft in government sector investment in 2015 (according to ESA 2010) and a sharp decrease in investment co-financed from EU funds. For 2016, we predict the implementation of investment co-financed from EU funds at approximately half the amount compared to the expectation for 2015, which is the last year in which it is possible to draw down subsidies allocated for the Czech Republic as part of the programming period 2007–2013. In the two years after that we are already forecasting the gradual renewal of investment co-financed from EU funds. In 2017 and 2018, we expect YoY increases in nominal gross fixed capital formation of 5%.

For the period 2016–2018, we expect a slow growth of expenditure on interest payments, which should be determined partly by a favourable situation on the financial markets and partly by the achieved and planned structure of the debt portfolio and effective management of liquidity. The average growth of interest costs of approx. 3% per year in the period of the medium-term outlook should stabilise the share of the cost of debt servicing at approximately 1.1% of GDP, while we expect the nominal level of expenditure on government debt service in 2018 at a similar level as in 2014.

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.

At present, discretionary measures are more or less exclusively limited to the revenue side of government budgets. Measures being prepared primarily include the introduction of fiscalisation of cash payments (possibly with the unification of the VAT rate for catering services at 15%), electronic VAT reporting, an increase in excise tax on tobacco products and an increase in gambling taxation. On the expenditure side, we take into account the rise in the public administration wage bill by 3% in 2016.

Assuming that these measures are not approved, government sector revenues would be lower by 0.5% of GDP in 2016, by 0.7% of GDP in 2017 and by 0.8% of GDP in 2018. The expenditure side would be nearly identical throughout the whole horizon of the programme for both scenarios. The general government deficit would be, without the discretionary measures, approx. 0.5% of GDP higher in 2016, 0.6% of GDP higher in 2017 and 0.7% of GDP higher in 2018. We also get a similar picture after adjusting the whole balance for the business cycle and one-off measures.

At present, as part of an amendment to the Labour Code (the Act No. 262/2006 Coll.), the cancellation is being considered of the accident insurance system, which would function in the government sector. This amendment is not considered in any scenario. However, it is necessary to note that such reversal would have a marginal impact on the results, since the accident insurance system was designed to have only a small positive impact on the government balance.

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

	2015	2016	2017	2018
Total revenue	**40.3**	**39.2**	**39.4**	**39.4**
Total revenue at unchanged policies	40.3	38.7	38.7	38.6
Cumulative discretionary revenue measures	-	0.5	0.7	0.8
Total expenditure	**42.1**	**40.5**	**40.3**	**40.0**
Total expenditure at unchanged policies	42.1	40.4	40.2	39.9
Cumulative discretionary expenditure measures	-	0.1	0.1	0.1
General government balance with discretionary measures	**-1.9**	**-1.2**	**-0.8**	**-0.6**
General government balance without discretionary measures	-1.9	-1.7	-1.5	-1.3
Total cumulative discretionary measures	-	0.5	0.6	0.7

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 2015–2018 are represented cumulatively, thus containing effect of changes in previous years.
Source: MF CR.

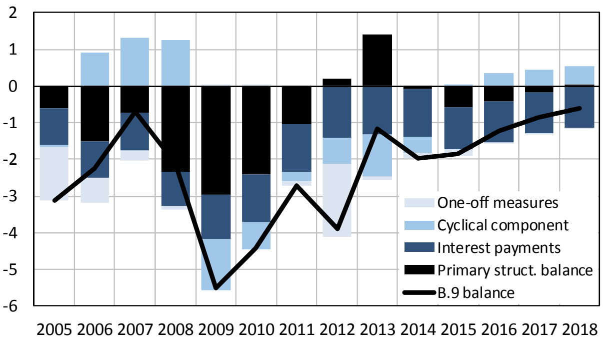
3.3 Structural Balance, Fiscal Stance

The structural balance in 2014 reached −1.4% of GDP, and we expect its deterioration to −1.7% of GDP in 2015. In the years of the outlook, the structural balance should gradually improve to −1.1% of GDP in 2018, mainly due to measures on the revenue side (see subchapter 3.2). Interest expenditure should, after a slight decrease in relative terms, stabilise at 1.1% of GDP. As a consequence, the primary structural balance will develop similarly to the structural balance.

In 2014, the most important one-off measure on the revenue side was the revenue of auction sale of frequency bands amounting to CZK 8.5 billion. The reimbursement paid by the Deposit Insurance Fund in amount of CZK 14.7 billion was the most important one-off expenditure in 2014. In 2015–2018, we do not expect any one-off measure on the revenue side. The most important measure on the expenditure side is the inclusion of the principal of the lease of JAS-39 Gripen aircrafts, accounted for as a single amount of CZK 10.5 billion in 2015. In 2015–2016, we further expect expenditure capital transfers for state guarantees of CZK 1 billion per year and in 2015–2018 expenditure on interest from state guarantees not exceeding CZK 1 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 has been closing with the gradual economic recovery (see Chart 2.2); this process should be concluded in 2015. For 2016–2018, we expect an extension of the positive output gap. Thereby we expect the cyclical component of the balance to rise from −0.4% of GDP in 2014 to 0.5% of GDP in 2018.

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



Source: CZSO (2015b). MF CR calculations.

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

The values of the structural balance and fiscal effort in 2014–2018 are shown in Table 3.5. Since 2014, the government has abandoned the restrictive fiscal policy that threatened the frail economic recovery, at the same time the termination of certain temporary measures and the strengthening of investment activity related to the renewed draw down of subsidies from EU funds will lead to the temporary deepening of the structural balance to −1.7% of GDP in 2015. In 2016–2018, the economy should already find itself in a positive output gap, and therefore the fiscal policy of the government should again be oriented slightly towards consolidation, thus ensuring the healthy development of general government finances (i.e. leading to achieving the medium-term budgetary objective).

The view of the fiscal effort and structural balance in 2016–2018 is 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. In the case a country is not in line with its medium-term budgetary objective, the average growth of potential product (1.6% for the Czech Republic) is decreased by the convergence clause (approx. 1.2 pp for the Czech Republic), which should provide an improvement in the structural balance by 0.5 pp per year. The comparison, presuming reference values of the potential product growth and of the convergence clause stated in EC (2013), which have been designated for 2014–2016, will remain valid also for 2017 and 2018, is shown Table 3.4.

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

	2016	2017	2018
Adjusted Real Expenditures	**4.1**	**1.5**	**1.0**
Expenditure Benchmark (SGP)	**0.5**	**0.5**	**0.5**

Source: EC (2013). MF CR calculations.

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

		2014	2015	2016	2017	2018
General government balance	*% of GDP*	**-2.0**	**-1.9**	**-1.2**	**-0.8**	**-0.6**
Structural balance	*% of GDP*	**-1.4**	**-1.7**	**-1.5**	**-1.3**	**-1.1**
Fiscal Effort	*pp of GDP*	**-1.5**	**-0.3**	**0.2**	**0.2**	**0.2**

Source: Source: CZSO (2015b). MF CR calculations.

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

In 2015, we expect a nominal value of government debt of CZK 1,828.6 billion (i.e. 40.9% of GDP). Its growth from CZK 1816.1 billion at the end of 2014 will be primarily determined by the inclusion of the principal of the lease of JAS-39 Gripen aircrafts, accounted for as a single amount of CZK 10.5 billion.

In comparison with last year's CP update, the structure and trend of government debt development have changed. Based on Eurostat's recommendation, the government sector now also includes selected financial institutions (the Czech Export Bank, the Czech-Moravian Guarantee and Development Bank, the Export Guarantee and Insurance Corporation and the Deposit Insurance Fund), increasing the level of consolidated debt by nearly CZK 50 billion.

Looking at the trend, the relative debt rate of the government sector in recent years has been improving considerably. In 2014, for the first time since 2006 a decrease in the debt quota was recorded, down to 42.6%. The Czech Republic is still one of the relatively least indebted countries in the EU. The debt quota level is at a safe distance both from the debt criterion of the Stability and Growth Pact and below the limit of the proposal of the national debt rule (see subchapter 7.1.3). We also expect a gradual decrease in the debt quota in 2016–2018, in total by approx. 0.8 pp to 40.2%. The reason for the change in the trend compared to the forecast of the last CP are the lower deficits of the government sector, the inclusion of liquidity from the treasury system in financing the state budget deficit (see subchapter 7.2.3 on liquidity and state budget management) and the improvement of the forecast for nominal GDP growth due to continuing economic recovery. The contributions of interest expenditure to a change in the quota should stabilise, after a decrease in 2015 to 1.2% of GDP (YoY decrease of 0.1 pp), at 1.1% of GDP in 2016–2018. The positive perception on the financial markets of fiscal discipline in the Czech Republic, the continuing economic recovery, the surplus of available liquidity on the interbank markets, and further also the stabilisation of the CZK value of state debt are reflected in its decrease. The forecast does not envisage any privatisation revenues.

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 2014 amounted to 28.2% of GDP. In other words, the size of the liquid amount for repayment of the debt, if required, would amount to 14.4% of GDP. Compared to 2013, it has decreased due to involving this disposable liquidity in financing the state budget deficit. The similar development is also expected in 2015. The ratio of net financial debt to total debt is increasing due to these operations. The possibilities for the use of in the next few years will depend on its further development and the involvement of additional entities in the central system of state financing. Further development of net financial debt thus corresponds to the development of gross government debt.

The central government subsector has the biggest share in the general government sector (see Table 3.6). In 2015, it is expected to reach a value of CZK 1,719.6 billion, i.e. a 94% share in total general government debt. The debt of the local government subsector represents the remaining 6% of the share in total debt; in 2015 we forecast it to amount to CZK 114.6 billion. Its value should decrease gradually to CZK 106.9 billion in 2016–2018. The reason for forecasting a decrease in the debt is the surplus of this subsector (among other reasons, due to an increase in revenues from shared taxes according to the amendment being prepared to Act No. 243/2000 Coll., on Tax Assignment – Chamber of Deputies Print No. 416). The subsector of social security funds shows a long-term 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 related to events of the debt crisis, and they continue to contribute to ensuring a prudent approach to debt sustainability and increasing the country's transparency on the state bond market. When drafting the medium-term strategy for state debt management, the emphasis has been given to re-financing, interest rate and currency risks as the most important sources of uncertainty in its management.

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 the short-term debt (i.e. debt payable within 1 year) in total state debt reached 14.9% at the end of 2014, representing a YoY decrease of 0.9 pp, and it fluctuated below the limit of 20% of total state debt. The same limit is also set for 2015. In the last few years, there has been a decrease in this indicator, which relates to an increase in the number of institutions falling under the state treasury system in connection with the amendment to the Act No. 218/2000 Coll., on Budgetary Rules. This has brought about a considerable increase of resources in the state treasury system, which has resulted in an increase in the available liquidity of the state and a decrease in issuing activity for government treasury bills. At the end of 2015, an increase in the share of short-term debt to 17.3% is expected, related to the relatively high repayments of bonds in 2016 and stabilisation of the CZK debt value at the end of 2015. In addition to 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 2014, the value of the share of medium-term debt was 55.7%, so its share increased by 2.1 pp. The limit for the share of medium-term debt remains at 70% for 2015. 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. Its target value is kept within the interval of 5–6 years, whereby the average time to maturity of state debt reached 5.5 years at the end of 2014. In 2015–2016, stabilisation around this level is expected.

The most important market risk for managing state debt is the interest rate risk. A prudent approach can help to mitigate the impact of fluctuating interest rates on the financial markets. The monitored indicator of the average time to re-fixing of state debt recorded a decrease of 0.1 year to 4.2 years at the end of 2014. This decrease is in line with a decrease in the average time to maturity of debt portfolio during 2014. The value of the average time to re-fixing lies within the target band of 4–5 years. This target is set with regard to optimising the costs of state debt and the risks resulting from re-fixing the interest rate. Since 2006 a target of 30–40 % of total state debt has also been set for re-fixing the interest on the debt portfolio within 1 year, i.e. the share of debt which is sensitive to interest rate fluctuations on the financial markets in the following year. The value at the end of 2014 is in the middle of the target band at 35.5% (an increase of 0.1 pp compared to 2013). The development of re-fixing interest within one year is developing counter to the average period before re-fixing. As far as the interest structure is concerned, the share of state debt with variable interest to total state debt reached 18.7% in 2014. In 2015–2018, this indicator should fluctuate around 20% (see Table 3.7). The effect of derivative transactions on interest rate exposures relates to operations hedging the currency risk of foreign issues.

Another market risk managed 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 introduced 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 by 2 pp at most, in the case of sudden local currency depreciation. At the end of 2014, this indicator was equal to 10.4% 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 2014, the share of net foreign-currency exposure of state debt denominated in euros reached 90.1% in net foreign-currency exposure. In the medium-term horizon, no significant change in the structure of foreign-currency exposure is expected (see Table 3.7). The share of foreign-currency state debt in total state debt at the end of 2014 was 14.5%. Compared to the end of 2013, there has been a decrease of 4.5 pp due to the repayment of the first and fourth issues of euro bonds in 2014.

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 2014 and the values of individual indicators for 2015–2018 fulfil the given strategic targets.

Table 3.6: General Government Debt by Sub-sector and Net Financial Debt
(in % of GDP)

	ESA Code	2013	2014	2015	2016	2017	2018
General government	S.13	**45.0**	**42.6**	**40.9**	**40.9**	**40.7**	**40.2**
Central government	S.1311	42.4	40.0	38.5	38.6	38.5	38.2
Local government	S.1313	2.8	2.7	2.6	2.4	2.3	2.1
Social security funds	S.1314	0.0	0.0	0.0	0.0	0.0	0.0
Net financial debt 1)		**28.0**	**28.2**	**28.9**	**29.0**	**28.8**	**28.3**

Note: Years 2014–2015 show notification. Years 2016–2018 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 (2015b). MF CR calculations.

Table 3.7: The State Debt's Refinancing, Interest and Debt Denominated in Foreign Currency
(in % of debt, average maturity in years)

		2013	2014	2015	2016	2017	2018
Refinancing							
Average maturity	*years*	**5.6**	**5.5**	**5.4**	**5.5**	**5.5**	**5.5**
Debt due within 1 year	*% of debt*	**15.8**	**14.9**	**17.3**	**13.7**	**15.5**	**14.3**
State Debt's Interest							
Debt with interest fixation within 1 year	*% of debt*	**35.4**	**35.5**	**35.4**	**32.8**	**37.4**	**39.6**
Fixed interest long-term debt due within 1 year	*% of debt*	8.6	7.5	5.7	4.4	9.2	7.9
Variable interest long-term debt	*% of debt*	16.8	18.7	20.7	19.7	19.9	23.4
Monetary instruments	*% of debt*	7.2	6.6	6.6	6.3	6.1	6.0
Effect of derivative operations	*% of debt*	2.9	2.5	2.4	2.3	2.2	2.3
Foreign Currency Exposition							
Foreign-currency exposition of the state debt 1)	*% of debt*	**9.4**	**10.4**	**11.2**	**12.1**	**12.2**	**11.9**
EUR exposition	*% of debt*	8.4	9.4	10.0	11.7	11.8	11.6

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

Compared to the CP scenario of April 2014, the current view of the economic development of the Czech economy and, to a certain extent, external assumptions seem to be more optimistic (Table 4.1).

In 2014, the economic activity increased more quickly compared to expectations, while GDP growth was driven exclusively by domestic demand. The economic recovery has been also favourably reflected by the labour market development. In spite of the pro-inflationary effect of the CZK exchange rate, the inflation rate only reached a very low value.

In 2015, the macroeconomic development should also be more favourable compared to the scenario of the previous CP. Estimates concerning in particular real GDP, household consumption, investment and the labour market have all improved.

In 2015, economic output will be supported by the low price of oil, the fiscal stimulus and the effort to draw down maximum possible EU funds from the financial perspective 2007–2013 before the end of 2015. Conversely, foreign trade will depress GDP growth in connection with the faster increase in volume of imports compared to exports.

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 slightly more optimistic.

As described above in subchapter 3.1, there was a one-off deterioration in the general government balance compared to the previous CP due to the inclusion of financial institutions in the general government and due to legislative limitations on stockpiling tobacco products. For 2015 and the following years, we expect a gradual improvement of the general government balance (for more detail – see chapters 3.1.2 and 3.2).

Table 4.1: Change in the Indicators of the Scenario

		April 2014 CP			April 2015 CP		
		2014	2015	2016	2014	2015	2016
External Assumptions							
GDP growth in EU28	%	1.6	1.8	2.0	1.3	1.6	1.9
Prices of oil (Brent)	USD/barrel	104.8	100.5	96.5	99.0	60.2	68.3
Exchange rate USD/EUR	USD/EUR	1.35	1.35	1.35	1.33	1.07	1.05
Exchange rate CZK/EUR	CZK/EUR	27.3	27.2	26.8	27.5	27.5	27.5
Real Values							
GDP	change in %	1.7	2.0	2.1	2.0	2.7	2.5
Households consumption	change in %	0.6	1.5	1.6	1.7	2.8	2.3
Government consumption	change in %	0.8	0.7	1.2	2.3	1.7	1.6
Gross fixed capital formation	change in %	2.7	2.0	2.1	4.5	5.3	4.2
Contribution of final domestic demand	p.p.	1.0	1.3	1.5	2.4	3.0	2.5
Contribution of foreign trade	p.p.	0.5	0.6	0.6	-0.1	-0.3	0.0
Output gap	%	-1.8	-1.2	-0.7	-1.2	0.1	0.9
Others							
Nominal GDP	CZK bn.	4023	4173	4303	4266	4467	4644
Harmonised index of consumer prices	change in %	1.0	2.3	2.1	0.4	0.2	1.4
GDP deflator	change in %	1.8	1.7	1.0	2.4	1.9	1.4
Employment	change in %	0.3	0.2	0.2	0.4	0.7	0.2
Unemployment rate	%	6.8	6.6	6.4	6.1	5.7	5.5
Balance of goods and services	% of GDP	7.7	8.4	8.8	6.9	7.8	8.0
Net lending/borrowing	% of GDP	1.2	1.2	1.0	1.0	2.1	1.0
General Government							
General government balance (B.9)	% of GDP	-1.8	-2.3	-2.0	-2.0	-1.9	-1.2
General government debt	% of GDP	44.9	46.0	47.1	42.6	40.9	40.9

Note: In the CP 2014 update, which was prepared according to ESA 95, the general government balance was calculated using interest expenditures adjusted for the net flow of swap-related flows. This is not present in the current CP, which is prepared according to ESA 2010 methodology.
Source: CZSO (2015a), CNB (2015), EIA (2015), Eurostat (2015), MF CR (2014a).

4.2 Sensitivity Analysis

The sensitivity analysis is calculated by means of the dynamic stochastic general equilibrium model, developed by MF CR. The alternative scenarios focus on some current issues concerning possible future development. Considering the high level of openness and dependence of the Czech economy on the external environment, the first of the scenarios shows the importance of the impacts 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 development and analyses the situation were it to sharply increase. All alternative scenarios are derived from the baseline scenario of the CP described in Chapters 2 and 3.[3]

4.2.1 Slower Economic Growth in the EU in 2015

The first scenario is based on the assumption that GDP growth in the EU will be approximately 2 pp lower in 2015 than in the baseline scenario. This difference corresponds to the amount of standard deviation of growth for the period 2000–2014.

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, 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 for foreign trade would be negatively reflected in real GDP growth, which would ultimately increase more slowly, by 1 pp in 2015 and by approx. 0.2 pp in 2016.

Lower export performance would be negatively reflected in the investment activity of firms, the growth rate of which would slow by 1.1 pp in 2015 and 0.7 pp in 2016 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 growth in unemployment. This effect would be most marked in 2015.

Higher uncertainty on the labour market would be reflected in household consumption, which would record a decrease in the growth rate of approx. 1.3 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 CZK, thus increasing the 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 stagnate in 2015. Their subsequent growth in the following years of the outlook would be slower by 0.2–0.3 pp compared to the baseline scenario.

The general government balance would be influenced by a lower collection of taxes paid by individuals from wages and by firms from their profits. Together with an increase in spending due to a greater amount of paid out unemployment benefits, government deficits would deteriorate by 0.3 pp in the first year and by 0.2 pp and 0.1 pp respectively in the following years. Higher deficits would subsequently accumulate into higher debt, approximately by 1 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 2016.

4.2.2 Higher Interest Rate

The second scenario assumes a 1.5 pp higher domestic interest rate in 2015, corresponding to the standard deviation of its development in 2000–2014.

Higher interest rates suppress domestic demand, in particular investment. Investment would increase by approximately 0.1 pp slower due to higher costs of investment 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 of wages. Due to higher interest rates, people with higher incomes could see an increase in the share of savings to the detriment of consumption. In contrast, a slightly lower domestic price level would work favourably for consumption. As a result, household consumption would slow growth by 0.1 pp.

[3] In the alternative scenarios we assume a development different from the baseline scenario always starting from the second quarter of 2015.

Table 4.2: Basic Macroeconomic Indicators – Sensitivity Scenarios

		2014	2015	2016	2017	2018
Baseline Scenario						
Gross domestic product	*Y-o-Y in %*	**2.0**	**2.7**	**2.5**	**2.3**	**2.3**
Private consumption	*Y-o-Y in %*	1.7	2.8	2.3	2.2	2.1
Gross fixed capital formation	*Y-o-Y in %*	4.5	5.3	4.2	3.2	3.2
Exports of goods and services	*Y-o-Y in %*	8.8	5.7	6.0	6.1	6.1
Imports of goods and services	*Y-o-Y in %*	9.5	6.6	6.6	6.6	6.6
Harmonised index of consumer prices	*Y-o-Y in %*	**0.4**	**0.2**	**1.4**	**1.8**	**1.9**
Unemployment rate	*in %*	**6.1**	**5.7**	**5.5**	**5.4**	**5.3**
General government balance	*% of GDP*	**-2.0**	**-1.9**	**-1.2**	**-0.8**	**-0.6**
Gross government debt	*% of GDP*	**42.6**	**40.9**	**40.9**	**40.7**	**40.2**
Alternative Scenario I - Lower GDP Growth in EU in 2015						
Gross domestic product	*Y-o-Y in %*	**2.0**	**1.7**	**2.3**	**2.3**	**2.3**
Private consumption	*Y-o-Y in %*	1.7	1.5	1.5	1.9	2.0
Gross fixed capital formation	*Y-o-Y in %*	4.5	4.2	3.5	3.2	3.4
Exports of goods and services	*Y-o-Y in %*	8.8	4.3	5.6	6.1	6.2
Imports of goods and services	*Y-o-Y in %*	9.5	5.8	6.3	6.6	6.6
Harmonised index of consumer prices	*Y-o-Y in %*	**0.4**	**0.0**	**1.1**	**1.5**	**1.7**
Unemployment rate	*in %*	**6.1**	**6.6**	**5.8**	**5.4**	**5.3**
General government balance	*% of GDP*	**-2.0**	**-2.2**	**-1.4**	**-1.0**	**-0.7**
Gross government debt	*% of GDP*	**42.6**	**41.3**	**41.6**	**41.7**	**41.2**
Alternative Scenario II - Higher interest rates						
Gross domestic product	*Y-o-Y in %*	**2.0**	**2.5**	**2.2**	**2.1**	**2.2**
Private consumption	*Y-o-Y in %*	1.7	2.7	2.2	2.1	2.0
Gross fixed capital formation	*Y-o-Y in %*	4.5	5.2	4.1	3.2	3.3
Exports of goods and services	*Y-o-Y in %*	8.8	5.5	5.8	6.0	6.1
Imports of goods and services	*Y-o-Y in %*	9.5	6.6	6.7	6.7	6.7
Harmonised index of consumer prices	*Y-o-Y in %*	**0.4**	**0.1**	**1.3**	**1.7**	**1.8**
Unemployment rate	*in %*	**6.1**	**6.1**	**6.1**	**5.8**	**5.4**
General government balance	*% of GDP*	**-2.0**	**-2.0**	**-1.4**	**-1.0**	**-0.7**
Gross government debt	*% of GDP*	**42.6**	**41.1**	**41.4**	**41.5**	**41.2**
Alternative Scenario III - Higher oil prices						
Gross domestic product	*Y-o-Y in %*	**2.0**	**2.4**	**2.5**	**2.3**	**2.3**
Private consumption	*Y-o-Y in %*	1.7	2.2	2.4	2.2	2.1
Gross fixed capital formation	*Y-o-Y in %*	4.5	5.1	4.1	3.2	3.2
Exports of goods and services	*Y-o-Y in %*	8.8	5.1	6.0	6.2	6.1
Imports of goods and services	*Y-o-Y in %*	9.5	5.9	6.6	6.7	6.6
Harmonised index of consumer prices	*Y-o-Y in %*	**0.4**	**0.5**	**1.4**	**1.8**	**1.9**
Unemployment rate	*in %*	**6.1**	**5.9**	**5.5**	**5.4**	**5.3**
General government balance	*% of GDP*	**-2.0**	**-2.0**	**-1.2**	**-0.8**	**-0.6**
Gross government debt	*% of GDP*	**42.6**	**41.1**	**41.1**	**40.8**	**40.3**

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

This scenario would also have negative impacts on foreign trade, where the effect of a slight CZK appreciation[4] 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 0.2–0.3 pp and the related higher unemployment.

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

[4] However, the effect of an exchange rate appreciation would not mean that the minimum limit set by the CNB of 27 CZK/EUR would be broken, at least not by mid-2016. As an average of the individual years 2015 and 2016, the exchange rate would be at 27.4 CZK/EUR versus 27.5 CZK/EUR in the baseline scenario.

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 41.2% of GDP, i.e. a level 1.0 pp higher than the baseline scenario expects.

4.2.3 Higher Oil Prices

The last scenario considered shows the possible impacts of an alternative development of oil prices compared to the baseline scenario. Here we assume that the current, still relatively low oil price, is only a short-term phenomenon and that already during 2015 there could be a sharp increase of 30%. The oil price during 2015 would be 78 USD per barrel on average (instead of the 60 USD per barrel considered in the baseline scenario). For 2016–2018, 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 slighter decrease) in 2015 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 a 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 2015.

The effects of both aforementioned shocks, i.e. both the increase in the oil price and the lower growth of foreign demand, would impact negatively on the Czech economy, in particular in 2015. 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 due to the relatively higher prices of foreign and domestic goods (up by approx. 0.6 pp), while investment in fixed capital would also grow 0.1–0.2 pp more slowly in 2015 and 2016. The total impact on real GDP growth in 2015 would be around −0.3 pp.

Due to negative changes in the economy, the expected production of firms would decrease, which could lead to downward pressures wages and an unemployment rate approximately 0.2 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, the 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.

Table 4.3: Assumptions of Alternative Scenario of Higher Oil Prices

		2014	2015	2016	2017	2018
Baseline						
Deflator of imports	*average 2010=100*	**109.4**	**108.2**	**108.0**	**108.5**	**108.8**
	growth in %	2.4	-1.0	-0.2	0.4	0.3
Crude oil Brent	*USD/barrel*	**99.0**	**60.3**	**68.3**	**73.5**	**77.3**
Alternative Scenario III - Higher oil prices						
Deflator of imports	*average 2010=100*	**109.4**	**110.0**	**109.8**	**110.3**	**110.6**
	growth in %	2.4	0.6	-0.2	0.4	0.3
Crude oil Brent	*USD/barrel*	**99.0**	**78.3**	**88.7**	**95.6**	**100.4**

Source: CZSO (2015a), EIA (2015), MF CR calculations.

4.3 Verification of the Macroeconomic Scenario by Other Institutions' Forecasts

Macroeconomic scenario of the CP was also compared with forecasts of other relevant institutions. The survey was conducted in April 2015 and its results are based on forecasts of 20 domestic institutions, together with the latest forecasts of the EC (2015a) and the International Monetary Fund (IMF, 2015). However, the whole CP timeframe is at least for some indicators covered by forecasts of only 12 institutions.

Key trends of the macroeconomic scenario of the CP 2015 are consistent with the average of forecasts of other institutions. The growth of the Czech economy, which could reach around 2.5% in 2015–2018, should be driven by the domestic demand, composed by both consumption (of households and government) and gross fixed capital formation. On the contrary, the contribution of net exports should be practically negligible.

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 2016, 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 2017 and 2018.

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

Table 4.4: Verification of 2015 Convergence Programme Scenario by Other Institutions' Forecasts

	Avearage of Forecasts				April 2015 CP			
	2015	2016	2017	2018	2015	2016	2017	2018
Growth in Real Terms								
Gross domestic product	**2.4**	**2.6**	**2.6**	**2.5**	**2.7**	**2.5**	**2.3**	**2.3**
Households consumption	2.2	2.2	2.3	2.3	2.8	2.3	2.2	2.1
Government consumption	2.0	1.6	1.5	1.4	1.7	1.6	1.5	1.3
Gross fixed capital formation	4.3	3.7	3.8	3.8	5.3	4.2	3.2	3.2
National consumer price index (aop)	**0.3**	**1.5**	**1.7**	**1.9**	**0.3**	**1.5**	**1.8**	**1.9**
GDP deflator (growth)	**1.4**	**1.5**	**1.6**	**1.8**	**1.9**	**1.4**	**1.4**	**1.5**
Employment (LFS)	**0.7**	**0.6**	**0.5**	**0.5**	**0.7**	**0.2**	**0.1**	**0.1**
Unemployment rate (LFS, level in %)	**5.7**	**5.5**	**5.2**	**5.1**	**5.7**	**5.5**	**5.4**	**5.3**

Source: MF CR (2015b).

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 expected demographic development which is expected to increase considerably over the next several decades the ratio of persons in retirement age to the economically active population, despite the last demographic projection 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 were taken in the area of pension security and the public health insurance system, primarily aimed at short-term or medium-term consolidation of government finances. However, with the change of the government the policy was reversed, and the current government is compensating previous cuts in order to protect the social groups affected.

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

In response to a ruling of the Constitutional Court (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 shifting the statutory retirement age without a fixed upper limit and, at the same time, removing benefits for women with children (i.e. a uniform retirement age will be applied to all persons born in a certain year). As regard these measures, no change has yet been made, although a measure is being discussed currently under which the retirement age according to the current regulation would be subject to regular revision and, if the demographic projection changed considerably, *ad hoc* modification would be made. This proposal has not yet been discussed by the government.

For 2013–2015, the total increase in pensions paid out (regular indexation) was originally limited to one third of the consumer price index growth and one third of real wage growth. However, the government has approved an amendment to Act No. 155/1995 Coll. (Act No. 183/2014 Coll.) according to which the validity of the reduced indexation has been shortened by one year and an extraordinary indexation of 1.8% (calculated for the average old-age pension) is effective for 2015. From 1 January 2016, the indexation formula will again be in the form of the total sum of full consumer price growth and one third of real wages growth. In the following years, the Act does not expect any extraordinary discretion of the government that could change the indexation size by government decision.

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 90 days, also when already commenced.

In addition, there exists a so-called preretirement scheme, which enables those subscribing to supplementary pension savings scheme (the 3rd pillar) to already draw funds 5 years before reaching the statutory retirement age without imposing any sanctions. However, preretirement is conditional upon having 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 prepension is drawn. The opportunity to draw preretirement was only used by 687 persons before the end of 2014, receiving an average benefit of CZK 9,370. As to the sustainability of the pension system, the impact of this measure is absolutely negligible.

5.1.2 Expert Committee on Pension Reform

In line with the Policy Statement of the Government, the Expert Committee on Pension Reform was established in spring 2014 under the auspices of the Minister of Labour and Social Affairs and the Minister of Finance. This committee should evaluate the current pension system and prepare proposals for changes to it. These proposals will be designed so that if they gain subsequent approval in the legislative process they should come into force not later than on 1 January 2017, in isolated cases earlier (for example, termination of the pension savings pillar).

The Expert Committee set out six targets in its mandate, covering a relatively wide area related to the pension system:

1) To propose a specific mechanism by means of which the setting of the retirement age will be regularly evaluated.

2) To propose such form of indexation mechanism that will ensure a proportional and dignified amount of pension for the whole period of its payment.
3) To propose a specific way for terminating the pension savings pillar.
4) To propose a setting for the parameters of the system whereby the principle of merits is strengthened without having any negative impact on protection against poverty in the pensioner population.
5) To propose changes in the parameters of supplementary funded pension schemes, in particular of the provided state support, in order to motivate the creation of long-term savings for old age, for using the saved funds for the payment of a regular pension and which would take into account the possibilities of individual types of family and households.
6) To propose such form of transfers among citizens, families and the state, intermediated by the pension system, which will ensure a balanced and generally acceptable position for all types of households.

5.1.3 Termination of the Pension Savings Pillar

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

As of 31 December 2014, 84,139 persons were registered in the pension savings pillar, and approx. 400 persons per month on average joined the system in the first months of 2015. 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 2014 was CZK 1.3 billion. Out of this amount, 93% is paid by employees and only approx. 7% is paid by self-employed persons. The share of voluntary payers is absolutely negligible. The amount taken out of the 1st pillar takes a 60% share in the total volume, i.e. it is approx. CZK 0.8 billion for the whole of 2014.

In line with its Policy Statement, the current Government of the Prime Minister Bohuslav Sobotka has decided to cancel the pension savings pillar as of 1 January 2016, whereby the winding up process should last until the end of 2016. The draft of the respective act has already been submitted to the Government of the Czech Republic. Before 31 March 2016, pension companies will inform participants of the termination of pension savings pillar. Funds accumulated in this system will be returned to the participants either by transferral to their accounts in the 3rd pillar or they will be paid into their bank accounts or in cash. Pension companies will pay out money to the participants according to the selected method in the period from 15 October 2016 to 31 December 2016. According to the estimate of MF CR, the costs of cancelling the pension savings pillar could reach up to CZK 1 billion and will be covered from the state budget.

5.1.4 Reforms in the Health Care Financing System

In the public health insurance system it is planned in 2015 to distribute among medical facilities via the reimbursement mechanism CZK 239.1 billion, which is approx. CZK 6.4 billion more than in 2014. An increase in the health-care expenditure compared to 2014 reflects the expected increase in revenues by approx. CZK 5.6 billion from contributions paid by employees and self-employed persons and higher payments from the state budget for state insured persons by approx. CZK 2.0 billion. It is discussed an increase in resources of the basic fund of health insurance companies for the payment of liabilities from provided healthcare services by approx. CZK 0.6 billion (based on the planned decrease in contributions to the reserve fund of health insurance companies). Higher health-care expenditure will compensate the drop in revenues from the cancelled regulatory fees for clinical examination by doctors, hospitalisation and prescriptions in pharmacies (an impact of approx. CZK 4.2 billion), which was cancelled by the government by Act No. 256/2014 Coll. with effect from 1 January 2015. Only the emergency service fee remains in force. Further, since 1 January 2015 the payment tariffs have increased for healthcare staff, which corresponds to an approx. 4% increase in the wage bill in the health care. In contrast, savings in the public health insurance system are evaluated at approx. CZK 2 billion due to a decrease in the value added tax rate for medicines, which was introduced by the government with effect from 1 January 2015 (the Act No. 262/2014 Coll.).

The intention of the government is to increase the transparency of health insurance company finances. The Committee for Assessing the Placement of Medical Devices, paid for by public health insurance and established in April 2014, should contribute to that. Its task is to assess proposals for the placement and operation of medical devices from the perspective of purposeful deployment, their effective utilisation and geographic placement, and to assess the suitability of providing subsidies from the state budget for the purchase of medical devices. Another measure is the approval of the so-called transparency amendment, expected to take effect from January 2016, one target of which is to ensure that health insurance companies publish contracts on the provision and payment for medical services and that health insurance companies have a statutory duty to provide the Ministry of Health and the Ministry of Finance with information and data for the creation of reimbursement mechanisms, monitoring the location and time availability and economic effectiveness of health services.

The government also plans to improve cost effectiveness, in particular in hospital care. Contributing in this regard will be the Act on Non-Profit Providers of Inpatient Health Care, scheduled to come into effect from January 2016. Its intention is to set rules for the management of hospitals by collective bodies with a transparent structure and unambiguous responsibility. Also in this area is the project DRG Restart, which by means of newly created standardised diagnostic and therapeutic algorithms and by regular updates of the data base should help build up a system for optimising payments for hospital care in order to increase their effectiveness and transparency.

5.2 Fiscal Impacts of a Population Ageing

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

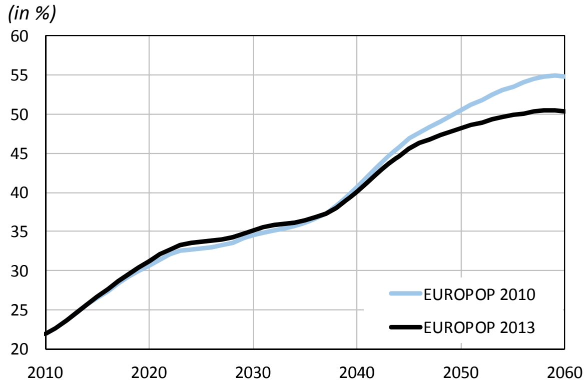
Long-term projections were updated for the last time in autumn 2014 in connection with the scheduled publication of the Ageing Report 2015. The results of the projections were reviewed by the Ageing Working Group on 25 September 2014 and are summarised in Table A.7.

From today's viewpoint, the biggest problem appears to be the 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 will rise the fastest, with its volume doubling. In volume terms, however, this constitutes a very small expenditure item.

As far as the pension expenditure is concerned, which has been the most important item so far in terms of an increase in expenditure, these should increase from the current 9.0% of GDP in 2013 to 9.7% of GDP in 2060 (measured in the ESA 2010 methodology). The negative factor remains demographic development; nevertheless the current demographic projection (EC 2014a) is more favourable for the Czech Republic than the projection in previous rounds. From this perspective, the share of the working-age population has been developing better in relation to pensioners (see Chart 5.1), which 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 %)

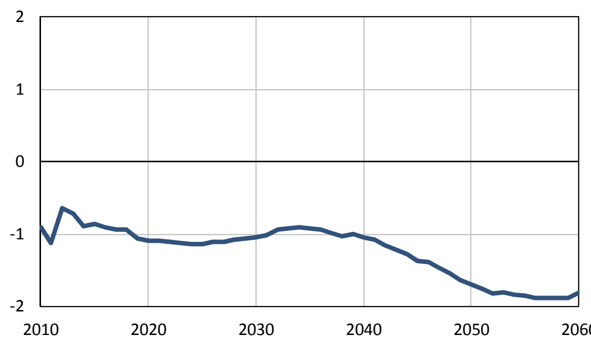


Source: EC (2011), EC (2014a).

The resulting projection for the balance of the pension system (see Chart 5.2) considers, in addition to the aforementioned pension expenditure, also revenues from social contributions, which are at a level of 7.9% of GDP[5] in all years of the projection. We expect that the balance will be relatively stable, around −1% of GDP, until the 2040s. In the following period, there will be an unfavourable demographic development 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 last years.

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

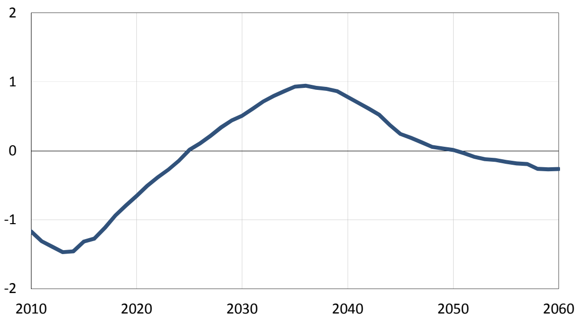
(in % of GDP)



Source: MF CR, projections of Ageing Working Group of the Economic Policy Committee.

[5] This assumption derives from the unchanged contribution rate considered for pension insurance over time and the assumption built into the macroeconomic scenario of a relatively constant share of compensation of employees in GDP.

Chart 5.3: The Ministry of Labour and Social Affairs Projection of Pension Account Balances
(in % of GDP)



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

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, is being driven upwards at the end of the projection in 2060. Similar development is also shown in the projection of the Ministry of Labour and Social Affairs, which administers legislation of the pension system. The projections carried out by the Ministry of Labour and Social Affairs by means of the micro-simulation model (see Chart 5.3) show that the balance of the system will be positive approximately from 2025 and will remain positive until 2050, following which it should show slight deficits (around 0.2% of GDP) with its peak in 2059. Under its current conditions and setting, the PAYG system is basically sustainable.

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

The sustainability analysis, based on the 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. According to EC (2014b), the S1 indicator, which expresses the percentage of GDP by which it is necessary to raise revenues or permanently reduce expenditures so that government debt amounts to 60% of GDP in 2030, has reached 0.1% of GDP at present. The S2 indicator, which specifies the amount of fiscal effort necessary for reaching parity between discounted revenues and expenditures on an infinite horizon, stands at 5.5% of GDP. The values of these indicators, however, do not so far take into account the updated projection of long-term expenditures (the updated results will be published by the Committee as late as after the Spring Forecast published on 5 May 2015). The S0 indicator, which specifies possible risks (fiscal or financial competitiveness risks) over the short term, is at the level of 0.12 for the Czech Republic for 2014, being significantly below the critical limit of 0.43.

5.3 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 government sector. They represent a risk of a growth in government sector outlays at the moment when debtors are not able to repay their liabilities for which the guarantee is provided. The total status of guarantees at the end of 2014 was 4.1% of GDP.

The majority share in government sector guarantees is taken by state guarantees, in particular the guarantee for the banking sector, specifically in the case of the takeover the IPB by ČSOB (3.7% of GDP). For this guarantee, based on a unilateral declaration, ČSOB expects its maturity in 2016 and the repayment of only a fraction of its value. So far, an amount of CZK 5.8 billion has been paid; however, no financial compensation was paid in this regard in 2014. Another important part of the total value of the status of state guarantees is the infrastructure development item of 0.2% of GDP. However, this has been constantly decreasing, as the financing of infrastructure development has been secured since 2001 by granting direct loans from the state, not by guarantees.

In 2014, no new state guarantee was provided.

Compared to the previous CP, the status of government guarantees has decreased due to reclassification of some financial institutions into the government sector (see subchapter 3.4), and thus provided state guarantees were consolidated in the sector. Further, recording of a guarantee for securing a loan from the CNB's foreign exchange reserves on behalf of the International Monetary Fund was modified. In the CP of 2014 (MF CR, 2014a), the whole promised value from the CNB of EUR 2.53 billion was still counted upon. Based on Eurostat's decision, now only the drawn loan framework as of the end of the given year is included in guarantees, which was 0.1% of GDP in 2014.

Above the framework of state guarantees, we expect guarantees amounting to 0.2% of GDP in the government sector. The most important of these include the provision of a guarantee to the Prague Public Transit Company for postponed repayments of CZK 7.4 billion in 2014 to purchase trams from the company Škoda Transportation, and further guarantees provided by local budgets for loans related to housing needs (CZK 0.4 billion) and hospitals in regions (CZK 0.2 billion).

For 2015, 0.1% of GDP is expected to be paid out in the area of state guarantees, while a fall to 3.8% of GDP in the status of recorded government guarantees is expected, due to the payment of due amounts. Provision of any new guarantee in 2015 is not expected.

6 Quality of Public Finances – Revenue and Expenditure

The government of the Czech Republic is focusing on rationalisation and increase of the effectiveness of the government sector functioning, on removal of all forms of wastage, and increase of transparency. At present MF CR, for example, publishes (also retrospectively) a list of all valid and invalid contracts without any limitation of invoiced amounts. For environmental commitments, tenders were opened for most public small-scale contracts and thereby the prices of these contracts were reduced. In terms of public finances, the clear priority is a higher amount of collected taxes without the need to increase the tax burden, and the ability to provide a greater volume of public goods without the need to increase total expenditure.

6.1 Strategy of Tax Policy and Fighting Tax Evasions

The fight against tax evasion is the main priority of the current coalition government and it is the basis from which the whole tax administration concept will in principle develop. Already during 2014, cooperation between financial administration units, customs and the police was strengthened considerably. Since 1 June 2014, Cobra, a team composed of these three institutions, has been in operation, focusing on tax evasion above CZK 150 million. The preliminary results of the work of this special group already suggest that Cobra represents the successful implementation of an operative measure in the fight against tax evasion. In its first nine months of operation, the fiscal effect reached approx. CZK 1.8 billion. At the same time, other systematic steps are being taken to increase the effectiveness of the activities of financial administration, both in its organisation and in the proposal of legislative measures on tax regulation. One-off thematic events are also being carried out.

Since 2015, activity concerning measures aimed at limiting opportunities for tax evasion is being strengthened, mainly in connection with value added tax. Specifically, this concerns a considerable extension in the scope of the reverse charge procedure as an effective and flexible instrument in the fight against tax evasion. In this measure, the Czech Republic sees great promise to further reduce the tax evasion rate in terms of value added tax, and is endeavouring to make maximum use of the possibilities given by current European law. The Czech Republic will further intensively negotiate with EC and the EU Member State representatives about the possibility of a higher flexibility rate for the general use of this institute.

More effective prevention of tax evasion is the main target of the current government coalition. Helping to meet this target are above all these three tools: electronic VAT reporting, fiscalisation of cash payments, and wider use of the reverse charge mechanism. The first two tools will be introduced from 2016, the third once a solution is found within the EU.

Now all VAT payers will have a duty to also send to the Financial Administration, in addition to their tax returns, other information – so-called electronic VAT report. This will include a list of taxable supplies together with their provider and consumer. By pairing these reports at the Financial Administration, better control will be exercised over the rightfulness of excessive deduction and ones' own tax liability. More computerisation of the circulation of tax documents reduces the administrative costs of tax administration and at the same time speeds up the tax administrator's ability to react to current threats in the form of tax evasion. For this reason, a general duty to file electronic tax returns has also been imposed since 2015 for most entities subject to corporate tax.

The basic premise of the fiscalisation of cash payments is the immediate reporting of sales electronically to the Financial Administration, with the emphasis on burdening obligatory entities with additional administrative costs as little as possible (one-off compensation in form of tax credit is being considered). Each payment transaction made will be marked with a unique identifier that will also be shown in the payment document issued to the buyer. Based on this document, it will be possible to verify at any time whether the given transaction was reported to the Financial Administration. During 2016, gradual introduction is expected of the obligation to record sales for individual groups of entities, according to the subject of enterprise. In the first phase of the project, fiscalisation of cash payments will mainly concern catering and accommodation services. In the next phase, the measures will be implemented into the retail and wholesale segments. The application of the Act will be extended to other activities gradually in relation to the results of the Financial Administration's risk analysis.

Other measures have been taken aimed at corporations operating within international groups. An annex has been attached to corporate income tax returns which maps intragroup flows that are frequent instruments for optimising the tax base and transferring profits. Thus, the CR has joined the list of countries actively fighting against profits leaving its jurisdiction.

International cooperation and information exchange is also constantly being strengthened, both at the OECD and EU levels. Cooperation and mutual provision of information are generally perceived as a very effective weapon in the global fight against tax evasion. At present, the external comment procedure is being held on the amendment to the Act on International Cooperation in Tax Administration implementing Council Directive 2014/107/EU of 9 December 2014 as regards the mandatory automatic exchange of information.

6.2 Other Aspects of Tax Policy

In order to decrease the tax burden of labour for certain groups of persons, the government has since 2015 again introduced the possibility of applying the basic personal tax credit for personal income tax also for working pensioners. Furthermore, from 2015 tax credit is also increased for a second and any additional child, thereby decreasing the tax burden for families with children. Increase in tax advantage for a second and any additional child is also planned for 2016. Tax credit for placement of the child was introduced and could be utilised since 2014. A taxpayer may claim expenditures for placing a child in child-care facilities for preschool children, including kindergarten up to the amount of minimum wage. From 2015, another limitation on lump-sum expenditure for self-employed persons is introduced, with an absolute limit of CZK 1.2 million for lump-sum expenditure of 60% and CZK 1.6 million for lump-sum expenditure of 80%, which was the first of the measures aimed at reducing the difference in taxation between employees and self-employed persons.

The Czech Republic is planning to increase the share of indirect taxation in the case of gambling taxation. An increase in rates is proposed as well as the extension of the subject of tax in the form of a new tax on gambling that will also systematically tax gambling operated via the Internet. Indirect taxes have also increased due to the proposal for a gradual increase in the rates of excise duty on tobacco products in 2016–2018. In the area of tobacco products, taxation on tobacco for smoking and on cigars has increased more than for cigarettes.

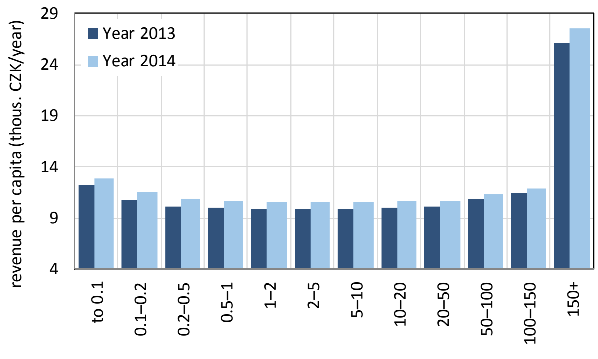
The planned modification of fees in some areas, such as the environmental fee for car registration, extracting surface or underground water and discharging waste water, as well as the planned increase in fees for mineral mining, can be identified as partial progress in the taxation of activities which have a negative impact on the environment.

6.3 Tax Assignment

With effect from 2013, the latest amendment to the Act No. 243/2000 Coll., on Tax Assignment (Act No. 295/2012 Coll.), decreased the differences in the average revenue of shared taxes per capita in municipalities with 200 to 50,000 inhabitants. Higher average revenue was maintained in the smallest municipalities and especially in the four largest towns in the CR. For 2014, no legislative change was made in the area of tax assignment and the year-on-year growth of average collection (see Chart 6.1) was caused by purely autonomous impacts in the form of the dynamics of the collection of shared taxes. Neither should any changes occur within the horizon of the submitted CP in the calculation of the share of municipalities in revenue of shared taxes. Nevertheless, from 2016 the government is proposing (Chamber of Deputies Print No. 416) to increase the share of regions in revenues from value added tax from 7.86% to 8.92% of nationwide revenues (returning to the value valid until 2011). Due to this regulation, we expect an increase in the revenues of regions (or decrease in revenues of the state budget respectively) of approx. CZK 3.5 billion.

Chart 6.1: Average Tax Revenue per Capita

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



Source: MF CR.

6.4 Rationalisation of General Government Expenditure

In accordance with the Policy Statement of the Government, due diligence was performed during 2014 for selected ministries' finances. Concluded agreements for public contracts and the expenditure of ministries based on registered invoices for 2011–2013 were analysed, among other data. The target was mainly to map approval procedures in public purchases and get a general picture of suppliers and unit prices for purchases of standardised items. Information obtained from this due diligence can be used as one of source materials for formulating specific measures aimed at removing wastage from public resources and rationalising state finances.

According to Resolution of the Government No. 924/2014, the purchase of specific commodities, starting from 2016, should be carried out through the state central purchasing system. Participation in this system will be 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 meeting the conditions for inclusion in state central purchasing has been prepared. The financial volume of commodities to which central purchasing should relate from 2016, is approx. CZK 13 billion. The potential for further extension is up to approx. CZK 19 billion, which represents nearly 30% of all purchasing expenditure of the central bodies of state administration.

Another measure that should increase transparency from 2016 in the use of funds, limit the potential for corruption and contribute ultimately to a decrease in the costs of purchasing goods and services is the prepared Act on the Contracts Register. According to the coalition proposal, all authorities and state firms will have a duty to publish on the Internet any contracts concluded with a value higher then CZK 50,000, excl. VAT (see also Chapter 7).

More economical use of real estate should be supported by using the Central Register of Administrative Buildings more effectively. At present this already registers more than 95% of all buildings owned by the state. The functional register will enable revenues and expenditure for buildings to be monitored and will help to optimise the deployment of government institutions and identify unnecessary property that will be subsequently offered for sale.

6.5 Composition of General Government Expenditure

Since 2009, an overall decrease in the volume of government expenditure in relation to GDP has been a clear trend, which should be interrupted in 2014 and 2015 only temporarily (for the reasons see Chapter 3). Subsequently, the trend shall continue in the years of the medium-term outlook. It should be taken into account that the amount of expenditure in 2012 is, in line with the ESA 2010 methodology, influenced by the one-off recording of financial compensation as part of the property settlement with churches and religious societies, amounting to CZK 59 billion or 1.5% of GDP, as well as by the flat-rate correction of refunds from the EU of CZK 11.9 billion or 0.3% of GDP (for more details see MF CR, 2013). In comparison with 2009 and 2018, the share of expenditure should drop by 3.6 pp.

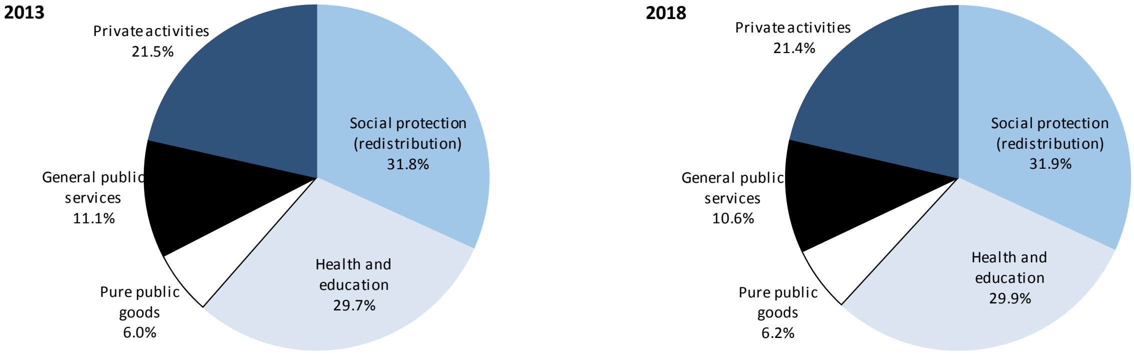
Alongside the general decrease in the share of government sector expenditure in GDP, a marked increase was only recorded in the period 2009–2013 (the data for 2014 according to the COFOG classification are not yet available) for expenditure on the environmental protection. A very slight increase was also recorded for expenditure in social protection and education.

In the outlook horizon, in accordance with the overall trend we expect to witness a relative decrease or stagnation of expenditure in all monitored categories (see also Table A.3 in the annex). We expect that in 2018 nearly half of government expenditure (approximately 20% of GDP) will again be used to cover expenditure on social security and health insurance of citizens.

Chart 6.2 indicates the structure of government sector expenditure in 2013 and its expected structure in 2018. The projection only shows a very limited decrease in the share of expenditure on general public services for the benefit of other groups during the monitored 5-year period.

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

(in % of total expenditure)



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

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

Source: CZSO (2015d). MF CR calculations.

7 Institutional Features of Public Finances

In the Czech Republic, steps continue to be implemented in order to strengthen the national framework for the implementation of fiscal and budgetary policy and to further increase the transparency of public finances. At the same time, proposals are under discussion concerning regulations for achieving compliance with the Council Directive No. 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the member states.

7.1 Strengthening of National Fiscal and Budgetary Framework

The transposition of the Council Directive No. 2011/85/EU on requirements for budgetary frameworks of the member states (hereinafter referred to as the Directive) into the legal order of the Czech Republic has been delayed due to the termination of discussions on legal regulations following the dissolution of the Chamber of Deputies of the Czech Republic in August 2013. The requirements of the Directive will now be implemented, in particular by these government proposals:

- Constitutional Act on Fiscal Responsibility
- Act on the Rules of Fiscal Responsibility
- Act Amending some Acts in Connection with the Adoption of the Legal Regulation of Fiscal Responsibility, and
- Act on Internal Management and Control in Public Administration.

The first three proposals for legal regulations were approved by the government in February 2015 and are currently being discussed in the Chamber of Deputies. In February 2015, the bill on internal management and control in public administration was also submitted to the government.

7.1.1 Accounting and Statistics

MF CR has created on its website a comprehensive presentation of data which the Directive requires to be published. This presentation is given in both Czech and English versions and is completed with methodological descriptions. The publishing of data is done according to the publication calendar.

In addition to fiscal data for individual subsectors of the general government sector, data on contingent liabilities are also published (government guarantees, non-performing loans and liabilities from public company activities), ownership interests held in private and public companies and off-balance sheet liabilities stemming from partnership projects between the private and public sectors. Further, the Report on Tax Reliefs in the Czech Republic for 2011 to 2015 has been published (MF CR, 2014c). Beyond the framework of information required by the Directive, data on the current form of the general government sector and so-called public sector are published. For more detail see MF CR (2015c).

7.1.2 Forecasts and Medium-term Budgetary Framework

By passing the draft Act on the Rules of Fiscal Responsibility, the requirements imposed on the preparation of macroeconomic and fiscal forecasts for fiscal planning will be set out in law. The institution responsible for drawing them up is MF CR. These forecasts are compared with the latest forecasts of the EC or with forecasts of other independent entities. The justification of any major differences thereby discovered, of any necessary measures adopted in case of major misrepresentation, of the methodologies used and forecast assumptions made, are all published. The fiscal forecast includes a sensitivity analysis of the development of the main fiscal variables with regard to at least the development of the GDP growth rate and interest rates.

In effort to ensure that fiscal planning is founded on realistic macroeconomic and budgetary forecasts based on the most probable or more prudent scenario, the Act proposes to establish a Committee for Fiscal Forecasts. The Committee will assess regularly and summarily the macroeconomic and fiscal forecasts of MF CR used for fiscal planning. It will have at least 7 members, who will be proposed by the National Budgetary Council (see subchapter 7.1.4) and appointed by the government for 3 years. The functioning of the Committee will be regulated by the statute and the rules of procedure proposed by both MF CR and the National Budgetary Council, and approved by the government.

Government institutions, except for local government institutions, will then use for the preparation of budgets and medium-term budgetary outlooks only the current macroeconomic and fiscal forecast of MF CR that was reviewed by the Committee.

7.1.3 Numerical Fiscal Rules

The Constitutional Act on Fiscal Responsibility will introduce new numerical fiscal rules. Their specific form will emanate from the bills on the Rules of Fiscal Responsibility and the Act Amending Some Acts in Connection with the Adoption of the Legal Regulation of Fiscal Responsibility. Three following essential fiscal rules are proposed to be introduced.

Expenditure Rule of the State Budget and State Funds
This is a basic rule defining the anti-cyclical character of government fiscal policy. On its basis, in the medium-term horizon, the state budget and state funds finances should be in the position of the medium-term budgetary objective, to which they should also return by means of the automatic corrective linking – due to retrospectively taking the difference between the expenditure level defined by the rule and the real expenditure level (k_{t+1}).

The starting point for defining the general government expenditure (G_{t+1}) will be the estimate of general government revenues approved by the Committee and adjusted based on the methodology developed by the National Budgetary Council together with MF CR for the business cycle (CAR_{t+1}) and increased by the medium-term budgetary objective (MTO_{t+1}). The impact of one-off and other temporary operations (M_{t+1}) or the possible increase in expenditure meeting the conditions of escape clauses defined by law will also be taken into consideration (U_{t+1}).

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

From this defined general government expenditure will be derived the expenditure framework of the state budget and state funds after considering other government institutions' finances and making methodological modifications between the ESA 2010 standard and the national budgeting methodology. This framework will then become the starting point for the preparation of the draft state budget and state funds budgets.

The rule will contain the statutorily defined escape clauses for expenditure incurred based on a deterioration of the security situation of the state; this comprises the total expenditure related to remediation of the consequences of natural disasters and meeting international contracts and other international obligations of the state exceeding 3% of GDP and for additional expenditure related to significant economic decline forecasted in the economy.

Debt Rule of Local Government Units
Responsible management of municipality and regional budgets should be ensured by defining a limit to their debts, a so-called precautious level of indebtedness (D_{t-1}). The limit will be set for each local government unit, based on an analysis of empirical data, at the level of 60% of the average of total revenues (R_i) for the last four years.

$$60\,\% \geq \frac{D_{t-1}}{(\sum_{i=t-4}^{i=t-1} R_i)/4}$$

If a local government unit exceeds this debt level, it should start reducing it by at least 5% of such excess per year. If it does not decrease its debt level in this way, a part of the revenues from its shared taxes will be withheld, reduced up to the amount required by law. When the statutorily determined level of debt is exceeded it will only be possible to use withheld funds for the repayment of debt. The MF CR will regularly publish a list of local government units with the debt level exceeding the 60% limit.

Debt Rule of the General Government Sector
Should the insufficient functioning of the previous rules be reflected in an increase in government debt, a rule for the debt level in relation to GDP has been proposed. This numerical rule defines the conditions under which the draft budgets of individual segments of the government sector (state budget, state funds budgets, health insurance schemes of health insurance companies and local government budgets) are prepared and limits new liabilities that would result in an increase in government debt with a maturity longer than 1 year.

The statutorily defined measures will be triggered in a situation when government debt (adjusted for the so-called cash reserve for state debt financing) exceeds 55% of GDP. The rule will be supplemented with escape clauses similar to those of the expenditure rule. The government will also be obliged to propose measures aimed at decreasing government debt if its amount exceeds 60% of GDP.

7.1.4 Independent Fiscal Institution

The function of independent fiscal institution in the Czech Republic will be performed by the National Budgetary Council, the establishment of which is proposed by the Constitutional Act on Fiscal Responsibility. The main tasks of the Council will include evaluating whether or not the numerical fiscal rules have been met. The Chamber of Deputies will be informed of the results of this evaluation in the Council's annual reports. Further, the Council will draw up and submit to the Chamber of Deputies a report on the long-term sustainability of public finances, also including an evaluation of how planned government policies might influence, by their direct long-term impacts, the sustainability of public finances. In its activity, the Council will be authorised to request information and cooperation from government institutions. The Council will have 3 members elected by the Chamber of Deputies at the proposal of the Government, Senate and CNB. The Chairman of the Council will be authorised to take part, with a consultancy vote, in meetings of the Government and the Committee for Fiscal Forecasts and, when the Council's own reports and opinions are discussed, also in meetings of the Chamber of Deputies and Senate. The Act defines strict conditions for ensuring the apolitical functioning of the Council. The tasks connected with professional, organisational, administrative, personnel and technical support of the Council's activity will be performed by the Office of the National Budgetary Council, which will be financed from a separate chapter of the state budget (similarly as e.g. for the Supreme Audit Office or the Constitutional Court).

7.2 Increasing Transparency and Effectiveness of Public Finances

7.2.1 Opendata Portal

At the beginning of 2015, MF CR launched the portal "Opendata of MF CR" where data emanating from the Ministry's activities are published. Published information should be complete, easily available, machine legible, using standards with freely available specifications and made available under clearly defined conditions of use with minimum restrictions and incurring the lowest possible costs for users.

The launch of the portal is based on the Czech Action Plan of the Open Government Partnership approved by the government and by which the Czech Republic has joined the international initiative of the same name.

The portal represents a pilot activity which other ministries are also starting to join. The target is to increase the total transparency of public administration. The following is published in the opendata format: paid invoices of MF CR; a list of all valid and invalid contracts; tax statistics; data on control results, gambling regulation and subsidies; and other data from activity of the office.

MF CR plans to extend the free publishing of data in the opendata format, e.g. with information from the Commercial Register, data from the Economic Entity Register, data regarding arbitrations, from the Register of Buildings owned by the State and from economic management surveys.

7.2.2 Public Inspection

The point of the new Act on Internal Management and Control in Public Administration is to review the legislative basis of management and control issues so that it is harmonised with updated internationally recognised standards of internal management and control systems (in particular INTOSAI, IIA) and proven European practice.

Thanks to new rules for management, only projects with proven benefit for taxpayers and not exceeding the possibilities of public budget administrators may be financed. The Act is based on the principles of management responsibility (transparent setting of management and control procedures with a clear link to the personal responsibility for the individual deciding a matter) and a unified audit (restricting duplicate controls). The application of the Act should lead to a reduction in the administrative burden, in particular for small municipalities having limited administrative and financial capacities.

It is proposed to repeal the participation of tax authorities in subsidy control, which will result in reducing the costs of controls and enable tax authorities to concentrate on fighting tax evasion, for example.

The conflicts of interest in public funds management are clearly defined. Preventing and detecting conflicts of interest will become an obligatory part of setting managing and control mechanisms. The requirements for the qualification of officials who manage public funds will also be defined.

Internal auditing will have to work independently from the control system. In order to increase the quality and independence of internal audits, so-called audit committees will be established.

MF CR will be responsible for setting and coordinating the management and control framework that will perform this role, in particular through the Central Harmonisation Unit. The Ministry will only audit central bodies of state administration that are responsible for further distribution of public funds.

7.2.3 State Treasury Liquidity and State Debt Management

From 2014 onwards, other state treasury liquidity has become actively involved in financing needs of state debt. By involving available liquidity from the state treasury system maintained by the CNB, it is possible not only to make savings on interest expenditure, but also the CZK value of gross state debt can be stabilised or even decreased. In the following phase, it is proposed to extend the group of government institutions falling under state treasury system, i.e. to include health insurance companies, public research institutions and the state organisation Railway Infrastructure Administration.

7.2.4 Consolidated State Financial Statement

The final phase of accounting reform in public finances is the so-called accounting consolidation of the state, or the drawing up financial statements for the Czech Republic. As of 1 January 2015, the so-called consolidation decree of the state (Regulation No. 312/2014 Coll.) came into effect, defining the extent and method of drawing up financial statements for the Czech Republic and the procedure for including accounting units in the consolidation units of the state. Starting from the accounting period 2015, the accounting units of state administration, self-government and other entities in which the state or local government apply their influence on management and control (trading corporations and other legal entities), constitute the consolidation unit of the Czech Republic.

The process of involving entities in the accounting consolidation of the state is divided into two phases. State administration and self-government entities will be included in the consolidation unit of the Czech Republic for the accounting period of 2015, and for the accounting period of 2016 they will also be joined by the accounting units of those state enterprises, health insurance companies or trading corporations in which the state or local government has an ownership interest with a corresponding influence on management and control.

Accounting statements for the Czech Republic will be drawn up for the first time for the accounting period of 2015 until 30 November 2016 for accounting units from the first phase of consolidation. Subsequently, accounting statements for the Czech Republic will be drawn up to the full extent until 30 September 2017 for the accounting period of 2016.

The aim of the accounting consolidation of the state is to draw up accounting statements for the Czech Republic that should provide their users with comprehensive economic information on the total financial situation and performance of state administration and self-government. In addition, they will be used as a supportive element in strengthening financial and budgetary planning as part of rationalisation of the use of public funds and in developing the management and control systems of public administration.

7.2.5 Key Analytical Indicators

The evaluating of performance of state administration accounting units, as setting of key analytical indicators normatives, has been integrated into the state budget preparation process. Key analytical indicators are focused on the condition and development of the operational economic result of state administration accounting units, with the emphasis on operating costs.

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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	2014 *Level*	2014	2015	2016 *Rate of change*	2017	2018
Real GDP	B1*g	**4168**	**2.0**	**2.7**	**2.5**	**2.3**	**2.3**
Nominal GDP	B1*g	**4266**	**4.4**	**4.7**	**4.0**	**3.7**	**3.8**
Components of real GDP							
Private consumption expenditure	P.3	**2061**	**1.7**	**2.8**	**2.3**	**2.2**	**2.1**
Government consumption expenditure	P.3	**820**	**2.3**	**1.7**	**1.6**	**1.5**	**1.3**
Gross fixed capital formation	P.51g	**1065**	**4.5**	**5.3**	**4.2**	**3.2**	**3.2**
Changes in inventories and net acquis. of valuables (% of GDP)	P.52+P.53	**-11**	**-0.2**	**-0.2**	**-0.2**	**-0.2**	**-0.2**
Exports of goods and services	P.6	**3431**	**8.8**	**5.7**	**6.0**	**6.1**	**6.1**
Imports of goods and services	P.7	**3198**	**9.5**	**6.6**	**6.6**	**6.6**	**6.6**
Contributions to real GDP growth							
Final domestic demand		**-**	**2.4**	**3.0**	**2.5**	**2.2**	**2.1**
Changes in inventories and net acquis. of valuables	P.52+P.53	**-**	**-0.3**	**0.0**	**0.0**	**0.0**	**0.0**
External balance of goods and services	B.11	**-**	**-0.1**	**-0.3**	**0.0**	**0.1**	**0.1**

Note: Real levels are stated in 2013 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 (2015a), MF CR (2015a). MF CR calculations.

Table A.1b: Price Developments

(indices 2010=100, growth in %)

	2014 *Level*	2014	2015	2016 *Rate of change*	2017	2018
GDP deflator	**105.3**	**2.4**	**1.9**	**1.4**	**1.4**	**1.5**
Private consumption deflator	**105.6**	**0.3**	**0.2**	**1.5**	**1.8**	**1.9**
Harmonised index of consumer prices	**107.7**	**0.4**	**0.2**	**1.4**	**1.8**	**1.9**
Public consumption deflator	**102.6**	**1.8**	**0.5**	**0.3**	**0.8**	**0.8**
Investment deflator	**103.5**	**1.6**	**0.7**	**0.9**	**0.9**	**0.9**
Export price deflator (goods and services)	**109.9**	**4.0**	**0.9**	**0.4**	**0.6**	**0.6**
Import price deflator (goods and services)	**109.4**	**2.4**	**-1.0**	**-0.2**	**0.4**	**0.3**

Source: CZSO (2015a), Eurostat (2015). MF CR calculations.

Table A.1c: Labour Market Developments

(growth in %)

	ESA Code	2014 *Level*	2014	2015	2016 *Rate of change*	2017	2018
Employment, persons		**5105**	**0.4**	**0.7**	**0.2**	**0.1**	**0.1**
Employment, hours worked		**9.1**	**1.0**	**0.2**	**-0.3**	**-0.2**	**-0.2**
Unemployment rate (%)		**6.1**	**6.1**	**5.7**	**5.5**	**5.4**	**5.3**
Labour productivity, persons		**793**	**1.6**	**2.0**	**2.3**	**2.2**	**2.2**
Labour productivity, hours worked		**441**	**1.0**	**2.5**	**2.8**	**2.5**	**2.5**
Compensation of employees	D.1	**1711**	**3.2**	**4.0**	**4.1**	**4.4**	**4.1**
Compensation per employee		**399**	**3.0**	**3.2**	**3.9**	**4.2**	**4.0**

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 2013 prices) per employed person or worked hour.
Source: CZSO (2015a, 2015c). MF CR calculations.

Table A.1d: Sectoral Balances

(in % of GDP)

	ESA Code	2014	2015	2016	2017	2018
Net lending/borrowing vis-à-vis the rest of the world	B.9	**1.0**	**2.1**	**1.0**	**0.9**	**0.8**
Balance of goods and services		6.9	7.8	8.0	8.0	8.1
Balance of primary incomes and transfers		-7.7	-7.9	-8.2	-8.4	-8.7
Capital account		1.8	2.2	1.2	1.3	1.5
Net lending/borrowing of the private sector	B.9	**2.9**	**4.0**	**2.3**	**1.7**	**1.4**
Net lending/borrowing of general government	B.9	**-2.0**	**-1.9**	**-1.2**	**-0.8**	**-0.6**
Statistical discrepancy		**0.0**	**0.0**	**0.0**	**0.0**	**0.0**

Note: Data from national accounts. Net lending/borrowing of general government for 2014–2015 based on notification, for 2016–2018 outlook.
Source: CZSO (2015b). MF CR calculations.

Table A.2a: General Government Budgetary Prospects

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

	ESA Code	2014 Level	2014 In % of GDP	2015	2016	2017	2018
Net lending (+)/borrowing (-) (B.9) by sub-sectors							
General government	S.13	**-85**	**-2.0**	**-1.9**	**-1.2**	**-0.8**	**-0.6**
Central government	S.1311	-89	-2.1	-1.9	-1.3	-0.9	-0.7
State government	S.1312	-	-	-	-	-	-
Local government	S.1313	7	0.2	0.1	0.1	0.1	0.1
Social security funds	S.1314	-3	-0.1	0.0	0.0	0.0	0.0
General government (S.13)							
Total revenue	TR	**1709**	**40.1**	**40.3**	**39.2**	**39.4**	**39.4**
Total expenditure	TE	**1794**	**42.0**	**42.1**	**40.5**	**40.3**	**40.0**
Net lending (+)/borrowing (-)	B.9	**-85**	**-2.0**	**-1.9**	**-1.2**	**-0.8**	**-0.6**
Interest expenditure	D.41	56	1.3	1.2	1.1	1.1	1.1
Primary balance		-28	-0.7	-0.7	-0.1	0.3	0.5
One-off and other temporary measures		**-7**	**-0.2**	**-0.2**	**0.0**	**0.0**	**0.0**
Components of revenues							
Total taxes		**824**	**19.3**	**19.1**	**19.4**	**19.4**	**19.4**
Taxes on production and imports	D.2	517	12.1	12.0	12.1	12.1	12.0
Current taxes on income, wealth etc.	D.5	307	7.2	7.1	7.2	7.3	7.4
Capital taxes	D.91	0	0.0	0.0	0.0	0.0	0.0
Social security contributions	D.61	**628**	**14.7**	**14.6**	**14.6**	**14.8**	**14.8**
Property income	D.4	**37**	**0.9**	**1.0**	**0.8**	**0.8**	**0.7**
Other		**221**	**5.2**	**5.6**	**4.4**	**4.5**	**4.5**
Total revenue	TR	**1709**	**40.1**	**40.3**	**39.2**	**39.4**	**39.4**
p.m.: Tax burden		**1452**	**34.0**	**33.7**	**34.0**	**34.2**	**34.2**
Components of expenditures							
Compensation of employees + Intermediate consumption	D.1+P.2	**515**	**12.1**	**11.9**	**11.6**	**11.5**	**11.2**
Compensation of employees	D.1	304	7.1	7.1	7.0	6.9	6.7
Intermediate consumption	P.2	211	4.9	4.8	4.7	4.6	4.5
Social payments		**805**	**18.9**	**18.7**	**18.5**	**18.4**	**18.3**
of which: Unemployment benefits [1)]		17	0.4	0.4	0.4	0.4	0.3
Social transfers in kind supplied via market producers	D.632	249	5.8	5.7	5.7	5.7	5.7
Social transfers other than in kind	D.62	555	13.0	13.0	12.7	12.7	12.6
Interest expenditure	D.41	**56**	**1.3**	**1.2**	**1.1**	**1.1**	**1.1**
Subsidies	D.3	**116**	**2.7**	**2.5**	**2.5**	**2.5**	**2.4**
Gross fixed capital formation	P.51g	**166**	**3.9**	**4.8**	**3.6**	**3.7**	**3.7**
Capital transfers	D.9	**59**	**1.4**	**1.1**	**1.1**	**1.1**	**1.1**
Other		**77**	**1.8**	**2.0**	**2.1**	**2.1**	**2.1**
Total expenditures	TE	**1794**	**42.0**	**42.1**	**40.5**	**40.3**	**40.0**
p.m.: Government consumption (nominal)	P.3	**828**	**19.4**	**18.9**	**18.6**	**18.3**	**18.0**

Note: Years 2014–2015 notification. Years 2016–2018 outlook.

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

Source: CZSO (2015b). MF CR calculations.

Table A.2b: No-policy Change Projections

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

	2014 Level	2014 In % of GDP	2015	2016	2017	2018
Total revenue at unchanged policies	**1709**	**40.1**	**40.3**	**38.7**	**38.7**	**38.6**
Total expenditure at unchanged policies	**1794**	**42.0**	**42.1**	**40.4**	**40.2**	**39.9**

Source: MF CR.

Table A.2c: Amounts to Be Excluded from the Expenditure Benchmark
(level in CZK billion, others in % of GDP)

	2014	2014	2015	2016	2017	2018
	Level			In % of GDP		
Expenditure on EU programmes fully matched by EU funds revenue	65	1.5	2.0	1.0	1.1	1.1
Cyclical unemployment benefit expenditure	0	0.0	0.0	0.0	0.0	0.0
Effect of discretionary revenue measures (year-on-year changes)	3	0.1	-0.2	0.5	0.3	0.1
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	2013	2018
General public services	1	4,6	4,3
Defence	2	0,8	0,9
Public order and safety	3	1,7	1,6
Economic affairs	4	6,0	5,7
Environmental protection	5	1,0	1,0
Housing and community amenities	6	0,8	0,8
Health	7	7,3	7,1
Recreation, culture and religion	8	1,1	1,0
Education	9	5,1	4,9
Social protection	10	13,3	12,7
Total expenditure	TE	41,9	40,0

Note: Year 2018 outlook.
Source: CZSO (2015d), MF CR (2015a). MF CR calculations.

Table A.4: General Government Debt Developments
(in % of GDP, average maturity in years, contributions in % of debt)

	ESA Code	2014	2015	2016	2017	2018
General government gross debt		42.6	40.9	40.9	40.7	40.2
Change in gross debt ratio		-2.5	-1.6	0.0	-0.2	-0.5
Contributions to changes in gross debt						
Primary balance		-0.7	-0.7	-0.1	0.3	0.5
Interest expenditure	D.41	1.3	1.2	1.1	1.1	1.1
Stock-flow adjustment		-2.5	-1.6	0.3	0.4	0.4
Difference between cash and accruals		0.1	0.1	0.0	0.0	0.0
Net accumulation of financial assets		-2.6	-1.7	0.3	0.4	0.4
Privatisation proceeds		0.0	0.0	0.0	0.0	0.0
Valuation effects and other		0.0	0.0	0.0	0.0	0.0
p.m.: Implicit interest rate on debt		3.1	2.8	2.8	2.8	2.8
Liquid financial assets		14.4	12.0	11.9	11.9	11.8
Net financial debt 1)		28.2	28.9	29.0	28.8	28.3
Debt amortization (existing bonds) since the end of the previous year 2)		3.4	3.0	3.8	2.7	3.3
Foreign-currency exposition of the state debt 2) 3)		3.7	3.7	4.4	4.4	4.3
Average maturity 2)		5.5	5.4	5.5	5.5	5.5

Note: Years 2014–2015 notification. Years 2016–2018 outlook.
1) Net financial debt is a difference between gross debt and liquid financial assets (monetary gold, Special Drawing Rights, currency and deposits, securities other than shares (consolidated at market value), shares and other equity quoted in stock exchange).
2) Figures only for the state debt. The state debt represents a debt generated by the state budget financing.
3) 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 (2015b). 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	2014	2015	2016	2017	2018
Real GDP growth (%)		**2.0**	**2.7**	**2.5**	**2.3**	**2.3**
Net lending of general government	B.9	**-2.0**	**-1.9**	**-1.2**	**-0.8**	**-0.6**
Interest expenditure	D.41	**1.3**	**1.2**	**1.1**	**1.1**	**1.1**
One-off and other temporary measures		**-0.2**	**-0.2**	**0.0**	**0.0**	**0.0**
Potential GDP growth (%)		**0.7**	**1.3**	**1.7**	**2.0**	**2.1**
contribution of labour		-0.2	0.1	0.0	0.0	-0.1
contribution of capital		0.4	0.6	0.7	0.7	0.7
total factor productivity		0.4	0.7	1.0	1.3	1.6
Output gap		**-1.2**	**0.1**	**0.9**	**1.2**	**1.4**
Cyclical budgetary component		**-0.4**	**0.1**	**0.3**	**0.5**	**0.5**
Cyclically-adjusted balance		**-1.5**	**-1.9**	**-1.6**	**-1.3**	**-1.1**
Cyclically-adjusted primary balance		**-0.2**	**-0.8**	**-0.4**	**-0.2**	**0.0**
Structural balance		**-1.4**	**-1.7**	**-1.5**	**-1.3**	**-1.1**

Note: Years 2014–2015 notification. Years 2016–2018 outlook.
Source: CZSO (2015b). 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	2014	2015	2016	2017	2018
Real GDP growth (%)						
Previous update		**1.7**	**2.0**	**2.1**	**2.5**	**-**
Current update		**2.0**	**2.7**	**2.5**	**2.3**	**2.3**
Difference		0.3	0.7	0.4	-0.2	-
General government net lending (% of GDP)						
Previous update	EDP B.9	**-1.8**	**-2.3**	**-2.0**	**-1.7**	**-**
Current update	B.9	**-2.0**	**-1.9**	**-1.2**	**-0.8**	**-0.6**
Difference		-0.2	0.4	0.8	0.8	-
General government gross debt (% of GDP)						
Previous update		**44.9**	**46.0**	**47.1**	**47.1**	**-**
Current update		**42.6**	**40.9**	**40.9**	**40.7**	**40.2**
Difference		-2.3	-5.1	-6.2	-6.4	-

Note: In the CP 2014 update, which was prepared according to ESA 95, the general government balance was calculated using interest expenditures adjusted for the net flow of swap-related flows. This adjustment is not present in the current CP, which is prepared according to ESA 2010 methodology.
Source: MF CR (2014a, 2015a). 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 [1)]						
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

Note: 1) The fully-funded pillar in the Czech Republic is based on optional entry system.
Source: EC (2014a). MF CR calculations.

Table A.7a: Contingent Liabilities

(in % of GDP)

	2014	2015
General government sector guarantees	4.1	3.8
of which: Linked to the financial sector	3.7	3.5

Source: MF CR.

Table A.8: Basic Assumptions

(interest rates and growth in %)

	2014	2015	2016	2017	2018
Short-term interest rate (CZ) (annual average)	0.4	0.3	0.3	0.4	0.5
Long-term interest rate (CZ) (annual average)	1.6	0.6	0.8	1.2	1.8
Nominal effective exchange rate (2010=100)	92.5	91.2	91.2	92.0	93.4
Exchange rate CZK/EUR (annual average)	27.5	27.5	27.5	27.2	26.8
World excluding EU, GDP growth	3.7	4.0	4.4	4.6	4.6
EU28 GDP growth	1.3	1.6	1.9	2.1	2.3
Growth of relevant foreign markets	4.3	3.0	4.1	4.3	4.3
World import volumes, excluding EU	2.1	3.9	5.2	5.2	5.2
Oil prices (Brent, USD/barrel)	99.0	60.2	68.3	73.5	77.3

Source: CNB (2015), EIA (2015), Eurostat (2015). MF CR calculations.

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