Ministry of Finance
Czech Republic

Convergence Programme
of the Czech Republic

April 2023

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Contents

The Convergence Programme is submitted on the basis of Article 121 of the Treaty on the Functioning of the European Union and the current version of Council Regulation (EC) No. 1466/97 on the Strengthening of the Surveillance of Budgetary Positions and the Surveillance and Coordination of Economic Policies. As such, it has been drawn up in accordance with the rules in force in the Council's Economic and Financial Committee (EFC, 2017) and is consistent with the National Reform Programme of the Czech Republic (Government Office, 2023).

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List of Abbreviations

CNB .... Czech National Bank
COFOG .... Classification of the Functions of Government
CP .... Convergence Programme of the Czech Republic
CZK .... Czech koruna currency code
CZSO .... Czech Statistical Office
EC .... European Commission
ESA 2010 .... European System of National and Regional Accounts from year 2010
EU .... European Union containing 27 countries
EUR .... euro currency code
GDP .... gross domestic product
MF CR .... Ministry of Finance of the Czech Republic
p. a. .... *per annum*
pp .... percentage point
US .... United States of America
USD .... US Dollar currency code

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 31 March 2023 release and fiscal data and policies to the 12 April 2023 release. Notification of general government deficit and debt was specified and approved by Eurostat on 21 April 2023.

Note

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

Introduction and Summary

External shocks in the form of the pandemic followed by the Russian invasion of Ukraine and the associated extreme volatility in energy markets have placed a heavy burden on society and the economy. Starting in 2020, the European Commission has for the first time ever activated a general escape clause to allow EU Member States to respond flexibly through fiscal policy in times of crisis. A New Generation EU instrument with a total allocation of over EUR 800 billion was created and adopted to support economic recovery. With the risks receding, the European Commission proposes a shift from an overall supportive fiscal policy from 2020 to 2022 to a neutral setting for 2023. The general escape clause is very likely to be deactivated next year. The European Commission has therefore invited Member States to indicate in this year's Stability and Convergence Programmes how their fiscal plans will ensure compliance with the 3% of GDP deficit benchmark, as well as credible and continuous debt reduction or debt sustainability at prudent levels over the medium term.

Recent developments have largely rehabilitated fiscal policy as an effective and necessary tool of the economic policy mix. Without its use, it is inconceivable that countries could cope with the consequences of such enormous pressures solely with monetary policy, which, moreover, in Europe pursues and addresses price stability almost exclusively. This means, on the other hand, that there has to be fiscal space to be used if necessary. The issue of the medium- and long-term sustainability of public finances therefore comes to the fore once again.

Although the Czech Republic had a relatively low general government debt before 2020, its significant increase in recent years calls for consolidation of public finances. The Czech government is therefore preparing measures to reduce the deficit by at least CZK 70 billion next year. Although the requirement to consolidate public finances is already included in the Budget Responsibility Rules Act from 2020. However, it only sets a minimum rate of reduction of the structural balance of 0.5 percentage points per year for the purposes of deriving the expenditure frameworks of the state budget and state funds, not a specific way of achieving the medium-term budgetary objective, which for the Czech Republic is currently a structural general government balance of −0.75% of GDP.

We expect that 2023 will continue to be strongly influenced by the geopolitical situation and the development of electricity and gas prices. The Czech economy, which is going through a mild recession, should gradually recover from the second quarter of this year. The Czech economy could be essentially flat year-on-year, while we expect GDP growth of 3.0% next year. This development is primarily determined by household consumption, which is reacting negatively to the rising price level. The negative output gap should gradually close towards the end of the forecast horizon. Although the inflation rate should decline, consumer prices should still rise at a double-digit rate on average this year due to market factors and energy prices. Inflation should not return to the tolerance band of the Czech National Bank's inflation target until 2024. In the area of earnings, real wages will continue to decline this year, albeit at a much slower pace than in 2022. After rising to 3% in 2023, the unemployment rate should start to fall again in the following years.

Public finances reached a deficit of 3.6% of GDP in 2022, mainly due to the state budget deficit, which generally bears the burden of fiscal expansion. The state budget's cash execution (in national cash terms) ended last year at CZK −360.4 billion and CZK −316.1 billion excluding the impact of EU funds. This is a significantly better result than budgeted, which was also affected by a number of one-off measures. For 2023, we are notifying a general government deficit of 3.5% of GDP, again to be determined by the performance of central government. We also expect a moderate deficit for health insurance companies, while local governments should be rather more subdued. The deficit performance of the general government sector is reflected in the level of debt, which rises by 2.1 percentage points to 44.1% of GDP in 2022, with debt expected to reach 43.5% of GDP in 2023. We expect the general government deficit to fall below 3% of GDP next year and to around 2% of GDP by the end of the outlook.

However, the forecast is burdened with relatively large risks and uncertainties. The development of energy prices is undoubtedly one of the biggest ones. The government has proceeded to set price caps on electricity and gas for 2023, with compensating the traders of these commodities for their losses. On the other hand, it has introduced temporary tax measures targeting extraordinary profits in the energy, mining or banking sectors. Energy prices will thus affect both sides of public finances to the tune of tens of billions CZK.

In addition to addressing the current structural imbalances in public finances, the government is preparing a set of measures to strengthen the long-term sustainability of the pension system. According to its programme statement, the government should present a comprehensive pension reform by the end of this year. Several areas where changes could be made have been publicly declared. These include the retirement age or the conditions for early retirement pensions.

In April 2023, the Convergence Programme of the Czech Republic was subject to an inter-ministerial comment procedure. The document was approved by the Government of the Czech Republic on 26 April 2023.

1 Economic Policy Intentions and Objectives

The measures adopted during the coronavirus epidemic, particularly in 2020 and 2021, and the other ones in response to the war in Ukraine and the energy crisis last year and this year, have led to a relatively rapid increase in debt. This is expected to continue to rise slightly over the outlook. While the Czech Republic still has relatively low general government debt, the adverse medium-term trend, including the effects of ageing population, will require an active government approach to consolidate public finances. The government plans to do so on a larger scale from 2024.

The Czech National Bank has gradually increased its base interest rate since June 2021, most recently to 7.0% at its meeting on 23 June 2022. Its aim was to weaken domestic demand pressures, anchor inflation expectations close to the target and ensure a return of inflation to 2%. At the same time, it intervened in the foreign exchange market last year in favour of the domestic currency in order to limit excessive fluctuations of the Czech koruna.

1.1 Fiscal Policy

In 2022, public budgets continued to be affected by external shocks and measures adopted to mitigate their impact on households and firms. Several programmes adopted during the pandemic were still active in the first part of the year, but their scale was already relatively small compared to 2020 and 2021. February saw the invasion of Ukraine by the Russian Federation and the subsequent unprecedented rise in energy and other commodity prices. These, together with other factors, led to a rise in the inflation rate, which significantly affected the performance of public finances. The initial reduction of the state budget deficit by almost CZK 100 billion was amended during the year and the state budget ended up with a deficit of CZK 360 billion.

In 2023, the effects of the energy crisis and high prices continue, making it difficult for the government to start consolidating public finances already this year. Nevertheless, expenditure frameworks for 2023, in terms of the structural balance, have been tightened by 0.4 pp above the legally required minimum rate of 0.5 pp. This corresponds to the recommendation in EC (2022) for this year: Overall, the fiscal position in 2023 for the EU and the euro area as a whole, taking into account the targeted energy measures, should be neutral.

For 2024, the shift towards an explicit return to a restrictive policy is already evident. The EC (2023b) argues that fiscal policy in 2023–2024 should focus on ensuring medium-term debt sustainability and on raising potential economic growth: Broad-based fiscal stimulus to aggregate demand is unwarranted and costly support measures cannot continue indefinitely: the focus should now be on strengthening fiscal sustainability through gradual fiscal consolidation and, where still necessary, targeted fiscal measures to support vulnerable households and businesses affected by high energy prices.

The fiscal policy of the Czech Republic is in line with these recommendations, as fiscal consolidation on a larger scale should be undertaken in 2024. Measures are currently discussed and should in total improve the structural deficit of public finances by at least 1 pp. The "consolidation package" of legislative measures should focus on both the expenditure and revenue sides of public budgets. On the revenue side, measures such as the abolition or reduction of certain tax exemptions are discussed. On the expenditure side, a review of public administration agencies with their subsequent streamlining is planned by the end of 2023. Furthermore, the Government Programme Statement envisages more targeted provision of social benefits.

The composition and timing of the consolidation reflects good practice examples of countries that have succeeded in correcting their fiscal imbalances in the past. It is a mix of measures that target imbalances and distortions in Czech public finances. The positive fiscal effort in the coming year is also consistent with a relatively favourable phase of the business cycle, when the economy should be experiencing a recovery, but still within a negative output gap.

In addition to the package, another decisive measure on the expenditure side is the adjustment of the extraordinary indexation of pensions from June 2023 (Act No. 71/2023 Coll.), when the pension will be increased by CZK 400 and the earnings-related part will increase by 2.3%. The change is expected to result in savings of CZK 20.6 billion in pension expenditure this year and CZK 35.3 billion in 2024. This saving is driven by a widening pension account deficit, which would otherwise reach around CZK 100 billion in 2023 and 2024.

1.2 Monetary Policy

Since 1998, the CNB's monetary policy has been conducted in an inflation targeting regime. Since 1 January 2010, the inflation target has been defined as 2% annual growth of the consumer price index, with a tolerance band of ±1 percentage point. The CNB defines the inflation target as medium-term and therefore tolerates some transitory deviations of actual inflation from the inflation target (e.g. due to changes to indirect taxes), the primary effects of which monetary policy does not normally react to and focuses only on the secondary effects.

The average inflation rate as measured by the national consumer price index rose to 15.1% in 2022. Not only food, fuel, electricity, natural gas and imputed rent, but also other categories of goods and services contributed to exceptionally strong inflationary pressures. Domestic demand pressures also boosted inflation, but these should be dampened by higher monetary policy rates. The appreciation of the koruna is also anti-inflationary in 2023. Average consumer price inflation could thus slow to 10.9% this year and further to 2.4% in 2024.

The koruna appreciated by 4.4% year-on-year to CZK 24.57/EUR on average for the whole of 2022. Calming of the situation in world markets, particularly in connection with European natural gas reserves, contributed significantly to the koruna's appreciation at the end of last year and at the beginning of 2023. As a result, the CNB did not need to support the domestic currency with foreign exchange interventions. We assume that the koruna exchange rate will be almost stable over the CP horizon, with virtually negligible appreciation against the level of Q1 2023. This development should be supported in the short term by the CNB's declared determination to intervene in the foreign exchange market in the event of significant depreciation pressures on the domestic currency. Towards the end of next year, the renewed real convergence of the Czech economy could already be having a positive effect. However, the expected reduction in the positive interest rate differential may still exert some depreciation pressure on the koruna.

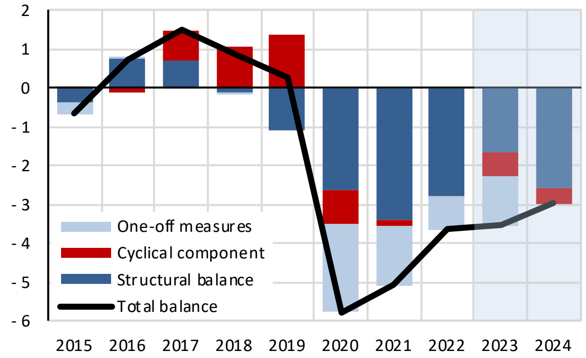
The joint document of the MF CR and the CNB (2022) "Assessment of the Fulfilment of the Maastricht Convergence Criteria and the Degree of Economic Alignment of the Czech Republic with the Euro Area", approved by the Czech Government in December 2022 (Government Resolution No. 1077/2022), recommended not setting a target date for euro area entry for the time being. Moreover, the Czech Republic did not meet the benchmarks of any of the Maastricht convergence criteria in 2022 and is unlikely to meet them in 2023.

In terms of the Czech Republic's own readiness to adopt the euro, weaknesses still remain. The structure of the Czech economy continues to diverge significantly from the euro area and the convergence process, in particular of price and wage levels, has not been completed. Given the ageing of the population, the long-term sustainability of public finances, whose stabilising effect should partly compensate for the loss of autonomous monetary policy after euro adoption, has not yet been resolved. On the contrary, the high degree of openness of the Czech economy and its strong trade and ownership interdependence with the euro area have long been arguments in favour of euro adoption.

Moreover, the assessment of the Czech Republic's economic readiness to adopt the euro has become much more difficult following the crisis triggered by the covid-19 pandemic and the ongoing Russian invasion of Ukraine. In this situation, the MF CR and the CNB have recommended to the Czech Government not to set a target date for euro area accession for the time being and not to seek entry into the relevant exchange rate mechanism.

Graph 1.1: General Government Balance

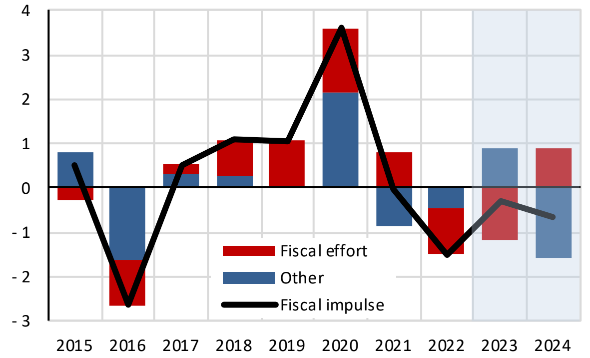
in % of GDP



Source: CZSO (2023a, 2023b). MF CR forecast and calculations.

Graph 1.2: Fiscal Effort and Fiscal Impulse

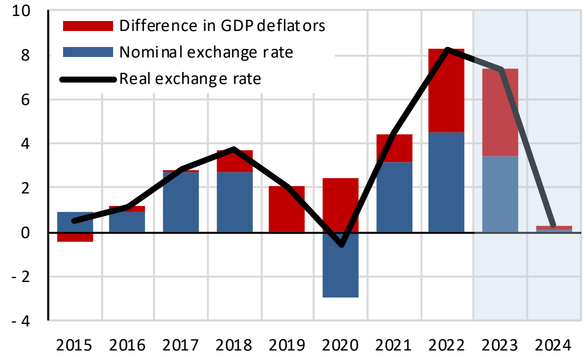
In percentage points, primary fiscal effort with opposite sign



Source: CZSO (2023a, 2023b). MF CR forecast and calculations.

Graph 1.3: Real Exchange Rate to the Euro Area

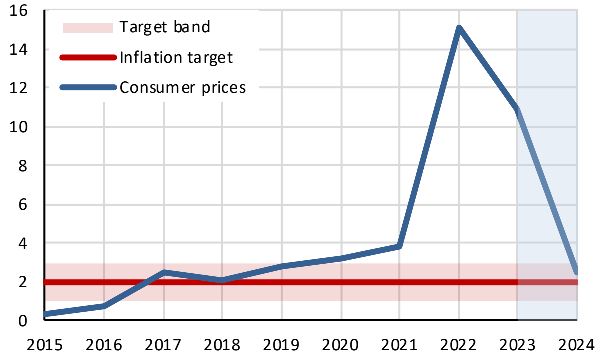
real exchange rate appreciation in %, contributions in pp



Source: CNB (2023a), CZSO (2023a), Eurostat (2023). MF CR forecast and calculations.

Graph 1.4: Consumer Prices

change in %, national consumer price index



Source: CNB (2023b), CZSO (2023a). MF CR forecast and calculations.

2 Macroeconomic Scenario

The weakened global economy was hit by several shocks in 2022. The war in Ukraine has depressed global economic growth and intensified inflationary pressures, especially in the case of food and energy prices. In many countries, inflation rates in the second half of last year were the highest since the 1980s, to which central banks responded by gradually raising interest rates. Although consumer price inflation appears to have peaked in a number of countries, the question remains as to how quickly will inflation return to the vicinity of inflation targets of individual central banks. From the perspective of the smooth functioning of global supply chains, further evolution of the pandemic, particularly in China, is a persistent risk.

2.1 Global Economy and Technical Assumptions

The end of last year was characterised by persistent problems in supply chains, high inflation and tightening of monetary policy in the world's major economies. Following the loosening of China's stringent coronavirus measures in December, its economy is expected to recover this year, which will significantly boost global economic growth. However, it will continue to be dampened by the impact of Russia's aggression against Ukraine, rising geopolitical tensions and ongoing monetary tightening in a number of countries. Global economic growth is thus expected to slow to 2.0% in 2023, but could accelerate to 2.8% in 2024 on the back of stronger household consumption (due to a fall in inflation) and the expected unwinding of supply chain frictions.

The EU's gross domestic product increased by 3.6% in 2022. Household consumption and gross fixed capital formation have contributed significantly to its growth. The EU's economic growth could reach 0.7% this year and accelerate to 1.5% in 2024. The European economy has shown considerable resilience in the face of the energy crisis, and the successful diversification of gas supplies has largely reduced dependence on Russian imports. Economic growth in both years will be underpinned by rising consumer and business confidence, a relatively resilient labour market, improved situation in supply chains, and recovering industry and services. By contrast, growth momentum should be dampened by tightening monetary conditions, weak external demand and persistently high inflation.

Mainly due to the war in Ukraine, the price of a barrel of Brent crude oil rose to an average of USD 101 in 2022, an increase of more than 40% compared to 2021. The development of the oil price in the CP in the following years reflects the declining futures price curve. In 2023, a barrel of Brent crude oil should trade on average at USD 77 (against USD 85 in the EC Winter Forecast, 2023a), with a gradual decline in the following years.

The forecast for the USD/EUR exchange rate is based on the development of forward contracts before the input data cut-off date. For this year, we thus estimate the average exchange rate at 1.08, while in subsequent years the dollar could weaken slightly towards USD 1.12/EUR.

On average, the koruna appreciated against the euro by 4.4% year-on-year to CZK 24.57/EUR in 2022. For this year, we expect the currency to appreciate by 3.3% to CZK 23.8/EUR. In the following years, the koruna should trade at a similar level.

Given the assumed monetary policy stance of the CNB and the ECB and inflation developments, we believe that long-term interest rates could average 4.5% in 2023 and fall to 4.0% in 2024.

2.2 Current Developments and a Medium-term Scenario

2.2.1 Economic Growth and the Demand Side

Real GDP increased by 2.5% in 2022, driven by fixed capital investment and increased inventory accumulation. Despite a number of fiscal stimulus measures, household final consumption expenditure declined due to a sharp increase in the cost of living, especially energy and food prices, and tighter monetary policy.

The Czech economy could grow by 0.1% in 2023. Households will continue to face the impact of high inflation this year, and their real consumption should fall further. Government consumption and gross fixed capital formation will be pro-growth, but weaker year-on-year inventory accumulation will slow the economy. The impact of generally weak domestic demand will be offset by the external trade balance.

Thanks to renewed growth in household consumption, GDP could increase by 3.0% in 2024. Economic growth should slow gradually in the following years.

Households' final consumption expenditure should be negatively affected this year by the continued decline in real disposable income and the restrictive monetary policy stance. The year-on-year dynamics will be strongly negatively affected by the growth profile of consumption in 2022. On the contrary, consumer spending by refugees from Ukraine, who are already classified mainly as residents from Q4 2022, will have a positive effect.

Given the persistently negative household sentiment, the savings rate is likely to remain elevated, with its decline expected to stimulate household consumption more significantly only next year. Nevertheless, the savings rate will remain above its long-term average. Indeed, the lower personal taxation from 2021 onwards (that has mostly benefited higher-income households, which have a lower propensity to consume) may have led to a structural break in the time series of the saving rate. Given these strongly negative factors, real household consumption could fall by 2.7% this year. In 2024, the aforementioned savings uptake should be compounded by a renewed rise in real household incomes in the face of moderating inflation, as a result of which we expect consumer spending to recover by 3.9%.

Government consumption could grow by 1.6% in 2023. The migration wave from Ukraine has led to an increase in staff capacity, especially in education, which will be reflected in employment growth. Purchases of goods and services will be supported by current subsidies from EU funds this year as the end of the 2014–2020 financial perspective approaches. In 2024, growth in general government consumption could slow slightly to 1.3%. In addition to lower employment dynamics in the general government sector, the impact of the transition to the new financial perspective 2021–2027 will also be felt, but will be somewhat offset by the ramp-up of current projects from other EU instruments, in particular the Recovery and Resilience Facility.

Gross fixed capital formation is expected to slow down in 2023 due to economic problems in euro area countries and rising capital goods prices. Monetary conditions, which will become restrictive towards the end of the year, will also take a toll on its dynamics. In contrast, investment activity will be positively affected by government spending co-financed by EU funds from the previous financial perspective. Thanks to economic growth in the euro area, we expect a recovery in private investment next year, but this will be hampered by the impact of the restrictive monetary policy stance. The transition to the new financial perspective of the European Structural and Investment Funds will see a decline in investment by the general government sector, largely offset by an increase in public investment from national sources. Thus, gross fixed capital formation may increase by 2.8% in 2023, while growth could slow to 0.5% in 2024.

We assume that the change in inventories will have a negative impact on GDP growth over the entire CP horizon. As a result, inventory accumulation should gradually return to normal levels as supply chain problems fade and inflationary pressures ease. However, it will nevertheless remain high in magnitude, due to companies' efforts to ensure continuity of the production process in the event of recurrent supply disruptions of key components. As a result, gross capital formation may increase by 0.9% this year and fall by 1.6% next year.

We expect exports of goods and services to grow by 4.1% this year. The impact of the slowdown in export markets will be largely cushioned this year by a pick-up in export performance driven by the unwinding of supply chain problems and the completion of work-in-progress inventories. In 2024, export growth could accelerate to 4.7%, thanks to a recovery in economic activity in major trading partner countries and the unwinding of supply-side frictions. The dynamics of exports and import-intensive investment demand is then reflected in the pace of imports of goods and services, which could rise by 3.0% in 2023 and 2.8% in 2024.

2.2.2 Potential Output and Business Cycle

Potential output growth has been extremely weak in 2020–2021 due to the covid-19 epidemic and the associated constraints on economic activity, but accelerated to 2.1% last year. The most important factor was the increase in total factor productivity (1.1 pp contribution), with capital stock contributing 0.7 pp to potential output growth. The production factor of labour also had a positive effect due to the increase in the participation rate.

Potential output growth is expected to accelerate to 2.5% this year. It should be supported by an increase in the working-age population associated with the migration wave from Ukraine, but will be negatively affected by the relatively lower level of economic activity of refugees. Potential output could grow by 2.2% per year in the coming years.

The output gap had returned to negative territory in the middle of last year and is expected to widen until Q2 2023, given the decline in economic activity. Thereafter, the output gap should gradually close, and at the end of the CP horizon the economy could be operating more or less at its potential.

2.2.3 Prices

The inflation rate, as measured by the Harmonised Index of Consumer Prices, averaged 14.8% for the whole of 2022. Inflation was determined mainly by market factors. On the supply side, they reflected high prices of energy, food, oil and many materials, which largely resulted from supply frictions and global uncertainty. Firms' costs were rising, largely because of import prices of energy and industrial inputs, but unit labour costs also played a role, with increased inflation expectations feeding through.

From January 2023, in addition to the earlier waiver of the renewables levy, the price caps on electricity and gas is also effective, so their contributions to annual inflation should gradually decrease. In addition, the successful filling of European gas reservoirs before the start of the heating season, the warm winter, savings by households and businesses and the securing of new gas suppliers have contributed to a significant fall in wholesale energy prices, which should also be gradually reflected in consumer prices. However, the fall in electricity prices in 2024 will be dampened by the return of the renewable energy levy. In 2023, electricity prices could rise by 37% and gas prices by 28% on average, while next year average prices could fall by 11% for electricity and 23% for gas.

This year will continue to be a period of markedly higher inflation, but annual price growth should decline at a rapid pace over the course of the year. The contribution of the administrative component to the average inflation rate should be highly positive, mainly due to the January rise in energy prices. The impact of the economy's position in the business cycle on inflation should be slightly anti-inflationary from the end of 2022 onwards, mainly due to a reduction in household consumption as a result of a sharp decline in real incomes. However, the tight labour market is increasing upward pressures on nominal wages, and is thus inflationary. Problems with the supply of production inputs and the associated surges in their prices should gradually recede over the course of the year. The price of oil should be anti-inflationary in 2023, as well as the exchange rate of the koruna against the major world currencies and the transmission mechanism of increased monetary policy rates.

In 2024, inflationary pressures will be shaped by market factors. The contribution of administrative prices to the average inflation rate could be negative due to expected cheaper electricity and gas. The price of oil and the appreciation of the koruna against the US dollar should continue to be anti-inflationary next year. Restrictive monetary policy will also continue to moderate inflationary pressures through interest rates. The effect of the koruna's exchange rate against the euro should already be neutral next year. Relatively high nominal wage growth could be an inflationary factor.

In line with the above, we expect the average inflation rate, as measured by the Harmonised Index of Consumer Prices, to reach 12.2% in 2023 and to fall significantly to 2.6% in 2024. Annual inflation should be above 8% at the end of this year, but next year it should be close to the upper boundary of the tolerance band around the CNB's inflation target.

The GDP deflator could increase by 9.9% in 2023. The continued high growth of the gross domestic expenditure deflator, especially household consumption, could be reinforced by a slight improvement in the terms of trade this year. In 2024, GDP deflator growth could slow to 3.8% due to lower price dynamics across all components of domestic demand.

2.2.4 Labour Market and Wages

The downturn in economic activity has so far had only a limited impact on the labour market. Persistent labour shortages continue to put upward pressure on the growth of nominal earnings, which has lagged well behind inflation, though.

At the beginning of 2022, the Czech Republic had a total population of 10.517 million, which increased by 16.7 thousand during the year to 10.533 million. The increase was due to a positive balance of foreign migration (37.1 thousand). However, this statistic does not yet include persons granted temporary protection in connection with the war in Ukraine. By the end of last year, a total of 432 thousand persons were allowed to stay in the Czech Republic on the basis of temporary protection status (CZSO, 2023e), but according to the CZSO's estimate, 306 thousand of them were actually residing in the Czech Republic at the end of the year. We infer that the vast majority of them were of working age, 26% were children and young people under the age of 19 and the remaining 4% were seniors. Meanwhile, the data for 2022 should be revised after assessing the nature of the stay of temporary protection holders. Therefore, in the forecast we work with adjusted data on international migration (positive balance of 343 thousand persons). The future intensity of migration flows due to the war in Ukraine cannot be estimated precisely, but we assume that some refugees will return to Ukraine, while immigration from this country will remain elevated (but not nearly as much as it was after the outbreak of the war).

The arrival of workers from Ukraine, accompanied by strong demand for labour, resulted in a 1.7% increase in employment (in the national accounts methodology) last year. Given the demographic trends and the severe labour shortages in many sectors, the scope for further employment growth (except for new foreign workers) is very limited. As a result of the economic downturn, to which the labour market usually reacts with some delay, we expect employment to fall by 0.4% this year, but to increase slowly in the following years thanks to renewed economic growth. Due to the above factors, the unemployment rate is expected to rise to 3.0% in 2023, but could then gradually decline to 2.7% over the CP horizon.

The increase in the statutory retirement age will play a dominant role in the expected evolution of the participation rate. Demographic aspects in the form of the changing share of age groups with a naturally high economic activity rate (especially 45–54 years) have so far been favourable, but their contribution will be slightly negative over the CP horizon. The inflow of refugees from Ukraine, whose labour market participation rate could temporarily lag behind the current level of participation, could have a negative impact.

Compensation of employees increased by 7.6% last year. Their dynamics was supported by the tight labour market situation, the influx of Ukrainian refugees and the increase in salary rates for a significant part of civil servants from 1 September 2022, which will be reflected in the development also this year. On the other hand, a decrease in economic activity accompanied by weaker labour demand will have a negative impact. Increased inflation expectations and, to some extent, the arrival of refugees from Ukraine are likely to be a growth factor. The minimum wage was increased by 6.8% with effect from 1 January 2023. The guaranteed wage has increased at the same rate in the highest job group (but this is probably only received by a marginal number of people), while the other grades have remained unchanged. We expect compensation of employees to rise by 7.2% this year, with the rate of increase slowing to around 4.5% in subsequent years. At this rate, the share of compensation of employees in GDP would fall below 42% at the end of the CP horizon.

2.3 Foreign Relations and Sectoral Balances

The Czech economy has mostly posted a slight surplus in net lending/borrowing vis-à-vis non-residents (ESA 2010 methodology) between 2013 and 2020. However, a deficit of 0.9% of GDP was recorded in 2021, which widened significantly to 4.9% of GDP in 2022.

Further deterioration in the balance of goods and services was the main reason for this development. In 2020, the trade balance was in a surplus of 6.7% of GDP, which fell to 3.0% of GDP in 2021, while in 2022 the balance of goods and services showed a deficit of 0.1% of GDP. Strong import dynamics in the context of high energy commodity prices had a major impact.

A slightly negative impulse then came from the long-term deficit balance of primary income, which is mainly influenced by distributed earnings of foreign-controlled companies. In fact, the primary income deficit widened from 4.1% of GDP (in 2021) to 4.3% of GDP in 2022 due to higher profits of foreign-controlled firms (mainly financial institutions) and the payment of profit shares of the domestic banking sector from 2019–2020. The deficit of the secondary income balance (1.0% of GDP) was similar to previous years.

As a result, the current external balance (equivalent to the current account of the balance of payments) recorded a deficit of 5.4% of GDP, which more than doubled in relative terms compared to 2021.

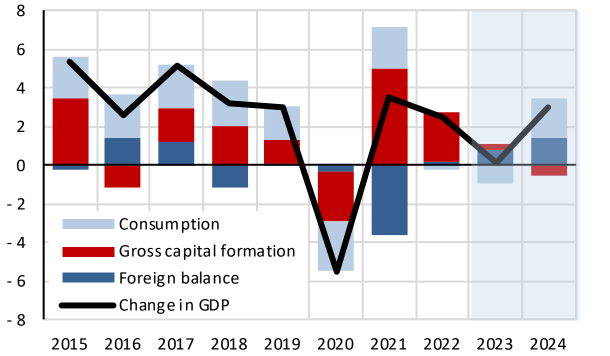
The capital transfers balance in 2022 showed a surplus of 1.2% of GDP thanks to capital subsidies from the EU budget for investment purposes. In relative terms, it thus remained unchanged compared to the previous year.

In the CP scenario, we assume that the deficit of the current external balance will ease to 2.8% of GDP this year due to the unwinding of price pressures in the industry and energy sectors. Going forward, the trade balance should also be supported by the expected economic recovery abroad. The current external balance should thus return to a surplus at the end of the CP horizon, as should net lending/borrowing.

In terms of sectoral balances, the private sector balance should show significant surpluses under the projected trajectory of the general government sector balance.

Graph 2.1: GDP Development

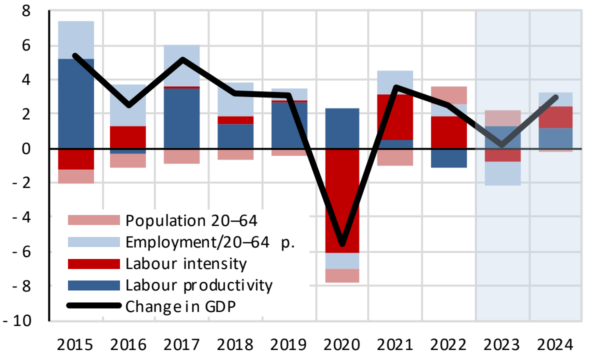
change in %, contributions in percentage points



Source: CZSO (2023a), MF CR (2023a). MF CR calculations and forecast.

Graph 2.2: GDP, Productivity and Labour Intensity

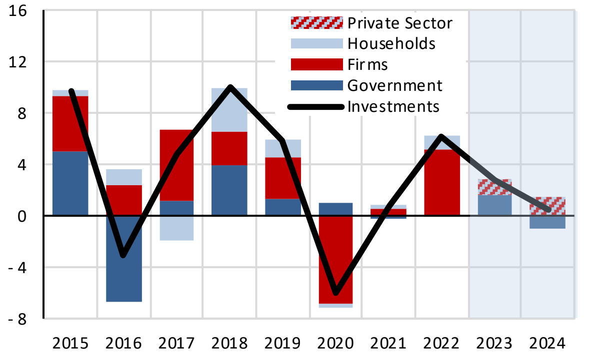
change in %, contributions in percentage points



Source: CZSO (2023a), MF CR (2023a). MF CR calculations and forecast.

Graph 2.3: Investment by Sector

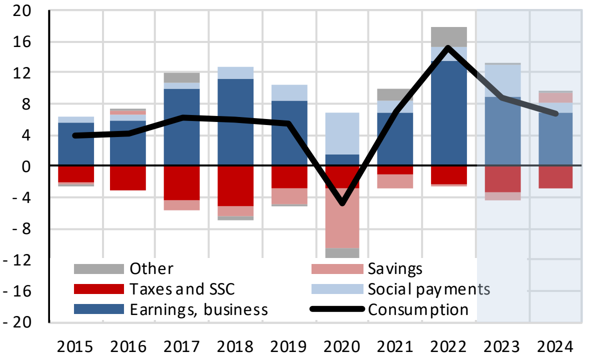
change of real gross fixed capital formation in %, contributions in pp



Source: CZSO (2023a), MF CR (2023a). MF CR calculations and forecast.

Graph 2.4: Nominal Consumption of Households

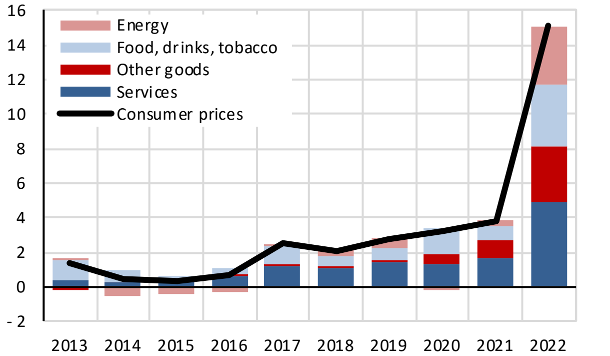
national concept, change in %, contributions in pp



Source: CZSO (2023a), MF CR (2023a). MF CR calculations and forecast.

Graph 2.5: Consumer Prices in Main Divisions

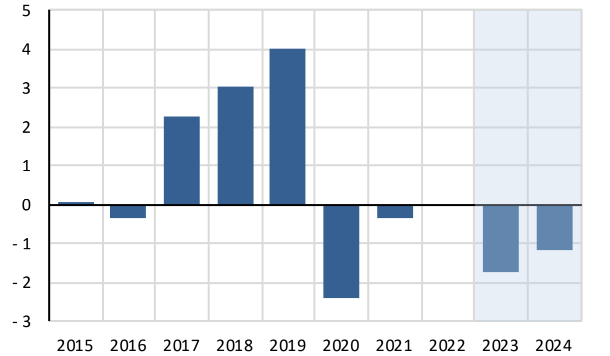
national concept, y-o-y change in %, contributions in percentage points



Source: CZSO (2023a). MF CR calculations.

Graph 2.6: Output Gap

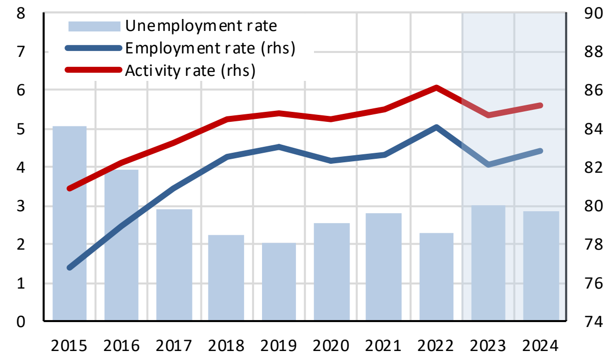
in % of potential product



Source: MF CR (2023a).

Graph 2.7: Unemployment, Employment, Activity Rates

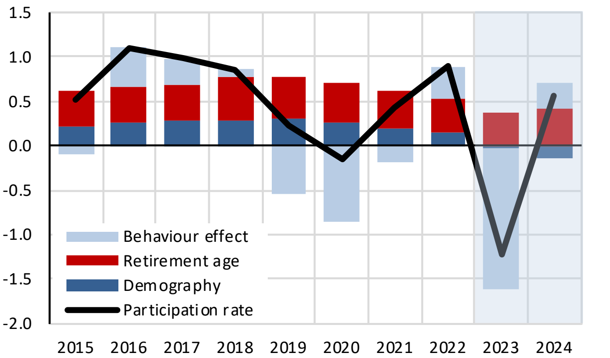
in %



Source: CZSO (2023c). MF CR calculations and forecast.

Graph 2.8: Changes in Participation Rate

change and contributions in percentage points



Source: CZSO (2023c), Eurostat (2023). MF CR calculations and forecast.

Table 2.1: Economic Output

levels in CZK billions, change in %, contributions in percentage points

	ESA Code	2022 Level	2022 Rate of change	2023	2024	2025	2026
Real GDP	B1*g	**6 259**	**2.5**	**0.1**	**3.0**	**2.9**	**2.5**
Nominal GDP	B1*g	**6 795**	**11.2**	**10.0**	**6.9**	**5.8**	**4.8**
Components of real GDP							
Private consumption expenditure	P.3	**2 747**	**-0.9**	**-2.7**	**3.9**	**4.0**	**3.0**
Government consumption expenditure	P.3	**1 318**	**0.6**	**1.6**	**1.3**	**1.6**	**1.8**
Gross fixed capital formation	P.51g	**1 687**	**6.2**	**2.8**	**0.5**	**2.2**	**2.4**
Changes in inventories and net acquis. of valuables (% of GDP)	P.52+P.53	**316**	**5.9**	**5.8**	**5.2**	**4.3**	**3.6**
Exports of goods and services	P.6	**4 694**	**5.7**	**4.1**	**4.7**	**3.2**	**2.9**
Imports of goods and services	P.7	**4 503**	**5.7**	**3.0**	**2.8**	**1.8**	**1.9**
Contributions to real GDP growth							
Final domestic demand		-	**1.3**	**-0.1**	**2.2**	**2.7**	**2.4**
Changes in inventories and net acquis. of valuables	P.52+P.53	-	**1.0**	**-0.5**	**-0.7**	**-0.8**	**-0.7**
External balance of goods and services	B.11	-	**0.2**	**0.8**	**1.4**	**1.0**	**0.8**

Note: Real levels are in 2021 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 contribution of the change in inventories and net acquisition of valuables is calculated from real values.
Source: CZSO (2023a), MF CR (2023). MF CR calculations and forecast.

Table 2.2: Prices of Goods and Services

indices 2015=100, rate of change in %

	2022 Level	2022 Rate of change	2023	2024	2025	2026
GDP deflator	**127.8**	**8.6**	**9.9**	**3.8**	**2.8**	**2.2**
Private consumption deflator	**133.0**	**16.0**	**11.9**	**2.8**	**2.3**	**2.0**
Harmonised index of consumer prices	**132.1**	**14.8**	**12.2**	**2.6**	**2.2**	**2.0**
Public consumption deflator	**132.9**	**4.2**	**6.1**	**3.1**	**2.4**	**2.1**
Investment deflator	**125.5**	**8.9**	**6.0**	**3.4**	**2.8**	**2.1**
Export price deflator (goods and services)	**111.6**	**8.3**	**3.3**	**3.1**	**2.3**	**1.8**
Import price deflator (goods and services)	**114.4**	**13.1**	**2.7**	**2.3**	**2.0**	**1.6**

Source: CZSO (2023a), Eurostat (2023). MF CR calculations and forecast.

Table 2.3: Employment and Compensation of Employees

price levels in current prices, rate of change in %

	ESA Code	2022 Level	2022 Rate of change	2023	2024	2025	2026
Employment (thous. of persons)		**5 450**	**1.7**	**-0.4**	**0.5**	**0.2**	**0.1**
Employment (mil. hours worked)		**9 553**	**3.6**	**-0.8**	**1.4**	**0.8**	**0.7**
Unemployment rate (%)		**2.3**	**2.3**	**3.0**	**2.8**	**2.7**	**2.7**
Labour productivity (thous. CZK/person)		**1 148**	**0.7**	**0.5**	**2.4**	**2.8**	**2.4**
Labour productivity (CZK/hours)		**655**	**-1.1**	**1.0**	**1.5**	**2.1**	**1.8**
Compensation of employees (bn. CZK)	D.1	**2 997**	**7.6**	**7.2**	**5.8**	**4.4**	**4.5**
Compensation per employee (thous. CZK/person)		**632**	**5.5**	**7.9**	**5.3**	**4.3**	**4.3**

Note: Employment and compensation of employees are based on domestic concept of national accounts. Unemployment rate is based on the Labour Force Survey methodology. Labour productivity is calculated as GDP in 2021 prices per employed person or hour worked.
Source: CZSO (2023a, 2023c). MF CR calculations and forecast.

Table 2.4: Sectoral Balances

in % of GDP

	ESA Code	2022	2023	2024	2025	2026
Net lending/borrowing vis-à-vis the rest of the world	B.9	**-4.9**	**-2.0**	**-0.3**	**0.6**	**1.0**
Balance of goods and services		-0.1	1.1	3.0	4.1	4.9
Balance of primary incomes and transfers		-5.3	-3.9	-4.2	-4.5	-4.8
Capital account		1.2	1.5	1.5	1.5	1.4
Net lending/borrowing of the private sector	B.9	**-1.3**	**1.6**	**2.6**	**3.0**	**3.2**
Net lending/borrowing of general government	B.9	**-3.6**	**-3.5**	**-2.9**	**-2.4**	**-2.2**
Statistical discrepancy		**0.0**	**0.0**	**0.0**	**0.0**	**0.0**

Note: National Accounts Methodology.
Source: CZSO (2023a). MF CR calculations and forecast.

Table 2.5: Basic Macroeconomic Assumptions

interest rates and change in %

		2022	2023	2024	2025	2026
Short-term interest rate (CZ) (annual average)	*% p.a.*	**6.3**	**7.1**	**5.5**	**3.2**	**2.6**
Long-term interest rate (CZ) (annual average)	*% p.a.*	**4.3**	**4.5**	**4.0**	**3.1**	**2.8**
Nominal effective exchange rate	*2015=100*	**114.8**	**118.7**	**119.0**	**119.2**	**119.4**
Exchange rate CZK/EUR (annual average)	*CZK/EUR*	**24.6**	**23.8**	**23.8**	**23.7**	**23.7**
World excluding EU, real GDP growth	*change in %*	**3.1**	**3.0**	**3.3**	**3.0**	**3.0**
EU real GDP growth	*change in %*	**3.6**	**0.7**	**1.5**	**1.5**	**1.3**
Real growth of relevant foreign markets	*change in %*	**4.3**	**2.0**	**2.9**	**2.8**	**2.5**
World import volumes, excluding EU	*change in %*	**4.4**	**2.4**	**3.6**	**3.5**	**3.2**
Oil prices (Brent)	*USD/barel*	**101.0**	**77.0**	**72.9**	**70.7**	**69.0**

Source: CNB (2023a), EIA (2023), Eurostat (2023a). MF CR calculations and forecast.

3 General Government Sector Finances

The Czech Republic's public finances reached a deficit of 1.5 pp lower year-on-year in 2022, despite the economy struggling with the consequences of Russia's aggression against Ukraine. The deficit of 3.6% of GDP included not only a number of one-off or temporary measures such as humanitarian aid and support to economic agents affected by high prices, but also the effects of measures that significantly and permanently reduced the tax burden during the covid-19 epidemic. The state budget deficit was cushioned by a positive balance of local governments. Thus, from a structural perspective, the fiscal restriction was less than 1 pp. In this year, we expect the public finance deficit similar to the last year. The forecast is burdened with relatively large risks (see Section 4.2) – energy prices play a key role in this respect. These will determine tax revenues from windfall profits and levies on excess revenues on one hand, and the compensation costs associated with the ceiling on electricity and gas prices on the other.

3.1 Current Developments of the General Government Sector

3.1.1 Outcome in 2022

According to data from the CZSO, the **general government sector** ended 2022 with a deficit of 3.6% of GDP, and in structural terms with a deficit of 2.8% of GDP. Although last year's deficit was mainly attributable to the state budget, the social security funds (health insurance companies) also ended in a slight deficit. On the other hand, local governments again recorded a surplus.

General government revenue grew by 10.0%, but high nominal GDP growth led to a decline in its proportion to 41.0% of GDP. For the same reason, the **composite tax quota** fell by more than 1 pp year-on-year, although tax revenue including social security contributions increased by 7.9%.

The **personal income tax** yield was 6.4% higher year-on-year, as the increase in the basic taxpayer credit by CZK 3,000 with an impact of CZK 12.3 billion (Act No. 609/2020 Coll.) counteracted the growth in the volume of wages and salaries in the economy. The negative impact of the tax exemption on income from government bonds (Act No. 609/2020 Coll.), together with the additional impact of the flat-rate income tax regime for sole traders with incomes of up to CZK 1 million (Act No. 540/2020 Coll.), and the change in the taxation of low-emission business vehicles used also for private purposes (Act No. 142/2022 Coll.) amounted to CZK 0.4 billion in total. The temporary increase in the limit for the application of the deduction for gifts to 30% of the tax base (Act No. 609/2020 Coll.) was extended to 2022 and at the same time the range of recipients and the purpose for the provision of gratuitous benefits in connection with aid to Ukraine and its population (Act No. 128/2022 Coll.) was expanded, resulting in an essentially zero year-on-year effect.

Social security contributions also depended on earnings growth, rising by 7.0%. Last year's dynamics of employee taxation was influenced by extraordinary remuneration paid to workers in the health care sector, social services and the armed forces in 2021. The monthly payment for a state insured person increased by CZK 200 per person as of 1 January 2022 (Government Regulation No. 253/2021 Coll.), but was reduced again by CZK 480 with effect from 31 August 2022, so that its average amount remained at the 2021 level (Act No. 260/2022 Coll.). The State's payment for temporary protection granted citizens of Ukraine brought approximately CZK 4.5 billion into the public health insurance system. CZK 0.6 billion more was spent on the payment of the extraordinary allowance for persons quarantined due to the covid-19 disease than in 2021 (Act No. 121/2021 Coll., as amended by Act No. 182/2021 Coll., Act No. 518/2021 Coll.). The change in the taxation of low-emission company cars used also for private purposes also had a negative impact on the social security contributions in 2022 of CZK 0.2 billion (Act No. 142/2022 Coll.).

The corporate income tax yield grew by 9.8% and was dampened by the end of the effective date of the change in the method of creation and tax deductibility of technical provisions for insurance companies with an impact of CZK 5.3 billion (Act No. 364/2019 Coll.), the extension of the validity of extraordinary depreciation in the amount of CZK 0.6 billion (Act No. 609/2020 Coll. and Act No. 366/2022 Coll.) or the tax exemption of CZK 1.5 billion of government bond yields (Act No. 609/2020 Coll.). The "meal voucher lump sum" (Act No. 609/2020 Coll.) reduced the yield in low hundreds of millions of CZK, as did the extension of the increased limit for claiming the gift deduction and the extension of the range of beneficiaries and the purpose for supporting Ukraine (Act No. 128/2022 Coll.). The opposite effect was the unwinding of the negative impact of the increase in the entry price threshold for depreciation of tangible assets of CZK 1.6 billion (Act No. 609/2020 Coll.).

The 15.8% year-on-year increase in **value added tax** revenue was determined by strong nominal household consumption due to high prices. We quantify the negative effect of previously approved discretionary measures, such as the reclassification of selected services to the second reduced tax rate in the first half of 2020 (Act No. 256/2019 Coll.) or the reduction of the rate for accommodation, sports and cultural events, ski lifts and other selected services from July 2020 (Act No. 299/2020 Coll.), at CZK 2.8 billion in total. On the other hand, the waiver of the tax on electricity and gas supplies at the end of 2021 in the amount of CZK 5.4 billion positively affected the dynamics in 2022 (Government Resolution No. 907/2021). The termination of the value added tax waiver on the purchase of respirators or the year-on-year lower impact of the tax waiver on the purchase of vaccines and tests generated CZK 1.6 billion.

Excise duties in terms of national legislation decreased year-on-year by 1.8%. The dynamics was dampened by the reduction of excise duty on petrol in the period from June to September 2022, or until the end of 2023 in the case of diesel, with an impact of CZK 6.7 billion (Act No. 131/2022 Coll., Act No. 286/2022 Coll.). On the other hand, the introduction of a fee on solar electricity for installations put into operation in 2009 and the increase in rates for 2010 installations had a positive impact of CZK 3 billion (Act No. 382/2021 Coll.) and an increase in the tax on tobacco products of CZK 2.5 billion (Act No. 609/2020 Coll.). In response to the increase in fuel prices, road tax rates were significantly reduced, which resulted in a revenue shortfall of CZK 4.2 billion in other taxes on production (Act No. 142/2022 Coll.). The remission of the renewable energy levy for households and companies amounted to CZK 4.6 billion. Taxes on production and imports were expanded by a new levy on the excess revenue of electricity producers, which brought in CZK 1.4 billion (Act No. 365/2022 Coll.).

The acceleration of revenue **transfers** reflected the implementation of projects co-financed by the EU from the ending 2014–2020 financial perspective and from the Next Generation EU Instrument. Higher profitability in state-owned companies and interest received as part of the Treasury's liquidity management have boosted **property income**.

General government expenditure grew by 6.7%, but, as in the case of total revenue, the high nominal GDP growth caused their fall in relative terms by 1.9 pp to 44.6% of GDP.

Final consumption expenditure slowed to 4.8% year-on-year and, unlike the previous few years, was mainly driven by intermediate consumption. The 10.6% growth reflected high inflation, EU co-financed projects as well as the migration wave from Ukraine. The increased base due to extraordinary remuneration payments in 2021 and moderate salary indexation were behind the 2.0% increase in **compensation of employees** in the general government sector. The 5.3% growth in **social transfers in kind** reflected spending on social services and health care, also used by Ukrainian refugees. The extension of the range of persons who could apply for the housing allowance, as well as the increase in the amount of the allowance itself due to the steep rise in energy prices, led to a year-on-year increase in benefits paid of CZK 1.9 billion (Act No. 17/2022 Coll., Government Regulation No. 289/2022 Coll.). The approval of higher benefits for persons with disabilities (mobility allowance) resulted in an expenditure of CZK 0.1 billion (Act No. 358/2022 Coll.). The dynamics of final consumption expenditure was corrected by a 13.5% growth in **general government output**.

The 9.0% increase in **cash social benefits** was driven by pension benefits, as in previous years. The increase of CZK 300 above the standard January pension indexation required CZK 10.6 billion (Act No. 323/2021 Coll.), while two extraordinary indexations due to the high inflation rate accounted for another CZK 1,017 on average from June onwards, with an impact of CZK 20 billion (Government Regulations No. 35/2022 Coll. and No. 36/2022 Coll.) and from September by an average of CZK 700, raising expenditure by another CZK 7.8 billion (Government Regulations No. 136/2022 Coll. and No. 137/2022 Coll.).

The increase in total of CZK 3.3 billion also affected benefits supporting families with children, such as child benefits and adjustments to the payment of parental leave allowance (Act No.285/2021 Coll.), the extension of the length of the support period for paternal leave to 2 weeks (Act No. 330/2021 Coll.) or the increase in foster care benefits (Government Regulation No. 292/2022 Coll.). The disposable income of families with children under 18 years of age was strengthened last year by a one-off allowance of CZK 5,000 per child for households with a gross annual income of up to CZK 1 million. For this one-off allowance was paid CZK 6.7 billion (Act No. 196/2022 Coll.). The impact of the increase in the care allowance for persons in the 3rd and 4th degree of dependence was calculated at CZK 3.4 billion (Act No. 328/2021 Coll.). A further increase of CZK 1.5 billion in expenditure on social benefits was related to the extraordinary indexation of the living and subsistence minima from April and July 2022, respectively (Government Regulations No. 75/2022 Coll. and No. 204/2022 Coll.). By contrast, the end of the payment of the special care allowance during epidemic resulted in year-on-year savings of CZK 3.6 billion. In the context of the migration wave of refugees from Ukraine, a humanitarian benefit of CZK 8.7 billion was paid (Act No. 66/2022 Coll. and No. 198/2022 Coll.) and the state budget transfer to the public health insurance system increased by about CZK 4.5 billion.

Higher debt and interest rates led to a 70% increase in **interest expenditure**, which in relative terms reached 1.2% of GDP.

Fixed asset investments grew at a rate of 9.5%, driven mainly by strong investment activity by local governments. Investments were strongly supported by the EU budget funds due to the upcoming end of the 2014–2020 programming period as well as the Next Generation EU Instrument. Their share of total investments increased year-on-year to almost 19%. Uncertainty in markets and gas supplies led to higher expenditure on strategic **stock** purchases.

Assistance to companies with the costs of high energy prices (Government Resolutions No. 786/2022 and No. 876/2022), which accrues to 2022 expenditure, amounted to CZK 5.5 billion. Support for heat from renewable energy sources, together with support for rail transport operators, was associated with a cost of CZK 1 billion (Government Regulation No. 470/2022 Coll.). The provision of accommodation for Ukrainian refugees in private accommodation facilities paid for by the regions with a state contribution cost CZK 2.5 billion (Government Regulation No. 206/2022 Coll. as amended by Government Regulation No. 322/2022 Coll.). By contrast, the year-on-year savings of tens of billions of CZK occurred because of the termination of anti-epidemic measures and related support programmes, for which accrued expenditure of more than CZK 3 billion was recorded. As a result, **subsidies** fell by almost 23%.

The 13.8% increase in **current transfers** was mainly due to assistance to households facing higher energy costs (electricity, gas, heat) in the form of the so-called energy-savings tariff with an amount of CZK 17.4 billion (Act No. 232/2022 Coll., Government Regulation No. 262/2022 Coll.). The contribution for solidarity households accommodating refugees from Ukraine required CZK 1.6 billion (Government Regulations No. 73/2022 Coll. and No. 205/2022 Coll., as amended by Government Regulation No. 439/2022 Coll.).

The 10.9% year-on-year decline in **capital transfers** was caused by the smaller impact of the payment of the compensation bonus (Act No. 519/2021 Coll.) and the year-on-year lower impact of loss carryback mechanism (Act No. 299/2020 Coll.). On the contrary, these factors were counteracted by payments to the Czech Post for the provision of universal postal services for the period 2018–2022 in the aggregate amount of CZK 7.5 billion and free of charge provision of military equipment to Ukraine in the amount of several CZK billions.

3.1.2 Outcome in 2023

The performance of public finances **in 2023** remains strongly dependent on energy market developments. The general government balance is expected to reach −3.5% of GDP. Adjusted for the impact of the business cycle and one-off measures which are mainly linked to energy prices this year, the deficit should be 1.6% of GDP. The main burden should be borne by the state budget, which is budgeted with a cash deficit of CZK 295 billion. Social security funds should also end up with a slightly negative balance. Local governments are likely to reach a surplus again.

General government revenues are expected to grow by 10.5%, similar to last year, with tax revenues including social security contributions rising by 8.4%. Despite this, the 10% estimated growth in nominal GDP results in a 0.5 pp decline in the tax quota to 34.2% of GDP.

High nominal consumption and the pace of government purchases and investment spending are contributing positively to consumption tax growth. **Value-added tax** is expected to grow by 8.1%, with autonomous growth reduced by a revenue shortfall due to the increase in turnover limit for tax registration from CZK 1 million to CZK 2 million with an impact of CZK 8.5 billion (Act No. 366/2022 Coll.). Conversely, the end of the tax waiver for the purchase of vaccines and tests should be positively reflected in tax revenue this year.

We estimate **excise tax** growth, as defined by national legislation, at 0.8%. Revenue will be boosted by CZK 2.4 billion due to the increase in rates on tobacco products (Act No. 609/2020 Coll.), while the reduced rate on diesel with effect until the end of 2023 will have an additional negative impact of CZK 2.9 billion (Act No. 286/2022 Coll.). Taxes on production and imports are expected to be enhanced by CZK 11.1 billion this year as a result of the levy on excess revenues of electricity producers (Act No. 365/2022 Coll.). By contrast, the waiving of the renewable energy levy for households and companies, effective until the end of 2023, is likely to represent an additional revenue shortfall of CZK 13.8 billion. The introduction of the register of excluded persons is expected to have a negative impact on gambling tax revenue this year by additional CZK 0.5 billion (Act No. 186/2016 Coll.).

In addition to wage and salary growth in the economy, income tax dynamics will be significantly affected by the introduction of a windfall tax. **Personal income tax** is expected to grow by 6.9% in line with the macroeconomic base. The continued tax exemption of government bond yields (Act No. 609/2020 Coll.), together with the extension of the flat-rate regime for taxpayers with annual incomes up to CZK 2 million (Act No. 366/2022 Coll.), will reduce tax revenue by an estimated CZK 0.5 billion in 2023. The termination of the temporary increase of the limit for the application of the deduction for gifts to 30% of the tax base associates with a positive impact of CZK 0.3 billion (Act No. 128/2022 Coll.).

The estimated 7.4% increase in **social security contributions** is primarily related to expected earnings developments. We also take into account an increase in the monthly payment per state insured person to CZK 1,900, which will bring additional revenues to health insurance companies of around CZK 12 billion this year (Act No. 260/2022 Coll.). The positive impact of CZK 1.9 billion should be connected with the payment of the extraordinary allowance for persons quarantined due to the covid-19 disease, which was discontinued last year (Act No. 518/2021 Coll.). Conversely, the introduction of a reduced social security rate (5% of the aggregate of the monthly assessment bases of the employees to whom the reduction is applied) when part-time work is arranged will diminish social and health insurance contributions by an estimated CZK 3.3 billion (Act No. 216/2022 Coll.). Revenue will be slightly reduced by the change in the taxation of low-emission company cars and the extension of the flat-rate regime.

The 25.2% growth in **corporate income tax** is influenced by higher profits, which are taxed at an extraordinary rate of 60% from the established threshold in the case of selected industries and companies and paid as a windfall tax with an estimated yield of CZK 28 billion (Act No. 366/2022 Coll.). The effect of the 2021 tax package (Act No. 609/2020 Coll.) is likely to be slightly negative this year, with the additional impact of the tax exemption of CZK 1.6 billion on government bond yields only partly offset by a year-on-year lower impact of CZK 1 billion from extraordinary depreciation.

The accelerating dynamics of revenue **transfers** should reflect the implementation of projects co-financed by the EU from the ending 2014–2020 financial perspective and, to a lesser extent, from the next perspective 2021–2027, as well as from the Next Generation EU Instrument. Regarding **property income,** the forecast foresees exceptionally high dividend income received by the government (in particular, more than CZK 40 billion from the energy company CEZ), while interest received on loans granted under the Treasury liquidity management (reverse repo operations) should be lower year-on-year.

General government expenditure is expected to grow by more than 10%, but to remain at 44.6% of GDP given similar nominal GDP growth. We estimate that **final consumption expenditure** will accelerate to 7.8% year-on-year, mainly due to the high rate of **intermediate consumption** (10.0%) reflecting still exceptionally high, though slowing, expected inflation rate.

Compensation of employees is expected to show dynamics of more than 7%. As of January 2023, salary scales for soldiers and members of the security forces have increased by 10% (or 17% respectively for members in the lowest 2 grades). In addition, the reason for the year-on-year increase in compensation is the increase in salary scales for non-teaching staff in education and civil servants working in culture, semibudgetary organisations or covered by the Civil Service Act since September last year. Similarly, the increase in the volume of funds for salaries of teaching staff by 4% from January 2023, new or increased working hours in the education sector, including the effects of the inclusion of Ukrainian children into the Czech education system.

The 8.7% increase in **social transfers in kind** reflects spending on health and social services, also financed by higher payments for the state insured persons. The increase in the amounts of the living and subsistence minima reflected in the amount of the housing supplement (Government Regulations No. 204/2022 Coll. and No. 436/2022 Coll.), together with the adjustment of the housing allowance (Act No. 456/2022 Coll.), will entail additional expenditure of an estimated CZK 2.8 billion. The increased mobility allowance approved with effect from December 2022 will require an additional CZK 0.7 billion this year (Act No. 358/2022 Coll.).

In the field of **cash social benefits,** we are counting mainly on an increase in pension benefits (16.8%), which are determined both by the standard January indexation plus the allowance for each child raised and by an extraordinary indexation due to the high inflation rate from this year's June. Since January, according to the statutory indexation formula, the average pension has increased by CZK 825 (Government Regulations No. 290/2022 Coll. and No. 291/2022 Coll.); in addition, there has been an increase of CZK 500 per month for each child raised, with an impact of around CZK 19 billion in 2023 (Act No. 323/2021 Coll.). The extraordinary indexation in June will take place according to the modified rules (Act No. 71/2023 Coll.), with an increase of CZK 400 for all pensions and a 2.3% increase in the earnings-related part; the average old-age pension should thus rise by CZK 750. The total budgetary impact for 2023 is CZK 15.4 billion. Last year's extraordinary indexations bring additional budgetary burden for the corresponding part of the year also in 2023.

In the area of pro-family policy, the child benefits were increased by CZK 200 in both the basic and increased assessments from January 2023 (Act No. 456/2022 Coll.) and foster care benefits were increased from October 2022 (Government Regulation No. 292/2022 Coll.), with a total calculated impact of CZK 1.3 billion this year. The introduction of the institution of substitute maintenance for dependent children will require an additional CZK 0.2 billion (Act No. 588/2020 Coll.). A further increase of CZK 0.8 billion in expenditure on social benefits is related to the indexation of the living and subsistence minima from July 2022 (Government Regulation No. 204/2022 Coll.) and January 2023 (Government Regulation No. 436/2022 Coll.). We also expect an increase in expenditure on unemployment benefits due to the forecasted higher unemployment rate. By contrast, the end of the payment of special care allowance during epidemic (Act No. 520/2021 Coll.), the one-off child allowance paid last year (Act No. 196/2022 Coll.) and the year-on-year lower humanitarian benefit for Ukrainian refugees (Acts No. 66/2022 Coll. and No. 198/2022 Coll.) should dampen the dynamics of cash social benefits to an expected 12.5%.

In particular, assistance to households, companies, public and other institutions in the form of energy price caps in an estimated amount exceeding CZK 40 billion (Government Regulation No. 5/2023 Coll.) is behind the exceptionally high dynamics of **subsidies**. Furthermore, in order to avoid the full impact of high electricity prices on the customer in the form of a regulated price for electricity transmission, the Government approved a subsidy to the transmission system operator of the Czech Republic in the amount of CZK 22.7 billion (Government Resolution No. 112/2023). The state will also pay compensation to distributors to cover part of the costs of electricity losses in regional and local distribution systems and losses in gas systems in the total amount of CZK 15.4 billion (Government Regulation No. 463/2022 Coll.). In the context of the ongoing conflict in Ukraine and the accommodation of Ukrainian refugees in private accommodation facilities paid for by the regions with a state contribution, the forecast assumes an amount of CZK 3.5 billion (Government Regulation No. 206/2022 Coll., as amended by Government Regulation No. 322/2022 Coll.). This should result in a year-on-year increase in subsidies of 31.0%.

The **current transfers**, which were increased last year due to the so-called energy-savings tariff, include this year a programme for customer support in the heating sector under the Temporary Crisis Framework with an amount of CZK 17 billion (Government Resolution 1100/2022). The contribution for solidarity households accommodating Ukrainian refugees should cost CZK 1 billion, which is CZK 0.6 billion less than in 2022. A significant year-on-year decrease should be recorded in **capital transfers**, whose 2022 base was increased by extraordinary expenditures, mainly the payment to the Czech Post in the amount of CZK 7.5 billion. The end of the payment of the compensation bonus also has a positive effect on the year-on-year dynamics. By contrast, the forecast assumes the realisation of guarantees provided by the National Development Bank and the Export Guarantee and Insurance Corporation in the total amount of CZK 4.5 billion. As a result of these factors, total transfers should fall by 3.1%.

Investments in fixed assets with an estimated growth of 15.8% should be significantly supported by the EU budget co-financing not only from the 2014–2020 programming period approaching its end, but also already by using funds from the 2021–2027 programming period, as well as funds from the Next Generation EU Instrument. Their share of total investments is expected to increase by more than 9 pp year-on-year to 28%.

3.2 General Government Outlook

The fiscal policy stance in the Czech Republic is based on the statutory commitment to gradually achieve the **medium-term budgetary objective** of 0.75% of GDP in terms of the structural deficit. The Act on Fiscal Responsibility Rules obliges the government to progress towards this target by at least 0.5 pp per year from 2022 onwards, when setting expenditure limits for the state budget and state funds. These should be compatible with the given structural deficit of the general government sector and the ex post performance of this sector should be in line with this setting (i.e. at worst at the level of these limits). Last year, the Czech government tightened the **expenditure frameworks** for the state budget and state funds so as to set the expenditure frameworks for the state budget and state funds with a year-on-year change in the structural deficit, from which the expenditure limits are derived, by 0.9 pp. The aim of the government is to continue the faster pace of public finance consolidation in the following years as well.

Nevertheless, we forecast persistent public deficits, which will be primarily determined by the **state budget**. The Czech Republic's general government deficit should fall below the 3% of GDP reference value as early as 2024 and deficits should continue to decline towards 2.2% of GDP in 2026.

For **local governments,** we expect continued surpluses, albeit somewhat lower in magnitude compared to recent years. Specifically, deferred capital projects that had to be tendered again because of high inflation should gradually be implemented at higher costs. In the outlook years, the return of inflation to the CNB's inflation target should slow down the pace of expenditure and contribute to an increase in surpluses in absolute terms.

Estimates of the performance of **social security funds** depend in particular on the predicted volume of wages and salaries in the economy, which is the decisive determinant of their future revenue growth. Given its dynamics (see Section 2.2.4) and rather moderate growth in expenditure after 2023, we expect the health insurance companies to run a slight surplus. The non-state budget and state funds components of the central government as a whole are expected to run small surpluses on average.

3.2.1 Revenue Outlook

General government revenue is expected to grow by 3.5% on average over the outlook years. However, we expect a higher rate of tax revenue, including social security contributions, averaging almost 5%.

In the case of **personal income tax,** discretionary measures have absolutely negligible impact over the 2024–2026 horizon. Thus, revenue is mainly determined by wage and salary growth, implying a rate of less than 6% in 2024 and around 4% in the outlook years.

Social security contributions should also be determined to a decisive extent by the development of wage bill in the economy. In 2024, the dynamics will be hampered by the additional effect of the reduced social insurance rate for selected groups of part-time employees with an impact of CZK 0.3 billion. In the accrual methodology, the aggregate also includes payments from the state budget for the so-called state insured to the public health insurance system. These payments will be indexed according to the inflation rate and real wage growth (similar to pensions), while another factor in the total number of insured persons will be the actual number of refugees from Ukraine (especially children). Contributions should thus rise by less than 5% on average.

For **corporate income tax,** the pace will continue to be affected in 2024 and 2025 by the continued effect of the windfall profits tax. However, revenue will gradually decline and we expect amounts of CZK 13 and CZK 11 billion in the respective years. The dynamics should be positively influenced by the extraordinary depreciation introduced during the pandemic and prolonged as a result of the energy crisis, the effect of which will disappear in 2027. On the other hand, the exemption of government bond yields will have a negative effect of around CZK 2 billion per year. Combined with the 5.7% average growth in gross operating surplus, the year-on-year average change in the tax yield stands at 2.4%.

Excise duties in terms of national legislation should grow by an average of 2.2%. In 2024, growth should be boosted by the expiry of the reduced rate on diesel at the end of 2023, with an impact of CZK 9.6 billion. In addition, autonomous development related to the economic recovery and rising real household earnings should have a positive impact.

Value-added tax revenue depends primarily on developments in nominal household consumption, part of the government consumption and government investment. The average growth in tax revenue of 5.4% is slightly below the growth rate of the macroeconomic base. The increase in the value-added tax registration limit of annual sales from CZK 1 million to 2 million will have a negative impact of CZK 1.5 billion in 2024. The termination of the preferential tax refund scheme for Czech Television and Czech Radio to the same extent as for commercial stations (Act No. 80/2019 Coll.) in the amount of CZK 0.4 billion will have a positive impact on tax revenue in 2025.

In the case of **other taxes on production and imports,** we expect a further reduction in gambling tax revenue due to the introduction of the excluded persons' register of CZK 0.3 and CZK 0.1 billion in 2024 and 2025, respectively. Re-established payments of households and firms on renewable energy sources will increase the revenue side of public finances by CZK 18.4 billion (corresponding to the evaluation of the cancellation of these payments in 2022). In contrast, the end of the effective date for the excess revenue levy will affect the dynamics in 2024 by CZK 11.1 billion.

For other revenue, we are working with declines over the entire forecast horizon for both transfers due to the evolution of payments from the EU budget for current and capital projects co-financed by the EU and the property income. Here, the decline is driven both by dividend policy between 2023 and 2024, when we expect a return to more common pre-crisis dividend levels, and by falling interest income.

3.2.2 Expected Expenditure Developments

We forecast average growth of 2.6% in **total general government expenditure** over the outlook years. The dynamics in 2024 is strongly influenced by the end of one-off and temporary operations adopted mainly in response to the energy crisis and effective in 2023.

Cash social benefits are expected to rise by 2.5% on average. The pace is primarily determined by the development of pension benefits, which we assume to be at the level of the statutory indexation formula according to the forecasted inflation rate and real wage growth (which, however, should not be strong enough to effectively affect the indexation pace over the horizon), including this year's extraordinary indexation from June 2023 with an additional impact of CZK 11 billion next year. On the other hand, the dynamics should be restrained by the end of the impact of the exceptional measures, be it the humanitarian benefit for refugees from Ukraine or the payment of a one-off allowance to families with children up to 18 years of age and a gross annual income of up to CZK 1 million.

We expect **nominal consumption** growth in the general government sector to be between 4 and 4.5% in all years. **Compensation of employees** is expected to rise especially in the education sector and we expect a relatively stronger increase also in the health sector. However, given the consolidation, we expect only modest growth for the rest of general government employees. For **social transfers in kind**, we expect health care payments to rise in line with developments in system revenues. For **intermediate consumption**, we forecast a slowdown in 2024, in line with the end of the 2014–2020 financial perspective and the start of the new 2021–2027 perspective. Growth should also be supported by other EU budget instruments. Here too, deferred spending on infrastructure and property repairs, especially at the local level, which are currently not being implemented due to supply-side constraints and a sharp increase in costs, should be reflected.

In the area of **investment**, we expect a surge in funding from the Recovery and Resilience Facility, the Just Transition Fund and the REACT-EU programme in 2024, followed by a gradual decline. For programmes co-financed by the European Structural and Investment Funds, we foresee a drop in 2024 due to the transition to the new financial perspective, followed by a return to the usual level given the early phase of the perspective cycle as well as a generally slightly lower allocation. We also foresee an increase in national investments due to the current geopolitical situation and the acceleration of the purchase of military equipment over virtually the entire horizon of the outlook.

Subsidies are expected to fall due to the end of support programmes introduced in the context of high energy prices (see Section 3.1). However, the area of production subsidies is one of the areas where the government has declared its efforts to seek savings. After a decline of around 25% in 2024 due to the end of a number of one-off measures (energy price ceiling schemes and the resulting compensations), we then expect further, albeit very modest, declines, with higher expenditure related to transitional transformational heat support and still relatively lower (albeit rising over time) renewable energy payment costs due to higher prices working against each other.

In line with our assumptions on interest rates, the volume of debt refinanced and the level of cash balances, we estimate that **interest expenditure** will grow by 10.5% on average. In relative terms, interest expenditure is projected to increase to 1.4% of GDP over the projection horizon (see also Section 3.4).

3.3 Structural Balance and Fiscal Position

The general government balance, net of the effect of the business cycle and one-off or other temporary operations, was −2.8% of GDP **in 2022**. The cyclical component was essentially zero.

One-off and other temporary operations amounted to −0.9% of GDP in 2022. On the revenue side, government measures to cushion the impact of rising energy prices included a reduction in the rate of excise duty on petrol and diesel from the beginning of June to the end of September, with an impact of CZK −4.2 billion, while the rate on diesel was reduced again from October, with an impact of CZK −2.5 billion by the end of the year, and a waiver of the renewable energy payments of CZK −4.6 billion. Revenues were slightly boosted by the introduction of levies on the excess income of electricity producers above the established ceiling of market income according to the method of electricity production, amounting to CZK 1.4 billion. On the expenditure side, some compensatory measures related to covid-19 not exceeding CZK 8 billion were ongoing. In the energy sector, support for households through the introduction of the energy-savings tariff had an impact of CZK −17.4 billion and the payment of a one-off allowance per child under 18 to households with an annual gross income of up to CZK 1 million had an impact of CZK −6.7 billion. The government also proceeded to support enterprises in energy-intensive sectors with an impact of CZK 5.5 billion. The balance was further aggravated by humanitarian benefits for refugees from Ukraine with an impact of CZK 8.7 billion.

The positive **fiscal effort** in 2022 was mainly due to an acceleration on the revenue side – value-added tax revenue grew strongly, personal income tax revenue also returned to growth after the 2021 tax changes, and revenues from EU funds increased; expenditure growth was slower than revenue growth.

We expect the **structural balance to improve** to −1.6% of GDP **in 2023**. In the context of stagnating real GDP, we expect the negative cyclical component to open at −0.6% of GDP.

This year, we expect **one-off operations** of −1.3% of GDP, mostly in the energy sector. On the revenue side, the impact of the waiver of the renewable energy payments is expected to be CZK −18.4 billion and the reduction in the excise duty rate on diesel CZK −9.6 billion. Revenues, on the other hand, should be supported by a tax on windfall profits of banks and energy companies of CZK 28.0 billion and a continued levy on excess revenues of CZK 11.1 billion. On the expenditure side, we expect an impact on subsidies specifically related to the capping of electricity and gas prices for households, enterprises and state institutions CZK −40.2 billion. The impact of subsidies to the state transmission system operator could reach CZK −22.7 billion and to energy distributors CZK −15.4 billion. The impact of subsidies provided by the government to customers in the heating sector should be CZK −17.0 billion. The one-off child allowance from 2022 should still have an impact of CZK −1.1 billion this year. Humanitarian benefits for refugees are expected to have an impact of CZK −7.8 billion.

In 2023, we expect a continuation of positive **fiscal effort**. On the revenue side, corporate income tax revenue (even after adjusting for the impact of windfall profits tax) and property income (dividends from CEZ) should grow significantly, and the growth of investment subsidies from the EU should accelerate. Expenditure growth will be largely one-off in nature.

The recovery in economic growth should lead to a gradual reduction in the negative cyclical component in **2024–2026**. The **structural balance** should **gradually improve** to −2.2% of GDP after a temporary deterioration in 2024, mainly due to a return of property income to normal levels and higher defence spending. The positive fiscal effort in the outlook years will be mainly supported by expenditure, which is expected to grow more moderately than in 2022 and 2023, and at a slower pace than future revenues. We expect one-off operations to be negligible.

The view on fiscal effort and the structural balance in the period 2024–2026 is complemented by the **expenditure rule of the Stability and Growth Pact**, according to which growth in adjusted real expenditure should be in line with average potential output growth (2.0% for the Czech Republic). The Czech Republic should comply with this rule over the entire outlook horizon in line with the trajectory of improvement of the structural balance.

3.4 General Government Debt, Strategy and Stability of State Debt

General government debt reached 44.1% of GDP at end-2022. The 2.1 pp year-on-year increase in debt is mainly due to the increase in state debt from 40.4% to 42.7% of GDP, which financed, inter alia, compensation to households and businesses, including other fiscal policy stimulus.

Between 2014 and 2019, there was a steady decline in the relative debt ratio. The reduction in the government debt-to-GDP ratio by a total of 14.4 pp to 30.0% of GDP in 2019 was almost identical to the entire increase after the Great Recession of 2009. The sharp deterioration in the state budget in 2020 and 2021 led to a 12 pp increase in general government debt. Nevertheless, the Czech government debt is still below the 60% of GDP threshold of the Stability and Growth Pact, as well as complying the debt quota level set by the Act on Fiscal Responsibility Rules as the so-called “debt brake rule” (55% of GDP net of the cash reserve for financing state debt).

We expect the debt ratio to continue to rise slightly over the outlook horizon, as the absolute size of public deficits will remain relatively significant. We forecast the general government debt to decrease 43.5% of GDP in 2023, and to reach 44.0% of GDP at the end of 2024. The debt is affected in both years by the repayment of loan of the CEZ Group. In 2026, general government debt is expected to reach 45.0% of GDP.

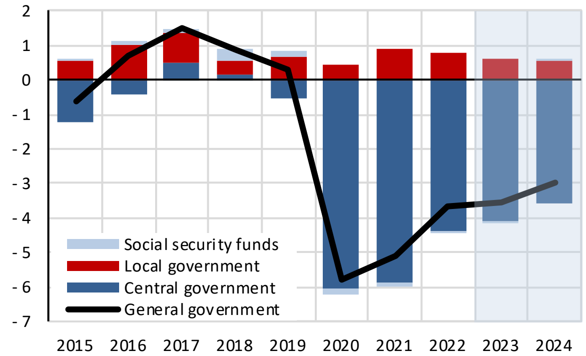
In terms of contributions to the change in debt, the dominant factor is the primary balance. Interest is projected to rise to 1.3% of GDP in relative terms between 2023 and 2024 and to remain at this level until almost the end of the outlook. In 2026, it should then rise further to 1.4% of GDP, although the forecast foresees a gradual decline in government bond yields. The long-term interest rate for convergence purposes should fall from the current 4.6% p.a. to 2.8% p.a. in 2026.

In 2020, the level of debt is also negatively affected by a decline in GDP at current prices, which has previously only happened in 2009 in the entire available series. From 2021 onwards, nominal GDP growth started to put the brakes on the increase in the debt quota again, and this should continue to be the case over the entire CP horizon. The 11.2% increase in GDP at current prices contributed to a relatively modest increase in the debt quota last year. We expect double-digit growth in nominal GDP in 2023 as well, while the rate of change should weaken in subsequent years due to a significant reduction in GDP deflator growth.

The current forecast does not foresee any significant privatisation revenues under Act No. 92/1991 Coll., on the Conditions of Transfer of State Property to Other Persons, as amended.

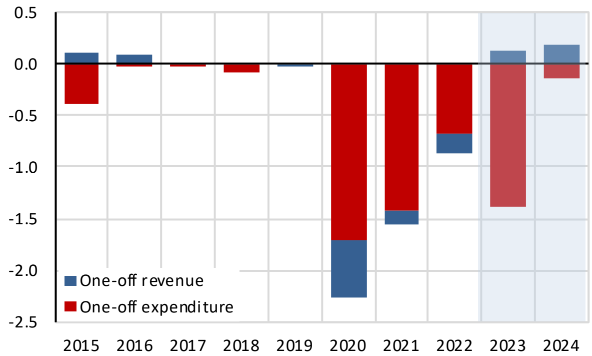
Central government accounts for the largest share of general government debt (Table 3.6). Their debt reached almost CZK 3,112 billion in 2022, accounting for about 97% of total (unconsolidated) general government debt. Local government debt accounted for the remaining 3%, reaching CZK 90.4 billion in 2022, and is projected to remain essentially flat at CZK 91 billion in subsequent years due to projected surpluses. The social security funds show a negligible level of indebtedness. Health insurance companies are broadly in surplus over the long term, except for recent years, when the deficit has been covered by balances from previous years.

Graph 3.1: Government Balance by Sub-sectors
in % of GDP



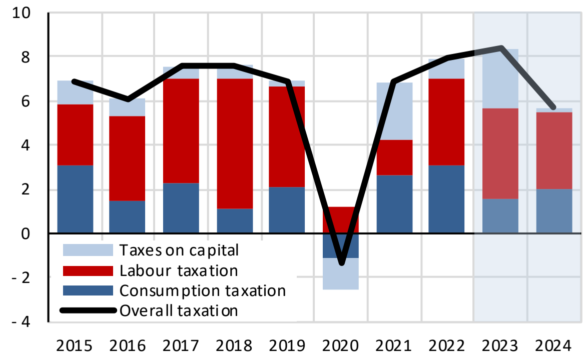
Source: CZSO (2023b). MF CR calculations and forecast.

Graph 3.2: One-off Measures
in % of GDP



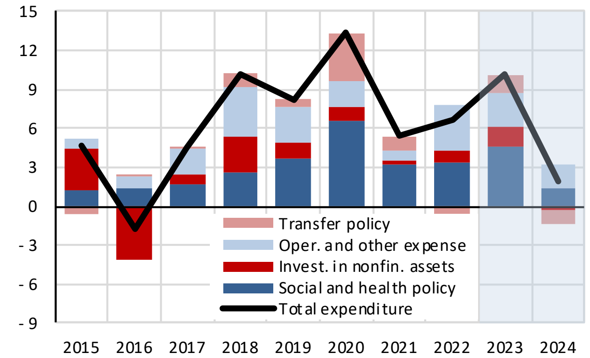
Source: CZSO (2023a), MF CR (2023a). MF CR calculations and forecast.

Graph 3.3: General Government Tax Revenue
change in %, contributions in percentage points



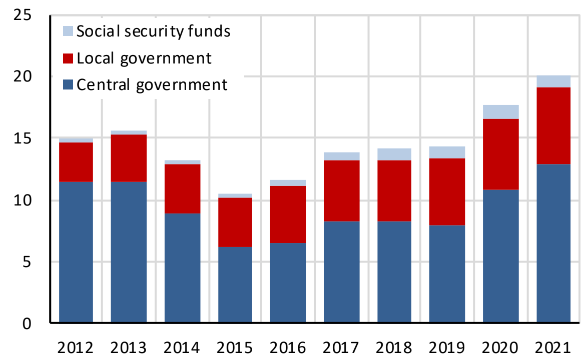
Source: CZSO (2023a, 2023b). MF CR calculations and forecast.

Graph 3.4: General Government Expenditure
change in %, contributions in percentage points



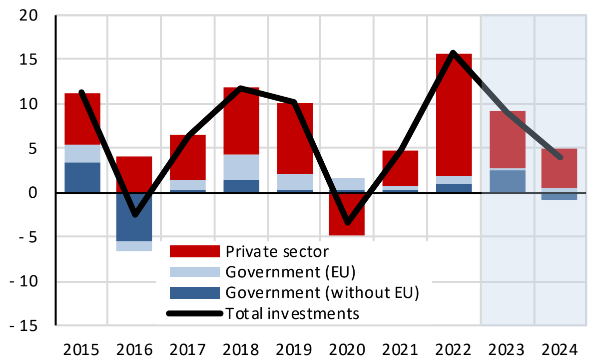
Source: CZSO (2023a, 2023b). MF CR calculations and forecast.

Graph 3.5: Liquid Financial Assets
in % of GDP, non-consolidated values



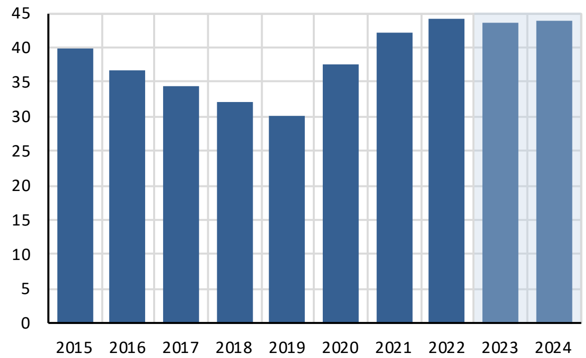
Source: CZSO (2023a, 2023b). MF CR calculations.

Graph 3.6: Investment Co-financing from EU Funds
nominal gross fixed capital formation change in %, contributions in pp



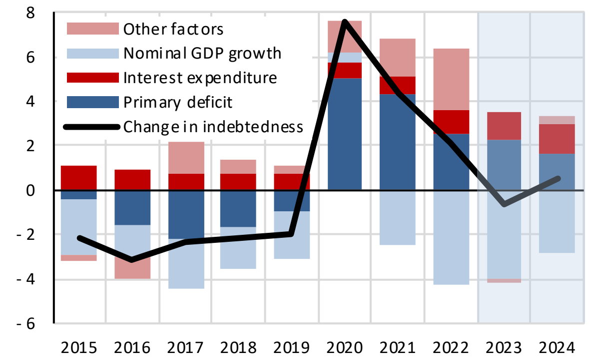
Source: CZSO (2023a), MF CR (2023a). MF CR calculations and forecast.

Graph 3.7: General Government Debt
in % of GDP



Source: CZSO (2023a, 2023b). MF CR calculations and forecast.

Graph 3.8: Changes in Debt-to-GDP Ratio
in percentage points



Source: CZSO (2023a, 2023b). MF CR calculations and forecast.

Table 3.1: General Government Budgetary Prospects

level in CZK billion, others in % of GDP

	ESA Code	2022	2022	2023	2024	2025	2026
		Level	*In % of GDP*				
Net lending (+)/borrowing (-) (B.9) by sub-sectors							
General government	S.13	**-247**	**-3.6**	**-3.5**	**-2.9**	**-2.4**	**-2.2**
Central government	S.1311	-298	-4.4	-4.1	-3.6	-3.1	-2.8
Local government	S.1313	53	0.8	0.6	0.6	0.6	0.6
Social security funds	S.1314	-2	0.0	-0.1	0.1	0.1	0.1
General government (S.13)							
Total revenue	TR	**2783**	**41.0**	**41.1**	**39.6**	**39.0**	**38.5**
Total expenditure	TE	**3030**	**44.6**	**44.7**	**42.6**	**41.4**	**40.6**
Net lending (+)/borrowing (-)	B.9	**-247**	**-3.6**	**-3.5**	**-2.9**	**-2.4**	**-2.2**
Interest expenditure	D.41	78	1.2	1.2	1.3	1.3	1.4
Primary balance		-169	-2.5	-2.3	-1.7	-1.2	-0.8
One-off and other temporary measures		**-59**	**-0.9**	**-1.3**	**0.0**	**0.0**	**0.0**
Components of revenues							
Total taxes		**1275**	**18.8**	**18.6**	**18.4**	**18.3**	**18.1**
Taxes on production and imports	D.2	771	11.3	10.8	10.8	10.8	10.8
Current taxes on income, wealth etc.	D.5	505	7.4	7.8	7.6	7.5	7.3
Capital taxes	D.91	0	0.0	0.0	0.0	0.0	0.0
Social security contributions	D.61	**1084**	**16.0**	**15.6**	**15.5**	**15.2**	**15.1**
Property income	D.4	**75**	**1.1**	**1.2**	**0.7**	**0.6**	**0.5**
Other		**348**	**5.1**	**5.7**	**5.1**	**4.9**	**4.7**
Total revenue	TR	**2783**	**41.0**	**41.1**	**39.6**	**39.0**	**38.5**
p. m.: Tax burden		**2360**	**34.7**	**34.2**	**33.8**	**33.6**	**33.3**
Components of expenditures							
Compensation of employees + Intermediate consumption	D.1+P.2	**1082**	**15.9**	**15.7**	**15.3**	**14.9**	**14.8**
Compensation of employees	D.1	690	10.2	9.9	9.7	9.5	9.3
Intermediate consumption	P.2	392	5.8	5.8	5.6	5.5	5.5
Social payments		**1167**	**17.2**	**17.5**	**16.9**	**16.4**	**16.0**
of which: Unemployment benefits [1)]		15	0.2	0.2	0.2	0.2	0.2
Social transfers in kind supplied via market producers	D.632	231	3.4	3.4	3.3	3.2	3.2
Social transfers other than in kind	D.62	936	13.8	14.1	13.6	13.2	12.8
Interest expenditure	D.41	**78**	**1.2**	**1.2**	**1.3**	**1.3**	**1.4**
Subsidies	D.3	**155**	**2.3**	**2.7**	**1.9**	**1.8**	**1.6**
Gross fixed capital formation	P.51g	**315**	**4.6**	**4.9**	**4.4**	**4.3**	**4.1**
Capital transfers	D.9	**49**	**0.7**	**0.5**	**0.6**	**0.6**	**0.6**
Other		**184**	**2.7**	**2.2**	**2.2**	**2.2**	**2.1**
Total expenditures	TE	**3030**	**44.6**	**44.7**	**42.6**	**41.4**	**40.6**
p. m.: Government consumption (nominal)	P.3	**1374**	**20.2**	**19.8**	**19.4**	**19.0**	**18.9**

1) Includes cash benefits (D.621 and D.624) and transfers in kind (D.631) related to unemployment benefits.
Source: CZSO (2023b). MF CR calculations and forecast.

Table 3.2: Amounts to Be Excluded from the Expenditure Benchmark

level in CZK billion, others in % of GDP

	2022	2022	2023	2024	2025	2026
	Level	*In % of GDP*				
Expenditure on EU programmes fully matched by EU funds revenue	**78**	**1.1**	**1.9**	**1.4**	**1.2**	**1.1**
Non-investment expenditure	18	0.3	0.5	0.3	0.3	0.3
Investment expenditure	60	0.9	1.4	1.1	0.9	0.8
Cyclical unemployment benefit expenditure	**-25**	**-0.4**	**0.0**	**0.0**	**0.0**	**0.0**
Effect of discretionary revenue measures (year-on-year changes)	**-20**	**-0.3**	**0.2**	**0.0**	**0.0**	**-0.2**
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 3.3: A Structure of Approved Discretionary Measures in 2022–2026

year-on-year discretional change, in CZK billion

	2022	2023	2024	2025	2026
Revenue Discretioanry Measures	**-19.8**	**13.4**	**1.4**	**-1.8**	**-13.9**
Taxation on labour	-9.2	-1.5	-0.4	-	-0.1
Taxation on capital	-10.5	28.0	-13.3	-1.8	-13.7
Taxation on consumption	-0.0	-12.9	15.1	0.3	-
Other revenue measures	-0.1	-0.2	-	-0.3	-0.1
Expenditure Discretionary Measures	**10.8**	**-65.4**	**115.4**	**-0.6**	**11.3**
Cash social benefits	-31.0	7.6	23.1	-0.6	-
Compensation of employees	3.1	-24.1	1.3	-	-
Health care	12.5	0.3	-	-	-
Subsidies	45.9	-69.6	70.5	-0.0	11.3
Capital transfers	4.0	14.0	0.2	-	-
Other expenditure measures	-23.6	6.3	20.3	-	-
Total	**-9.1**	**-52.0**	**116.8**	**-2.4**	**-2.6**
% of GDP	-0.1	-0.7	1.5	-0.0	-0.0

Source: MF CR calculations and forecast.

Table 3.4: Revenue and Expenditure Forecast and Outlook in No-policy-change Scenario

in % of GDP

	2022	2022	2023	2024	2025	2026
	Level	*In % of GDP*				
Total revenue at unchanged policies	**2783**	**41.0**	**40.9**	**39.7**	**39.0**	**38.6**
Total expenditure at unchanged policies	**3030**	**44.6**	**43.0**	**42.0**	**40.8**	**40.2**

Source: MF CR calculations and forecast.

Table 3.5: Cyclical Developments

change in %, output gap in % of potential product, contributions in percentage points, other in % of GDP

	ESA Code	2022	2023	2024	2025	2026
Real GDP growth (%)		**2.5**	**0.1**	**3.0**	**2.9**	**2.5**
Net lending of general government	B.9	**-3.6**	**-3.5**	**-2.9**	**-2.4**	**-2.2**
Interest expenditure	D.41	**1.2**	**1.2**	**1.3**	**1.3**	**1.4**
One-off and other temporary measures		**-0.9**	**-1.3**	**0.0**	**0.0**	**0.0**
on the revenue side		-0.2	0.1	0.2	0.2	0.0
on the expenditure side		0.7	1.4	0.1	0.1	0.0
Potential GDP growth (%)		**2.1**	**2.5**	**2.2**	**2.2**	**2.2**
contribution of labour		0.4	0.5	0.1	0.1	0.1
contribution of capital		0.7	0.7	0.7	0.6	0.6
total factor productivity		1.1	1.2	1.4	1.5	1.6
Output gap		**0.0**	**-1.8**	**-1.2**	**-0.4**	**-0.1**
Cyclical budgetary component		**0.0**	**-0.6**	**-0.4**	**-0.1**	**0.0**
Cyclically-adjusted balance		**-3.6**	**-2.9**	**-2.5**	**-2.3**	**-2.2**
Cyclically-adjusted primary balance		**-2.5**	**-1.7**	**-1.3**	**-1.0**	**-0.8**
Structural balance		**-2.8**	**-1.6**	**-2.6**	**-2.3**	**-2.2**

Source: CZSO (2023b). MF CR calculations and forecast.

Table 3.6: General Government Debt Developments

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

	ESA Code	2022	2023	2024	2025	2026
General government gross debt (consolidated)		**44.1**	**43.5**	**44.0**	**44.4**	**45.0**
Central government		45.7	44.9	45.5	46.2	46.9
Local government		1.3	1.2	1.2	1.1	1.0
Social security funds		0.0	0.0	0.0	0.0	0.0
Change in gross debt ratio		**2.1**	**-0.6**	**0.5**	**0.5**	**0.5**
Contributions to changes in gross debt						
Primary balance		**-2.5**	**-2.3**	**-1.7**	**-1.2**	**-0.8**
Interest expenditure	D.41	**-1.2**	**-1.2**	**-1.3**	**-1.3**	**-1.4**
Stock-flow adjustment		**2.7**	**-0.2**	**0.4**	**0.4**	**0.4**
Difference between cash and accruals		-1.0	0.4	0.2	0.2	0.0
Net accumulation of financial assets		3.8	0.1	0.4	0.2	0.0
Privatisation proceeds		0.0	0.0	0.0	0.0	0.0
Valuation effects and other		-0.1	0.0	0.0	0.0	0.0
p. m.: Implicit interest rate on debt		**-2.7**	**-2.8**	**-2.9**	**-2.9**	**-3.1**
Debt according to Act No. 23/2017 Coll., art. 13 [1]		44.1	43.5	44.0	44.4	45.0
Liquid financial assets [2]		18.2	16.7	16.0	15.5	14.8
Net financial debt [3]		25.9	26.8	27.9	29.0	30.2

1) Difference between gross debt and liquid financial assets (monetary gold, Special Drawing Rights, currency and deposits, market value of securities other than shares, shares and other equity quoted in stock exchange) according to Act No. 218/2000 Coll.
2) Liquid financial assets are defined as monetary gold, Special Drawing Rights, currency and deposits, securities other than shares (consolidated at market value), shares and other equity quoted in stock exchange.
3) Net financial debt is the difference between gross debt and liquid financial assets.
Source: CZSO (2023b). Calculations and forecast of MF CR.

Table 3.7: The State Debt's Refinancing, Interest and Foreign Currency Exposition

in % of debt, average maturity in years, data in the national methodology

		2022	2023	2024	2025	2026
Refinancing						
Average maturity	*years*	**6.2**	**6.4**	**6.5**	**6.5**	**6.5**
Debt due within 1 year	*% of debt*	**12.1**	**8.8**	**10.5**	**10.5**	**9.7**
Debt amortization (existing bonds) since the end of the previous year	*% of GDP*	**3.1**	**2.7**	**2.3**	**3.1**	**3.0**
State Debt's Interest						
Debt with interest fixation within 1 year	*% of debt*	**23.2**	**20.1**	**21.8**	**21.8**	**17.9**
Fixed interest long-term debt due within 1 year	*% of debt*	3.9	4.8	7.4	7.4	3.7
Variable interest long-term debt	*% of debt*	14.4	12.2	11.5	11.8	11.8
Monetary instruments	*% of debt*	5.1	3.1	2.8	2.6	2.5
Effect of derivative operations	*% of debt*	-0.2	0.0	0.0	0.0	0.0
Foreign Currency Exposition						
Foreign-currency exposition of the state debt [1]	*% of debt*	**5.8**	**5.2**	**4.8**	**4.4**	**4.2**
EUR exposition	*% of debt*	5.2	4.7	4.3	4.0	3.7

1) State debt denominated in foreign currencies adjusted for collateral and assets.
Source: MF CR.

4 Comparison with the Previous Convergence Programme, Risks of Forecast and Sensitivity Analysis

Comparisons between this year's and last year's CP are focused on evaluating the 2022 forecast and the change in forecast for 2023. However, as in previous years during the epidemic, comparisons are highly problematic. The energy crisis has gradually necessitated a number of measures on the national and international scene that could not have been anticipated last April. The following years can be viewed in a similar way, which, moreover, are influenced by differences between forecasts and reality.

Sensitivity analyses of macroeconomic and fiscal forecasts, including their outlook, are carried out on the basis of changes in selected assumptions. The first scenario considers lower economic growth in the EU and its impact on the highly open Czech economy. Another scenario assesses the sensitivity to a possible sudden increase in interest rates.

4.1 Comparison with the Scenario of the Previous Convergence Programme of the Czech Republic

4.1.1 Macroeconomic Scenario

The macroeconomic scenario of last year's CP, drawn up shortly after the start of Russia's military aggression against Ukraine, was based on the assumption that the conflict would end during 2022 and that economic sanctions against the Russian Federation would not disrupt oil and gas supplies to Europe. Although the assumptions did not materialise, economic growth was stronger last year compared to the CP 2022 scenario (see Section 2.2.1). On the other hand, expectations for 2023 have deteriorated significantly – while last year's CP foresaw real GDP growth of 3.6%, the CP 2023 scenario works with an increase in economic output of only 0.1%. There are also large differences in the structure of growth in both years, for all expenditure components except government consumption.

The expected price trajectory also differs from the previous CP (see Section 2.2.3). The CP 2022 scenario assumed that annual inflation would peak at slightly above 12% in mid-2022 and then decline relatively quickly, with inflation expected to be close to 2% by the end of 2023. However, inflation slightly exceeded 19% at the beginning of this year and, according to CP 2023, it should return to the tolerance band around the CNB's inflation target only in 2024.

Employment and unemployment (see Section 2.2.4) evolved more or less in line with the previous CP scenario in 2022, but wage dynamics were noticeably affected by high inflation. Although we expect nominal earnings growth to be stronger over the entire horizon of the CP 2023 than in the CP 2022, the level of real earnings is lower due to faster price growth.

4.1.2 Fiscal Scenario

Last year's CP projected a 5.6% growth in tax revenues, including social security contributions, for 2022 (see Section 3.1.1). Personal income tax and social security contributions performed better, reflecting stronger wage and salary growth of more than 3 pp. Corporate income tax also grew faster by 1 pp. This is again related to the macroeconomic base, with gross operating surplus growing faster by around 3.5 pp. The value added tax was supported by higher nominal household consumption due to higher inflation. Of the non-tax revenues, property and sales revenues ended up higher.

By contrast, actual spending in 2022 widened the public deficit more than projected. The CP 2022 predicted a 4.8% change in expenditure, while the actual figure was 6.7% (see Section 3.1.1). General government consumption increased by 0.4 pp more compared to last year's forecast. In terms of its composition, the higher growth in compensation of employees (due to the increase in wages and salaries with effect from September, which was not known in April) offset the lower growth in intermediate consumption. Total public investment grew by 9.5%, which is also relatively close to the forecast (10%) in last year's CP. However, the most pronounced differences were in social benefits, where two, instead of one, extraordinary pension indexations during 2022 took place, leading to a 2 pp higher pace of benefits than was estimated. Interest costs grew significantly faster (almost twice as fast) due to higher-than-expected government bond yields. While subsidies were relatively close to the forecasted year-on-year decline, capital transfers, instead of increasing by 37%, fell by around 11%. The primary reason for this is the failure to capture the originally contemplated expenditure of the Financial Market Guarantee System in connection with the closure of Sberbank CZ, a.s. due to the high probability of recovery of funds.

In contrast to the previous forecast, this year's CP predicts stagnation in real GDP for 2023. On the other hand, we expect higher growth in the GDP deflator. Nominal GDP growth should thus be more than 2 pp higher than predicted last year (see Section 2.2.1). Moreover, there are significant differences in the amount of discretionary measures taken into account. On the revenue side, taxes and social contributions were forecast to grow by 6.8% last year, while the CP 2023 works with a 1.6 pp. higher growth rate. The main determinant is one-off tax revenues related to extraordinary gains (see Section 3.1.2).

For expenditure, growth in the CP 2022 was forecast at 3.5% for 2023, while we expect growth of around 10% this year (Section 3.1.2). Also in this case, the impact of additional expenditure related to the energy crisis is decisive.

4.2 Risks of Macroeconomic and Fiscal Forecast

4.2.1 Risks of Macroeconomic Forecast

The macroeconomic framework of the Convergence Programme is burdened by a number of risks that, taken together, we consider to be **skewed to the downside**.

Natural gas supplies from Russia to the EU are severely restricted and we do not expect them to resume. We anticipate that this shortfall will be replaced by increased gas imports from other countries (including liquefied natural gas). At the same time, demand for natural gas is expected to decline as a result of continued high prices, additional energy savings and a shift to alternative technologies. We see the failure to meet these assumptions, especially in the medium term, as the main downside risk to the forecast.

In the forecast, we also work under the assumption that the next likely waves of the **covid-19** pandemic can be managed without the need to adopt macroeconomically significant counter-epidemic restrictions. However, developments in China are a significant risk, as is the emergence and spread of new coronavirus variants, against which available vaccines or experienced disease would provide little protection.

The **failure of** several **banks** in the United States and the troubles of Credit Suisse have increased volatility in the financial markets. Although these events pose a risk, especially if confidence in the stability of the banking sector were to erode further, we do not foresee a significant impact on the real economy, either in the US or in Europe.

However, a significant risk to the Czech economy is the further development of inflation and **inflation expectations**. It is crucial that inflation expectations return to close to the CNB's inflation target. Otherwise, a return of inflation to 2% would require even tighter monetary policy, which would entail additional economic costs. The structure and intensity of **fiscal consolidation**, which is complicated by the impact of the Russian aggression in Ukraine, high inflation and the need to ensure energy sufficiency, will also be crucial.

Available data suggest that the imbalances that characterised the **labour market** before the pandemic are still present. Staff shortages are evident in almost all sectors of the economy and represent a significant barrier to production growth, particularly in the construction sector. However, in addition to the weak economic dynamics, the influx of refugees from Ukraine is also contributing to the easing of the mismatch between demand and supply in the labour market and the associated upward pressure on wages.

In the medium and long term, given demographic developments, it will be crucial to make the **integration of refugees** from Ukraine as successful as possible and to increase **labour productivity**, for example by investing in automation, robotization and digital technologies. Given the high involvement of Czech firms in global supply chains, a strong impetus for productivity growth would also be their shift to higher value-added positions (either towards the initial R&D phase or towards the phase of selling the final product).

The gross savings rate of households, as well as the level of net lending/borrowing, has remained elevated since the outbreak of the pandemic. These "extra savings" could now be used by some households to **cushion the impact of high consumer price growth on real consumption**.

A rise in interest rates and a substantial increase in prices could cause some households and firms to run into repayment problems, leading to a deterioration in the quality of banks' loan portfolios. For the time being, however, the share of non-performing loans in total loans to households and non-financial corporations has continued to decline slowly. **Overvaluation of residential property prices** also remains a risk.

Given the importance of **the automotive industry** for the Czech economy, the strong pro-cyclicality of this sector, its export orientation and dependence on supply chains is a risk. The risks in the automotive industry are further exacerbated by structural changes due to the gradual tightening of emission standards and the transition to electromobility. This will require huge investments in the development of technology, machinery and equipment or infrastructure. An impact on employment or supplier-customer relations can also be expected.

4.2.2 Risks of Fiscal Forecast

The fiscal forecast then assumes these macroeconomic risks, both through the effects on the revenue side and in the case of some expenditure items. On the revenue side, the realisation of most macroeconomic risks would be reflected in a reduction in government revenue. Higher inflation would have the opposite effect.

A significant risk to the fiscal forecast is the further development of **electricity and gas prices**. These will affect both the revenue and expenditure side. On the revenue side, the government has introduced two temporary tax measures targeting windfall gains, mainly in the energy sector. Declining prices should therefore lead to lower revenues in this respect. On the other hand, lower energy prices should imply a reduction in expenditure related to compensating traders for losses due to the price caps. The current energy price situation represents a rather positive scenario.

Higher inflation would lead to the need for higher **indexation of pensions** and probably also some other **social benefits**. This would increase state budget spending and could lead to further adjustments in the social area. At the same time, the volume of **cash and in-kind social benefits for households at risk of poverty** would continue to rise.

In the area of **gross fixed capital formation,** the dynamics will depend on the further development of the use of the Recovery and Resilience Facility, as well as on the start of the new financial perspective 2021–2027.

The overall impact of the materialisation of these risks on public finances is thus rather negative. Although the situation in the area of energy prices (with a strong spillover into headline inflation) has so far developed in a positive direction, adverse scenarios in the area of pensions represent a relatively costly risk per se. If they were to materialise, they would require a rather massive retrenchment, which could also affect investment and thus have a negative impact on both current and long-term economic growth. Without corresponding austerity measures or changes in revenues, the balance would otherwise deteriorate, including an even stronger increase in **debt service**.

Compared to the baseline scenario of the CP, however, the upcoming **consolidation of public finances** is of course a positive risk. Its scope is to amount to at least CZK 70 billion. This would lead to a faster decline in general government deficits and a revision of the current indebtedness trend.

4.2.3 Alternative Scenario

A positive risk to the general government balance in the Czech Republic is the level and structure of public finance consolidation. Its intensity and composition will also affect the macroeconomic framework of the CP, and through second-round effects, the final budgetary impact of individual measures.

The form of consolidation is currently under discussion, which is why it is not part of the baseline scenario of the CP forecast. The structure of consolidation should affect both the expenditure and revenue sides of public budgets with the aim of reducing the state budget deficit by at least CZK 70 billion. The package of measures is primarily aimed at 2024.

The alternative CP scenario therefore contains an illustration of the impact of consolidation on public budgets. The starting point is a fiscal effort of 1 pp. We assume that there would be a partial widening of the negative output gap and therefore not a full pass-through of the consolidation package to the overall balance. The effects of the business cycle will affect tax revenues and social security contributions as well as some social spending.

Consolidation would lead to an improvement in the general government balance to 2.1% of GDP, with deficits falling to 1.4% of GDP over the CP horizon due to adequately changed base. Lower deficits would also have a positive impact on general government debt, which would not grow but would very likely continue to fall to between 42% and 43% of GDP.

However, the estimate of the general government balance and debt has to be taken as a mean value, with a relatively large standard deviation risk. Risks and uncertainties will need to be taken into account when setting expenditure frameworks for the coming years.

4.3 Sensitivity Analysis

The sensitivity analysis is calculated using a dynamic stochastic general equilibrium model developed by the MF CR. The alternative scenarios focus on certain issues of possible future developments. The first scenario considers lower economic growth in the EU and its impact on the highly open Czech economy, which is dependent on the external environment. The second alternative scenario assesses a possible sudden increase in interest rates. Both alternative scenarios are derived from the baseline scenario of the Convergence Programme. In the alternative scenarios, we assume different developments from the baseline scenario in the first half of 2024.

4.3.1 Lower GDP Growth in the EU in 2024

Economic developments in EU trading partners are important for the economic growth of the small open economy of the Czech Republic. The first scenario assumes **slower GDP growth in the EU in 2024** by 2.6 pp, which corresponds to the standard deviation over the period 2002–2022.

Initially, a reduction in foreign demand for domestic products would be reflected in a drop in net exports. However, the subsequent pressure on currency depreciation would dampen the negative effects on net exports through more expensive imports. A worse outcome for foreign trade would be reflected in a slowdown in real GDP growth in the Czech Republic by 0.7 pp in 2024 compared to the baseline scenario. Lower growth in corporate profits due to weaker exports would slow investment by 0.5 pp. A negative income effect in the form of relatively lower growth of wages and returns on capital would slow down household consumption by 0.3 pp.

The impact on the general government balance is negative by 0.2 pp in the first year of the outlook, with a maximum differential of 0.1 pp in subsequent years. The lower economic performance has an impact on taxes and social security contributions on the revenue side, while on the expenditure side it leads mainly to an increase in spending on unemployment benefits. In the projection years, the effect of lower inflation on the indexation of pension benefits is slightly positive. Debt would then increase by 0.2 pp more in 2023 than in the baseline scenario and then the differential would increase to 0.4 pp by the end of the projection. In addition to a higher deficit, this would reflect a lower level of nominal GDP over the entire horizon.

4.3.2 Rise in the National Interest Rate

The dynamic model in the second scenario simulates an **additional monetary policy tightening** for 2024 of 1.1 pp above the baseline scenario. This value corresponds to the standard deviation of short-term interest rates between 2002 and 2022.

A more restrictive monetary policy would have a negative effect on economic development. Pressure on the appreciation of the Czech currency would increase price of exports, while imported goods would become relatively cheaper. However, a slight slowdown in exports by 0.3 pp would put downward pressure on imports, given the high import intensity of exports. Lower income and a fall in profits of business entities would have a similar effect. As a result, import growth would be slightly lower than in the baseline scenario.

Lower household incomes due to slower wage growth would also affect consumption adversely. In addition, a higher interest rate would motivate households to save and thus postpone consumption for the future. Restrictive monetary policy would thus result in a deepening of the decline in household consumption by 0.2 pp.

Firms' profitability would fall as a result of the decline in foreign as well as domestic demand. Firms would react to the fall in profits and the rise in the cost of credit by slowing investment by 0.2 pp.

Given the negative impact of the higher interest rate on investment, consumption and exports, the resulting impact on GDP growth would also be negative by 0.3 pp.

The impact on public finances in this scenario is relatively small. The effects on revenue and expenditure almost offset each other, with the most important expenditure items, i.e. social expenditure, rising less due to lower inflation and real wage dynamics. As a result, the general government debt ratio at the end of the projection horizon differs from the baseline scenario by only 0.2 pp.

4.4 Verification of the Macroeconomic Scenario by the Committee on Budgetary Forecasts

In accordance with Act No. 23/2017 Coll., on 18 April 2023, the macroeconomic scenario and the general government revenue forecast were assessed by the Committee on Budgetary Forecasts in terms of probability of their materialisation. The Committee assessed both the macroeconomic and revenue forecasts as realistic (CBF, 2023a, 2023b).

Table 4.1: Change in the Indicators of the Scenario

		April 2022 CP				April 2023 CP			
		2022	2023	2024	2025	2022	2023	2024	2025
External Assumptions									
Real GDP in EU	*change in %*	**2.5**	**3.1**	**2.8**	**1.7**	**3.6**	**0.7**	**1.5**	**1.5**
Prices of oil (Brent)	*USD/barrel*	**104.8**	**91.3**	**83.5**	**78.8**	**101.0**	**77.0**	**72.9**	**70.7**
Exchange rate USD/EUR	*USD/EUR*	**1.11**	**1.10**	**1.10**	**1.10**	**1.05**	**1.08**	**1.10**	**1.11**
Exchange rate CZK/EUR	*CZK/EUR*	**24.4**	**24.2**	**24.1**	**24.0**	**24.6**	**23.8**	**23.8**	**23.7**
Real Values									
GDP	*change in %*	**1.2**	**3.6**	**3.2**	**2.4**	**2.5**	**0.1**	**3.0**	**2.9**
Households consumption	*change in %*	0.5	4.5	4.0	3.5	-0.9	-2.7	3.9	4.0
Government consumption	*change in %*	1.0	1.0	1.1	1.6	0.6	1.6	1.3	1.6
Gross fixed capital formation	*change in %*	2.2	5.9	0.1	0.2	6.2	2.8	0.5	2.2
Contribution of final domestic demand	*p.p.*	1.0	3.9	2.2	2.0	1.3	-0.1	2.2	2.7
Contribution of foreign trade	*p.p.*	0.1	0.2	1.3	0.9	0.2	0.8	1.4	1.0
Output gap	*%*	**-1.8**	**-0.5**	**-0.1**	**-0.1**	**0.0**	**-1.8**	**-1.2**	**-0.4**
Others									
Nominal GDP	*CZK bn.*	**6618**	**7135**	**7550**	**7904**	**6795**	**7475**	**7989**	**8451**
Harmonised index of consumer prices	*change in %*	**11.3**	**4.2**	**2.0**	**2.0**	**14.8**	**12.2**	**2.6**	**2.2**
Employment	*change in %*	**2.1**	**1.3**	**0.2**	**0.1**	**1.7**	**-0.4**	**0.5**	**0.2**
Unemployment rate	*%*	**2.5**	**2.6**	**2.4**	**2.3**	**2.3**	**3.0**	**2.8**	**2.7**
Wages and salaries	*change in %*	**6.0**	**6.2**	**3.9**	**4.0**	**9.1**	**7.5**	**5.8**	**4.4**
General Government									
Revenue	*% of GDP*	**40.4**	**40.0**	**38.5**	**37.6**	**41.0**	**41.1**	**39.6**	**39.0**
Value-added tax	*change in %*	12.2	8.8	4.4	4.4	15.8	8.1	5.5	5.9
Excise taxes	*change in %*	4.2	5.2	0.2	0.6	-1.8	0.8	6.3	0.3
Personal income tax	*change in %*	-0.2	6.2	4.2	4.0	6.4	6.9	5.8	3.9
Corporate income tax	*change in %*	9.0	10.8	7.0	4.8	9.8	25.2	1.2	5.6
Social security contributions	*change in %*	4.4	5.3	3.2	3.4	7.0	7.4	6.2	4.0
Expenditure	*% of GDP*	**45.0**	**43.2**	**41.4**	**40.3**	**44.6**	**44.7**	**42.6**	**41.4**
Compensation of employees	*change in %*	0.5	3.2	3.0	3.5	2.0	7.1	4.5	3.5
Intermediate consumption	*change in %*	11.7	5.0	3.0	3.0	10.6	10.0	3.5	4.0
Social transfers in kind	*change in %*	2.1	2.2	2.3	2.3	5.3	8.7	5.5	3.0
Social benefits other than in kind	*change in %*	7.0	7.0	3.4	1.8	9.0	12.5	3.2	2.3
Gross fixed capital formation	*change in %*	10.0	10.4	-13.3	-6.2	9.5	15.8	-2.7	1.9
General government balance	*% of GDP*	**-4.5**	**-3.2**	**-2.9**	**-2.7**	**-3.6**	**-3.5**	**-2.9**	**-2.4**
Structural balance	*% of GDP*	**-3.1**	**-3.1**	**-2.9**	**-2.7**	**-2.8**	**-1.6**	**-2.6**	**-2.3**
General government debt	*% of GDP*	**42.7**	**43.4**	**44.4**	**45.4**	**44.1**	**43.5**	**44.0**	**44.4**

Source: CNB (2023a), CZSO (2023a), EIA (2023), Eurostat (2023), MF CR (2022a).

Table 4.2: Alternative Scenario of the Fiscal Forecast
in % of GDP

	2022	2023	2024	2025	2026
Revenue forecast of the Convergence Programme	41.0	41.1	39.6	39.0	38.5
Alternative revenue forecast	41.0	41.1	39.4	38.7	38.2
Expenditure forecast of the Convergence Programme	44.6	44.7	42.6	41.4	40.6
Alternative expenditure forecast	44.6	44.7	41.4	40.2	39.5
Balance forecast of the Convergence Programme	-3.6	-3.5	-2.9	-2.4	-2.2
Alternative balance forecast	-3.6	-3.5	-2.1	-1.6	-1.4
Debt forecast of the Convergence Programme	44.1	43.5	44.0	44.4	45.0
Alternative debt forecast	44.1	43.5	43.1	42.7	42.5

Source: CZSO (2023b). MF CR calculations and forecast.

Table 4.3: Basic Macroeconomic Indicators – Sensitivity Scenarios

		2023	2024	2025	2026
Baseline Scenario					
Gross domestic product	*Y-o-Y in %*	**0.1**	**3.0**	**2.9**	**2.5**
Private consumption	*Y-o-Y in %*	-2.7	3.9	4.0	3.0
Gross fixed capital formation	*Y-o-Y in %*	2.8	0.5	2.2	2.4
Exports of goods and services	*Y-o-Y in %*	4.1	4.7	3.2	2.9
Imports of goods and services	*Y-o-Y in %*	3.0	2.8	1.8	1.9
Harmonised index of consumer prices	*Y-o-Y in %*	**12.2**	**2.6**	**2.2**	**2.0**
Unemployment rate	*in %*	**3.0**	**2.8**	**2.7**	**2.7**
General government balance	*% of GDP*	**-3.5**	**-2.9**	**-2.4**	**-2.2**
Gross government debt	*% of GDP*	**43.5**	**44.0**	**44.4**	**45.0**
Alternative Scenario I - Lower GDP Growth in EU in 2024					
Gross domestic product	*Y-o-Y in %*	**0.1**	**2.3**	**3.0**	**2.5**
Private consumption	*Y-o-Y in %*	-2.7	3.6	3.8	3.0
Gross fixed capital formation	*Y-o-Y in %*	2.8	0.0	1.9	2.4
Exports of goods and services	*Y-o-Y in %*	4.1	3.1	3.0	2.9
Imports of goods and services	*Y-o-Y in %*	3.0	1.6	1.5	1.8
Harmonised index of consumer prices	*Y-o-Y in %*	**12.2**	**2.6**	**2.2**	**2.0**
Unemployment rate	*in %*	**3.0**	**3.3**	**2.7**	**2.7**
General government balance	*% of GDP*	**-3.5**	**-3.1**	**-2.5**	**-2.2**
Gross government debt	*% of GDP*	**43.5**	**44.2**	**44.7**	**45.4**
Alternative Scenario II - Higher Interest Rates					
Gross domestic product	*Y-o-Y in %*	**0.1**	**2.7**	**2.8**	**2.5**
Private consumption	*Y-o-Y in %*	-2.7	3.7	3.9	3.0
Gross fixed capital formation	*Y-o-Y in %*	2.8	0.3	2.3	2.5
Exports of goods and services	*Y-o-Y in %*	4.1	4.4	3.0	2.8
Imports of goods and services	*Y-o-Y in %*	3.0	2.7	1.8	1.9
Harmonised index of consumer prices	*Y-o-Y in %*	**12.2**	**2.3**	**2.1**	**2.0**
Unemployment rate	*in %*	**3.0**	**3.1**	**2.7**	**2.7**
General government balance	*% of GDP*	**-3.5**	**-3.0**	**-2.5**	**-2.2**
Gross government debt	*% of GDP*	**43.5**	**44.1**	**44.6**	**45.2**

Note: Different values in the text and in the table are caused by the rounding of values to one decimal place.
Source: CZSO (2023a), EIA (2023), Eurostat (2023), MF CR calculations and forecast.

5 Sustainability of Public Finance

The public finances of the Czech Republic are presently rated as medium-risk in terms of long-term sustainability. Far most important factor is the expected demographic developments, which are likely to significantly increase the ratio of pensioners to the persons of working age over the next few decades. However, the process of population ageing is not a matter for the distant future, but is already evident today. This is putting pressure on public finances and thus creating a need to reform social systems. The Policy Statement of the Government explicitly mentions the end of 2023 as the deadline for presenting a comprehensive pension reform. However, the phenomenon of population ageing affects not only old-age pensions but also other parts of public finances such as health, long-term care and education.

5.1 Government Strategy and Implemented Reforms

5.1.1 Current State of the Public Pension System

The pay-as-you-go pension insurance system, regulated by Act No.155/1995 Coll., has undergone many changes since its entry into force, mainly concerning the retirement age, the calculation of pensions and the method or amount of indexation. The system for calculating pensions is based on the individual's previous earnings, but adjusts them by means of reduction thresholds. The amount of income relevant for the calculation of pensions is included in full up to 44% of the average wage and only 26% above that level up to 400% of the average wage. Earnings above 400% of the average wage do not affect the assessment base for the calculation of pensions, which is fully in line with the social insurance contribution cap of the same level.

The latest adjustment of the pension system in terms of the retirement age applies with effect from 1 January 2018 (Act No. 203/2017 Coll.). The retirement age for both men and women increases until it is unified at 65 after 2030. The Ministry of Labour and Social Affairs is also required by law to submit a report on the pension system to the government at five-year intervals (the first report was considered by the last government in September 2019). The aim of the reports is to assess the current retirement age and, if necessary, propose adjustments to the retirement age so that insured persons can spend on average a quarter of their lives in retirement. In addition, the changes to the retirement age setting do not affect people who are over 55 at the time of the revision. However, the revision mechanism does not oblige the Government, but only recommends to submit the change in the retirement age to Czech Parliament for approval. The Government took advantage of this arrangement and decided not to change the current setting of retirement age for the time being. The statutory retirement age also affects the conditions of pertaining permanent widow's and widower's pensions, where the age limit is linked to old-age pensions. For early retirement pensions, the threshold is gradually shifting from three to five years before the statutory retirement age. This maximum period of five years can be used, at the cost of significant penalties, by persons whose statutory age limit is 65 or over.

With effect from 1 January 2023, two changes have been made to the amount of pensions and the retirement age by Act No. 323/2021 Coll. The first change concerns the adjustment of the earnings-related part of pension benefit depending on the number of children raised. For each such child, an amount of CZK 500 is added to the pension of one of the parents, which will be further indexed according to the rules in force. The second change is that the early retirement pension for Integrated Rescue System workers will not be reduced if the insured has worked in the system for at least 20 years.

In the area of early retirement pensions, there are generally several penalty rates that progressively reduce the resulting benefit throughout the period over which the pension is paid out. A reduction of 0.9% applies to the basis of calculation up to 360 days before the statutory retirement age, 1.2% for the period from the 361st to the 720th day before the statutory retirement age and finally 1.5% for periods beyond 720 days (up to the limit permitted by law). The earnings-related part of the old-age pension benefit is then reduced by these amounts for every, at least commenced, 90 days.

In addition, there is a system of pre-retirement scheme that allows participants in supplementary pension savings (Pillar III) to draw their funds without penalty up to 5 years before reaching the statutory retirement age. However, a condition for pre-retirement is the amount of accumulated funds in the private Pillar III, which should ensure a monthly pension of at least 30% of the average wage. The old-age pension benefit is not reduced for the years in which the pre-retirement pension is taken. As of the end of 2022, only 5,335 persons with an average benefit of CZK 13,318 took advantage of the pre-retirement scheme. The number of people receiving the pre-retirement pension thus increased year-on-year by 1,028 people.

There are three groups of disability pensions in the Czech Republic, divided according to the degree of disability. A person may be entitled to a disability pension if his/her working capacity is decreased by at least 35% as a result of a long-term adverse health condition. The first degree of disability applies to a decrease in working capacity of 35% to 49%, the second degree of 50% to 69% and the third degree of 70% and above.

The indexation of pensions paid from the pay-as-you-go system is determined by the sum of the growth of the consumer price index or the pensioners' cost-of-living index (whichever is higher) and one half of the real wage growth. The indexation is carried out once a year on 1 January, except where inflation has reached at least 5% since the end of the previous reference period. On the other hand, in the case of periods of low inflation and/or low real wage growth, there is the possibility for the government to adjust the amount of the indexation. If the increase in the average pension according to the standard indexation formula does not reach 2.7%, the Government is entitled to index pensions up to that level by regulation of the government. In addition, for persons over particular age, there is an increase in the earnings-related part of pension benefit by a stated amount (for persons aged 85 and over, by CZK 1,000 per month, and for persons aged 100 and over, by a further CZK 1,000).

The government has announced its intentions to strengthen the long-term sustainability of the pension system **through several parametric adjustments**. The government has set up an advisory team to discuss a number of these issues. Representatives of the parties of the governing coalition have declared that they are discussing issues related to the possible extension of the retirement age or proposals to modify the conditions for early retirement pensions.

5.1.2 Development in the Healthcare System

The cash balances of health insurance companies in bank accounts have averaged 0.6% of GDP over the last ten years, reaching a peak in 2020 (1.1% of GDP), before declining to 0.8% of GDP in the following year, primarily due to so-called compensatory decrees that took into account the impact of the coronavirus epidemic on the performance of the public health insurance system (e.g. they compensated increased expenditure of health care providers, determined an extraordinary bonus to medical staff for working during epidemic or included additional compensation for 2020 for segments where there was a higher drop in the volume of services provided), which has impact on the rise in expenditure in cash terms in 2021. In 2022, the impact of the pandemic on expenditure decreased significantly, but the resulting level of cash balances was negatively affected by high price increases and the influx of refugees from Ukraine. In spite of these factors, the level of cash balances increased to CZK 56.8 billion (0.8% of GDP). This year, given the projected deficit performance of the public health insurance system according to the health insurance plans, cash balances could decrease to CZK 49.3 billion (0.7% of GDP). In the following years, based on the medium-term outlook of the health insurance companies' performance, their further decrease is expected, both in absolute terms and as a proportion of GDP. The causes of the above-mentioned increases in healthcare expenditure are relatively short-term in nature; in the medium and long term, the main factors will be the ageing of the population, the gradual increase in high-cost healthcare services, the inclusion of new and very costly drugs in reimbursed care, the introduction of innovative treatments and the increase in the cost of medicines reimbursed to healthcare providers at specialised centres. It is thus clear that the public health insurance system will have to set a long-term lower dynamics of expenditure in relation to revenue, and also implement measures to increase efficiency and economy in health care spending. In addition, other measures will also have to be taken to address both the level of available resources of the public health insurance system and their structure.

Several measures contribute to improving the **efficiency of spending**. A large part of this is the long-term DRG Restart project. Under this project, the **CZ-DRG system** was developed and implemented across the board **in the acute inpatient care segment**, which will be used to classify hospital cases into approximately 1,800 DRG groups (hospital case classification system), which make up over 700 DRG bases in 2023. This year, then, there is a significant increase in the volume of cases reimbursed by lump sum case to 10.3% of the total number of hospital cases (only 0.4% in 2019). Conversely, there is a noticeable downward trend in the share of lump sum reimbursement (92.5% in 2019 to 51.4% in 2023). A gradual increase in the volume of care covered by the lump sum case is planned for the next few years in healthcare reimbursement, but this will need to take into account the heterogeneity of healthcare providers through cost modifiers linked to the structural characteristics of hospitals (particularly relevant for care provided by specialised centres). However, these compensations should only be partial, so that these providers are incentivised to make savings and increase efficiency in their health care expenditure. This year, the CZ-DRG system is also being reflected for the first time in the reimbursement of **day care**, where it is planned to significantly increase its share in the total volume of procedures in the coming years. Greater use of same-day care will lead to lower unit costs for surgical procedures, reduced need for staff, increased productivity in terms of more efficient use of hospital capacity, shorter waiting times and faster, more comfortable patient recovery at home.

Spending efficiency is also affected by the ongoing overall **digitalisation of the healthcare system**, which is expected to take place in several phases, with the final aim of streamlining the provision of healthcare services, their reimbursement and control in healthcare providing. The first phase was initiated with the approval of Act No. 325/2021 Coll., on the Electronicisation of Health Care, whereby the basic elements of a functional e-health system will be built between 2022 and 2026. Last year, core health registers (of health services, health workers and patients) were created, which are a source of unambiguous, real-time and correct data for the identification of subjects. Health care providers are to be required to use these core data from 2024. In parallel, an Integrated Data Interface has been created to ensure secure sharing of data and medical records and to maintain authorised communication between the entities involved in eHealth. According to the Act, the Ministry of Health will then issue the so-called eHealth Standards, which define the structure, content and format of data files and data messages, the interface for maintaining and transmitting health records in electronic form and their security, classification, nomenclature and terminology for their use. Health care providers will be obliged to comply with them from 2026. In the next phases of digitalisation, beyond the scope of this law, it is planned to introduce a medical documentation index as an information system describing the basic typology of existing medical documentation (only for exhaustively defined parts) and bringing together metadata about the documentation.

Box 1: Automatic Indexation Mechanism of State Insurance Payments for the State-Insured Persons

Financing of health care in the Czech Republic is primarily based on payments of contributions from compulsory health insurance by employees, employers and self-employed persons. Another important component of the public health insurance system's revenue is **payments from the state budget for the so-called state-insured persons** (in 2022, on average about 6.1 million persons, including mainly old-age pensioners, children, women on maternity or parental leave and the unemployed, for whom the state paid insurance contributions totalling CZK 129.4 billion) **in the amount of the product of the 13.5% contribution rate and the assessment base**. In most cases, the amount was set by law by the government on the basis of political agreements, or could be changed by regulation of the government by 30 June, with effect from 1 January of the following year. Accordingly, account was to be taken of the development of average wages, the possibilities of the State budget and the development of the financial balance of public health insurance system. The payment from the state budget thus determined is paid monthly by the MF CR to a special account of the public health insurance on the basis of the number of state-insured persons communicated by the health insurance companies. The total resources of the public health insurance system are subsequently redistributed from the special public health insurance account to the individual health insurance companies according to the number of insured persons, their gender, age structure and cost indices of the age groups of insured persons to finance the health care guaranteed by Act No.48/1997 Coll. However, this method of determining the assessment base was very non-transparent and made it difficult for health insurance companies to plan the total revenue and the related health care expenditure.

In accordance with the Policy Statement of the Government, **Act No.260/2022 Coll.** was thus approved, which **introduces an automatic indexation mechanism** for determining the amount of the assessment base for insurance contributions paid by the state for the state-insured persons, which the Government will publish by regulation of the government by 30 September of the calendar year preceding by one year the calendar year for which the assessment base is determined. The initial value of the assessment base is set by this act at CZK 14,074 for 2023, so under the new mechanism it will be adjusted for the first time for 2024 **by the sum of the growth of prices and one half of the real wages growth**, when

- **The price growth** is determined as the year-on-year percentage increase in the June base consumer price index (cost of living) for households in total as determined by the CZSO in the year preceding the calendar year in which the date of the increase in the assessment base falls. If consumer prices fall, a zero increase is assumed.
- **Real wage growth** shall be determined by a ratio whose numerator is the ratio of the general assessment base one year prior to the year of its determination to the general assessment base two years prior to the year of its determination. The denominator is then, with equal time lags, the share of the average annual consumer price index for total households calculated from the original base consumer price indices established by the CZSO. If the share for determining the growth in real wages is less than 1 in a given period, the growth in real wages is taken into account only for the increase in the assessment base at which this share is greater than 1.

Table 5.1: Estimated Insurance Payments per State-insured Person in 2024–2026

		2022 *Reality*	2023 *Reality*	2024 *Outlook*	2025 *Outlook*	2026 *Outlook*
Growth of the assessment base	*%*	0.0	7.5	10.0	2.3	2.2
Price factor	*%*	×	×	10.0	2.3	2.2
Wage factor	*%*	×	×	0.0	0.0	0.0
Assessment base	*CZK/month*	13 089	14 074	15 482	15 839	16 188
Insurance payment on 1 state-insured person	*CZK/month*	1 768	1 900	2 091	2 139	2 186
Total payment on state-insured persons	*CZK bn*	129.4	141.1	154.5	157.5	160.7
	% of GDP	1.9	1.9	1.9	1.9	1.8

Note: For the year 2022, the assessment base is a weighted average – in the period 1 January – 31 August the assessment base was CZK 14,570 (i.e. premium per 1 insured person CZK 1,967) and in the period 1 September – 31 December the assessment base was CZK 11,014 (i.e. premium per 1 insured person CZK 1,487).
Source: MF CR (2023a). MF CR calculations.

In order to strengthen the efficiency in the provision of health care, the **Clinical Recommended Procedures project** was also implemented in 2018–2022, which represents a binding methodological procedure based on which physicians proceed in solving a specific medical problem in the process of diagnosis and treatment, and which guarantees the use of effective diagnostic and therapeutic means, both in terms of medical and other health sciences and in terms of efficient use of public resources. Organisational and procedural clinically recommended procedures address the distribution of care, the sequence of health services consumed, and set the trajectory of patients in the system, interdisciplinary collaboration, define types of health care providers and set parameters for equipment or staffing. Narrowly focused procedures then describe the content of a particular activity or phase of treatment. The project has developed 41 clinically recommended procedures for areas with the greatest defined heterogeneity in health care providing, which should be reflected in the standardisation of care and, in combination with the CZ-DRG system, in the amount of reimbursement, thereby eliminating large cost differences in health cases between health care providers. According to the Policy Statement of the Government, it is planned to continue their development within the Agency for Health Research of the Czech Republic in the following years.

In the area of **health care financing resources**, several adjustments to the assessment base for contributions paid by the state for the state–insured persons were approved last year. With the approval of Act No. 260/2022 Coll., Regulation of the Government No. 253/2021 Coll., which increased the assessment base to CZK 14,570 as of 1 January 2022, was annulled with effect from 31 August 2022, while at the same time reducing it to CZK 11,014. The Act also increased this assessment base to CZK 14,074 with effect from 1 January 2023. The Act also introduced an **automatic indexation mechanism** for determining the assessment base on insurance contributions for state-insured persons. Starting in 2024, it will be adjusted by the sum of prices growth and one half of the real wages growth (see Box 1 for details). According to the Policy Statement of the Government, the government also plans to introduce **voluntary supplementary insurance** for care that is not reimbursed. This systemic change would diversify the resources of financing to some extent and its introduction is estimated to increase the revenue of the public health insurance system by up to 3–5%.

5.2 Fiscal Impacts of Population Ageing

The estimates of the impact of ageing are based on long-term projections carried out in cooperation with the Ageing Working Group of the Council of the EU's Economic Policy Committee. The analyses are based on demographic assumptions and a methodologically consistent macroeconomic framework for EU countries, the UK and Norway (EC, 2020). The projections therefore do not reflect the current medium-term macroeconomic and fiscal outlook for the Czech Republic. The projections are made under the constant-policy assumptions. They are therefore indicative of a system that is legislatively anchored at the time of the projections, taking into account current practice where discretion is allowed in the legal framework. Long-term analyses are not intended to predict specific values, but to show trends and dynamics over the long term. The most recent update of the long-term projections was made in autumn 2020 in the context of the preparation of the 2021 Ageing Report and covers the period up to 2070.

Eurostat population projections (EC, 2020) are the basis for the current long-term projection results. For comparison, the previous Eurostat projection (EC, 2017) and the medium scenario of the CZSO's latest projection (CZSO, 2018) can be used. The latter was used to assess the relationship between the current retirement age and life expectancy. It was also the basis for the OECD (2020). The CZSO updates its demographic projections once every 5 years, i.e. the next one will be published at the end of 2023.

A basic comparison of the above demographic projections shows that a decline in the Czech population can be expected in the long term. The most optimistic projection in this respect is the CZSO's projection, which is somewhat closer to the current Eurostat projection (see Graph 5.6). The difference between the two scenarios stems almost exclusively from the different assumptions about the evolution of net migration. While the CZSO assumes a constant net influx of 26,000 persons per year over time, Eurostat in its update expects a gradual decline from the current level of around 24,000 to around 8,000 persons per year.

However, the age structure of the population is particularly important for projections of social and health system expenditure. The dependency ratio, measured as the ratio of the number of persons over 65 to the number of persons of working age (15–64), follows a very similar pattern across projections. It is expected to almost double by 2060, reaching around 55% (see Graph 5.7).

Of course, this is not only a consequence of the decline in the number of working age individuals, but also of the increase in average life expectancy. The share of people aged 85 and over in the number of people aged 65 and over is projected to more than double over the projection horizon. Only a temporary reduction in the dependency ratio is then expected in the later decades of the projections. The strong growth after 2035 and the peak in the period roughly between 2045 and 2060 is mainly due to the demographic bulge of those born in the 1970s. After 2060, their influence is expected to diminish, but in the following period the dependency ratio will be influenced by the ageing of the stronger population cohorts born nowadays.

Economic activity rates for age cohorts above 54 are projected to increase until 2030 in line with the extension of the statutory retirement age. However, they remain roughly constant after 2030, reflecting the current institutional set-up of the pension system. Although the revision mechanism is part of the pension system, it does not oblige the government, but only recommends to submit a change in the retirement age to the Czech Parliament for approval. For this reason, the EC rejected the application of the revision mechanism in the long-term projections. The projection therefore works with the retirement age as a fixed ceiling of 65 years from 2030 onwards.

The development of pension expenditure relative to GDP was relatively favourable in the pre-crisis period, mainly due to the macroeconomic environment. The initial value of expenditure in the previous projections was 9.0% of GDP in 2013, while pension expenditure was 1.0 pp lower in 2019. In contrast, higher growth in wages and salaries, employment and participation rates led to dynamic growth on the revenue side of the system. This had a positive impact on its balance, which stood at 0.3% of GDP in 2019 (the initial year of the projections) (MF CR, 2021a). The pandemic and the measures taken on the revenue side then led to a deterioration of the system's balance to −0.7% of GDP in 2020 (MF CR, 2021b). Although the pension account was broadly balanced in 2021, high inflation and the resulting two extraordinary indexations caused a deficit of 0.3% of GDP in 2022. Further pressures on the expenditure side should then exacerbate the imbalance between pension contributions and pension expenditure paid this year.

The trend in pension expenditure projections is primarily determined by demographic trends and retirement age, but the sizeable economic downturn in 2020 also plays an important role in the medium term. According to the pension projection, pension expenditure as a share of GDP was projected to rise to 9.5% in 2020 (the actual figure was 0.4 pp lower) and then gradually fall below 9% until 2030. However, after 2030, the increase in the retirement age will halt and those born in the demographic bulge in the 1970s will start retiring. This will lead to a rather dramatic increase in expenditure up to 11.9% of GDP just before 2060, followed by a decline in expenditure to 10.9% of GDP at the end of the projection horizon in 2070 (Graph 5.8). The decline in the expenditure-to-GDP ratio is again driven by demographic factors. This is because individuals born in the demographic trough in the 1990s or later will retire and replace those born during the demographic bulge.

The projection assumes constant pension revenues relative to GDP over the entire horizon. This follows from the assumption that the wage bill in the economy should evolve in line with labour productivity over the longer term. As a result, the share of labour production factor in GDP is kept fixed, on which a constant pension contribution rate of 28% of gross wage or salary is applied. The scheme's revenues are thus at the 2019 initial year level of 8.5% of GDP over the entire horizon.

With revenue in relative terms kept constant, the resulting pension system balance follows the path of pension expenditure (Graph 5.8). We expect a relatively stable balance until 2030, while the balance deteriorates thereafter, bottoming out at −3.2% of GDP around 2060. It improves again in the last decade, reaching −2.5% of GDP in 2070.

In the area of health care and long-term care, the situation in terms of growth momentum of expenditure is similar to previous projections. In the baseline scenario, health care expenditure increases by less than one fifth (from a baseline of 5.6% of GDP in 2019 to 6.6% of GDP in 2070) and long-term care expenditure more than doubles (from 1.5% of GDP in 2019 to 3.2% of GDP in 2070).

In addition to the baseline projection scenario, a reference scenario was also developed that differs from the pure demographic scenario in several respects. In the case of health care, it is a higher income elasticity, with demand for health care services initially growing one tenth faster than the standard of living (measured as GDP per capita). The increase in life expectancy is assumed to be half spent in good health (as opposed to all the increase spent in poor health in the baseline scenario). In addition, for long-term care, the baseline scenario includes an assumption of higher growth in compensation of employees in social services in line with the rise of labour productivity in the economy (instead of GDP per capita growth, which is lower).

Demographic effects increase health care expenditure at the end of the horizon by 1.2 pp, higher income elasticity by a further 0.3 pp, while the effect of good health in the additional life expectancy reduces the increase in expenditure in the reference scenario by 0.6 pp. In the case of the long-term care, the impact of demographic trends is quantified at 1.4 pp, the higher compensation of employees an additional 0.3 pp. The effect of the good health in the additionally lived years in the projection offsets the higher income elasticity.

Finally, the last major long-term expenditure item, education, is expected to grow from 3.4% of GDP in 2019 to 4.1% of GDP in 2070. This is essentially the same as in previous projections and it is the highest increase in the EU as a whole. The reason for the increase is the higher growth in compensation of employees in education relative to the projected economic growth.

The total increase in expenditure between 2019 and 2070 is more than 6.0 pp, as shown in Graph 5.11. The increase in health care, long-term care and education, taken together, is 3.3 pp. However, these are just the baseline scenarios. With health care and long-term care in particular, most alternative (sensitivity) scenarios show an increase that, for the most part, is higher. The only exceptions are the scenarios including the impact of healthier lifestyle.

Box 2: New Eurostat Demographic Projections

On 30 March 2023, Eurostat released a new demographic projection of the EU population as part of the three-year update cycle. This comprehensive projection serves as an input for the long-term projections of age related expenditure prepared by the EC within the Ageing and Sustainability Working Group (AWG).

However, the baseline scenario for long-term expenditure projections, also presented in this Convergence Programme, is based on Eurostat projections published in the first half of 2020 (EC, 2020). The two projections differ in particular in the date of their publication, the more recent one being based on data from the 2021 census carried out in European countries. Eurostat then uses a single, consistent methodology for all countries in its projections, taking into account their interlinkages, i.e. those between EU countries and the outside world.

Table 5.2: Main Assumptions of Demographic Projections

		2022	2030	2040	2050	2060	2070
Total fertility rate							
Eurostat (2020)	*children per woman*	1.72	1.75	1.77	1.78	1.78	1.78
Eurostat (2023)	*children per woman*	1.72	1.73	1.74	1.75	1.75	1.75
Male life expectancy at birth							
Eurostat (2020)	*years*	76.9	78.4	80.2	81.8	83.4	84.8
Eurostat (2023)	*years*	75.9	77.9	79.8	81.6	83.3	84.8
Female life expectancy at birth							
Eurostat (2020)	*years*	82.6	83.9	85.4	86.7	88.0	89.2
Eurostat (2023)	*years*	81.9	83.5	85.1	86.6	87.9	89.2
Net migration							
Eurostat (2020)	*persons*	28 380	16 289	16 576	17 490	17 969	18 155
Eurostat (2023)	*persons*	470 787	-1 800	29 698	26 214	23 771	24 839

Note: Projections originally reach to 2080 for older Eurostat projection and to 2100 for the newer one. We present the data here just to 2070, which is the horizon of long-term projections for the evaluation of the fiscal impact of population ageing.
Source: EC (2020), Eurostat (2023).

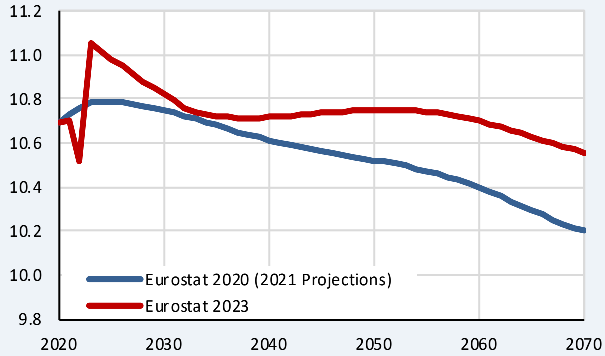
The basic assumptions of the two demographic scenarios are compared in Table 5.2. The two projections do not differ substantially in life expectancy, and the fertility rate is only slightly lower. These differences can be attributed to the adaptation of the projection models. The more significant impact in terms of population size has the higher estimated net migration balance. This is strongly influenced, especially in the short term, by the inflow of people to the Czech Republic as part of the migration wave from Ukraine. In the longer term, the differences are much smaller, and the new projection is closer to the CZSO's view, which in its 2018 projections assumed a long-term constant net migration balance of 26,000 persons per year. However, this indicator is generally considered the most difficult variable to figure out in the projections.

Eurostat continues to project a decline in the population of the Czech Republic in the long term. While the 2020 scenario shows projected data from 2020 onwards in the following graphs, the update contains actual data for the years 2020–2022. These, as can be seen especially in the total population data (Graph 5.1), are marked by a decline in the number of persons due to the inclusion of the 2021 census results and a subsequent increase due to the inflow of migrants. The relatively steep decline in population over the next ten years or so is driven by the assumption of a gradual return of most Ukrainians to their homeland. However, even in the long term, the new projection looks more favourable for the Czech Republic in terms of the number of people due to the cumulatively better migration balance. At the end of the 2070 horizon, the difference is approximately 355,000 persons.

However, the basic factor influencing the fiscal impact of ageing is the structure of the population with respect to the number of people of working age or post-productive age. The demographic dependency ratio, which measures the number of persons aged 65 and over relative to those aged 15–64, is lower over the entire projection horizon, as showed in the Graph 5.2. The difference is initially 1.5 pp, peaks around 2060 (3.0 pp) and declines to 2.0 pp towards the end. This change in the higher share of working age population is mainly due to the higher migration balance of people in younger age cohorts.

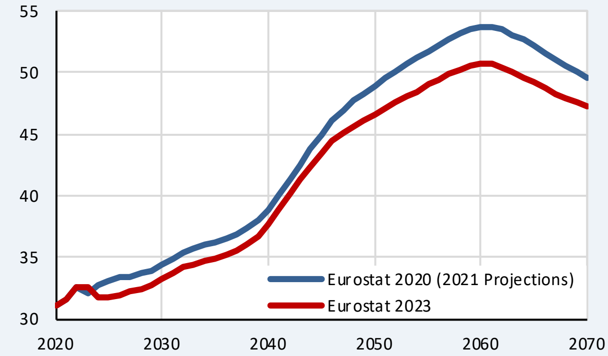
To assess the impact of alternative demographic developments on the pension system, it is first necessary to reflect the changes in the macroeconomic scenario. The baseline scenario of the CP is based on projections calculated by the EC for EU countries in the AWG on the basis of Eurostat's 2020 demographic projections. The alternative scenario is based on updated demographics and is based on the calculations of the MF CR using the same methodology for calculations of the macroeconomic framework. In order to ensure the best possible comparability, the alternative scenario keeps parameters not directly related to demographic developments (e.g. development of total factor productivity, labour productivity, growth of capital as a share of hours worked, etc.) identical to the baseline scenario. The unemployment rate also remains the same at the level of the long-term structural unemployment rate estimated for the Czech Republic in the EC projections. The differences from the baseline scenario thus stem from the higher number of working-age population, which consequently increases the labour factor. The positive contribution of the labour market through the structure of the population is also illustrated by the higher participation rate (Table 5.3), which reflects the higher number of people in economically active cohorts. These factors, given the assumption on labour productivity developments, have a positive effect on GDP growth, especially in the long run. The annual values around 2030 showing slower growth rates of real GDP and participation are due to the aforementioned return of some workers back to Ukraine.

Graph 5.1: Population
thousands of persons



Source: EC (2020), Eurostat (2023).

Graph 5.2: Dependency Ratio
in %, ratio of persons aged 65+ to persons aged 15–64 years



Source: EC (2020), Eurostat (2023). MF CR calculations.

Table 5.3: Differences of Alternative and Baseline Macroeconomic Scenarios
percentage points

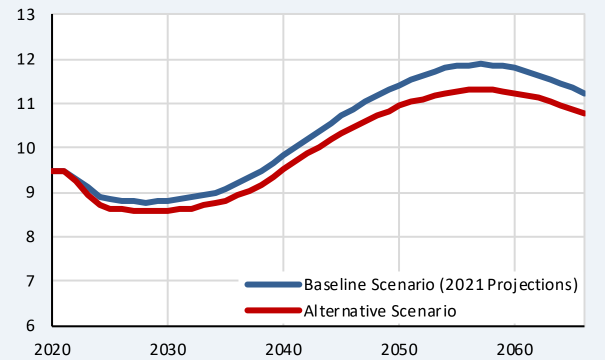
	2019	2020	2030	2040	2050	2060	2070
Labour productivity growth	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real GDP growth	0.0	0.0	-0.1	0.2	0.2	0.1	0.0
Participation rate of males (aged 20–64)	0.0	0.0	0.0	0.2	0.3	0.2	0.0
Participation rate of females (aged 20–64)	0.0	0.0	-0.1	0.0	0.1	0.2	0.1
Total participation rate (aged 20–64)	0.0	0.0	-0.1	0.1	0.3	0.2	0.1
Unemployment rate	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Population aged 65+ over total population	0.0	0.0	-1.4	-1.8	-2.7	-3.0	-1.8

Note: Difference between the alternative projection and the baseline projection scenario depicted in Table 5.4.
Source: EC (2020). MF CR calculations.

The impact of the different demographic and resulting macroeconomic scenarios on pension expenditure is not very dramatic. The new, more optimistic projection leads to a higher number of pensioners, especially in later years, but an important factor in this scenario is the higher level of GDP, which reduces the ratios. Pension expenditure is the determining factor for the evolution of the pension system balance relative to GDP. Even though the alternative scenario is based on higher GDP, income does not play a role in this ratio. The revenue-to-GDP ratio is assumed (for better comparability) to be constant over the projection horizon in both scenarios, given the same long-term evolution of wages and salaries and GDP. The resulting balance is thus more favourable in the alternative projection due to lower expenditure dynamics, ranging up to 0.4–0.6% of GDP at the end of the projection horizon.

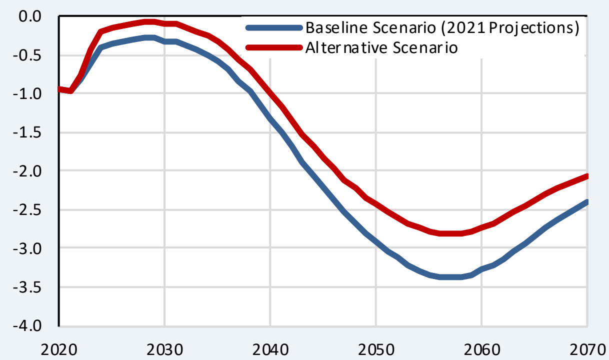
Although Eurostat's demographic projections differ in terms of population size, the age structure is the decisive factor. It is very likely that, despite the potentially more positive outcome of the pension balance, the balance will gradually fall towards −2.8% of GDP (compared to −3.4% of GDP in the baseline scenario) as the baby boomers retire. The conclusions for the assessment of long-term sustainability are thus virtually identical in both scenarios.

Graph 5.3: Projection of Pension Expenditures
in % of GDP



Source: Projection of MF CR and the Ageing Working Group of the Economic Policy Committee.

Graph 5.4: Projection of Pension Account Balances
in % of GDP



Source: Projection of MF CR and the Ageing Working Group of the Economic Policy Committee.

5.3 Sustainability Analysis

The long-term projections are followed by a sustainability analysis that identifies the extent of required fiscal consolidation to ensure the stability of public finances. So-called sustainability indicators are calculated to show how far-reaching measures would be needed to reduce the expenditure ratio or increase the revenue-to-GDP ratio accordingly.

The EC regularly publishes three sustainability indicators (see EC, 2023c). **Indicator S1** generally expresses by what percentage of GDP the primary structural balance of the general government sector needs to be adjusted so that general government debt to be 60% of GDP at the end of a rolling 15-year horizon (currently 2037). This indicator for the Czech Republic currently stands at 3.9% of GDP, indicating medium risk. A key determinant is the cost of ageing, the impact of which is 3.3 pp.

Indicator S2 measures the level of fiscal effort required to achieve equality of discounted revenues and expenditures over an infinite horizon. According to the latest published calculations, it is 5.5% of GDP. The value of this indicator is strongly influenced by the cost of ageing, which amounts to 4.4% of GDP, while the impact of the initial budgetary position is the remaining 1.1% of GDP. The value of the S2 indicator also falls into the medium-risk category.

The S0 indicator shows possible fiscal or financial risks in the short term. It is thus different in nature from indicators S1 and S2, as S0 quantifies the degree of risk. For the Czech Republic, the current value of the S0 indicator is 0.24, which is below the critical threshold of 0.46 in the low-risk band.

The Czech Republic is currently assessed as a medium-risk country in terms of the long-term sustainability of public finances. In order to return to the low-risk zone, it is therefore necessary to address future pressures on public finances due to demographic changes in particular. This concerns all components of the long-term projections, i.e. pensions, health care and long-term care, as well as education. In addition, it is necessary to gradually consolidate public finances and put indebtedness back on a downward trajectory.

5.4 General Government Guarantees

The issue of **guarantees** provided by the general government sector to other entities complements the view on the sustainability of public finances. Guarantees represent an increase in general government expenditure when the debtor is unable to repay the obligations for which the guarantee is provided. Before the pandemic, the volume of guarantees provided in the Czech Republic was quite negligible.

A significant share of the general government guarantees (excluding COVID programmes) is accounted for by guarantees provided by local governments amounting to 0.03% of GDP. The most significant of which is guarantee for the Prague Transport Company in the case of deferred payments for the purchase of trams in the amount of CZK 1.6 billion. Others are guarantees granted by local governments for loans related to housing needs (CZK 0.2 billion).

In 2018, a state guarantee was provided to secure the CNB's loan to the International Monetary Fund from its foreign exchange reserves (Act No.179/2018 Coll.). The pledged credit framework is up to EUR 1.5 billion, but the reported amount of the guarantee depends on the status of the credit drawn down. However, the guaranteed loan has not yet been drawn down.

As part of the solution to the crisis caused by the pandemic, in March 2020 the Government approved the COVID II Guarantee Programme (Government Resolution No.260/2020) with indirect support to affected companies in the form of state guarantees with a guarantee capacity of CZK 20 billion. Guarantees amounting to CZK 11.6 billion were provided under this programme. On 20 April 2020, the COVID Prague programme was announced as a complement to the COVID II programme under similar conditions. The guarantee provided under this programme amounted to CZK 1.3 billion. Both programmes were exhausted relatively quickly and ended already during 2020.

With the adoption of Act No. 228/2020 Coll., leeway was created for the implementation of the COVID III Guarantee Programme. The support was provided in the form of a guarantee by the then Czech-Moravian Guarantee and Development Bank (now the National Development Bank) to a cooperating bank for a portfolio of transactions of final beneficiaries. The programme guaranteed 90% of the loan principal up to CZK 50 million for operating or investment financing of an enterprise with up to 250 employees, or 50% for an investment loan of up to CZK 90 million. For businesses with 250 to 500 employees, it guaranteed 80% of the amount of the operating or investment loan, up to a maximum of CZK 50 million, or 50% for an investment loan up to CZK 80 million. The maximum guarantee period was 3 years for operating loans and 6 years for investment loans. The provision of loans under this programme was terminated on 31 December 2021. As of the same date, over 7,500 guarantees for loans amounting to CZK 42.9 billion had been provided.

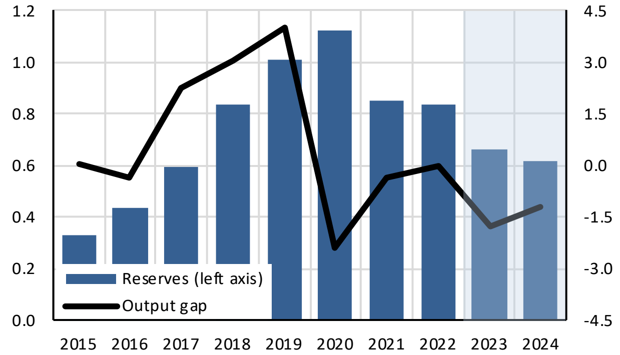
In addition to these programmes, the National Development Bank provides guarantees under the COVID Sport Guarantee (Government Resolution No. 46/2021) with a maximum guarantee period of 3 years (applications are accepted until 30 June 2023) and the COVID Travel Agency Guarantee for small and medium-sized travel agencies (Government Resolution No. 51/2021) with a guarantee period of 1.5 years (applications closed on 17 December 2021). This was followed by the Travel Agency Guarantee programme (Government Resolution No.982/2021) from January 2022. Guarantees were granted under this scheme until 30 June 2022. A total of CZK 0.3 billion of guarantees were issued under both schemes by the end of 2022. As a result of the increase in energy prices, a second round of calls for the COVID Travel Agency Guarantee scheme was approved, with applications to be submitted between 1 February 2023 and 29 December 2023. The maximum guarantee amount is CZK 1.5 million.

In the context of rising energy prices, the National Development Bank opened the Energy Guarantee Programme under the Expansion Guarantees scheme. This programme is a form of energy support from the government to companies that are facing a sharp increase in energy prices and whose energy costs amount to more than 10% of operating costs. The guarantee can be issued with a commercial loan that will finance routine operating costs such as utility costs, supplier-customer invoices, inventory and material purchases, and labour costs, for up to 2 years. The amount of the guaranteed credit can be up to CZK 10 million. The support also includes a financial contribution to the payment of interest costs of up to CZK 800 thousands. On 9 December 2022, the receipt of applications was terminated due to the fulfilment of the programme's allocation. The book value of the provided guarantees amounts to CZK 53.3 million

Act No. 214/2020 Coll. enabled the Export Guarantee and Insurance Corporation to expand its portfolio of activities to include the provision of guarantees under the COVID Plus programme. The guarantees were intended for large enterprises with at least 250 employees and whose total sales account for exports from at least one-fifth. The loan amount ranged from CZK 5 million to CZK 2 billion. The maximum loan amount corresponded to 25% of the company’s annual turnover. The amount of the guarantees was 90% of the principal amount of the loan, in the case of EGAP’s internal rating of ‘B–’ it was 80% (the rating scale used corresponds to S&P and Fitch ratings). The programme was not intended for firms that were experiencing existential problems prior to the declaration of the state of emergency. The guarantee was applied for through a commercial bank and the maximum duration of the guarantee was 6 years. The volume of guarantees granted as of 31 December 2022 amounted to CZK 13.1 billion received by 137 firms. The programme was terminated at the end of 2021.

Graph 5.5: Health Insurance Companies' Reserves

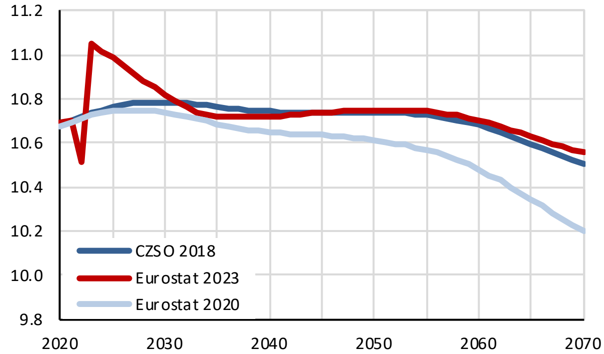
left axis: in % of GDP, right axis: in % of potential product



Note: "Reserves" on health insurance companies' accounts.
Source: Statements of Health insurance Companies, MF CR.

Graph 5.6: Czech Population in Different Projections

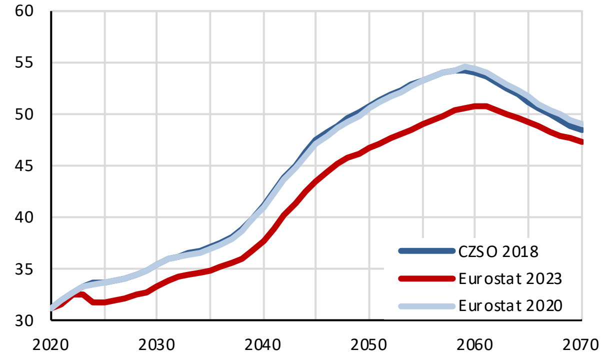
millions of persons



Source: CZSO (2018), EC (2020), Eurostat (2023).

Graph 5.7: Old-age Dependency Ratio

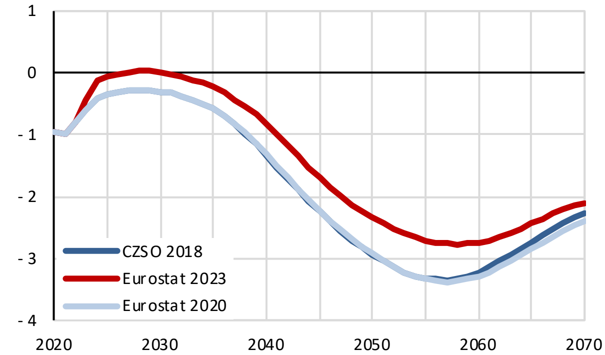
in %, ratio of persons aged 65+ to persons aged 15–64 years



Source: CZSO (2018), EC (2020), Eurostat (2023).

Graph 5.8: Projection of Pension Account Balances

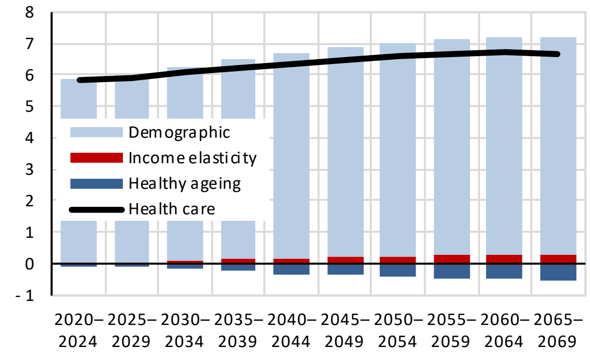
in % of GDP



Source: MF CR calculations and forecast

Graph 5.9: Health Care Scenarios

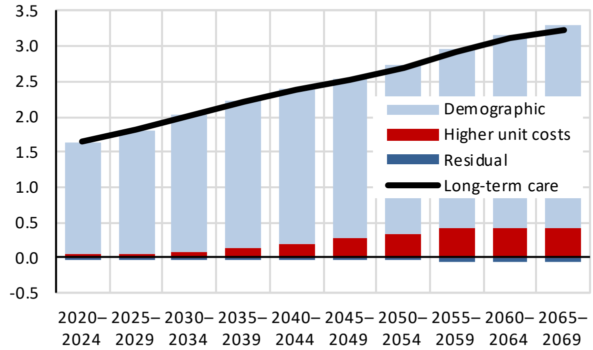
difference in pp from the reference case in % of GDP, 5Y average



Source: EC (2021a). MF CR calculations.

Graph 5.10: Long-term Care Scenarios

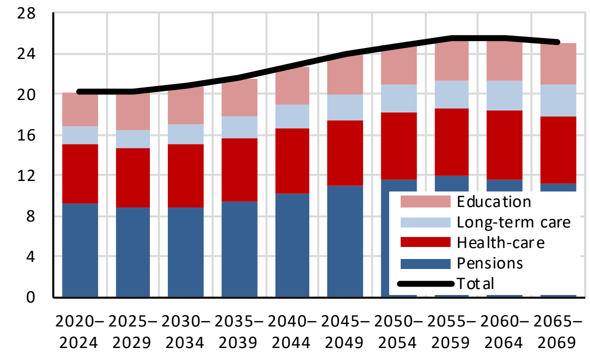
difference in pp from the base case in % of GDP, 5Y average



Note: Residual is difference of income elasticity and healthy aging impacts.
Source: EC (2021a). MF CR calculations.

Graph 5.11: Expenditure Projections – Reference Cases

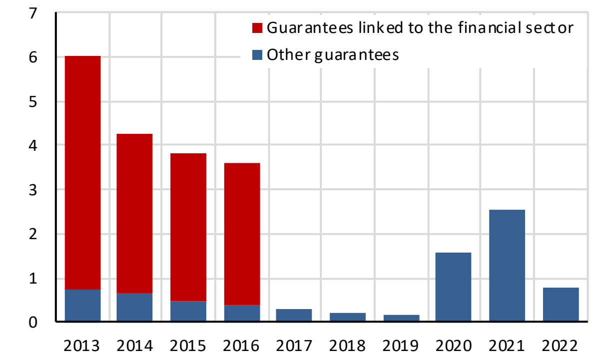
in % of GDP, age-related expenditure, 5Y average



Source: EC (2021a). MF CR calculations.

Graph 5.12: General Government Guarantees

in % of GDP



Source: MF ČR.

Table 5.4: Long-term Sustainability of Public Finances

expenditure and revenue in % of GDP, change and rates in %

	2019	2020	2030	2040	2050	2060	2070
Total expenditure	**41.1**	**47.2**	**40.8**	**42.4**	**45.0**	**47.2**	**47.5**
of which: Age-related expenditures	18.5	20.6	20.6	22.3	24.5	25.7	24.7
Pension expenditure	8.0	9.4	8.8	9.8	11.4	11.8	10.9
Social security pensions	8.0	9.4	8.8	9.8	11.4	11.8	10.9
Old-age and early pensions	6.7	7.9	7.4	8.5	10.1	10.4	9.5
Other pensions	1.3	1.5	1.4	1.4	1.3	1.4	1.4
Occupational pensions	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Health care	5.6	6.1	6.0	6.3	6.6	6.7	6.6
Long-term care	1.5	1.7	1.9	2.3	2.6	3.0	3.2
Education expenditure	3.4	3.4	3.8	3.8	3.9	4.2	4.1
Other age-related expenditures	22.5	26.6	20.2	20.2	20.5	21.5	22.8
Interest expenditure	0.7	0.8	1.3	1.4	2.2	3.3	4.3
Total revenue	**41.3**	**41.5**	**39.3**	**39.3**	**39.3**	**39.3**	**39.3**
of which: Property income	0.6	0.6	0.6	0.6	0.6	0.6	0.6
of which: Pension contributions	8.3	8.2	8.5	8.5	8.5	8.5	8.5
Pension reserve fund assets	**0.7**	**0.7**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
of which: Consolidated public pension fund assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Assumptions							
Labour productivity growth	**2.0**	**1.9**	**2.2**	**2.1**	**1.9**	**1.7**	**1.5**
Real GDP growth	**2.6**	**-6.2**	**1.9**	**1.3**	**1.3**	**1.7**	**1.5**
Total participation rate (aged 20–64)	**89.3**	**89.4**	**87.8**	**86.4**	**87.3**	**88.0**	**87.4**
Participation rate of males (aged 20–64)	74.5	74.6	75.3	73.7	74.3	75.6	74.9
Participation rate of females (aged 20–64)	82.0	82.2	81.7	80.3	81.0	82.0	81.3
Unemployment rate	**2.0**	**4.8**	**3.5**	**3.5**	**3.5**	**3.5**	**3.5**
Population aged 65+ over total population	**19.8**	**20.1**	**22.1**	**25.0**	**28.3**	**29.6**	**27.9**

Note: Macroeconomic assumptions are based on long-term projections of the EC and can differ from the medium-term macroeconomic scenario presented in Chapter 2. Total revenue and the age-unrelated expenditure in relative terms are kept constant to their 2026 level to mitigate distortion in impacts of ageing on public finance. On the other hand, total revenue and expenditure in the long run are thus distorted by the medium term budgetary position and the development after 2026, when the autonomous development of the projection is not corrected by the statutory trajectory of public finance consolidation and subsequent adherence to the medium-term budgetary objective.

Source: EC (2020). MF CR calculations.

Table 5.5: Sustainability Indicators S1 and S2

in % of GDP

	S1	S2
Cost of Ageing	3.3	4.4
Budgetary position	0.9	1.1
Debt requirement	-0.3	-
Total	**3.9**	**5.5**

Source: EC (2023c).

Table 5.6: Contingent Liabilities

in % of GDP

	Measures	Date of adoption	Maximum cont. liabilities *% of GDP*	Estimated take-up *% of GDP*
In response to COVID-19	"COVID II" Guarantee	2020	0.05	0.00
	"COVID Prague" Guarantee	2020	0.01	0.00
	"COVID III" Guarantee	2020	0.21	0.00
	"COVID Sport" Guarantee	2021	0.00	-
	"COVID Travel Agency" Guarantee	2021	0.00	0.00
	"COVID Plus" Guarantee	2020	0.19	0.00
	"SURE" Programme Guarantee	2020	0.14	-
	Subtotal		**0.60**	**0.01**
Others	Guarantees provided by central government			
	- Macro-financial Assistance (MFA) to Ukraine	2022	0.02	-
	- other central government guarantees		0.11	0.01
	Guarantees provided by local governments			
	- for loans related to the housing needs	2014	0.00	-
	- for purchase of trams by Prague Transport Company	2012	0.02	-
	- other guarantees of the general government sector	2014	0.01	0.00
	Subtotal		**0.17**	**0.01**
	Total		**0.77**	**0.01**

Note: Amount of guarantees is calculated to the end of 2022.
Source: MF CR.

6 Quality of Public Finance Revenue and Expenditure

Tax policy in the upcoming period will continue to focus on a pro-client approach to tax entities, identification and possible abolition of non-systemic tax exemptions, reduction of the bureaucratic burden in tax and fee administration and ensuring better measures against transfer pricing abuse and illegal optimisation practices and tax evasion. It also seeks to respond flexibly to unexpected situations in an effort to mitigate their impact on economic agents.

On the expenditure side, several measures have been taken to promote rationalisation and increase efficiency. One of them is energy savings in public administration, while others concern areas such as public procurement, management of state property and the continuation of digitisation of public administration.

6.1 Tax Policy Outlook

As of 1 January 2023, the obligation to **keep electronic registration of sales** has been abolished, as it has proved to be quite inefficient and administratively demanding system with the increasing volume of non-cash payments. Another measure aimed at reducing the administrative burden on entrepreneurs is the increase in the **limit for compulsory VAT registration** to CZK 2 million effective from 1 January 2023, the simultaneous extension of the **flat-rate tax scheme** also to those with incomes up to CZK 2 million and setting the amount of the flat-rate tax and flat-rate social security contributions for incomes from CZK 1 million to CZK 2 million.

Last year, the government reacted to a significant rise in fuel and energy prices. In order to mitigate the impact of the energy crisis on fuel prices, the **excise duty on petrol and diesel** was temporarily **reduced by** CZK 1.50 per litre for the period from 1 June to 30 September 2022. For diesel, the effective period was extended to the end of 2023.

On the other hand, the changes in the situation have brought about a large degree of redistribution of profits in the economy, particularly in favour of companies in the energy and banking sectors. In order to mitigate the impact on the entities adversely affected by these circumstances, resources had to be sought to cover these steps.

One source of funding is the so-called **windfall profits tax** (regulated by the Income Tax Act). This tax is based on the parameters of the EU Council Regulation. The temporary windfall tax will apply from 1 January 2023 for a period of 3 years (i.e. 2023–2025) for exceptionally profitable companies in the energy production and trade, banking, oil extraction and fossil fuel extraction and processing sectors. It will apply a 60% tax surcharge on the excess profits of these companies, which is determined as the difference between the tax base in 2023–2025 and the average of the tax bases for the last 4 years (i.e. 2018–2021) plus 20%. Income from activities subject to the extraordinary tax shall be determined as the total annual net turnover according to relevant accounting legislation to such activities for a taxpayer that is not a bank or the annual net interest income for a taxpayer that is a bank.

Furthermore, a **levy on excess revenues** was introduced through Act No. 365/2022 Coll., amending the so-called Energy Act. The aim is to ensure compliance with the requirements of Council Regulation (EU) 2022/1854 on high energy prices, which sets ceilings for disproportionately high market revenues from electricity sales.

The subject of the levy is the market income from the sale of electricity in the period from 1 December 2022 to 31 December 2023. Exempt from the levy are producers who operate production facilities with an installed power of up to and including 1 MW, producers of electricity from supported energy sources under the Act on Supported Energy Sources, as well as pumped-storage power plants and biomethane production plants. The levy is 90% of the excess income. Producers are to send the excess income to the state in the form of monthly advances.

Excess income for the purposes of the excess income levy means the positive difference between the market income and the market income ceiling for the levy period. The market income ceilings for producers are set in order to cover, in principle, normal operating costs and possible investments.

A new **Accounting Act** is being prepared, reflecting the need to modernise accounting rules to meet current user requirements with an emphasis on financial reporting. It includes, for example, the extension of the use of International Financial Reporting Standards (IFRS) for the preparation of financial statements, the introduction of the possibility to use a functional currency (i.e. the currency in which the entity carries out most of its activities, which may be e.g. euro, dollar, pound, etc.) for accounting and income taxes. This is further linked to changes in income taxes, such as the recodification of the tax treatment of assets (in particular, changes in the area of depreciation of assets – reduction in the number of depreciation groups, switch to monthly depreciation), introduction of the possibility to determine the tax base on the result of economic activity according to international financial reporting standards, introduction of the possibility to calculate income tax in the functional currency, conceptual change in the valuation of assets and debts, etc. The act is expected to be submitted to the government in the second half of 2023 with effect from 1 January 2025.

A so-called **consolidation package** is currently being prepared. For the time being, the National Economic Council of the Government has put forward proposals, which are being further elaborated, and the Government is now discussing which of them it will use and implement. The measures under consideration on the revenue side are aimed at both reducing the public deficit and simplifying the tax system (abolishing exemptions, etc.).

The adoption of Council Directive (EU) 2022/2523 of 14 December 2022 on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the EU continues the EU's efforts to end tax practices of multinational enterprises that allow them to shift profits to jurisdictions where they are subject to no or very low taxation. This major reform aims to stop competition on corporate tax rates by introducing a global minimum level of taxation. By removing much of the benefits of shifting profits to jurisdictions with zero or very low taxation, the reform will even the conditions for businesses around the world and allow jurisdictions to better protect their tax bases. The issue is linked to the Organisation for Economic Co-operation and Development's 'Tax Challenges Arising from the Digitalisation' project under the Base Erosion and Profit Shifting (BEPS) initiative. The rules of the Directive apply to entities that are members of multinational enterprise groups or large domestic groups that reach an annual consolidated revenue threshold of at least EUR 750 million. The minimum effective level of taxation should be 15%. The Directive should be transposed by Member States by 31 December 2023.

6.2 Rationalisation of General Government Expenditure

6.2.1 Joint Procurement of the EU Member States for Energy

To better coordinate natural gas purchases from external suppliers and their stable supply to the national economies, Council Regulation (EU) 2022/2576 was adopted in December 2022 to strengthen solidarity through better coordination of gas purchases, reliable price benchmarks and cross-border gas exchanges. The new rules allow **Member States and energy companies to jointly purchase gas on world markets** through a two-stage mechanism. In the first phase, gas undertakings and companies consuming gas in the EU and Energy Community countries submit information on their gas import needs to a service provider, which aggregates demand, taking into account, among other things, price, volume and the destination of supply, and searches the world markets for offers to cover the total demand. Member States require domestic undertakings to use a service provider established by the EC for gas volumes corresponding to 15% of the scope of their respective gas storage obligations for 2023. Beyond that 15%, aggregation is voluntary. In the second phase, gas undertakings and companies then purchase gas through the platform, either individually or in consortia with other companies. Purchases can be made either through tenders or auctions organised by the service provider. Pooling demand at EU level ensures that EU Member States are in a better negotiating position when buying gas on world markets and do not compete with each other by offering a higher price in the process.

6.2.2 Public Procurement

In connection with the adoption of the amendment to the Act on the Implementation of International Sanctions, Act No. 240/2022 Coll. was approved, which amended, among other things, Act No. 134/2016 Coll., on Public Procurement. With effect from 1 September 2022, a contracting authority may not award a public contract to a tenderer if it is in breach of international sanctions. It also newly regulates the procedural processes for all contracting authorities in the event that an international sanction applies to the selected supplier or subcontractor, and also allows the contracting authority to terminate the contractual relationship with the supplier if it finds that the supplier is subject to a public procurement ban. Thus, this regulation contributes to greater legal certainty and allows for a smooth termination of the contractual relationship with a supplier subject to international sanctions.

Public procurement is also related to the adoption of Act No. 245/2022 Coll., amending the **Act on the Register of Beneficial Owners**, which was approved as a result of a conflict between the original definition of beneficial owner and the European Directive. The essence of the amendment is the abolition of the two-component definition of beneficial owner based on the concepts of ultimate beneficiary and person with ultimate influence and the adoption of the definition of beneficial owner according to the so-called 5th AML Directive. A beneficial owner is thus, with effect from 1 October 2022, any person who ultimately owns or controls a legal entity or legal arrangement. This general definition is then further elaborated for corporations, foundations, institutes, benefit corporations and trusts in the Beneficial Owners Register Act. The amendment also expands the circle of persons who do not have to register the beneficial owner because they do not have one (e.g. the state, local government, a voluntary association of municipalities, a contributory organisation of the state or a local government, a public beneficial legal entity, a public research institution, a state enterprise, etc.). The contracting authority is furthermore obliged to find out the data on the beneficial owner of the selected supplier, if it is a Czech legal entity (except for legal entities that do not have a beneficial owner), directly from the register of beneficial owners, whose data the contracting authority is obliged to provide in the public procurement documentation. If the supplier has not fulfilled its registration obligation towards the register, the contracting authority is obliged to exclude the selected supplier from the tender procedure.

The government's proposal for a **more comprehensive amendment to the Public Procurement Act** (Chamber of Deputies Print No. 249) is also in the second reading of the legislative process. The amendment proposes to modify the method of determining the estimated value of a public contract of a regular nature, whereby it would now be possible to determine the estimated value only in the case of sub-limit public contracts and small-scale contracts. Furthermore, it is proposed to reduce the administrative complexity of the procurement process, in particular by easing the regulation of the submission of documents on the qualifications of the selected supplier before the conclusion of the contract and the abolition of the obligation to conclude the contract in the electronic form of communication. This should lead both to a reduction in transaction costs on the part of both the contracting authority and the supplier and to a speeding up of the procurement process. Further streamlining of public procurement, especially in the field of information and communication technologies, is planned under the Chamber of Deputies Amendment Proposal No. 1597. The intention of this proposal is to specify the public contracting authority at the level of the Czech Republic, so that the organisational unit of the State would be an operational unit with functional autonomy in public procurement and would thus be entitled to determine its estimated value separately and independently of public contracts of a similar type awarded by other organisational units of the State. By treating the State as a whole in public procurement, it would thus be able to use its own capacities within the State administration, irrespective of the legal form of the contracting authority. This will be particularly important in the case of public procurement of information technology, where more complex project solutions can be developed across government units, resulting in more cost-effective and efficient use of public funds.

As part of the long-term intention to further streamline the public procurement system, the Government approved (Government Resolution No. 375/2022) a new **Strategy for the Electronicisation of Public Procurement for the period 2022–2030**, which reflects the needs of the state to address the information support of the public investment process in a systematic manner and in connection with the development of eGovernment in the Czech Republic and EU. This document builds on previous strategies and the National Plan for the introduction of e-procurement for the period 2006–2010. In the new 9-year period, the main objective will be to increase efficiency in the form of better data and access to information on public procurement, as well as greater integration of the National e-procurement infrastructure and ensuring compliance with the changing legislative and methodological environment and the evolving eGovernment in the Czech Republic and EU.

6.2.3 Energy Savings in Public Administration

In the context of high electricity and gas prices, the government has approved a set of measures for public authorities that should lead to rationalisation and greater energy efficiency, which will result in savings of public funds. In the first phase, public sector bodies are recommended to use the 'Effect III' programme with a total allocation of CZK 13 million, under which they can apply for a subsidy to cover up to 90% of eligible costs (max. CZK 500 thousand) for the implementation of an energy management system. By implementing energy management, they can continuously monitor energy consumption, evaluate it and subsequently implement energy-saving measures. Municipalities and voluntary associations of municipalities can also use the programme with a total allocation of CZK 35 million to apply for a subsidy amounting to 70–90% of eligible costs (max. CZK 400–500 thousand) for the preparation of a local energy concept, which should be a tool to optimise the energy supply in relation to the energy consumed in the locality of a particular municipality or voluntary association of municipalities. In the next phase, the organisational units of the state can apply (by the end of 2023) for a subsidy of up to 100% of the eligible costs (max. CZK 16,500/GJ of primary energy savings from non-renewable sources) from the National Recovery Plan programme with a total allocation of CZK 2.9 billion for comprehensive support to revitalise the buildings under their ownership with the aim of reducing final energy consumption and achieving primary energy savings from non-renewable sources of at least 30%. Public entities (except for projects in the capital city of Prague) can also apply for subsidies from several calls of the Operational Programme Environment. A total allocation of CZK 825 million is earmarked for increasing the use of renewable energy sources both in public buildings and in the final energy consumption in public infrastructure, with a maximum of 50% of eligible costs covered for public sector entities. In addition, there are calls with an allocation of CZK 1 billion financing eligible costs for public sector entities for reducing energy consumption or increasing energy efficiency of catering and laundry facilities primarily in schools, health and social facilities, and other technological equipment in public buildings and infrastructure. The total allocation of CZK 800 million is earmarked for the reimbursement of eligible costs in the case of construction of new public buildings in passive energy standard. Two calls for support for complex energy saving projects in public buildings with a total allocation of CZK 5 billion were also announced.

6.2.4 State Property Control

Management of state property is carried out through the Office for Government Representation in Property Affairs (hereinafter referred to as the Office) through several channels. Every year, state property is sold or leased, and since 2018 also through an electronic auction system. By the end of 2022, this system generated cumulated revenues of approximately CZK 2.3 billion. Furthermore, the occupancy of state-owned administrative buildings is being optimised, to which state institutions paying rent to non-public entities in the area are being transferred. In 2022, there were 56 transfers from privately rented to state-owned buildings, thus realising savings on rent paid totalling CZK 10 million. Since 2015, a total of 503 dislocations have been implemented, saving more than CZK 215 million of public funds annually paid for rent.

In an effort to deal more efficiently with unnecessary state property and to reduce the state budget's expenditure on its management, or to increase revenue by selling it, several measures were implemented. In 2022, the Methodological Material for State Organisational Units and Selected State Organisations (MF CR, 2022b), which focuses on transfers of state property to municipalities and regions, was updated. Thus, the grounds for gratuitous transfer or outright sale have been expanded or the obligation for municipalities and regions to use the transferred property only for the agreed purposes has been removed, thus substantially simplifying and accelerating the transfer of unnecessary real estate to local government units. In addition, this year the Government approved (Government Resolution No. 56/2023) the obligation for organisational units of the State, State contributory organisations, State funds, State enterprises, the Budějovický Budvar national enterprise and the Railway Administration to prepare an audit of their real estate registered in the Land Registry, an overview of which was provided by the Office. The audit must define whether or not the real estate is necessary for them to carry out their activities and indicate and justify whether or not it can be transferred to the Office. Subsequently, the Office will send all municipalities with extended administration and regions a list of unneeded properties for their entire administrative district and ask them to review which properties could be used for their development activities. After receiving feedback, the Office will prioritise the disposal of properties requested by municipalities and regions. In this regard, a new digital platform, the State Property Map, has been established to facilitate the search for state properties in each municipality. In 2024, the Government expects to approve an amendment to Act No. 219/2000 Coll., on the Property of the Czech Republic and its Representation in Legal Relations, which would introduce an obligation for all organisational units of the State and selected State organisations to inform municipalities and regions of their intention to alienate tangible immovable property located on their territory. Subsequently, municipalities and regions would have the opportunity to express interest in such property, with the proviso that they would be entitled to the transfer for selected real estate. These so-called entitlement transfers would be of two types, i.e. gratuitous (e.g. for transfers of road land or land for a public utility building) and remunerative (e.g. land built up by a building owned by a local government unit or public open spaces). As part of reciprocity, it is planned to enshrine a similar system in the Act on Municipalities, the Act on Regions and the Act on the Capital City of Prague. Thus, in the case of transfers of clearly defined property of local governments, the state would also be entitled to acquire such property, basically under the same conditions under which municipalities and regions will be entitled to acquire real estate from the state.

State Ownership Policy Strategy

In 2020, the Government approved (Government Resolution No. 115/2020) the State Ownership Policy Strategy (MF CR, 2020), which is based on the Organisation for Economic Co-operation and Development's Guidelines on Corporate Governance of State-Owned Enterprises (OECD, 2015). It defines the principles of the state's behaviour as an owner or co-owner of commercial companies or state-owned enterprises and ensures the transparent and effective exercise of ownership rights. Following the adoption of the Strategy, a **Report on the implementation of measures resulting from the State Ownership Strategy** for the previous year is submitted to the Government by the end of May each year. The report for 2021 (MF CR, 2022c) states that the division of the portfolio of companies with partial state ownership and state-owned enterprises has changed. Three entities were reclassified as strategic - the state-owned enterprises Fuel Combine Ústí and DIAMO, which were subsequently merged, and OTE, a.s., one entity (The Government Testing Laboratory of Machines) was reclassified from strategic importance to the category of support and 7 entities were liquidated. In total, there are 110 state-owned or co-owned entities, of which 60 are state-owned enterprises. In addition, a follow-up **Report on the activities and results of strategic companies with partial state ownership, state-owned enterprises and national enterprise** for the previous year is submitted to the Government by the end of October. The report for 2021 (MF CR, 2022d) provides basic information (including the number of employees) and a set of financial indicators on a total of 36 strategic entities in which the state currently exercises ownership and founder rights through seven ministries, namely the MF CR, the Ministry of Interior, the Ministry of Industry and Trade, the Ministry of Transport, the Ministry of Defence, the Ministry of Agriculture and the Ministry of Regional Development. In terms of legal form, there are 16 joint stock companies, 18 state-owned enterprises, 1 national enterprise and 1 state organisation. Last year, these entities, through the ministries, managed assets totalling approximately CZK 1,663 billion and reported an aggregate after-tax profit of CZK 10.1 billion. In 2021, the strategic entities paid a dividend to the state budget or transferred to the founder's fund a total of CZK 23.5 billion.

6.2.5 Changes in the Digitalisation of Public Administration

Digital and Information Agency

In accordance with the Government's Policy Statement concerning the area of Digitisation, Act No. 471/2022 Coll., amending Act No. 12/2020 Coll., on the Right to Digital Services, was approved. The Act created the Digital and Information Agency as of 1 January 2023, which started its activities as of 1 April 2023 after a three-month transition period necessary for the transfer of all legal competences, assets and staff. This new central state administration body will effectively manage the digitisation of the state and specific digitisation and IT projects within the framework of gradually established specialised units concentrating experts on the given issues (so-called competence centres). In this context, the gradual establishment of three competence centres is planned – for shared services and training, for uniform standards and user-friendliness, and for analysis, cooperation and development. These centres will solve complex IT problems, prepare new procedures and agendas, test and develop proposed solutions, build on foreign experience and look for opportunities to apply them in local conditions. Subsequently, they should share experiences and best practices and assist other ministries. Competence centres will not operate independently within the Agency, but will work closely with or complement existing departments and divisions. The establishment of the Agency will also mark a step change in the funding of large shared and central government systems. There will also be a modification of the competences of the Administration of Basic Registers and, in particular, of the Office of the Chief Architect of eGovernment, where the agency will now approve public administration projects related to information and communication technologies. In this context, the Agency's competences will be expanded and the process of approving these projects will be changed by eliminating problems of both an institutional and a substantive nature, where the scope and content of the projects under consideration will be adjusted.

Digital Tools and Public Registers

In connection with the need to transpose Directive (EU) 2019/1151 of the European Parliament and of the Council of 20 June 2019 amending Directive (EU) 2017/1132, Act No. 416/2022 Coll. was approved in 2022, which changes the conditions for the application of digital instruments in commercial corporations and the functioning of public registers. As of 1 July 2023, this will make it possible to create limited liability companies (in particular private limited liability companies) fully electronically, using model articles of association, and will further enhance the use of digital tools throughout the life cycle of commercial corporations by allowing them to enter data in the public register, deposit documents into the dossier and establish branches in other Member States fully electronically. The scope of publicly and free of charge accessible data on all limited liability companies registered in EU Member States on websites as well as the exchange of information between Member States' business registers will also be strengthened. With effect from 1 July 2024, there will also be an adjustment to the scope of voluntarily entered data into public registers for the organizational units of foreign foundations and foreign institutes.

6.3 Composition of General Government Expenditure

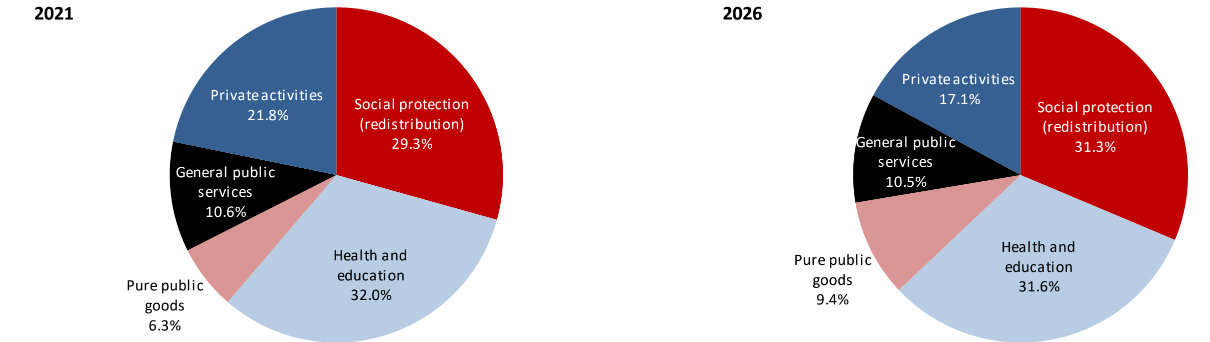
Between 2018 and 2020, the total amount of general government expenditure grew both in absolute terms (on average by about CZK 235 billion per year) and in relation to GDP (by an average of 2.7 pp per year). After an unprecedented, historically highest growth of expenditure in 2020, it decreased year-on-year in relation to GDP by 0.7 pp in the following year, while in absolute terms it increased by CZK 145.2 billion. However, this is only more than half of the growth in 2020.

The increase was mainly driven by expenditure in three sections. The largest contribution to growth was in the Health section, primarily in the Public Health Services group due to the increase in pandemic-related social transfers in kind. In addition, compensation of employees and social transfers in kind in the Hospital services group contributed to this growth. Expenditure in Economic Affairs grew due to government compensation to businesses during the coronavirus pandemic, mainly due to subsidies in the General Economic, Commercial and Labour Affairs and Transport groups. The third section contributing significantly to the overall increase in expenditure is Education, mainly due to the increase in compensation of employees in the regional education. In contrast, there was a year-on-year decrease in expenditure in Public Order and Safety, due to a fall in intermediate consumption and gross fixed capital formation.

Over the outlook horizon, total general government expenditure is projected to be on a downward trajectory, with the level of expenditure in 2026 lower by almost 6 pp compared to 2021. The rapid expenditure growth of 2020 and 2021 (primarily in Health and Economic Affairs sections) caused by government fiscal measures to support households and businesses during the pandemics is being "replaced" in 2022 and 2023 by expenditure related to the mitigation of energy crisis and high inflation. However, by the end of 2026, we estimate a 2.5 pp decline in expenditure in Economic Affairs section compared to 2021. Thus, the largest share of the overall decline in expenditure will come from expenditure on private activities (especially Economic Affairs due to subsidy reductions and Recreation, Culture and Religion). However, despite the projected decline in general government expenditure, there will be a very significant 1 pp increase in expenditure in Defence section, due to the approval of the Defence Financing Bill (see Section 7.3.2), which would require national defence expenditure of at least 2% of GDP annually starting with the 2024 State Budget. Thus, we expect that total expenditure on pure public goods in the form of defence and public order and safety expenditure will amount to around 3.8% of GDP at the end of the forecast horizon. The forecast also includes expenditure on science and research spent cross-sectionally in individual sections, taking into account the government's intentions according to its Policy Statement. Graph 6.1 and Table 6.1 show the composition of general government expenditure by function in 2021 and its projected composition in 2026. We estimate that in 2026, more than half of general government expenditure will be on social security and provision of health care to the population (i.e. 20.8% of GDP).

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

in % of total expenditure



Note: The category "Pure public goods" includes "Defence" and "Public Order and Safety". The category "Private activities" is a sum of "Economic Affairs", "Environmental Protection", "Housing and Community Amenities", and "Recreation, Culture and Religion". For details see ECB (2009).
Source: CZSO (2023d). MF CR calculations and forecast.

Table 6.1: General Government Expenditure by Function

in % of GDP

	Code	2021	2026
General public services	1	**4.9**	**4.3**
Defence	2	**1.0**	**2.0**
Public order and safety	3	**2.0**	**1.9**
Economic affairs	4	**7.2**	**4.8**
Environmental protection	5	**0.9**	**0.7**
Housing and community amenities	6	**0.6**	**0.4**
Health	7	**9.8**	**8.1**
Recreation, culture and religion	8	**1.3**	**1.0**
Education	9	**5.0**	**4.8**
Social protection	10	**13.6**	**12.7**
Total expenditure	TE	**46.5**	**40.6**

Note: Year 2026 outlook.
Source: CZSO (2023d), MF CR (2023a). MF CR calculations and forecast.

7 Changes in the Institutional Framework of Fiscal Policy

In recent years, there has been a strong emphasis on investment in digitalisation and green transition. These areas are supported to a considerable extent both by Cohesion Policy funds and the EU's Recovery and Resilience Instrument, where the Czech Republic is also considering the possibility of using its loan part. The institutional capacity of resources for investment in transport infrastructure is being expanded. In the area of transparency of public finances, there has been a shift in cooperation with the European Anti-Fraud Office or a change in the law on conflict of interest. In the area of budgetary and fiscal policy, a change in the European fiscal framework is under preparation, and at the national level the government aims to strengthen fiscal discipline by reflecting the rules of fiscal responsibility in the country's constitutional order.

7.1 Changes Related to Investment and the Capital Market

7.1.1 Next Generation EU

The Next Generation EU Instrument was approved as a complement to the Multiannual Financial Framework 2021–2027, amounting to EUR 807 billion to be borrowed by the EC on the financial markets and guaranteed by the EU budget. These funds are then to reinforce selected budget chapters and instruments through the EU budget in 2021–2024, or be provided to a lesser extent in the form of loans to Member States. The loans will then be repaid in the period 2028–2058 through increased contributions to the EU budget or the introduction of new own resources. In 2020, Regulation (EU) 2021/241 of the European Parliament and of the Council establishing the **Recovery and Resilience Facility**, which forms the core of the EU's Next Generation Instrument, was adopted. A Recovery and Resilience Plan (National Recovery Plan) approved by the EU Council is a condition for the disbursement of funds to finance structural reforms and public investment. The Plan, in the form of a comprehensive package of investments and reforms, with a clear timetable and quantified costs, is intended to contribute to the digital transformation of the economy and to the achievement of the EU's climate goals. An implementing Council Decision was approved in 2021, and last year the Czech Republic concluded an operational arrangement with the EC, which specifies the milestones and targets contained in the Recovery and Resilience Plan and which is also a necessary condition for submitting a request for payment from the Recovery and Resilience Facility. Currently, the Czech Republic has met 37 milestones and targets and is to receive, after approval by Member States, around CZK 22 billion for energy efficiency improvements in public buildings and investments in railways or digital services.

The overall allocation of the Recovery and Resilience Plan will be increased in 2023 for several reasons. Following the refinement of the allocation key based on the economic performance of the Czech Republic, the amount should increase by around CZK 14 billion due to the inclusion of **EU REPower** in the Recovery and Resilience Facility. This is a new plan put forward by the EC in May 2022 in response to the problems and disruption in the global energy market caused by Russia's invasion of Ukraine. It has a total allocation of EUR 20 billion and aims to end the EU's dependence on fossil fuels from Russia and make further progress towards the EU's climate targets, while the digital target (20% of spending from the plan's total allocation) will not be applied to new REPower EU measures, while the climate target (37%) will remain in place. For the Czech Republic, approximately CZK 16 billion is earmarked for investments in energy security. In March 2023, in connection with this plan, the Government decided (Government Resolution No. 153/2023) to reallocate the so-called Brexit reserve (funds to finance measures to support the economic sectors most affected by the UK's withdrawal from the EU) in the amount of EUR 54.9 million to the EU REPower allocation for energy saving measures in rail transport. The final option for updating the Recovery and Resilience Plan is to accept a **loan from the Recovery and Resilience Facility**, with a maturity of 30 years from the date the tranche was granted, with the Czech Republic paying only interest for the first 10 years. The loan would be disbursed in bi-annual tranches based on the achievement of the milestones and targets of the National Recovery Plan. The interest rate would be based on the evolution of the yield of the Next Generation EU Instrument bonds issued by the EC on behalf of the EU. The government is considering to borrow primarily for energy transition investments, with one of the decision criteria being more favourable interest costs compared to the issuance of long-term government bonds. In March 2023, the government decided (government resolution 212/2023) to notify the EC of preliminary interest in a loan in the minimum amount of EUR 2.9 billion. The loan focuses on financial instruments in the field of energy transition and strategic fossil fuel projects. At the same time, interest in a maximum loan volume of up to EUR 11 billion has also been indicated to the EC. A final decision on the acceptance of the loan must be made by August this year, with the loan agreement between the EC and the Czech Republic to be concluded by the end of 2023.

7.1.2 Extension of Modernisation Fund Programmes

The Modernisation Fund was set up by the EC with the adoption of Directive 2003/87/EC, allowing Member

States to finance investments in the period 2021–2030 to develop low-carbon technologies, modernise energy systems and improve energy efficiency. In order to support the financing of energy-saving investment measures as well as the acquisition of alternative energy sources for households, the Government approved (Government Resolution No.940/2022) the expansion of the existing structure of the 9 programmes of the Modernisation Fund by the **HOUSEnerg programme**. The allocation of this programme amounts to 14.2% of the total resources of the Modernisation Fund, whereby subsidies are used to support investment projects to reduce the energy consumption of residential buildings, to acquire renewable energy sources and to achieve savings in primary non-renewable energy, but also, for example, to provide a contribution to achieving a higher energy standard in new buildings.

7.1.3 Investments in Rail Transport in the Form of PPP

In an effort to increase investment in the field of rail transport, the government is considering implementing projects in the form of a public-private partnership (PPP) model as a complementary way of ensuring the construction, financing, operation and maintenance of transport infrastructure. Implementing projects through this model would free up the State Transport Infrastructure Fund's budget to invest in other necessary infrastructure projects at the same time. However, the operation of the railway and the revenues from charges from carriers would remain the responsibility of the State. The private partner would be responsible for ensuring the operability of the constructed line and financially rewarded (and penalised) for the quality of its construction availability over the entire duration of the project, i.e. about 25–35 years.

The Ministry of Transport and the Railway Administration have prepared two pilot projects for the modernisation and construction of railway lines (from Prague Veleslavín to Václav Havel Airport and Nemanice I – Ševětín) with total investment costs of CZK 41.2 billion. For these two investment projects, the Government approved (Government Resolution No. 624/2022) the preparation of feasibility studies, while the benefits and risks of this financing model in rail transport will be further evaluated.

7.1.4 Investments from the European Investment Bank

In order to strengthen investment in transport infrastructure, the Czech Republic and the European Investment Bank concluded a memorandum in November 2022, the purpose of which is to establish a framework for planned cooperation between the two parties in relation to financial and technical support needed for the implementation of strategic railway infrastructure projects. This is an additional source of financing beyond the state budget, whereby the **Czech Republic will be able to draw on loans of up to EUR 7 billion in 2023–2027**, which will co-finance and complement funds from the Recovery and Resilience Facility, the Operational Programme Transport 2021–2027 and the Connecting Europe Facility. These loans will primarily finance major investment projects (e.g. TEN-T rail corridors and nodes where infrastructure is electrified or where electrification is planned within 10 years, or where infrastructure will be adapted for zero carbon trains within 10 years), regional rail development or investments in digitisation and automation to optimise the use of rail capacity and improve safety and interoperability.

Currently, the relevant investment projects are being assessed by the European Investment Bank and technical consultations are underway with representatives of the Ministry of Transport, the State Fund for Transport Infrastructure and the Railway Administration. Subsequently, the projects will be submitted to the Steering Committee and the Board of Directors of the European Investment Bank for approval. After their approval, the loan agreement will be submitted to the MF CR. It will then be approved at the government level, while the acceptance of the tranches will not be binding for the MF CR and will depend on the interest rate conditions that the European Investment Bank will achieve on the financial market by issuing its bonds. Assuming the advantageousness in terms of interest expenses compared to the standard debt financing through the issuance of Czech government bonds, it is likely that a loan of approximately CZK 25 billion will be drawn this year (with a subsequent loan to the State Fund for Transport Infrastructure). This will largely cover the need for additional resources for the State Transport Infrastructure Fund in the amount of CZK 30.7 billion (Government Resolution No.825/2022).

7.1.5 Investment Incentives Changes

Currently, according to Act No. 72/2000 Coll., on Investment incentives and Government Regulation No. 221/2019 Coll., projects with high value added and strategic projects are supported. The approval of Government Regulation No. 89/2023 Coll. introduced **changes in the definition of the conditions for higher value added** in the form of extending the criterion of higher value added to all regions of the Czech Republic (except regions with a share of unemployed persons of at least 7.5%) and tightening it (increasing the expenditure on cooperation with a research organisation to 2% of eligible costs and increasing the share of research and development workers in the number of employees from the current 2% to 3%). Strategic investment actions (e.g. large-scale investments or investment projects aimed at expanding the production capacity of products needed to implement the necessary energy transformation of the Czech Republic) are exempted from these increased limits. In addition, more targeted support is introduced for the production of technologies and equipment that will contribute to energy savings and energy transformation. These are in particular products for which a shortage or partial unavailability on the market has been identified and there is a need to support the increase of their production capacity in the Czech Republic. This is ensured by a change in the setting of support conditions. Investments aimed at the production of these products can now obtain an investment incentive in the form of material support for the acquisition of tangible and intangible fixed assets for strategic investment actions without having to reach an investment of CZK 2 billion and create 250 new jobs. The amount of support for the acquisition of tangible and intangible fixed assets for strategic investment projects is then increased up to 20% of eligible costs in all regions (currently, this level of material support is available only in the Karlovy Vary, Ústí nad Labem and Moravian-Silesian regions). If the investment is approved by the government as a strategic investment action, it will also not have to comply with the higher value added thresholds.

Beyond these changes, the Government approved an amendment to the Investment Incentives Act (Parliamentary Document No. 409), which changes the **approval process for investment incentives**. It is proposed to abolish the current obligation to submit each application for an investment incentive to the government for approval and instead to approve it at the level of departmental deliberation while respecting the administrative procedure. The decision on the investment incentive will be issued on the basis of an assessment of the conditions and obligations set out in the relevant legislation and in accordance with the binding opinions of the authorities concerned (the MF CR, the Ministry of the Environment, the Ministry of Labour and Social Affairs and the Ministry of Agriculture). However, applications for strategic investment projects to obtain a financial contribution for the acquisition of tangible and intangible fixed assets will continue to be submitted to the Government. Therefore, the government will not decide whether or not to support the project, but only whether or not to provide direct funding for the project, according to the possibilities of the state budget. The removal of the political factor in the final approval phase should not only increase the credibility of the investment incentive system, but also the legitimate predictability of the approval procedure.

7.1.6 Development of Czech Capital Markets

In accordance with the Concept of Capital Market Development in the Czech Republic 2019–2023 (MF CR, 2019), the government plans to adopt several amendments to laws to support the capital market. Within the framework of the amendment to Act No. 256/2004 Coll., on Capital Market Business, it is proposed to introduce a so-called **investment pension account**, which would hold selected investment instruments (in particular shares, bonds, investment certificates, shares in investment funds, money market instruments or hedging derivatives) or cash. The custodian of such an account will be a securities dealer or a bank in the case of cash. The investment pension account will be tax-advantaged in a similar way to a supplementary pension, supplementary retirement savings or life insurance. The employer will be able to contribute to the employee's investment pension account, which will be tax exempt income for the employee. Income from the transfer of assets in the account will also be tax exempt. In addition, contributions made to the investment pension account will be deductible from the tax base up to an aggregate limit of CZK 48,000. This applies to all tax-supported retirement savings products. For the purposes of the tax support, the statutory conditions will have to be met (in particular, the "60+60 rule", i.e. withdrawals from the account only in the year the taxpayer reaches the age of 60, and the arrangement of the product for a minimum period of 60 months). The amendment to Act No. 427/2011 Coll. on supplementary pension savings plans to introduce a new type of participatory fund, the so-called **alternative participatory fund**. It will be less strictly regulated in terms of fees and investment strategy, which will allow investments in, for example, "private equity" funds (funds investing with a 10-year investment horizon in large unlisted companies) and infrastructure projects, thereby increasing the efficiency of the third pension pillar. It is also proposed to **allow simultaneous participation in both the transformed and the participant funds** in order to allow participants to transfer more easily to participant funds without having to cancel their participation in the transformed fund. In order to **motivate people to make higher contributions to the pension funds** and at the same time to achieve a neutral impact on the state budget, it is also proposed to increase the lower limit of the state contribution from the current CZK 300 to CZK 500 per month and the upper limit from the current CZK 1,000 to CZK 1,700 per month, with the amount of the state contribution being linear in the proportion of 20% of the participant's contribution.

7.2 Increasing Efficiency and Transparency of Public Finances

7.2.1 Open Public Administration Data

The basic legal framework for open data in the Czech Republic is Act No. 106/1999 Coll., on Free Access to Information. It sets out the basic principles and requirements for the quality of information provided, which obliged entities must comply with when providing information. Furthermore, if obliged entities provide information in open data quality, this information must be provided in an open and machine-readable format and must be registered in the national open data catalogue, which is managed by the Ministry of the Interior. Currently, 283 entities provide more than 142,000 datasets to the national open data catalogue on a mandatory and voluntary basis. With effect from 1 February 2022, there is a legal obligation (Act

No. 261/2021 Coll.) to publish specific areas of data as open data. State authorities, regional authorities and municipal authorities of municipalities with extended powers must then publish metadata of information published in a way allowing remote access on their official boards and metadata of these official boards as open data. Mandatory entities must publish public registers, indexes, records and lists as open data, while for existing registers, indexes, records and lists the obligation is postponed until the end of 2023. Last year, Directive (EU) 2019/1024 of the European Parliament and of the Council on open data and the re-use of public sector information was transposed, which, with effect from 1 January 2023, among other things, extends the range of obliged entities to include public undertakings controlled by the state, introduces the obligation to publish dynamic data in the form of open data or to publish high-value datasets as open data. With effect from 1 January 2024, a central register will be set up as a public administration information system to publish the annual reports of obliged entities. The Ministry of the Interior will be the administrator of this register.

In the area of public finances, open data are published primarily by the MF CR, with 732 datasets currently published. Several information systems are also part of the MF CR's open data. First of all, the Monitor information portal, which provides data on budget and accounting information from all levels of state and local government, including illustrative graphical outputs. Next is the CEDR III information system, which provides data on subsidies, repayable financial assistance and other similar transfers provided from the state budget, state funds, state financial assets and the National Fund (including European subsidies) and their beneficiaries. The DotInfo information system enables to seek out the providers of grants and repayable financial assistance from the state budget.

7.2.2 European Anti-Fraud Office

Act No. 34/2023 Coll. on the Coordination of Cooperation with the European Anti-Fraud Office will enter into force on 1 April 2023. This is an adaptive regulation for the implementation of Regulation (EU, Euratom) 2020/2223 of the European Parliament and of the Council amending Regulation 883/2013, since in the Czech legal system no national administrative authority with the relevant competence has so far had the competence to obtain or provide data to the European Anti-Fraud Office to the extent required by the relevant provisions of this Regulation. The adoption of this Act defines the competences of the MF CR as a new entity in the exercise of the anti-fraud coordination service. The MF CR, on behalf of the Czech Republic, is the administrative and legal partner of the European Anti-Fraud Office in the performance of the coordination service. It organises, for example, meetings with the office with the entities concerned during on-site inspections, provides the necessary documents and information for its investigations and assists the course of its investigations in the Czech Republic. In parallel, Act No.35/2023 Coll. amending certain acts in connection with the adoption of the Act on the Coordination of Cooperation with the European Anti-Fraud Office was adopted. Its adoption amends three laws (on banks, credit unions and the central register of accounts). The scope of the entities is extended to include the MF CR, to which banks are now entitled to submit information on matters subject to banking secrecy, including records of transactions. The same obligation will apply to credit unions for information to be kept confidential.

7.2.3 Conflict of Interest Act

The Chamber of Deputies is currently considering an amendment to the Conflict of Interest Act (Chamber of Deputies Print No. 110), which aims to streamline the legal regulation and increase the enforceability of the law in the area of conflict of interest. In particular, it targets provisions that prohibit public officials and companies they actually own from receiving subsidies and investment incentives and from owning media. As there is still no consensus on the form of this key anti-corruption legislative document in the above-mentioned areas, Act No. 180/2022 Coll. amending Act No. 159/2006 Coll. on Conflict of Interest was issued. The amendment addresses the issues arising from the Constitutional Court's ruling of 11 February 2020, Case No. Pl. CC 38/17, which abolished the possibility of unlimited anonymous inspection of submitted notifications as of 31 December 2020. In response to the publication of the notice on the conflict of interests, there were also several court proceedings in the matter of the state's responsibility for the unconstitutional widespread publication of sensitive personal data of representatives of municipalities and cities, which were eventually dealt with by the Constitutional Court. The rulings in Case Nos. IV.CC 579/22 and IV.CC 2296/22 indicate that it is unconstitutional for a public authority to apply provisions of a law that have been challenged by the Constitutional Court for interfering with the constitutionally guaranteed fundamental rights or freedoms of the addressee of the legal act, even if the provisions have been repealed with a deferred period of time for remedy. In this way, the Constitutional Court responded to the continuation of the possibility of unlimited disclosure of property declarations of municipal and regional representatives by the Ministry of Justice following the Constitutional Court's annulment ruling (Case No. Pl. CC 38/17). The approved amendment, effective from 1 July 2022, introduces access to the Central Register of Notices upon request of a duly identified applicant and provides that all data from the Register of Notices may be used only for the purpose of establishing a possible violation of a public official's duties. It also excludes from the category of public officials the non-elected deputy mayors in Type I municipalities and non-elected councillors in Type I and Type II municipalities and introduces an obligation to delete from the Central Register of Notices within 60 days those persons who are no longer covered by the Conflict of Interest Act.

7.2.4 Whistleblower Protection Act

In November 2022, the Government approved the Whistleblower Protection Bill (Parliamentary Document No. 352), which transposes Directive (EU) 2019/1937 of the European Parliament and of the Council of 23 October 2019 on the protection of persons who report breaches of Union law. In addition to the actual protection of so-called whistleblowers (who report wrongdoing got known in a work-related context) from retaliation, the directive and related national legislation also aim to prevent illegal and corrupt practices in the interest of cultivating the public space. The law will provide protection from retaliation to employees and public servants, business partners of employers, tradespeople, interns and volunteers, and others. The right cannot be waived, and protected persons may seek appropriate satisfaction in the event of retaliation. Notification may be made in three ways: through an internal notification system established by the obligated entity, by notification to the Department of Justice, and in specific cases designated by law, by publication. The draft law commands obliged entities (e.g. certain contracting authorities, employers with more than 50 employees, public authorities explicitly designated by law) to establish an internal notification system. The draft also regulates the procedures for receiving and handling notifications and the rights and obligations of persons involved in the protection of whistleblowers, and establishes offences and the power to sanction them.

7.2.5 Public Spending Review

The desire to spend public expenditure as efficiently, economically and effectively as possible has led to the launch of a pilot project of **public spending review**. The project is being carried out in cooperation with the Organisation for Economic Co-operation and Development. The issue of subsidies for training of health care workers was selected as the first area of review, both on the basis of a negative opinion of the Supreme Audit Office (SAO, 2020) and due to the high growth dynamics of expenditure and other demands for expenditure growth in this segment. In 2022, the expenditures in the area of subsidies for postgraduate medical training, which are covered by the state budget, were analysed for their consistency with government policy objectives and their efficiency and effectiveness. As a result of the investigation, several recommendations were made, including: the introduction of prioritization of resource allocation based on the (potential) shortage of physicians in the region/specialty (taking into account the age structure of physicians); improved coordination between the Ministry of Health and health insurance companies (e.g. elimination of duplication of funding from the state budget and health insurance budgets); consideration of the possibility of linking (part of) the subsidy to the future practice of the medical profession in the region or directly in the health care facility to strengthen the effectiveness of the public funds spent (similarly, the possibility of taking into account the success rate of completing postgraduate training). The Ministry of Finance considers the thematic evaluation of state budget expenditures within the framework of the retrospective evaluation of expenditures as an effective tool that leads to increasing transparency and medium-term sustainability of public finances, and therefore intends to use the so-called spending review also for the evaluation of other areas of public expenditures (education, security, public administration).

7.2.6 Public Finance Management and Control

The project **Strengthening Public Finance Management and Control** financed by the EEA and Norway Grants is being implemented, in order to obtain an independent evaluation of the current state of public finance management and control and to identify the main weaknesses and their causes. As part of this project, public administrations are subjected to a detailed analysis of the internal processes of management and control of public finances and subsequently various options for simplification are assessed. In the course of the project, several analyses concerning the functioning of the internal control systems of public administrations were prepared, which should assess and evaluate the current set-up on the basis of an examination of the internal control system set-up in 30 selected public administrations. Furthermore, the basic principles and rules of internal audit, constitutional limits of regulation of public finance management and control in relation to regional authorities or proceedings for breach of budgetary discipline are analysed and evaluated. The outcome of this project should be a draft bill on the Management and Control of Public Finances, which would make the system of management and control of public finances more efficient and increase the protection of public funds.

7.2.7 More Detailed Monitoring of Local Budgets during an Emergency

On 1 July 2022, Decree No. 160/2022 Coll., amending Decree No. 5/2014 Coll., on the Method, Terms and Scope of Data Submitted for the Evaluation of the Implementation of the State Budget, Budgets of State Funds, Budgets of Local Governments and Budgets of Voluntary Associations of Municipalities, as amended, entered into force. The aim of the amendment was to require **detailed monitoring of revenues and expenditures of local governments related to extraordinary events of regional or national importance** (e.g. migration crises, pandemics and natural disasters) in the classification according to the Decree on Budgetary Composition. For the purposes of this Decree, an emergency is an event with a potentially significant impact on public budgets, e.g. linked to the declaration of a state of emergency, a state of national emergency or a state of war. The existing Statement for the Evaluation of the Budgetary Performance of Local Governments and Voluntary Associations of Municipalities has been modified to classify revenues and expenditures by section, item, instrument and spatial unit to show that they are revenues and borrowed funds received or expenditures related to emergencies of regional or national significance.

An emergency is currently declared as "01 – Aid to Ukraine" for expenditure on purchases (e.g. acquisition of goods and services), transfers or borrowed funds. Other exceptional events will be numbered in two digits, ascending and in chronological order, and will be announced and published on the MF CR website, together with their names and effective dates (i.e. the moment from which the entities concerned will track and report this exceptional event for receipts, borrowed funds received and expenditures).

7.3 Budgetary Policy

7.3.1 EU Fiscal Framework Reform

In response to the lessons learned from recent economic crises, but also to higher and more disparate levels of national government debt or the need to facilitate investment in common EU priorities, the EC proposed a **reform of the EU's economic governance framework** in November 2022**.** The intention is to make the framework simpler, more transparent and more efficient, with greater national ownership and better enforcement of rules, while allowing for reform and investment and contributing to a realistic, gradual and sustainable reduction of high debt levels. The framework proposed by the EC is based on national **medium-term fiscal and structural plans**. These would integrate fiscal, structural reform and investment objectives, including targets to address macroeconomic imbalances where appropriate, into a single coherent medium-term plan. Member States would have greater flexibility in setting the fiscal adjustment path. A single indicator – net primary expenditure, i.e. expenditure under the direct control of the government – would serve as the basis for setting the fiscal adjustment path and conducting annual fiscal surveillance. The process would work in several steps:

- The EC would present a benchmark fiscal adjustment path for a four-year period based on its methodology for (medium-term) debt sustainability analysis. This benchmark adjustment path should ensure that the debt of Member States with significant or medium risks starts to decline credibly and that the deficit remains below the 3% of GDP reference value.
- Member States would then submit plans setting out their medium-term fiscal path, priority reforms and public investment commitments. Member States could propose a longer adjustment period, extending the fiscal adjustment path by up to three years, if it is based on a set of reform and investment commitments that contribute to debt sustainability and respond to common EU priorities and objectives.
- The EC will consider the plans with a positive assessment if debt starts to decline or remains at a prudent level and the budget deficit remains below the 3% of GDP reference value over the medium term. Following a positive assessment by the Commission, the Council would approve the plans.
- The EC would continuously monitor the implementation of the plans and Member States would submit annual progress reports on the implementation of the plans to facilitate effective monitoring and ensure transparency.

At the same time, stronger EU enforcement tools would be introduced to ensure proper implementation of the plans. The excessive deficit procedure based on breaches of the deficit reference value would be maintained, while the excessive deficit procedure based on the debt criterion would be strengthened. It would be activated if a Member State with a debt above 60% of GDP deviates from the agreed expenditure path. It is also proposed to adjust financial and reputational sanctions and to introduce a new instrument to ensure the implementation of reform and investment commitments, on which a longer adjustment path would be based. Non-compliance could then lead to a more restrictive correction process. Changes to the prevention and correction of macroeconomic imbalances are also proposed in form of strengthening the early identification of macroeconomic risks. Currently, the proposal is being discussed among the member states, while the issuance of relevant legislative proposals was to follow the meeting of the European Council in March. This implies that agreement on a new fiscal framework will not be reached before the start of the budgetary procedures for 2024.

7.3.2 Change in Funding for Defence Spending

In accordance with the Government's Policy Declaration, a draft of Act on the Financing of Defence of the Czech Republic was submitted to the Chamber of Deputies (Chamber of Deputies Print No. 369), which, starting in 2024, guarantees **a minimum annual defence expenditure in the state budget of 2% of GDP** and enables stable and transparent financing of strategic military acquisitions. According to this law, defence expenditure means both the expenditure of the Ministry of Defence and expenditure claimed by other chapters of the state budget, if it falls under the definition of defence expenditure set out in the North Atlantic Treaty Organisation documents *PO(2018)0048 NATO Defence Expenditure Definition*. The Alliance defines defence expenditure as payments made at central government level (i.e. not to regional, local or municipal authorities) to specifically meet the needs of the armed forces of an ally, allies or the Alliance. Thus, it includes, for example, supplies for direct use by the armed forces, expenditure on wartime stockpiling of finished military equipment, employers' contributions to pension funds for active personnel, and retirement pensions for retired military personnel. Conversely, compensation for war damage and benefits and payments to veterans, civil defence and civil preparedness expenditure are not included. In the new concept of defence expenditure, the administrators of the chapters of the state budget submit to the Ministry of Defence for approval the inclusion of national defence expenditure at the latest 36 months before the beginning of the financial year in which the expenditure is to be included in the budget.

The Act also introduces the legal institute of a strategic project of the Army of the Czech Republic as a minimum three-year project with a fundamental impact on the defence capability of the Czech Republic with a budget exceeding CZK 300 million. Their selection will be subsequently approved by the Government after coordination with the Alliance plans under the responsibility of the Ministry of Defence and after discussion with the MF CR. In order to improve the flexibility of the use of resources for financing these projects, it is proposed that entitlements arising from a strategic project under one programme can be used for another project under another programme, i.e. the Ministry of Defence will have an aggregate amount of funds for strategic projects each year, which can be used more easily for individual projects.

7.3.3 State Support for Insurance and Export Financing

As a result of the Russian aggression against Ukraine and the ensuing economic impact on EU Member States, the EC has modified the so-called Temporary Framework (Commission Communication 2022/C 426/01) for other State aid instruments. This allows Member States until the end of 2023 to provide public support to companies affected by the economic impact (in particular high prices of energy, raw materials and other commodities) and indirectly by the ensuing sanctions. In this context, Act No. 363/2022 Coll. amending Act No. 58/1995 Coll. on Insurance and Financing of Exports with State Support was adopted, which, with effect from 1 December 2022, defined more generally the possibility of providing guarantees so as to extend, without further legislative intervention, State support in relation to its need in the event of emergency measures in order to maintain or increase the availability of liquidity for the entities listed in the Act. Furthermore, the subjects of support have been extended to include export-oriented enterprises, which are defined as individuals or legal entities having an export share of at least 25% of the total annual revenue from the sale of products, services and goods for the last accounting period. It is also clearly defined that the sources for the supported financing are provided from the state budget, from borrowings or loans granted by the MF CR pursuant to Act No. 218/2000 Coll., on Budgetary Rules, or on the financial markets. The Act also specifies the determination of the Czech Export Bank's losses from the operations of supported financing, the reimbursement of which is covered by subsidies from the state budget. Thus, the loss now includes the costs of write-offs of receivables, income from the use or release of provisions and reserves, received insurance performance, gains and losses from modifications of financial assets related to supported financing. Conversely, items relating to financial derivative transactions are excluded. These financial operations are a purely commercial decision of the Bank and are not directly related to the supported financing, as they are carried out on stable financial and capital markets and it should be the duty of the Czech Export Bank to carry out such operations prudently and without claiming that the losses incurred will be covered by subsidies from the State budget.

7.3.4 New Agricultural Subsidy Plan

In October 2022, the Government approved (Government Resolution No. 860/2022) the Strategic Plan of the Common Agricultural Policy for the period 2023–2027 (MoA, 2022), which was subsequently notified by the EC in November. This plan represents a key instrument of support for the agricultural sector and rural areas for the period in question by setting agricultural, food and forestry objectives for which agricultural subsidies from European and national sources will be allocated, totalling approximately CZK 200 billion. The main objective of the adopted plan is more effective support in the form of direct payments to farmers, which make up the largest share of the common agricultural policy. Thus, from 2023, several changes have been made to the subsidy system which are based on the principle of merit. The new redistributive payment is set at 23% of the total amount of direct payments that farmers receive for the first 150 hectares of land farmed. This payment makes up for the basic area subsidy, for which the annual allocation has been reduced from CZK 12 billion to around CZK 6.2 billion. These steps are thus primarily aimed at supporting smaller farms. Significant additional funds are then provided when applying organic solutions (e.g. in the form of a financial bonus for farmers who farm more organically than they are obliged to).

7.3.5 State-owned Enterprises in the State Treasury System

In order to strengthen the state's liquidity position and streamline the state treasury's liquidity management, the proposed amendment to Act No. 218/2000 Coll., on Budgetary Rules (Chamber of Deputies Print No. 369), contains the inclusion of state-owned enterprises (including the national enterprise) under accounts subordinated to the State Treasury system. This will only lead to the maintenance of accounts with the CNB and the execution of payments through the CNB. However, the accounting and reporting is not to be linked to the integrated treasury system. The amendment also proposes that, similarly to the state contributory organisations, state funds, the Railway Administration, health insurance companies and state enterprises should be allowed to set up accounts outside the CNB on the basis of a reasoned request and approval by the MF CR.

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Annex: Convergence

In 2022, the economic level of the Czech Republic, expressed in terms of gross domestic product per capita at current purchasing power parity, was 9% lower than in the EU and 22% lower than in Germany. Although the economic level of the Czech Republic was rapidly approaching the EU average between 2000 and 2008 due to strong economic growth, the convergence process then stalled until 2013 due to recessions and only a slight recovery. Subsequently, however, the Czech Republic started to slowly converge towards the EU average again until 2020, when the world was paralysed by the coronavirus pandemic, a synchronised decline in economic activity occurred and the convergence process stopped again (see Graph A.1In the context of the lingering effects of the pandemic and the Russian aggression against Ukraine, which led to a sharp increase in prices and a tightening of monetary policy, we expect that the convergence process could resume only in 2024.

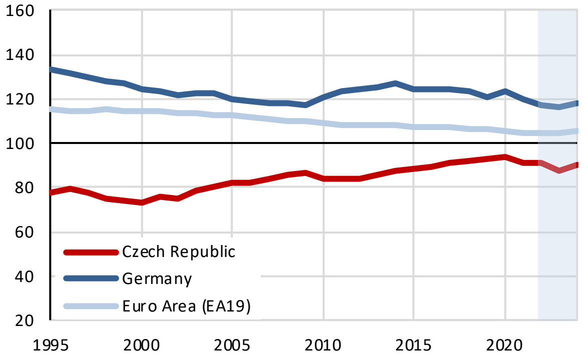
Since 1995, the comparative price level of the Czech Republic had been on an almost uninterrupted upward trend. In 2008, it reached 72% of the EU average, and thereafter, with the exception of 2009, remained close to this level. During 2013 and 2014, the comparative price level declined as a result of the CNB's exchange rate commitment and the related depreciation of the koruna against the euro, and even fell to the 2006 level in 2014. Since 2015, however, it has gradually risen again (see Graph A.2). This year, the comparative price level is expected to increase more significantly, including as a result of the appreciation of the koruna, to 87% of the EU average. It should remain at this level next year.

Despite the weaker economic recovery, labour productivity per hour worked should continue to increase gradually this year as a result of the appreciation of the Czech currency (see Graph A.3). Labour productivity in the Czech Republic could thus increase to 63% of the EU level and remain at this value next year.

After 2008, wage convergence temporarily stopped. Subsequently, the average wage in the private sector in the Czech Republic hovered around 46% of the EU level. In 2017–2019, due to the economic upturn and the increase in the minimum and guaranteed wage, this ratio started to increase again until 2020, when it fell slightly. The tight labour market has contributed to an increase in the average wage, which reached 60% of the EU average in 2022, or 74% in PPP terms.

Graph A.1: Relative Economic Level

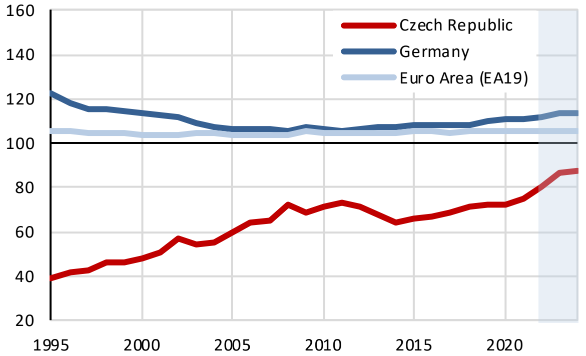
EU27=100, GDP per capita in current purchasing power parities



Source: CZSO (2023a), Eurostat (2023). MF CR calculations and forecast.

Graph A.2: Comparative Price Level

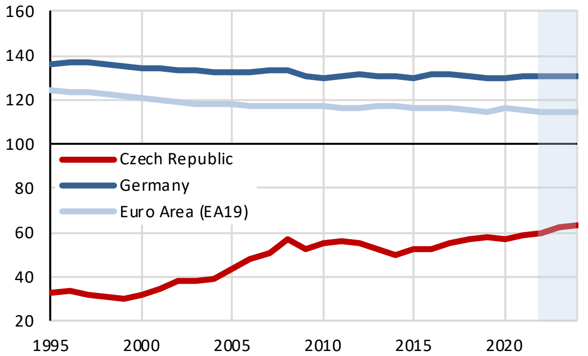
EU27=100



Source: CZSO (2023a), Eurostat (2023). MF CR calculations and forecast.

Graph A.3: Real Labour Productivity

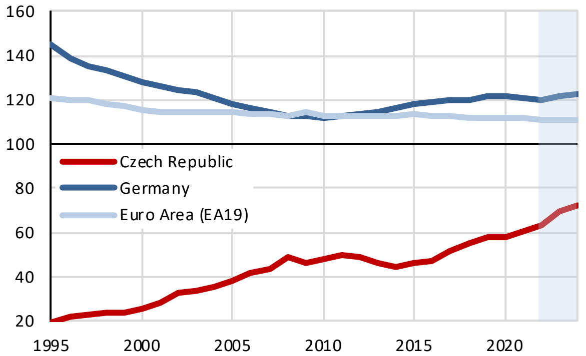
EU27=100, constant prices of 2010, per hour worked



Source: Eurostat (2023). MF CR and AMECO (2023) calculations and forecast.

Graph A.4: Average Compensation of Employee

EU27=100



Source: AMECO (2023), Eurostat (2023). MF CR calculations and forecast.

Glossary

Accrual methodology means that economic transactions are recorded at the time an economic value is created, transformed or cancelled or when receivables and liabilities increase or decrease, regardless of when the transaction will be paid (unlike the cash principle, which is the basis of, for example, the state budget).

Balance of payments captures economic transactions between residents and non-residents for a given territory in a certain period of time. The basic structure of the balance of payments is based on the methodology of the International Monetary Fund and includes the current, capital and financial accounts (including changes in foreign-exchange reserves).

Capital transfers include acquisition or loss of an asset without equivalent consideration. They may be made in cash or in kind. **Capital transfer in cash** is defined as cash transfer without expected consideration from the unit which received the transfer. **Capital transfer in kind** is based on the transfer of ownership of an asset (other than inventory and cash) or decommitment by a creditor for which no consideration, assumption of debt, etc. was received.

Comparative price level is the ratio of the GDP at market exchange rate to the GDP in purchasing power parity.

Consumer price index is one of the indexes measuring the price level. It is constructed on the basis of regular monitoring of the prices of selected goods and services (so-called representatives) in the consumption basket of households. Each representative has a certain weight. The consumption basket is divided into 12 categories (e.g. food and non-alcoholic beverages; alcoholic beverages, tobacco; clothing and footwear; housing, water, electricity and fuel; etc.). **Harmonised index of consumer prices** is calculated in EU countries according to uniform and legally binding procedures, which (unlike national indexes) allows for comparability of this indicator among countries.

Cyclically adjusted balance of the general government sector is used to identify the fiscal policy stance because it does not include the impact of those parts of revenues and expenditures which are generated by the position of the economy in the business cycle.

The **debt rule of the national fiscal framework** activates legally defined measures if the relative government debt ratio (minus the cash reserve of government debt financing) exceeds 55% of GDP. These measures set out the conditions for the preparation of budget drafts for individual segments of the general government sector (state budget, budgets of the state funds, health insurance plans of health insurance companies and budgets of local governments) and other public institutions limit new liabilities leading to an increase in the general government debt with a maturity of more than 1 year.

Dependency rate (demographic) is the ratio of the senior-age population (over 64 years old) to the working-age population – it thus does not reflect retirement age extending. **Dependency rate according to the applicable legislation** is the ratio of the retirement-age population according to the applicable legislation to the number of other inhabitants over 14 years of age. **Effective dependency rate** refers to the ratio of the number of old-age pensions paid to the number of employees.

Discretionary measures represent direct interventions of executive or legislative authorities in general government revenue and expenditure.

The **expenditure rule of the national fiscal framework** serves as the basis for the preparation of the draft of the state budget and the budgets of state funds. The rule derives the maximum amount of government sector expenditure from the structural part of the government sector revenue increased by 1% of GDP. This increase represents the established medium-term budgetary objective of the Czech Republic. The rule is supplemented by an automatic correction mechanism reflecting in retrospective the gap between the actual level of expenditure and the expenditure prescribed by the rule, and is accompanied by precisely defined escape clauses under Act No. 23/2017 Coll., on fiscal responsibility rules.

The **expenditure rule of the Stability and Growth Pact** limits the growth of adjusted real expenditure of general government sector adjusted by discretionary revenue measures (so-called adjusted expenditure), thus the given member state shall reach the medium-term budgetary objective and would follow it henceforward. The adjusted expenditure of countries which meet their medium-term budgetary objective shall grow at most by the average rate of growth of the potential output calculated in 10-year horizon containing 5 past years, the current year and 4 following years. The average rate of the potential output growth is updated annually, based on the Spring European Economic Forecast with the validity period for the following year. For countries which have not yet reached their medium-term budgetary objective, the highest acceptable rate of adjusted expenditure growth is lower than the average growth of the potential output. The difference between the two rates is referred to as the convergence margin, which reflects the fiscal effort required for the gradual achievement of the medium-term budgetary objective.

Fiscal impulse is used to assess the impact of government fiscal policy on economic growth. Unlike the primary fiscal effort, it does not include revenues from EU funds and expenditures to the EU budget, and on the contrary, it includes certain one-off operations (usually government measures with a direct fiscal impact).

Fiscal effort is a year-on-year change in the structural balance indicating expansive of restrictive setting of the fiscal policy in a given year.

Fiscal sustainability indicators, based on long-term projections, characterise the sustainability of public finances and the extent of the changes necessary to attain it. The EC uses three main indicators. **Indicator S0** consists of 28 macro-financial and fiscal indicators and indicates fiscal risks for the coming year. **Indicator S1** indicates by how many percent of GDP the primary structural balance must be improved in the medium term for next 5 years to make the general government sector debt reach 60% of GDP in 2030. **Indicator S2** enumerates by how many percent of GDP the primary structural balance must be permanently improved to make the general government debt remain stable in an infinite time horizon (i.e. the current value of future primary balances to be equal to the current general government debt).

The **general government sector** is defined by internationally harmonised rules of the EU. In the Czech Republic, it includes, in the ESA 2010 methodology, three main subsectors: central government, local government and social security funds.

Government Deficit and Debt Notification is the quantification of fiscal indicators submitted by each EU member state twice a year to the EC under Council Regulation (EC) No. 479/2009 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community, as amended. It is compiled for the general government sector using the accrual methodology. The Czech Statistical Office processes the data for the past four years and MF CR prepares the prediction for the current year. The notification contains both a basic set of notification tables, including key indicators such as balance and debt, with an explanation of the transition from the balance in the national methodology to the accrual balance and contributions to the change in debt, as well as a number of supplementary questionnaires, such as the guarantee table.

Government final consumption expenditure includes government payments which are subsequently used for consumption of individuals in the household sector (mainly reimbursement of health care by health insurance companies for services provided by medical facilities) or are consumed by the entire society (such as expenditure on army, police, judiciary, state administration, etc.). General government services, provided for consumption to the entire society, are usually valued at the level of own costs for a given service because they do not pass through a market which would value them. For the above reasons, consumption consists mainly of intermediate consumption (i.e. goods and services, excluding fixed assets consumed in the production of other goods or services), compensation to employees (wages and salaries including the part of social security contributions paid by employers), social transfers in kind to households (in particular payments by health facilities outside the general government sector) or consumption of the fixed capital. The value calculated is not the entire value of these transactions but only the value associated with the production valued at own costs. The costs associated with the production of activities which pass a market fully or partly and for which the general government sector receives payment are excluded from its consumption.

Gross fixed capital formation represents the investment activities of units. Fixed capital is represented just by assets used in production for more than one year. It also includes for example military equipment, expenditure on research and development, etc.

Gross domestic product (GDP) is the monetary expression of the total value of goods and services newly created in a given period in a given territory. **Real GDP** is the gross domestic product, expressed in the prices of the reference year. This transformation enables, in analysing GDP (or other variables), to eliminate the impact of price changes over time and to focus only on the changes in physical volume. **Gross value added** represents the difference between the value of production and intermediate consumption (production consumed in the production of other goods or services).

Inflation is a sustained growth in the general price level, i.e., internal currency depreciation. The price level is measured using price indices, such as the consumer price index or the harmonised index of consumer prices. The most commonly mentioned **year-on-year inflation rate** is the relative change in the consumer price index compared to the same month of the previous year. The **average inflation rate** is the relative change in the average of the consumer price index in the last 12 months compared to the average of the consumer price index in the previous 12 months. Inflation rates are expressed as a percentage. By **administrative measures on consumer prices** are meant state measures that directly affect the price level. They include the effect of changes in indirect taxes (value-added tax, excise and energy taxes) and regulated prices (e.g. electricity, gas, heat, water and sewerage, public urban transport).

Long-term interest rates are measured on the basis of yields of long-term government bonds or comparable securities until maturity in percent per year. Bonds with residual maturity ranging from 8 to 12 years (the use of these limits is fully based on the conditions of the Czech government bond market, which were set based on the periodicity of Czech government bond issues) are classified as representative. From this set, a combination of bonds whose average residual maturity is closest to the 10-year limit is then generated.

Medium-Term Budgetary Objective is expressed in the structural balance of general government sector and should ensure the sustainability of public finance of the given country. It reflects both the growth potential of the country and its level of indebtedness. Compliance with the medium-term objectives should allow Member States to maintain sufficient reserves of −3% of the GDP against the reference value of the balance of general government sector during common cyclical fluctuations, to secure the progressive steps towards sustainability and ensure space for any necessary budgetary operations. The procedure for its calculation is determined by the Code of Conduct (EFC, 2017). For the Czech Republic it currently corresponds to the level of structural balance of −0.75% of GDP and is revised every three years.

One-off and other temporary measures are revenue or expenditure measures that only have a temporary impact on the general government balance and often stem from events outside the direct control of executive or legislative authorities (e.g. flood relief expenditure).

Output gap is the difference between real and potential output measured in percent of potential output. It serves to identify the position of the economy in the cycle.

Potential output is the level of economic output in the “full” utilisation of available resources. Full utilisation of resources is meant here rather as optimal and balanced, which does not lead to pressures such as changes in the inflation dynamics, etc.

Short-term interest rate is in the Czech Republic represented by PRIBOR 3M, as the reference value for the interest rate indicating the average rate, for which banks can borrow on the market for interbank deposits with a maturity of three months.

Using the **purchasing power parity** method, comparison of the economic performance of individual countries within the EU is carried out in Purchasing Power Standards, which is an artificial currency unit that expresses a quantity of goods that can be purchased on average for 1 euro in the EU after currency conversion for countries using a different currency unit than the euro.

Social benefits in cash are social benefits (e.g., pension insurance benefits, state social security benefits) paid to households from the general government sector.

Structural balance is the difference between cyclically adjusted balance, and one-off and temporary measures (for both components see above). **Primary structural balance** is further adjusted for interest payments.

Unemployment (Labour Force Sample Survey) corresponds to the number of persons who simultaneously met three conditions in the reference period (reference week): they were not employed, actively sought work and were ready to take up work within 14 days at the latest. **Unemployment rate** expresses the ratio of the number of the unemployed and the labour force. A person unemployed for more than 12 months is considered **long-term unemployed**.

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