



# **Convergence Programme Czech Republic**

**November 2007**

# Contents:

Introduction .....	5
1 Economic Policy .....	7
1.1 Fiscal Policy .....	7
1.2 Monetary Policy .....	8
1.3 Structural policies.....	8
2 Macroeconomic Scenario .....	10
2.1 The World Economy and Technical Assumptions.....	10
2.2 Current Macroeconomic Development .....	11
2.3 The Medium-Term Scenario .....	12
2.4 Net Lending/Borrowing and Sectoral Balances .....	17
2.5 The Growth Implications of Structural Reforms.....	18
3 General Government Deficit and Debt.....	20
3.1 The Government's Strategy and the Medium-Term Fiscal Targets.....	20
3.2 Current Development of Public Finances .....	20
3.3 The Medium-Term Fiscal Outlook .....	21
3.4 The Structural Balance and the Fiscal Stance .....	22
3.5 Government Debt .....	23
3.6 The Budgetary Impact of Major Reforms .....	24
4 Comparison with the Previous Convergence Programme and Sensitivity Analysis.....	26
4.1 Comparison with the Previous Macroeconomic Scenario .....	26
4.2 Comparison with the Fiscal Framework of the Previous Convergence Programme	27
4.3 Sensitivity Analysis.....	28
5 Quality of Public Finances – Revenues and Expenditures.....	33
5.1 The Government's Strategy .....	33
5.2 General Government Revenues.....	33
5.3 General Government Expenditures .....	36
6 Sustainability of Public Finances .....	41
6.1 The Government's Strategy .....	41
6.2 The Fiscal Consequences of an Ageing Population – a Long-Term Projection .....	42
7 Changes to the Institutional Framework for Fiscal Policy .....	45
7.1 Changes to Budgetary Legislation .....	45
7.2 Ending the Activities of the Czech Consolidation Agency.....	46
7.3 Simplifying the System of Tax Administration .....	47
8 Annexes .....	48
8.1 Table Annex .....	48

## List of Tables:

Table 2.1: Assumptions on the external environment.....	10
Table 2.2: Economic growth .....	14
Table 2.3: Prices of goods and services .....	15
Table 2.4: Employment and wages .....	16
Table 2.5: Net lending/borrowing .....	18
Table 3.1: General government deficit by sub-sector .....	21
Table 3.2: General government deficit by sub-sector .....	22
Table 3.3: Structural balance.....	23
Table 3.4: Government debt by sub-sector .....	23
Table 3.5: Government debt and related indicators .....	24
Table 3.6: Balance of the effects of budgetary measures.....	25
Table 4.1: Assumptions of the scenario .....	26
Table 4.2: Change in the indicators of the macroeconomic scenario.....	27
Table 4.3: Comparison with the previous Convergence Programme.....	28
Table 4.4: Scenario of exogenous variables.....	28
Table 4.5: Macroeconomic effects of the optimistic scenario .....	29
Table 4.6: Macroeconomic effects of the pessimistic scenario.....	30
Table 5.1: General government revenues.....	34
Table 5.2: The impact of tax changes on general government revenues .....	35
Table 5.3: General government expenditures .....	37
Table 5.4: The impact of changes in the social legislation .....	39
Table 5.5: General government expenditures by function .....	39
Table 6.1: Macroeconomic projection assumptions.....	43
Table 6.2: Long-term projection of general government revenues and expenditures.....	43
Table 6.3: Scope of needed fiscal consolidation .....	44
Table 7.1: Transfers to and from the reserve funds.....	46
Table 8.1: Economic growth .....	48
Table 8.2: Price development.....	48
Table 8.3: Labour market development .....	48
Table 8.4: Analysis of the change in the net financial position .....	49
Table 8.5: General government budget.....	49
Table 8.6: General government debt.....	50
Table 8.7: Cyclical development.....	50
Table 8.8: Divergence from the previous update .....	51
Table 8.9: Long-term sustainability of public finances.....	51
Table 8.10: Basic assumptions .....	52

## List of Charts:

Chart 2.1: Real GDP.....	Chart 2.2: Inflation rate (HICP) .....	11
Chart 2.3: Employment .....	Chart 2.4: Current account/HDP .....	12
Chart 2.5: Output gap.....	Chart 2.6: Potential GDP growth .....	13
Chart 2.7: Decomposition of GDP growth.....	Chart 2.8: GDP per capita .....	14
Chart 2.9: HICP.....	Chart 2.10: GDP inflator and terms of trade .	16
Chart 2.11: Employm. and participation rates..	Chart 2.12: Unemployment rate .....	17
Chart 5.1: Government expenditures by function .....		40
Chart 6.1: Projection of expenditures.....	Chart 6.2: Primary deficit and debt .....	44

# Introduction

As a part of the EU's multilateral fiscal surveillance and economic policy coordination process, the Czech Republic hereby submits the regularly updated Convergence Programme (the "CP"). The previous CP, submitted in March 2007, was based on the 2007 State Budget prepared by the former governments and approved by the Chamber of Deputies of the Parliament of the Czech Republic (the "Czech Parliament") in December 2006. A summary of the objectives of the current government relating to its Programme Declaration was contained in the last section of the CP.

The new government, formed by a coalition of the Civic Democrats, the Christian Democrats, and the Green Party, did not receive a vote of confidence from the Czech Parliament until January 2007 and has inherited a budget that implied fiscal expansion for 2007. With respect to the distribution of power in the Czech Parliament after the elections, the government has a limited political mandate (the coalition and the opposition both received 100 seats). Thus, the government cannot act without the support of the opposition political parties. The government has accepted the 2007 budget for this reason as well. Nevertheless, it had also expressed its intention to halt fiscal expansion and to bring public finances back to the original trajectory of a declining deficit.

The economic assessment of the previous CP contained the following recommendations: (i) to stop the deterioration of the budgetary disciplines in 2007 and to remove the excessive deficit in a credible and sustainable manner by 2008 at the latest, (ii) to revise the expenditure structure with the goal of reducing the share of mandatory expenditures, and (iii) with respect to increasing expenditures relating to an ageing population, to improve the long-term sustainability of public finances by implementing needed reforms in the pension and healthcare systems.

The draft state budget for 2008 and the draft medium-term budgetary outlook for 2009 and 2010 respect the established deadline for removing the excessive deficit and respond to the above-mentioned recommendations. An important step is the adoption of the Act on Stabilisation of Public Finances<sup>1</sup> amending 49 acts primarily relating to mandatory expenditures.

The objective of the government is to continue with the reform measures. It would like to get support for the prepared drafts outside the sphere of the parliamentary political parties so that the adopted reforms will be irreversible. The goal is to pass the reforms during the current electoral term, i.e. by mid-2010.

The CP is in line with other Czech strategic documents – the Czech Republic's Updated Strategy for Eurozone Accession of August 2007, the Report on Implementation of the National Lisbon Programme 2005–2008 of October 2007, and the National Strategic Reference Framework for the period 2008 to 2013.

The previous CP from March 2007 was sent to the Czech Parliament for information. In contrast to previous years, the relevant committees had paid closer attention to the CP this time. They asked the government to keep them posted about any new developments during the year and to inform them of how the CP was assessed by the European Commission and

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<sup>1</sup> Act No. 261/2007 Coll. on Stabilisation of Public Finances, adopted on 19 September 2007

the ECOFIN Council and what additional steps have been approved in the procedures relating to the excessive deficit. Following the discussion, the committees called upon the government to remedy the situation.

# 1 Economic Policy

## 1.1 Fiscal Policy

An important priority for the upcoming period continues to be improving the structural parameters of public finances and meeting the deadline for eliminating the excessive deficit, which is set for 2008. In addition, the government has committed itself to launching reforms that will ensure the long-term sustainability of public finances.

The primary objectives of the government in the fiscal area are:

- Reducing the general government deficit to below 3% of GDP in 2008, to 2.6% in 2009 and to 2.3% in 2010,
- With respect to government expenditures, reducing their dynamics, commencing the restructuring process and improving their effectiveness,
- Lowering the tax burden and limiting the administrative burden and tax distortion by simplifying the tax system, and
- Reforming the pension and healthcare systems.

The active measures towards reducing the deficit are focused, in particular, on savings on the expenditure side of public budgets, especially in the area of mandatory expenditures, which are the primary cause of the current problems. In the first phase, the government concentrated on reducing the negative effects of changes in the social legislation approved prior to the parliamentary elections in 2006. In addition, these steps will help increase the effectiveness of the social system and strengthen motivation with respect to economic activity.

On the revenue side, the tax burden will be gradually lowered and the tax system will be simplified. Reduced labour taxation for physical persons and transparent and business friendly tax administration are the main factors supporting economic growth.

The fiscal targets for 2009 and 2010, on which the medium-term budgetary outlook is based, are a part of the political agreement between the government coalition parties, and so in this respect, these targets are binding for the government. The targets ensure that the government deficit is kept below 3% of GDP. However, they do not encourage a more rapid rate of fiscal consolidation. A pre-condition for successful fiscal consolidation is thorough implementation of a fiscal targeting regime and upholding the medium-term expenditure frameworks.

Reducing the general government deficit to 1% of GDP by 2012 continues to be a medium-term budgetary objective. Reaching this objective will require that additional reform measures be adopted.

As for the negative fiscal impact of an ageing population, the government is preparing reforms of the pension and healthcare systems, and it would be beneficial to utilise the current period of favourable economic development to launch these reforms.

## 1.2 Monetary Policy

The CNB will continue to conduct monetary policy with the help of the inflation targeting regime. The current inflation target has been valid since January 2006. The target is expressed for annual CPI inflation at a level of 3% with a maximum deviation of one percentage point in each direction. In March 2007, the CNB announced a new inflation target of 2% for annual CPI inflation (with a tolerance band of  $\pm$  one percentage point), effective from January 2010. In addition, the CNB has announced that it would allow a gradual reduction in inflation to the level of the new inflation target far enough in advance so that inflation is close to the target by the date it takes effect.

The reduction in the inflation target reflected, in particular, the longer-term perspective for inflation targeting in the Czech Republic due to the postponement of the euro adoption date beyond the originally envisaged horizon of 2010 (see below) and the current low-inflationary environment of the Czech economy exhibited in inflation expectations anchored at low levels. Lower inflation in the Czech Republic in line with the new target further increases the chances of meeting the Maastricht price stability criterion in the future. The CNB continues to view its inflation targets as medium-term in nature, and real inflation may temporarily deviate from them as a result of exogenous shocks. Changes to indirect taxes are one such shock; monetary policy does not react to the first-round effects of such changes and concentrates only on their second-round effects.

The Czech Republic's original Strategy for Eurozone Accession has not been fulfilled, and the originally envisaged euro adoption date in the Czech Republic, 2009/2010, is no longer realistic. The Czech Republic's Updated Strategy for Eurozone Accession approved by the Czech government in August 2007 states that the main obstacle to meeting the Maastricht criteria is still the unconsolidated state of public finances. This, along with the low flexibility of the Czech economy, especially the labour market, is also a risk to Czech economic performance in the Eurozone and prevents it from reaping the benefits associated with adopting the euro. The euro adoption date will, therefore, be linked to resolving these problematic areas with a fundamental public finance reform and strengthening the flexibility of the Czech economy. In this respect, ERM II entry is still viewed as only a necessary condition for adopting the euro, and hence, the amount of time spent in ERM II should be kept at a minimum.

An increase in nominal interest rates can be expected within approximately the next 12 months as a result of rising inflation pressures, the position of the economy in the economic cycle and development abroad.

## 1.3 Structural policies

The objective of the structural reforms is to make the economy competitive so that it can take full advantage of the benefits of integrating with the European Economic Area and of globalisation, while minimising their negative impact. Hence, the main focus will be on increasing productivity (the business environment, research and development, innovation, sustainable use of resources, modernisation, and development of the transport and ICT networks) and employment (labour market flexibility, labour market integration, and education).



A comprehensive amendment to the Trade Licensing Act geared to simplifying administration<sup>2</sup> and measures for improving regulation (obligation to reduce the overall administrative burden of businesses by 20% by the end of 2010 and the duty to assess the impact of regulation as of November 2007)<sup>3</sup> should help to improve the business environment. The recodification of insolvency law, effective from 1 January 2008, will resolve the long-term problematic area of terminating business activities. This should shorten the length of the bankruptcy process and strengthen the role of creditors.

The transition from competitive advantage based on low wages to a “knowledge-based economy” requires an increase in and the effective use of resources allotted to science and research, as well as a change in the institutional environment. The public funds available for research and development are being gradually increased (goal for 2010: 1% of GDP). The structure of expenditures is constantly being changed from institutional to special-purpose financing. The private sector plays a key role in increasing the economy’s innovative capabilities. Government policy gives preference to programmes with financial contributions from the private sector and promotes the coordination of projects between research institutions and firms.

Insufficient infrastructure is still considered to be a weak spot for rapid economic growth. Massive investment in transportation infrastructure will continue in future years as well. In addition to resources from the structural funds, redirecting public funds relaxed by the mandatory expenditure reforms will help finance these investments.

The measures included in the Act on Stabilisation of Public Finances give clear and comprehensible guidelines for an active employment policy. The objective is to increase motivation with respect to job hunting and to encourage, in particular, the low-income groups to reduce their dependency on social support and to start actively looking for jobs. Introducing ceilings for the assessment base of social and health insurance, along with reducing tax progression relating to employee incomes, should contribute to creating better conditions for employing a highly qualified labour force.

An obstacle to a knowledge-based economy is the level of education, especially university and life-time education. The “White Book of Tertiary Education” project was launched with the goal of creating a comprehensive programme for reforming the tertiary education system and formulating the main objective of the new Tertiary Education Act. In July 2007, the government adopted a comprehensive national Strategy for Life-Time Learning. The Act on Acknowledging the Results of Further Education, which allows the assessment of education gained outside the education system, has been in effect since August 2007.

A detailed summary of the priorities and approved measures in this area is contained in the Report on Implementation of the National Lisbon Programme 2005–2008 (Czech Republic’s National Reform Programme), which the government approved in October 2007.

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<sup>2</sup>Approved by the government on 22 October 2007.

<sup>3</sup> Each draft of primary and secondary legislation at the government level must be comprehensively assessed according to the methods of RIA (Regulatory Impact Assessment), which assesses the legislation from the viewpoint of economic, social and environmental effects, including the impact on the business environment.

## 2 Macroeconomic Scenario

The macroeconomic scenario was conceived as realistic and conservative with an effort to balance out the positive and negative risks of economic development.

### 2.1 The World Economy and Technical Assumptions

#### The world economy<sup>4</sup>

The assumptions relating to the future development of the external environment of the Czech economy can be summarised as follows:

- The world economy continues to grow at a dynamic pace. The Asian economies will contribute more and more to this growth, especially China and India. Growth in the USA will slow down in 2008.
- Economic growth in the EU-27, which in 2006 had reached its highest level since 2000 (3.0%), will slow down slightly to around 2.5% in upcoming years. Net exports and investments will have a particular impact on this slowdown. An important growth factor has been shown to be the free movement of goods and capital in relation to new member states, wider possibilities of cooperation and an increase in the mobility of the labour force in the enlarged EU. As a part of the convergence process, the new member states will grow at a faster pace than the old members.
- The USD price for oil will remain at a high level even in upcoming years with a slight declining tendency. The high demand especially in the Asian economies limits the possibility of a larger price drop.

**Table 2.1: Assumptions on the external environment**

		Year 2006	Year 2007	Year 2008	Year 2009	Year 2010
<b>USD/EUR exchange rate</b>	<i>(annual average)</i>	1.25	1.35	1.34	1.34	1.34
<b>GDP EU-27</b>	<i>(real growth in %)</i>	3.0	2.7	2.5	2.5	2.5
<b>GDP Germany</b>	<i>(real growth in %)</i>	2.9	2.7	2.3	2.3	2.4
<b>Oil prices</b>	<i>(Brent, USD/barrel)</i>	65.4	68	73	67	65

Source: Eurostat, IMF, calculations of the Ministry of Finance

A risk associated with this scenario is the possible occurrence of unforeseeable events with a global impact that would further aggravate the geopolitical climate and the instability of world commodities and financial markets as well as the already disquieting mortgage crisis in the USA. Another risk is the possibility of a recession in the USA.

<sup>4</sup> For technical reasons, it was not possible to use the “common assumptions on the external environment” in preparing the CP. The Spring EC Forecast published in May 2007 was, for obvious reasons, already outdated and the assumptions of the Autumn Forecast were not yet known at the time of preparing the macroeconomic scenario (September 2007). Therefore, the CP was supplemented by a sensitivity analysis of certain macro-indicators based on the exogenous variables in Section 5.

## Technical assumptions

The assumptions on short-term interest rates were chosen to be consistent with meeting the CNB's inflation target.

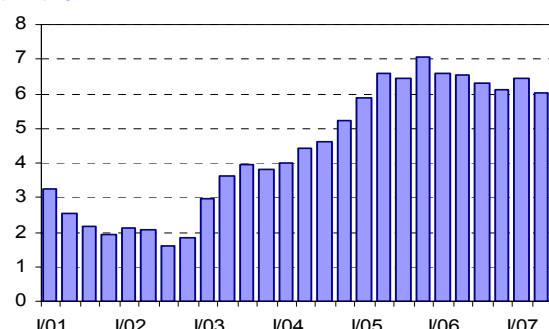
The lead in productivity growth over the Eurozone countries should be reflected in the real appreciation of the CZK/EUR exchange rate. Assuming the same or a slightly lower level of inflation, space for nominal appreciation at an average rate of ca 3.0% will be created, which should result in an average rate of 25.80 CZK/EUR in 2010. A technical assumption of stability of 1.34 USD/EUR was elected for the USD/EUR exchange rate.

## 2.2 Current Macroeconomic Development<sup>5</sup>

Robust growth of the Czech economy, which reached 6.4% in 2006, continued in H1 2007 as well (6.2% year-on-year; quarterly figures of 1.5% and 1.4% in Q1 and Q2, respectively). This growth was almost exclusively generated by domestic demand. In H1 2007, the dynamics of real gross domestic income was 1.8 percentage points higher than GDP growth due to terms of trade. The potential GDP growth rate has reached a value of just above 5.0%, especially thanks to the robust contribution from total factor productivity. At the end of 2005, the negative output gap closed and the position in H1 2007 is characterised by a positive gap of ca 1.4%.

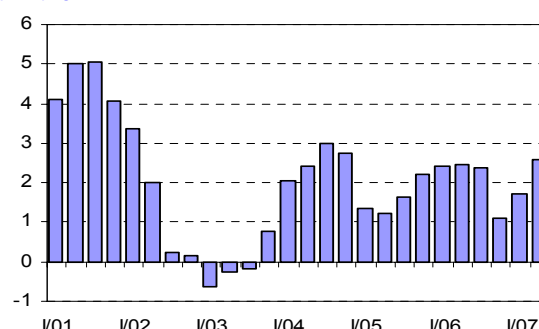
**Chart 2.1: Real GDP**

y-o-y growth in %



**Chart 2.2: Inflation rate (HICP)**

y-o-y growth in %



Source: Czech Statistical Office

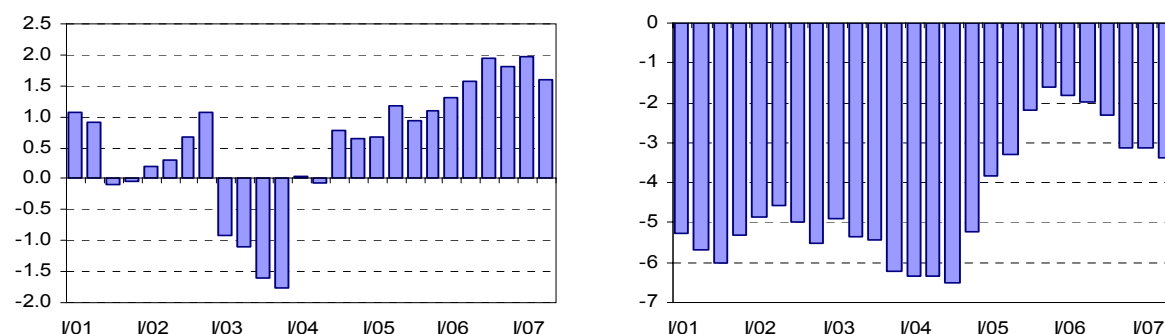
The low-inflationary environment in the Czech economy has managed to continue thanks especially to credible monetary policy. An important role is also played by the highly competitive environment. In 2006, the average annual inflation rate (based on the HICP) reached 2.1%. In August 2007, consumer prices increased year-on-year by 2.6%. In addition to the administrative impact, the prices of energy and food contributed most to HICP growth. Over the long term, CPI inflation has been pulled, in particular, by housing costs.

Development on the labour market has also been positive. Employment (according to ESA 95) has been increasing since Q3 2004. In Q2 2007, growth reached 1.6%. The dynamics of labour productivity growth has been continuing. The unemployment rate, according to the

<sup>5</sup> Based on the available data as of 15 September 2007; commodity prices on world markets after this date are not taken into account.

Labour Force Survey, topped out at 8.4% in Q1 2004, and since this time, has sharply declined in relation to economic growth. It fell to 5.3% in Q2 2007, which is a decrease of 1.8 percentage points year-on-year and the lowest level in the last almost 10 years. Besides the cyclical effects, the structural characteristics have also apparently shown a slight improvement.

**Chart 2.3: Employment (according to ESA 95) y-o-y growth in %** **Chart 2.4: Current account/GDP in %**



Source: Czech Statistical Office, Czech National Bank

The external economic imbalance, expressed by the share of the current account balance in GDP has been within a sustainable range. Although it had slightly worsened in Q2 2007 against year-end 2006 by 0.3 of a percentage point to -3.4 %, the surplus for the balance of goods and services, on the contrary, increased by 0.7 of a percentage point to 2.8% of GDP. The main source of the current account deficit has been the outflow (repatriation) of income from foreign direct investment.

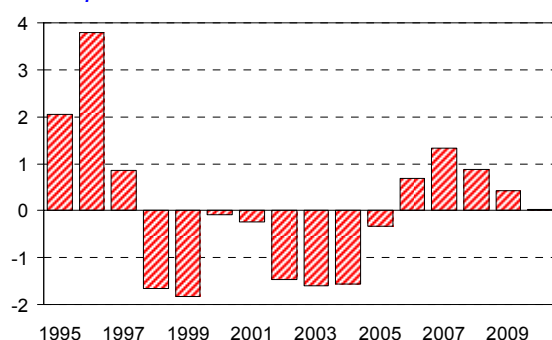
## 2.3 The Medium-Term Scenario

### Potential GDP and the position within the economic cycle

The current dynamic economic growth is both structural and cyclical in character<sup>6</sup>. Increasing economic potential is generated by rapid growth in the trend components of total factor productivity.

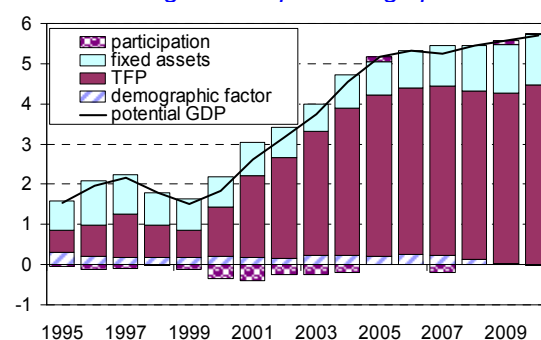
<sup>6</sup> Calculations of potential GDP and the output gap are currently made using the national methodology also based on the Cobb-Douglas production function. The methodology was described in the 2002 Pre-Accession Economic Programme. The main distinction from the European Commission's method, important for interpreting the results, is the use of the clause "zero sum of output gaps over time".

**Chart 2.5: Output gap**  
in % of potential GDP



Source: Calculations of the Ministry of Finance

**Chart 2.6: Potential GDP growth**  
contribution to growth in percentage points



The programme scenario is based on the assumption that the potential growth rate will be above 5.0% with a slight tendency towards acceleration and will reach 5.7% in 2010. Total productivity growth is based, in particular, on the improvement in institutional parameters in the economy and the quality of the business environment and on introducing new technology related to the inflow of foreign direct investment. The continued integration into the EU economic structures remains a long-term growth factor.

The contribution of capital stock growth will be above one percentage point and will, therefore, reflect the high level of investment in the Czech economy. On the contrary, the positive contribution of an increase in the number of persons in their productive years will be gradually reversed. The impact of the participation rate for 2007 will apparently register negative values. In the years to follow, it should again become positive thanks to increased work motivation as a result of economic reform.

We assume that macroeconomic policies will be set in such a way that economic performance and potential GDP will approach the same level by the end of the period.

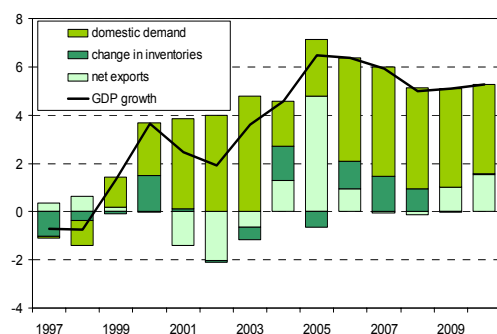
## GDP and the demand side

Real GDP growth should be in a range of 5% in the period up to 2010. Domestic demand's contribution to growth (without the change in inventory) should decline from 4.5 percentage points in 2007 to 3.7 percentage points in 2010.

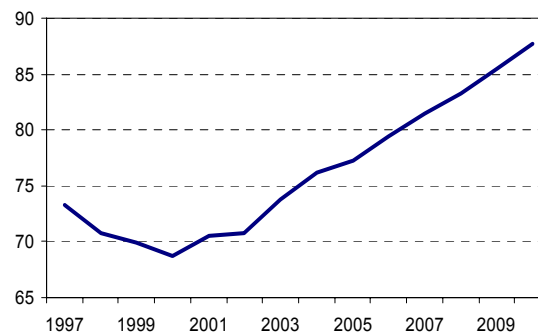
The growth trajectory of potential GDP implies that the process of economic convergence with the neighbouring advanced EU countries will continue. The Czech Republic's economic level (GDP per capita in purchasing power parity) in comparison with the EU-27 will increase by about 8.0 percentage points against 2006 to ca 88% in 2010.

**Chart 2.7: Decomposition of GDP growth**

Contribution to growth in percentage points

**Chart 2.8: GDP per capita**

calculated in purchasing power parity, EU-27 = 100



Source: Czech Statistical Office – quarterly national accounts, Eurostat, calculations of the Ministry of Finance

Household consumption growth (including non-profit institutions) will begin to fall behind the growth rate for economic performance starting in 2008. The effects of the Act on Stabilisation of Public Finances will play a role here. In addition, the debt burden of households will reduce the growth rate of expenditures for final consumption.

Government consumption should be flat or even slightly decrease in the future. Government institutions are expected to behave economically with respect to employment in the general government as well as the purchase of goods and services. The decline in expenditures will be slightly curbed by the costs associated with the Czech Republic's EU presidency in 2009.

**Table 2.2: Economic growth**

CZK billion, increase in %

	ESA code	Year 2006 level <sup>1)</sup>	Year 2006 rate of change	Year 2007 rate of change	Year 2008 rate of change	Year 2009 rate of change	Year 2010 rate of change
1. Real GDP	B1*g	3186	6.4	5.9	5.0	5.1	5.3
2. Nominal GDP	B1*g	3220	7.5	9.6	8.3	7.6	7.6
Components of real GDP							
3. Private consumption expenditure	P.3	1530	4.4	6.5	4.2	4.6	4.2
4. Government consumption expenditure	P.3	669	1.1	-0.6	-0.4	-0.3	-0.5
5. Gross fixed capital formation	P.51	803	7.6	6.0	9.0	7.8	7.2
6. Changes in inventories and net acquisition of valuables	P.52+P.53	61	1.9	3.0	3.7	3.8	3.6
7. Exports of goods and services	P.6	2497	15.9	13.2	11.9	12.9	13.5
8. Imports of goods and services	P.7	2374	15.2	13.9	12.7	12.4	12.4
Contribution to real GDP growth							
9. Final domestic demand			4.3	4.5	4.2	4.1	3.7
10. Change in inventories and net acquisition of valuables	P.52+P.53		1.1	1.5	0.9	0.0	0.0
11. External balance of goods and services	B.11		1.0	-0.1	-0.1	1.0	1.5

Note: 2006 levels are given in prices for the previous year.

Item 6 expresses the share of the change in inventories to GDP in current prices.

Source: Czech Statistical Office – quarterly national accounts, calculations of the Ministry of Finance

Following a temporary slowdown in investment activities in 2007, the dynamics should be renewed primarily due to the continued inflow of foreign direct investment. The tax reform measures should also stimulate the investment processes, while new capacities are expected to be primarily export oriented. A higher drawdown of resources from the structural funds and the Cohesion Fund in support of small and medium-size enterprises and channelled into infrastructure investment by way of co-financed public budgets should also have a positive impact.

The contribution of the trade balance for goods and services in constant prices to GDP growth has achieved positive figures since 2004. We expect figures of around zero for 2007 and 2008. Along with the rise in new capacities and weakening of domestic demand growth, another increase in the contribution of foreign trade can be expected in upcoming years to values above 1.0 percentage point during a rapid increase in the share of foreign trade turnover in GDP.

### Prices

**Table 2.3: Prices of goods and services**

	Year 2006	Year 2007	Year 2008	Year 2009	Year 2010
<b>Percentage changes</b>					
<b>HICP</b>	2.1	2.4	3.9	2.3	2.1
<b>GDP deflator</b>	1.1	3.5	3.1	2.3	2.2
<b>Consumption of households deflator</b>	1.6	2.0	3.5	2.1	2.2

*Source: Czech Statistical Office – price statistics and quarterly national accounts, calculations of the Ministry of Finance*

The low-inflationary character of the Czech economy should be preserved in future years as well. The positive influence of the inflation targeting regime, which guides the inflation expectations of economic agents, and the high level of competition on the internal market have contributed to this development. Other anti-inflationary factors include the continued appreciation of the Czech koruna and smooth non-inflationary growth of unit labour costs. Nevertheless, the prices of electricity will rise. We expect a growth tendency for food prices in relation to using raw materials such as organic fuels. The market fluctuation of other prices should remain moderate.

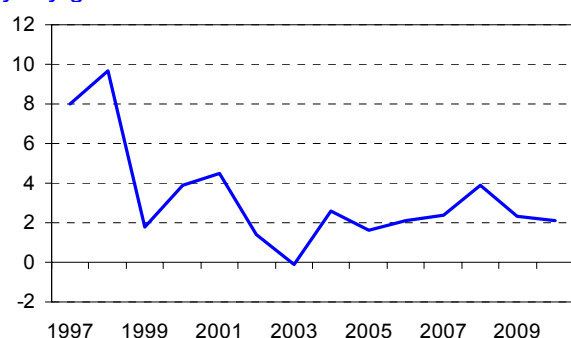
In 2008, we anticipate a temporary, one-time increase in the HICP to 4.0%. This will be caused by the large contribution of administrative measures (around 3.0 percentage points to the December year-on-year growth in the national CPI methodology) primarily associated with reform measures. From the standpoint of individual items, it will concern, in particular, an increase in the reduced VAT rate (0.8 of a percentage point), an increase in excise taxes on cigarettes (0.6 of a percentage point), an increase in electricity prices (0.4 of a percentage point), a rise in regulated rent (0.4 of a percentage point) and introducing ecology taxes (0.2 of a percentage point).

In future years, we expect inflation expectations to gradually approach the CNB's new inflation target (national CPI of 2%) effective from 2010. This creates conditions for meeting the inflation convergence criterion with the assumption that prices in certain EU member states will not significantly deviate downwards from the ECB's definition of price stability.

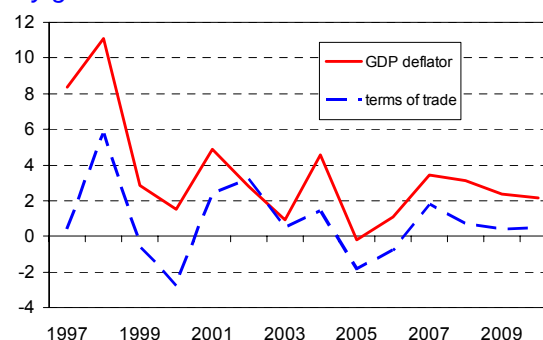
During the monitored period, growth of the implicit GDP deflator should stabilise slightly above 2.0% close to HICP growth.



**Chart 2.9: HICP**  
y-o-y growth in %



**Chart 2.10: GDP deflator and terms of trade**  
y-o-y growth in %



Source: Czech Statistical Office – price statistics and quarterly national accounts, calculations of the Ministry of Finance

## The labour market and wages

The positive development of labour market indicators is primarily the result of the favourable position in the economic cycle. However, structural problems are still present and are reflected in the strong regional disparity. The reasons behind this development are low professional and regional mobility, the lack of motivation of low-income groups to seek work actively, the rigidity of labour contracts concluded for indefinite periods, and the still underdeveloped mortgage market. The problems on the labour market also signal the growing number of job vacancies, which is the highest in the history of the market economy in the Czech Republic.

The demand side of the labour market will still be affected, in particular, by high economic growth in the scenario period. The newly approved set of measures geared to stabilising public finances, which will increase work motivation, will have a positive impact on the demand side, and in particular, on the supply side. In addition to reducing the burden of direct taxes, there will also be changes in the area of social benefits in 2008, which should increase the public accountability of the benefit system and prevent its abuse.

**Table 2.4: Employment and wages**

	Year 2006	Year 2007	Year 2008	Year 2009	Year 2010
<b>Percentage changes</b>					
Employment (ESA 95)	1.7	1.5	1.1	0.5	0.2
Compensation of employees	7.5	9.2	7.3	7.1	7.0
Compensation per employee <sup>1)</sup>	5.7	7.7	6.5	6.9	7.0
Unit labour costs <sup>2)</sup>	1.0	3.2	2.6	2.2	1.8
<b>Per cent</b>					
Unemployment rate ILO	7.1	5.5	4.8	4.5	4.5
Employment rate <sup>3)</sup>	65.3	66.0	66.6	66.9	67.1
Activity rate <sup>4)</sup>	70.3	69.8	69.9	70.0	70.2

<sup>1)</sup> Compensation per employee (Czech concept) according to national accounts

<sup>2)</sup> Ratio of nominal compensation per employee and labour productivity growth from real GDP

<sup>3)</sup> Share of total employment in the population (both 15 to 64 years old) according to the Labour Force Survey

<sup>4)</sup> Share of the labour force in the population (both 15 to 64 years old) according to the Labour Force Survey

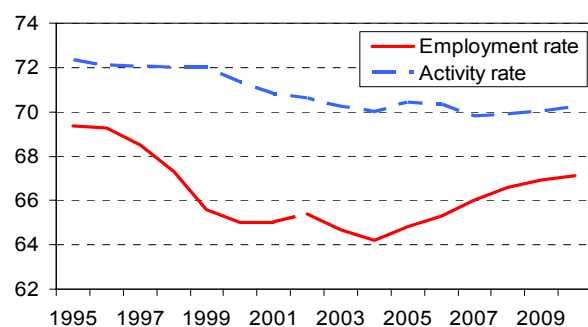
Source: Czech Statistical Office – employment statistics and quarterly national accounts, calculations of the Ministry of Finance



We anticipate an additional rise in employment in the future, due mainly to the integration of foreigners and persons outside the labour force. The unemployment rate in 2008 should drop to 4.8% and to 4.5% in following years. This value can be considered to be the maximum limit.

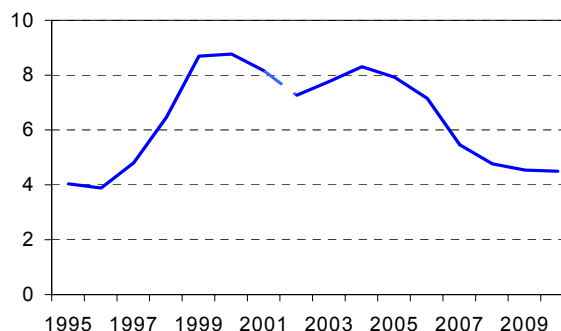
**Chart 2.11: Employment, participation rates**

in %



**Chart 2.12: Unemployment rate**

in %



*Note: The employment and unemployment rate and economic activity from the Labour Force Survey is not comparable between 2001 and 2002 due to changes in methodology.*

*Source: Czech Statistical Office – employment statistics, calculations of the Ministry of Finance*

The growth rate dynamics of compensation of employees strengthened at the beginning of 2007, which should have only been a one-off event. In 2008, the increase in labour supply should curb wage pressures. Considering that the reduction in income taxes will have less of an effect than the measures relating to social benefits, there will be an overall slowdown in disposable income growth in nominal and especially real terms, which will be reflected in lower household consumption growth. In the income structure of households, there will be a positive shift in proportion in favour of the share of incomes from labour, adjusted for taxes and contributions to social security, and to the detriment of social benefits.

In future years, we anticipate smooth development with respect to growth in unit labour costs to the level of GDP deflator growth, which should not cause inflation pressures.

## 2.4 Net Lending/Borrowing and Sectoral Balances<sup>7</sup>

We anticipate a gradual improvement in the net lending balance from a deficit just below 3.0% of GDP in 2005 and 2006 to a surplus in 2010 for the first time in the history of the Czech Republic.

A surplus in the non-fuel component of the balance of goods should steadily rise thanks to increasing export performance and an improvement in the competitiveness of domestic producers. New capacities with a large export potential have had an impact, mainly in the automobile industry, information and communication technologies and with respect to the

<sup>7</sup> In accordance with the rules of the “Code of Conduct”, this section is prepared using the methodology of national accounts. On the basis of the relationship between investments and savings, this allows the complete disaggregation of a surplus or deficit in foreign relations to the individual economic sectors. This differs from the analogical, ordinarily employed methodology of the balance of payment’s current account in the categorisation of some transactions and in the fact that it contains additional items (capital transfers, acquisition of non-produced, non-financial assets).

substitution of imported intermediate products with domestic products. In the fuel component of the balance, the declining koruna prices of mineral fuels should have a positive effect. As for the balance of services, we expect a stable surplus in the share in GDP with continued improvements in the balances for transportation and tourism and deterioration for so-called other services.

The most significant negative component in net lending will be the worsening balance of primary incomes, which reflects the increasing flow of repatriated and reinvested profits from direct investment and compensation of foreign employees. The balance of current and capital transfers will be positively affected by the balance of financial flows from the EU thanks to the contributions from the structural funds, the Cohesion Fund and those supporting agriculture and regional development.

**Table 2.5: Net lending/borrowing**

	Year 2006	Year 2007	Year 2008	Year 2009	Year 2010
% of GDP					
<b>Balance of goods and services</b>	3.2	4.2	4.3	5.2	6.6
- mineral fuels (SITC 3)	-4.3	-3.5	-3.5	-3.0	-2.6
- other goods	6.4	6.5	6.6	7.0	8.0
- services	1.1	1.2	1.2	1.2	1.2
<b>Balance of primary income and transfers</b>	-6.2	-6.9	-6.6	-6.6	-6.5
- primary income	-5.4	-6.5	-6.8	-7.1	-7.3
- transfers	-0.8	-0.4	0.2	0.4	0.8
<b>Capital transfers</b>	0.3	0.2	0.7	0.9	1.0
<b>Net acquisition of non-produced assets</b>	0.0	-0.1	-0.1	-0.1	-0.1
<b>Net lending/borrowing vis-a-vis ROW (B.9)</b>	-2.7	-2.6	-1.7	-0.6	1.0
<b>Net lending/borrowing of the private sector</b>	0.0	1.0	1.2	2.0	3.3
- households	-0.6	-1.2	-1.6	-1.0	-0.4
- financial and non-financial institutions	0.5	2.2	2.8	3.0	3.7
<b>Net lending/borrowing of general government</b>	-2.7	-3.6	-2.9	-2.6	-2.3

1) e.g. payments for licences, patents and trademarks

Source: Czech Statistical Office – annual national accounts, calculations of the Ministry of Finance

As for the specific sector contributions to net lending in the economy, the general government's position should improve after 2007. The position of households will continue to show a deficit due to substantial housing investments, which will be higher than generated savings. The main improvements could be expected in the sector of financial and non-financial institutions.

## 2.5 The Growth Implications of Structural Reforms

The CP contains the assessed effects of the approved reform measures in accordance with the National Reform Programme. These measures will bring a one-off negative impulse in 2008 that will be reflected especially in slowed household consumption growth. In the medium-term horizon, we expect the prevalence of effects contributing to an increase in the potential growth of the Czech economy.

A combination of reform measures will bring positive effects to the labour market as well. A reduction in direct taxation and increasing the accountability of social benefits will encourage

work motivation. This will reflect a turn in the trend of participation rate. Labour should thus once again register a positive contribution to potential GDP growth.

## **3 General Government Deficit and Debt**

### **3.1 The Government's Strategy and the Medium-Term Fiscal Targets**

The main objectives of the government in the area of fiscal policy (see Section 1), which will be reflected in the general government finances in the medium-term horizon, are reducing the general government deficit towards the medium-term budgetary objective, lowering the dynamics of overall government expenditures, limiting the share of mandatory expenditures and a slow reduction in the tax burden.

In contrast with the previous CP update, the government has set more ambitious fiscal targets for the general government deficit of 3.0% of GDP in 2008, 2.6% in 2009, and 2.3% in 2010. In addition, more strict expenditure ceilings for the state budget and state funds have been approved, which should ensure that the set targets are reached.

On the expenditure side, the government has agreed to extensive budgetary savings in the area of mandatory social expenditures and wages and salaries. In contrast, expenditures especially of an investment character have been partially strengthened. Hence, the volume of the medium-term expenditure ceilings will be reduced by 0.4% of GDP in 2008 and 0.9% of GDP in 2009.

Limiting the dynamics of government expenditures allows a slow reduction in the tax burden, relating especially to the taxation of labour and legal entities. A reduction in direct taxation will be more than fully offset in 2008 and partially offset in the years to follow by increases in value added tax, excise taxes and by introducing environmental taxes.

The stabilisation budget measures that were passed in the first phase of the planned structural reforms should ensure the sustainable elimination of the excessive deficit by 2008 at the latest.

The current settings of fiscal policy do not ensure that the medium-term budgetary objective will be reached by 2012. Meeting this deadline will require the adoption of additional budgetary measures. The second phase of reforms, which should also resolve the long-term sustainability of public finances, will be the subject of political discussions in 2008.

### **3.2 Current Development of Public Finances**

General government institutions have registered a deficit. From 2004 to 2006, however, the sector had performed better than was originally expected. This was, on the one hand, the result of higher-than-expected revenues due to the partially cyclical and partially structural increase in tax collection. On the other hand, the lower level of expenditures had caused a reduction in the deficit as a result of the newly introduced possibility of transferring unlimited amounts of unused budgetary funds to future years. During these three years, funds totalling 2.1% of GDP were transferred to the reserve funds in this manner.

**Table 3.1: General government deficit by sub-sector**

% of GDP	ESA code	Year 2002	Year 2003	Year 2004	Year 2005	Year 2006	Year 2007 (1)
<b>Net lending (+)/borrowing (-) (EDP B.9) by sub-sectors</b>							
<b>General government</b>	<b>S.13</b>	<b>-6.8</b>	<b>-6.6</b>	<b>-3.0</b>	<b>-3.5</b>	<b>-2.9</b>	<b>-3.4</b>
<b>Central government</b>	<b>S.1311</b>	<b>-6.1</b>	<b>-6.0</b>	<b>-2.7</b>	<b>-3.5</b>	<b>-2.8</b>	<b>-3.5</b>
<b>Local government</b>	<b>S.1313</b>	<b>-0.5</b>	<b>-0.5</b>	<b>-0.2</b>	<b>-0.1</b>	<b>-0.5</b>	<b>-0.2</b>
<b>Social security funds</b>	<b>S.1314</b>	<b>-0.2</b>	<b>-0.1</b>	<b>-0.1</b>	<b>0.0</b>	<b>0.4</b>	<b>0.3</b>

(1) Notifications (October 2007)

Source: Czech Statistical Office, Ministry of Finance (2007)

General government finances in 2007 are encumbered by a high increase in social expenditures as a result of changes in the social legislation approved prior to the parliamentary elections in 2006. These changes contribute to a rise in the deficit of around 1.0 percentage point of GDP in 2007.

The general government balance will reach a figure of about -3.4% of GDP, which is an improvement of 0.6 of a percentage point over the estimate from last year's CP update. The change in the estimate has been mainly caused by higher-than-expected revenues from taxes and social contributions as a result of the continued economic boom. However, the original fiscal target of -3.3% of GDP will probably not be reached.

One risk for the economic results in 2007 is the possibility of using more resources from the reserve funds. In view of tightening the conditions for disposing of these funds (see Section 7), the budget headings are more motivated to use these funds, which in turn, may increase government expenditures.

### 3.3 The Medium-Term Fiscal Outlook

#### The budget for 2008

The state budget for 2008 is formulated in such a way that the general government deficit is reduced to under 3% of GDP. The planned deficit, according to the national method of fiscal targeting, is 2.5% of GDP. Considering that the expected deficit using the ESA 95 methodology should exceed the national fiscal target by a maximum of 0.4 of a percentage point according to current estimates, a reserve for eliminating the excessive deficit has already been created for 2008.

The general government balance in 2008 is estimated to be -2.9% of GDP in 2008, i.e. 0.1 of a percentage point better than the set fiscal target. Moreover, the balance of risks points to a lower deficit. The prediction of tax revenues can be assessed as conservative on the basis of the latest information on tax collection and macroeconomic development. In comparison with past performance, the assumption on the deficit for general government institutions, not relating to expenditure frameworks and health insurance companies, has also been set in a relatively conservative manner.

**Table 3.2: General government deficit by sub-sector**

% of GDP	ESA code	Year 2006	Year 2007 (1)	Year 2008 (2)	Year 2009 (2)	Year 2010 (2)
<b>Net lending (+)/borrowing (-) (EDP B.9) by sub-sectors</b>						
<b>General government</b>	<b>S.13</b>	<b>-2.9</b>	<b>-3.4</b>	<b>-2.9</b>	<b>-2.6</b>	<b>-2.3</b>
<b>Central government</b>	<b>S.1311</b>	<b>-2.8</b>	<b>-3.5</b>	<b>-2.9</b>	<b>-2.5</b>	<b>-2.2</b>
<b>Local government</b>	<b>S.1313</b>	<b>-0.5</b>	<b>-0.2</b>	<b>-0.1</b>	<b>-0.1</b>	<b>-0.1</b>
<b>Social security funds</b>	<b>S.1314</b>	<b>0.4</b>	<b>0.3</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>

(1) Notifications (October 2007)

(2) Outlook

Source: Czech Statistical Office (2006), Ministry of Finance

### Outlook for 2009 and 2010

The budgetary outlook for 2009 and 2010 anticipates another gradual reduction in the government deficit. The pace of fiscal consolidation approximately corresponds to the objectives presented in last year's CP. The budgetary measures passed during last year focused, in particular, on a return to the original trajectory and elimination of the excessive deficit in the originally planned term of 2008. Hence, the largest fiscal effort is concentrated in the period up to 2008.

A slower decline in the deficit for upcoming years stems from the fact that the expected overall positive impact of reform measures in the area of social benefits and taxes decreases over time. The deficit reduction in 2009 and 2010 is, therefore, secured through savings in other expenditures, especially for defence and wages and salaries. An acceleration in the rate of reducing the deficit is conditioned by continued reform measures in future years as well.

### 3.4 The Structural Balance and the Fiscal Stance

According to current estimates, the Czech economy has reached the peak of its economic cycle. Real GDP will approach its potential from 2008 to 2010 due to slowing of real GDP growth to a level below potential growth. This will show up as a gradual closing of the positive output gap and a reduction in the cyclical component of the general government balance.

Fiscal effort in the form of a year-on-year change in the structural balance is the highest in 2008, at which time it will reach a value of 0.6 of a percentage point of GDP. From 2009 to 2010, the estimated fiscal effort will reach 0.4 of a percentage point of GDP. To meet the requirement of minimum fiscal effort during these two years, it will be necessary to accept additional measures for accelerating the decline in the deficit by a minimum of 0.1% of GDP each year.

### 3 General Government Finances – Deficit and Debt

**Table 3.3: Structural balance<sup>(a)</sup>**

% of GDP	ESA code	Year 2006	Year 2007 (1)	Year 2008 (2)	Year 2009 (2)	Year 2010 (2)
1. Real GDP growth (%)		6.4	5.9	5.0	5.1	5.3
2. Net lending of general government	EDP B.9	-2.9	-3.4	-2.9	-2.6	-2.3
3. Interest expenditure	EDP D.41	1.1	1.2	1.3	1.2	1.2
4. One-off and other temporary measures		-0.2	0.0	0.0	0.0	0.0
5. Potential GDP growth (%)		5.3	5.2	5.5	5.6	5.7
<i>contributions:</i>						
- total factor productivity		4.1	4.2	4.2	4.2	4.5
- labour		0.3	0.0	0.1	0.1	0.0
- capital		0.9	1.0	1.1	1.2	1.3
6. Output gap		0.7	1.3	0.9	0.4	0.0
7. Cyclical budgetary component		0.2	0.3	0.2	0.1	0.0
8. Cyclically-adjusted balance (2 – 7)		-3.2	-3.8	-3.2	-2.7	-2.3
9. Cyclically-adjusted primary balance (8 + 3)		-2.1	-2.6	-1.9	-1.5	-1.1
10. Structural balance (8 – 4)		-3.0	-3.7	-3.1	-2.7	-2.3

(a) The data in rows 5 to 10 are based on the current estimates of the Ministry of Finance.

(1) Estimate

(2) Outlook

Source: Ministry of Finance

### 3.5 Government Debt

The outlook for the government debt has improved over last year's CP update under the influence of a lower-than-expected deficit in 2006 and due to a reduction in the expected resources needed to finance the deficit between 2007 and 2010.

**Table 3.4: Government debt by sub-sector**

% of GDP	ESA code	Year 2006	Year 2007 (1)	Year 2008 (2)	Year 2009 (2)	Year 2010 (2)
<b>Gross debt by sub-sectors</b>						
General government	S.13	30.1	30.4	30.3	30.2	30.0
Central government	S.1311	27.6	27.8	27.9	27.9	27.7
Local government	S.1313	2.7	2.6	2.5	2.4	2.4
Social security funds	S.1314	0.0	0.0	0.0	0.0	0.0

(1) Notifications (October 2007)

(2) Outlook

Source: Czech Statistical Office (2006), Ministry of Finance

In view of relatively rapid economic growth, the government deficit should approach a level stabilising the share of debt in GDP during the outlook horizon.

The government debt is increasing at a slower pace than would correspond to absolute deficit accumulation. Besides debt instruments, the deficits are financed through the sale of financial assets, especially as a part of privatisation. Thus, deficit performance is also partially reflected in an increase in the general government's debt liabilities, and to a certain degree, also in a reduction of the volume of financial assets with no impact on the debt. Drawing on unused financial resources acquired through privatisation for government expenditures will help

### 3 General Government Finances – Deficit and Debt

prevent increases in the government debt in future years as well (see the negative value of the item “Net accumulation of financial assets”).

**Table 3.5: Government debt and related indicators**

% of GDP	Year 2006	Year 2007 (1)	Year 2008 (2)	Year 2009 (2)	Year 2010 (2)
<b>Gross debt</b>	30.1	30.4	30.3	30.2	30.0
<b>Change in gross debt ratio</b>	-0.1	0.2	0.0	-0.1	-0.2
<b>Contributions to change in gross debt</b>					
<b>Primary balance</b>	1.8	2.3	1.7	1.3	1.1
<b>Interest expenditure</b>	1.1	1.2	1.3	1.2	1.2
<b>Nominal GDP growth</b>	-2.3	-2.5	-2.3	-2.1	-2.1
<b>Stock-flow adjustment</b>	-0.8	-0.7	-0.6	-0.6	-0.3
- Difference between cash and accruals	0.0	0.0	-0.3	-0.2	0.0
- Net accumulation of financial assets	-0.8	-0.7	-0.4	-0.3	-0.3
of which: privatisation proceeds <sup>(3)</sup>	0.1	0.9	0.0	0.0	0.0
- Revaluation effects and other	0.0	0.0	0.0	0.0	0.0
<b>p.m. implicit interest rate on debt</b>	3.6	3.9	4.2	4.1	4.0

(1) Notifications (October 2007)

(2) Outlook

(3) Privatisation alone does not have any impact on the amount of the debt. However, privatisation revenues are one of the potential sources of non-debt financing for the deficit.

Source: Ministry of Finance

The outlook does not take into account any unapproved privatisation transactions. Should some of the planned privatisation projects take place and should privatisation revenues be used to finance government expenditures, the government debt would increase at a slower rate than in the outlook.

### 3.6 The Budgetary Impact of Major Reforms

The fiscal outlook for the period 2008 to 2010 is affected by the approved set of reform measures. The plans to carry out these measures were presented in last year's CP update. A significant part of these measures was incorporated into the legislative changes and then into the 2008 state budget and its medium-term outlook.

Some of the measures have fiscal motives, especially the need to lower the government deficit. Another part of the measures aims at meeting the priorities of the National Reform Programme, in particular, supporting economic performance and improving the labour market. Table 3.6 summarises the effects of all active budgetary measures. One aspect deals with fiscally motivated expenditure savings in the area of social benefits<sup>8</sup> and wages and salaries. Another aspect involves increasing expenditures that have a positive effect on economic growth and employment.

<sup>8</sup> Adjustments are not only made to the social system to achieve budgetary savings, but also to increase motivation with respect to economic activity and to reduce the distortion effect of the system on the decision-making of economic agents.



**Table 3.6: Balance of the effects of budgetary measures**

% of GDP	Year 2007 (1)	Year 2008 (2)	Year 2009 (2)	Year 2010 (2)
<b>No-policy-change scenario</b>				
<b>Government balance - Autumn 2006 (last year's update)</b>	<b>-4.0</b>	<b>-3.5</b>	<b>-3.2</b>	<b>.</b>
Change in no-policy-change scenario	0.6	0.3	0.5	.
<b>Government balance - Autumn 2007 (current update)</b>	<b>-3.4</b>	<b>-3.2</b>	<b>-2.7</b>	<b>-2.4</b>
<b>Impacts of budgetary measures</b>				
<b>Revenue</b>	<b>-</b>	<b>0.2</b>	<b>-0.4</b>	<b>-0.8</b>
Taxes	-	0.2	-0.4	-0.6
Social contributions	-	0.0	0.0	-0.1
<b>Expenditures</b>	<b>-</b>	<b>-0.2</b>	<b>-0.5</b>	<b>-0.9</b>
Social transfers	-	-0.8	-0.8	-0.9
Compensations of employees	-	-0.1	-0.2	-0.3
Other expenditure cuts and savings	-	0.0	-0.1	-0.4
Increase in investment to infrastructure	-	0.3	0.2	0.3
Other expenditure measures	-	0.4	0.3	0.4
<b>Government balance</b>	<b>-</b>	<b>0.3</b>	<b>0.1</b>	<b>0.1</b>
<b>Fiscal targets</b>				
<b>Government balance</b>	<b>-3.4</b>	<b>-2.9</b>	<b>-2.6</b>	<b>-2.3</b>

(1) Notifications (October 2007)

(2) Outlook

Source: Ministry of Finance

Reducing the deficit in the autonomous scenario between last year's CP update and the current CP update has developed out of the more favourable assumptions on macroeconomic development, which are reflected in higher estimated revenues from taxes and social contributions.

Fiscally motivated expenditure savings contribute to a reduction in the general government deficit of 0.9 of a percentage point of GDP in 2008, of 1.1 percentage points of GDP in 2009 and 1.6 percentage points of GDP in 2010. This savings is used in part to gradually lower the tax burden of labour and legal entities and in part to strengthen expenditure priorities.

Additional revenues as a result of better-than-expected macroeconomic development are fully used to lower the deficit. At the same time, the expenditure side is being restructured from mandatory expenditures to discretionary expenditures and the revenue side from direct to indirect taxation (see Section 5 for a more detailed description of the measures).

## 4 Comparison with the Previous Convergence Programme and Sensitivity Analysis

### 4.1 Comparison with the Previous Macroeconomic Scenario

The differences between the macroeconomic scenarios of the current programme and last year's programme are related to the following:

- New observations of the macroeconomic phenomena were included.
- In addition to normal specifications, the timetables for the quarterly and yearly accounts were revised, relating in particular to the change in the method for expressing foreign trade with goods and services.
- The exogenous assumptions of the programme were slightly changed.
- The estimate for the potential GDP growth rate was increased.
- The effects of the measures contained in the Act on Stabilisation of Public Finances were included.

As a part of the assumptions of the programme's scenario, it is assumed that development in EU countries has slightly improved against the previous programme, especially in Germany. The impact of higher expected USD prices for oil from 2008 to 2010 has almost been offset by the weaker USD exchange rate vis-à-vis the EUR and the CZK.

**Table 4.1: Assumptions of the scenario**

	CP 2006			CP 2007			Difference		
	2006	2007	2008	2006	2007	2008	2006	2007	2008
<b>GDP growth (%)</b>									
<b>USA</b>	3.5	3.4	2.6	2.8	2.1	2.5	-0.7	-1.3	-0.1
<b>EU-25</b>	1.7	2.7	2.2	3.0	2.8	2.5	1.3	0.1	0.3
<b>Germany</b>	0.9	2.2	1.4	2.9	2.7	2.3	2.0	0.5	0.9
<b>Prices of oil</b>									
<b>(USD / barrel)</b>	54.4	67.5	59.8	65.4	67.8	72.5	11.0	0.3	12.8
<b>Exchange rate</b>									
<b>USD / EUR</b>	1.24	1.25	1.26	1.25	1.35	1.34	0.01	0.10	0.08

Source: Ministry of Finance

More favourable macroeconomic development in comparison with the previous programme will occur in 2007. Economic growth is ca 1.0 percentage point higher, while domestic demand's contribution exceeds expectations by 1.6 percentage points. Expansion of domestic demand is non-inflationary in nature (HICP growth of 0.2 of a percentage point). Employment will increase and unemployment will decline at a significantly faster pace. Thanks to the surprising improvement in the terms of trades, the surplus in the balance of goods and services will substantially increase.

The change in the projection for 2008 to 2010 carries with it the persistence of deviations in real and projected development in 2007 and the effects of the approved reform measures. The

## 4 Comparison with the Previous Convergence Programme and Sensitivity Analysis

result is slightly faster anticipated economic growth in nominal and real terms with a higher domestic demand contribution, a one-time increase in inflation in 2008, and a significantly tenser situation on the labour market.

**Table 4.2: Change in the indicators of the macroeconomic scenario**

	CP 2006			CP 2007			Difference (p.p.)		
	2006	2007	2008	2006	2007	2008	2006	2007	2008
<b>Growth in real terms (in %)</b>									
GDP	6.0	4.9	4.8	6.4	5.9	5.0	0.4	1.0	0.2
Households consumption	3.9	4.2	4.1	4.4	6.5	4.2	0.5	2.3	0.1
Government consumption	-1.0	0.5	-0.3	1.1	-0.6	-0.4	2.1	-1.1	-0.1
Gross fixed capital formation	6.5	7.8	7.9	7.6	6.0	9.0	1.1	-1.8	1.1
Contribution of domestic demand (pp)	4.9	4.4	4.1	5.4	6.0	5.1	0.5	1.6	1.0
Contribution of foreign trade (pp)	1.1	0.5	0.7	1.0	-0.1	-0.1	-0.1	-0.6	-0.8
Potential product	5.0	5.1	5.1	5.3	5.2	5.5	0.3	0.1	0.4
Output gap (%)	0.9	0.7	0.4	0.7	1.3	0.9	-0.2	0.6	0.5
<b>Growth (in %)</b>									
HICP	2.4	2.6	2.5	2.1	2.4	3.9	-0.3	-0.2	1.4
GDP deflator	1.4	2.6	2.9	1.1	3.5	3.1	-0.3	0.9	0.2
Employment	1.6	1.0	0.5	1.7	1.5	1.1	0.1	0.5	0.6
Unemployment rate (level in %)	7.2	6.7	6.5	7.1	5.5	4.8	-0.1	-1.2	-1.7
Exchange rate CZK/EUR (level)	28.4	28.0	27.5	28.3	28.0	27.4	-0.1	0.0	-0.1
Balance of goods and services (in % of GDP)	1.8	2.2	3.1	3.2	4.2	4.3	1.4	2.0	1.2
Net lending/borrowing (in % of GDP)	-2.8	-1.4	0.2	-2.7	-2.6	-1.7	0.1	-1.2	-1.9

Source: Ministry of Finance

### 4.2 Comparison with the Fiscal Framework of the Previous Convergence Programme

The fiscal scenarios for this year's and last year's CP updates are compared in Table 4.3. In view of the more favourable macroeconomic assumptions and the approval of the stabilisation budgetary measures, the outlook for the general government deficit is more optimistic in this year's update.

The share of the general government deficit in GDP, according to the available data in 2006, was 0.6 of a percentage point lower than the prediction in last year's update. Better results than those of the budget deficit will likely be attained in 2007 as well. In 2008 and 2009, the government deficit should be about 0.6 of a percentage point lower than in last year's CP.

## 4 Comparison with the Previous Convergence Programme and Sensitivity Analysis

**Table 4.3: Comparison with the Previous Convergence Programme**

% of GDP	ESA code	Year 2006	Year 2007 (1)	Year 2008 (2)	Year 2009 (2)	Year 2010 (2)
<b>Real GDP growth (%)</b>						
Previous update		6.0	4.9	4.8	4.8	.
Current update		6.4	5.9	5.0	5.1	5.3
Difference		0.4	1.0	0.2	0.3	.
<b>General government net lending</b>						
Previous update	EDP B.9	-3.5	-4.0	-3.5	-3.2	.
Current update	EDP B.9	-2.9	-3.4	-2.9	-2.6	-2.3
Difference		0.6	0.6	0.6	0.6	.
<b>General government gross debt</b>						
Previous update		30.6	30.5	31.3	32.2	.
Current update		30.1	30.4	30.3	30.2	30.0
Difference		-0.5	-0.1	-1.0	-2.0	.

(1) Estimate, notifications (October 2007)

(2) Outlook

Source: Ministry of Finance

### 4.3 Sensitivity Analysis

Czech economic development during the past five years can be considered as favourable. Nevertheless, it should be noted that the economy is affected by a range of conflicting factors. This includes, in particular, the positive impact of the inflow of foreign direct investment over an extended period of time as well as the negative effect of very high oil prices and the prices of other commodities. Considering that any simulation of the effects of the structural changes associated with the inflow of foreign direct investment is very complicated and highly disputable, attention is focused on the macroeconomic effects of oil prices.<sup>9</sup> However, the unfavourable development of raw material prices does not only have a negative impact on the Czech economy, but it also affects economic development in the EU as a whole.<sup>10</sup> We have, therefore, decided to supplement the sensitivity analysis with two secondary effects, i.e. the impact of foreign demand and foreign inflation.

We test the sensitivity of the Czech economy with the help of two scenarios. The optimistic scenario combines positive external supply and demand shocks. It is based on the assumption of a gradual decline in the price of oil, slightly higher foreign demand dynamics, and on the contrary, a lower growth rate for foreign industrial prices. On the other hand, the pessimistic scenario is derived from the assumptions of a higher price for oil, lower foreign demand dynamics and accelerated foreign inflation.

<sup>9</sup> For a quantitative analysis of the effects of the above factors on Czech economic development, the Ministry of Finance employs a medium-term, quarterly calibrated model. This model is a standard Keynesian model supplemented with a neoclassical supply side.

<sup>10</sup> We focus exclusively on the probable impact of oil price fluctuations on the EU economy. The simulation results of the MULTIMOD model, set up and managed by the International Monetary Fund, were used to estimate the sensitivity of the European economy.

**Table 4.4: Scenario of exogenous variables**

		Year 2006	Year 2007	Year 2008	Year 2009	Year 2010
<b>UK Brent</b>						
<b>Optimistic</b>	USD/barrel		62.8	62.5	51.8	50.0
<b>Baseline</b>	USD/barrel	65.4	67.8	72.5	66.8	65.0
<b>Pessimistic</b>	USD/barrel		72.8	82.5	81.8	80.0
<b>GDP EU 15</b>						
<b>Optimistic</b>	y/y in %		2.9	2.8	2.7	2.6
<b>Baseline</b>	y/y in %	3.0	2.7	2.5	2.5	2.5
<b>Pessimistic</b>	y/y in %		2.6	2.2	2.3	2.4
<b>PPI EU 15</b>						
<b>Optimistic</b>	y/y in %		3.4	3.1	3.5	3.8
<b>Baseline</b>	y/y in %	3.9	3.9	3.9	3.9	3.9
<b>Pessimistic</b>	y/y in %		4.4	4.7	4.3	4.0

Source: Ministry of Finance

### Optimistic scenario

The settings of the scenarios are characterised by the primary nominal and secondary real impact on the Czech economy. Thanks to the assumed slow decline in the price of oil to around USD 50 per barrel, we can expect a very substantial improvement in the external imbalance during the simulation measured by the balance of payments current account. A lower price for oil has a very positive income effect. Thanks to the relatively high energy demands of the Czech economy, firms reduce their production costs, which is reflected positively in lower price dynamics.

Higher foreign demand growth will then have a positive impact on acceleration of the export growth rate and in turn on industrial activity. However, thanks to the slowly declining import intensity of the supply side of the Czech economy, the higher export dynamics will also lead to high import dynamics. So the overall positive effect will be partially reduced. The higher dynamics for economic activity should be associated with higher demand for labour as well as higher labour productivity, which reduces the impact on employment growth. Thanks to lower raw material prices and lower foreign price dynamics, positive price and wage development can be expected.

**Table 4.5: Macroeconomic effects of the optimistic scenario**

		Year 2006	Year 2007	Year 2008	Year 2009	Year 2010
<b>Gross domestic product</b>						
<b>Consumption expenditures</b>	volumes, y/y in %	4.4	6.5	4.3	4.8	4.4
<b>Gross fixed capital formation</b>	volumes, y/y in %	7.6	6.0	9.2	8.0	7.5
<b>Government expenditures</b>	volumes, y/y in %	1.1	-0.6	-0.4	-0.3	-0.5
<b>Export of goods and services</b>	volumes, y/y in %	15.9	13.3	12.2	13.5	13.9
<b>Import of goods and services</b>	volumes, y/y in %	15.2	14.0	12.9	12.8	12.7
<b>Gross domestic product</b>	volumes, y/y in %	6.4	6.0	5.3	5.6	5.9
<b>Labour market</b>						
<b>Total employment</b>	y/y in %	1.7	1.5	1.2	0.6	0.4
<b>Unemployment rate</b>	in %	7.1	5.5	4.7	4.4	4.4
<b>Wages and salaries</b>	y/y in %	5.7	7.7	6.4	6.8	6.9
<b>Prices</b>						
<b>Consumer price index</b>	y/y in %	2.1	2.3	3.7	1.9	1.8
<b>Gross domestic product deflator</b>	y/y in %	1.1	3.7	3.5	2.2	2.0
<b>Government sector</b>						
<b>Deficit</b>	in % of GDP	-2.9	-3.4	-2.7	-2.4	-2.0
<b>Debt</b>	in % of GDP	30.1	30.3	30.0	29.5	29.0
<b>Other indicators</b>						
<b>PRIBOR 3M</b>	in % p.a.	2.3	3.0	3.5	3.1	2.8
<b>Current account</b>	in % of GDP	-3.0	-2.4	-1.7	-0.4	1.4

Source: Ministry of Finance

Due to the moderate deceleration of inflation and an increase in GDP dynamics, there will only be insignificant changes in the volume of wages and salaries. Hence, the revenue increase for income taxes is actually negligible. In addition, with respect to the composition of economic growth, even the revenues from consumption (VAT and excise tax) have not significantly increased. The expenditure side of the budget assumes nominal rigidity of the expenditure frameworks, and for the given simulations, it has actually not changed.<sup>11</sup> The decline on the expenditure side of the budget is associated with a decline in debt service, which is affected by a lower level of nominal interest rates and lower expenditures for unemployment benefits. The optimistic scenario would lead to a slight improvement in general government finances.

### Pessimistic scenario

With the pessimistic scenario, oil price developments would immediately cause the external imbalance to worsen. A secondary effect would be lower foreign demand dynamics, and on the contrary, faster foreign price growth. Lower foreign demand could be reflected in lower export performance and, in turn, lower GDP dynamics. Higher foreign price growth would put additional pressure on import price growth and production cost growth. In addition, higher price dynamics would prompt the acceleration of wage demands, which would cause production costs to increase again with an effect on prices. The central bank could then be expected to react with higher interest rates.

<sup>11</sup>In reality, positive price development could also be connected to savings on the expenditure side of the budget (e.g. lower indexation of pensions, social benefits, etc.). However, this factor is not accounted for in our simulations, which could cause the deficit or debt to be overestimated in the specific scenario.

## 4 Comparison with the Previous Convergence Programme and Sensitivity Analysis

**Table 4.6: Macroeconomic effects of the pessimistic scenario**

		Year 2006	Year 2007	Year 2008	Year 2009	Year 2010
<b>Gross domestic product</b>						
Consumption expenditures	volumes, y/y in %	4.4	6.5	4.1	4.4	4.0
Gross fixed capital formation	volumes, y/y in %	7.6	6.0	8.9	7.6	6.9
Government expenditures	volumes, y/y in %	1.1	-0.6	-0.3	-0.2	-0.5
Export of goods and services	volumes, y/y in %	15.9	13.1	11.5	12.4	13.0
Import of goods and services	volumes, y/y in %	15.2	13.9	12.5	12.0	12.1
Gross domestic product	volumes, y/y in %	6.4	5.9	4.7	4.6	4.7
<b>Labour market</b>						
Total employment	y/y in %	1.7	1.5	1.1	0.4	0.1
Unemployment rate	in %	7.1	5.5	4.8	4.6	4.7
Wages and salaries	y/y in %	5.7	7.7	6.6	7.1	7.1
<b>Prices</b>						
Consumer price index	y/y in %	2.1	2.5	4.1	2.7	2.4
Gross domestic product deflator	y/y in %	1.1	3.3	2.8	2.5	2.4
<b>Government sector</b>						
Deficit	in % of GDP	-2.9	-3.5	-3.0	-2.9	-2.6
Debt	in % of GDP	30.1	30.5	30.6	30.9	31.1
<b>Other indicators</b>						
PRIBOR 3M	in % p.a.	2.3	3.0	3.7	3.5	3.3
Current account	in % of GDP	-3.0	-2.9	-2.9	-2.1	-0.5

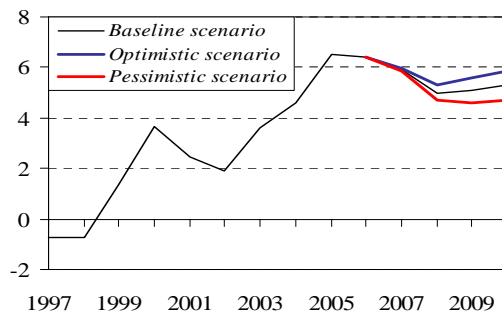
Source: Ministry of Finance

Higher inflation acceleration than deceleration of real variables (employment, GDP) causes certain tax revenues to increase, even in the pessimistic scenario. However, a higher inflation rate is associated with higher nominal interest rates and thus higher debt service costs. An increase in the drawdown of unemployment benefits would also occur.<sup>12</sup> With the pessimistic scenario, a deterioration in public finance performance could be expected.

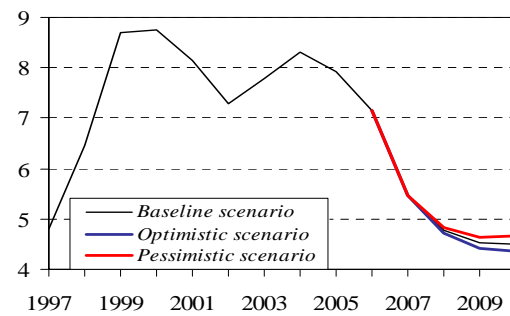
<sup>12</sup> In addition, it should be pointed out that a higher inflation rate in our scenario is not related to the additional indexation of old-age pensions or other social benefits. This simplification could cause the resulting rise in the deficit or public debt to be underestimated in the pessimistic scenario.

## 4 Comparison with the Previous Convergence Programme and Sensitivity Analysis

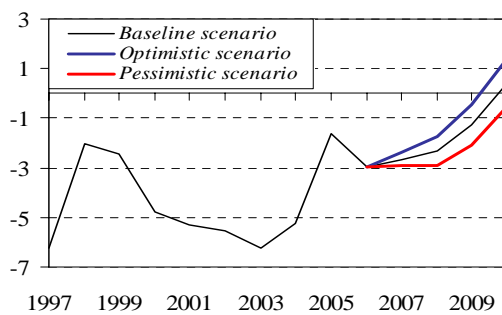
**Chart 4.1: GDP (y-o-y in %)**



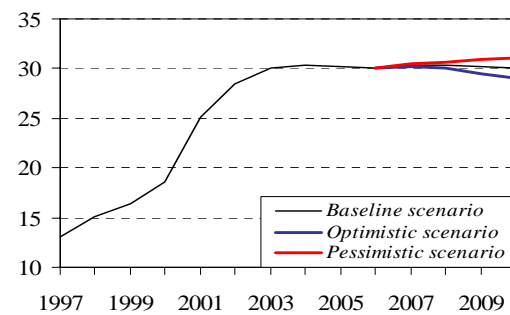
**Chart 4.2: Unemployment rate (in %)**



**Chart 4.3: Current account (in % GDP)**



**Chart 4.4: Government debt (in % GDP)**



Source: Ministry of Finance



## **5 Quality of Public Finances – Revenues and Expenditures**

### **5.1 The Government's Strategy**

One of the objectives of the government's strategy is to improve the quality of public finances, especially in the areas of fiscal discipline, effective management of government expenditures and tax administration, long-term sustainability and the institutional framework. In this respect, the government approved a set of measures in 2007 on the revenue and expenditure side geared to stabilising public finances and lowering the general government deficit below 3% of GDP in 2008 (see Section 3 for details). Over the longer-term horizon, the government's objective involves reforms of the pension and healthcare systems, which strengthens the long-term sustainability of public finances (see Section 6 for details). Measures relating to the quality of the institutional framework are discussed in Section 7.

With respect to restructuring the expenditure side, the austerity measures in the area of social mandatory expenditures play a key role. The said measures will slow down the growth dynamics of these expenditures and will make state assistance in the social sphere more effective.

Another important area helping to limit the mandatory and quasi-mandatory expenditures in the general government is expenditures for employee wages in state administration.

In addition to the fiscal targets, the planned measures also monitor fulfilment of the priorities contained in the National Reform Programme. This involves, in particular, promoting economic growth and employment by reducing the overall tax burden of economic agents. The shift of the tax burden from direct taxes to indirect taxes will continue. At the same time, simplifying the tax system will reduce the administrative burden and tax distortion.

### **5.2 General Government Revenues**

In addition to deficit reduction, the approved expenditure oriented consolidation allows another gradual decline in the compound tax quota. The tax burden in terms of the compound tax quota was in a range of 36.0% of GDP in 2006 and recorded a year-on-year decrease of 0.8 of a percentage point. The gradual decline in the tax quota was the result of total tax revenues being lower than unit elasticity vis-à-vis GDP and also measures geared to reducing the high taxation of labour and legal entities. Direct taxation in the form of current income taxes will decline from 8.8% of GDP in 2007 to 7.5% of GDP in 2010 (see Table 5.1).

On the contrary, the increase in indirect taxation will work towards increasing the share of general government revenues in GDP. This increase is evident from the year-on-year increase in the share of taxes for production and import (particularly VAT and excise tax) from 10.9% of GDP in 2007 to 11.5% of GDP in 2008. In future years, an autonomous decline will occur due to lower-than-unit elasticity of indirect tax revenues in GDP.

The revenues from social contributions will be, among other things, adversely affected by introducing a maximum assessment base, and starting from 2009, also by adjustments to the

## 5 Quality of Public Finances – Revenues and Expenditures

sickness insurance system (see Box 5.2 for details). As a result, their share in GDP will gradually decline from 16.2% in 2006 to 15.0% of GDP in 2010.

The share of total general government revenues in GDP will decline from 40.7% in 2006 to 37.1 % in 2010.

**Table 5.1: General Government Revenues**

% of GDP	ESA code	Year 2006	Year 2007 (1)	Year 2008 (2)	Year 2009 (2)	Year 2010 (2)
<b>Components of revenues</b>						
<b>Total taxes</b>		<b>19.7</b>	<b>19.7</b>	<b>19.7</b>	<b>18.9</b>	<b>18.3</b>
Taxes on production and imports	D.2	10.9	10.9	11.5	11.1	10.8
Current taxes on income, wealth etc.	D.5	8.8	8.8	8.2	7.7	7.5
Capital taxes	D.91	0.0	0.0	0.0	0.0	0.0
<b>Social contributions</b>	<b>D.61</b>	<b>16.2</b>	<b>16.2</b>	<b>15.9</b>	<b>15.4</b>	<b>15.0</b>
<b>Property income</b>	<b>D.4</b>	<b>0.8</b>	<b>0.6</b>	<b>0.5</b>	<b>0.5</b>	<b>0.4</b>
<b>Other</b>		<b>3.9</b>	<b>3.3</b>	<b>3.3</b>	<b>3.3</b>	<b>3.4</b>
<b>Total revenue</b>	<b>TR</b>	<b>40.7</b>	<b>39.8</b>	<b>39.5</b>	<b>38.1</b>	<b>37.1</b>
<b>p.m.: Tax burden</b>		<b>36.0</b>	<b>35.9</b>	<b>35.7</b>	<b>34.3</b>	<b>33.3</b>

(1) Estimate

(2) Outlook

Source: Czech Statistical Office (2006), Ministry of Finance

### Box 5.1: Changes in taxation

#### Personal income tax (PIT)

As of 1 January 2008, a flat PIT rate of 15% will be valid in the Czech Republic for so-called “super-gross wages” (gross wage plus premiums paid by employers, which will increase the tax base by 54.3%). The rate should be reduced to 12.5% on 1 January 2009 (however, the new amendment to the Income Tax Act planned for the first half of 2008 will set the concrete rates). The same rates will apply to most items subject to withholding taxes (for PIT and CIT). Changes will also occur with respect to tax credits. Starting on 1 January 2008, the credit for a taxpayer or spouse with no income will be increased from CZK 7,200 to CZK 24,840, and starting on 1 January 2009, this credit will be reduced to CZK 16,560 due to lowering the tax rate. Credits for children in 2008 will increase from CZK 6,000 to CZK 10,680, and reduced to CZK 10,200 in 2009. Credits for students should be CZK 4,020 for both years. Joint taxation of spouses will be cancelled, as well as the minimum tax base for self-employed individuals.

The changes relating to PIT reduce general government revenues by ca CZK 21 billion in 2008, ca CZK 30 billion in 2009 and ca CZK 34 billion in 2010.

#### Corporate income tax (CIT)

As of 1 January 2008, the CIT rate will be reduced from 24% valid for 2007 to 21%, further to 20% starting on 1 January 2009 and finally to 19% from 1 January 2010. In this way, the long-term process of reducing the CIT rate will continue. The tax rate reduction will be accompanied by some expansion of the tax base. This will involve, in particular, tightening the rules for low capitalisation and restricting the tax-deductible nature of interest, as well as additional taxation of unpaid obligations, taxation of other revenues for lotteries and gaming above the actual waged amounts, cancelling tax deductions on receivables due up to 31 December 2004 and certain other changes in the area of the creation of reserves.

The total decline in revenues as a result of the CIT measures are expected to be ca CZK 9 billion in 2008, ca CZK 24 billion in 2009 and ca CZK 34 billion in 2010.

### Value added tax (VAT)

Two rates for value added tax exist side by side in the Czech Republic – the reduced 5% rate and the 19% standard rate. As of 1 January 2008, the reduced VAT rate will be increased from 5% to 9%. The rate increase concerns especially food, construction work for social housing and housing services and regular mass transportation.

Keeping two tax rates (the standard tax rate will remain 19%) helps maintain the social sensitivity of reform with respect to the economically inactive population, such as pensioners or non-working parents with children, and low-income households. The rate increase is not expected to fully affect the final retail prices of certain products and services on highly competitive markets, such as the food market. In order to support environmentally friendly behaviour, certain products were reclassified as items with a reduced tax rate, and consideration is being given to other products as well.

This measure is expected to increase state budget revenues annually by ca CZK 27 to 29 billion during the specified years.

### Excise taxes

Starting in 2008, taxes on cigarettes and tobacco are to increase. The price of a pack of cigarettes should increase by up to CZK 7. The tax on tobacco is currently CZK 905 per kilogram, and this tax should increase to CZK 1,280 per kilogram.

Another change in excise taxes is the introduction of an environmental tax on electricity, natural gas and solid fuels.

Electricity: As of 1 January 2008, an electricity tax of CZK 28.30 per MWh will be introduced. However, some exceptions will be made (e.g. for mass rail transportation or ecological production).

Natural gas: As of 1 January 2008, a natural gas tax of CZK 30.60 per MWh will be introduced for heat production. An engine tax will be introduced and gradually increased to CZK 264.8 per MWh by 2020 (no tax exists at this time). An exception will be, for example, households using natural gas for heating. This tax will not apply to fuel for boats either.

Solid fuels: The rate will be CZK 8.5 per GJ and will not apply to electricity producers.

These measures should bring an additional CZK 11.6 billion in revenue in 2008, of which CZK 4.6 billion will be for environmental taxes.

### Property taxes

As a part of the changes to the tax system in the Czech Republic, exemptions for inheritance and gift taxes will be expanded so that they apply to relatives and persons living with a decedent or donor in one household. New powers relating to real estate tax will pass to the municipalities, such as influencing the amount of the tax or exempting farmers from paying taxes on agricultural land.

The impact of the changes in property taxes anticipate a reduction in public budget revenues of ca CZK 0.4 billion.

The active tax policy measures are summarised in Table 5.2 below.

**Table 5.2: The impact of tax changes on general government revenues**

CZK bn	Year 2008	Year 2009	Year 2010
<b>Taxes total</b>	<b>7.9</b>	<b>-14.7</b>	<b>-27.9</b>
<b>Taxes total (% of GDP)</b>	<b>0.2</b>	<b>-0.4</b>	<b>-0.6</b>
of which: Value added tax	27.2	28.0	29.2
Personal income tax	-21.2	-30.1	-34.3
Corporate income tax	-9.3	-23.8	-34.0
Excise taxes	11.6	11.6	11.6
Property taxes	-0.4	-0.4	-0.4

Source: Ministry of Finance

### 5.3 General Government Expenditures

In view of the slow decline in the share of revenues in GDP, fiscal consolidation relies on the savings from the expenditure side of the public budgets. The overall tendency towards a decline in general government expenditures vis-à-vis GDP is, in turn, supported by the government's active austerity measures and, similar to the revenue side, the under-proportional growth of certain general government expenditures with respect to a high GDP growth rate.

Low growth in the volume of wages and salaries in state administration will be reflected in the declining share of general government expenditures for the compensation of employees in GDP. The government's objective is to increase the volume of wage resources in the state-regulated sphere by only 1.5% per year. An increase in the average wage to a level of at least 4.5% and also increasing the efficiency of state administration should be ensured by a reduction of at least 3% in the number of employees in public administration per year. Nevertheless, the outlook assumes a substantially faster increase in the volume of wages in the general government (ca 3.5% per year). Employment in the sector as a whole significantly exceeds the regulated sphere, and the remainder of the government sector apparently will not fully follow the government's objectives. The share of compensation of employees in GDP will drop from 7.8% in 2006 to 6.7% of GDP in 2010.

The share of government expenditures in the purchase of goods and services will also experience a declining trend. The austerity measures will be reflected in the share of total government consumption in GDP, which will decrease from 21.2% to 17.4% during the period 2006 to 2010.

A decisive means of consolidation for meeting the fiscal targets, however, will be the savings in the area of mandatory and quasi-mandatory expenditures, which make up almost three fourths of the total expenditures in the state budget for 2007. The government approved reform measures described in Box 5.2 are then expected to be positively reflected in the decline in the share of total social transfers in GDP from 17.9% in 2006 gradually to 16.3% of GDP in 2010. Any expenditures for social benefits other than in-kind benefits will register the largest decline. Between 2007 and 2008, these expenditures will decline from 13.0% to 12.3% of GDP, and by 2010, will continue to decline to 11.5% of GDP.

On the contrary, gross creation of fixed capital will register an increase, which will increase in terms of its share in GDP from 5.0% in 2006 to 5.6% of GDP in 2010 as a result of investment projects financed through EU funds, among others. A gradual increase in the drawdown of resources should be reflected first in a high and then gradually lower growth rate of government investment.

The share of granted subsidies and current and capital transfers in GDP (in Table 5.3, a part of the item "Other") shows only a slight decline up to 2010 in comparison with 2006.

Interest payments for the general government will slightly increase from 1.1% in 2006 to 1.2% of GDP in 2010 due to an increase in interest rates on newly issued bonds.

The share of total expenditures in GDP for 2006 declined year-on-year by 1.3 percentage points to 43.6% and should continue to decline to 39.4% of GDP by 2010.

Table 5.3: General government expenditures

% of GDP	ESA code	Year 2006	Year 2007 (1)	Year 2008 (2)	Year 2009 (2)	Year 2010 (2)
<b>Components of expenditures</b>						
Compensation of employees	D.1	7.8	7.6	7.3	7.0	6.7
Intermediate consumption	P.2	6.6	5.8	5.5	5.1	4.8
Social transfers		17.9	18.2	17.4	16.8	16.3
Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	5.3	5.2	5.1	5.0	4.8
Social transfers other than in kind	D.62	12.6	13.0	12.3	11.8	11.5
Interest expenditure	EDP D.41	1.1	1.2	1.3	1.2	1.2
Subsidies	D.3	1.9	2.0	2.2	1.9	1.8
Gross fixed capital formation	P.51	5.0	5.1	5.3	5.4	5.6
Other		3.3	3.4	3.6	3.3	3.1
Total expenditures	TE	43.6	43.3	42.4	40.7	39.4
p.m.: Government consumption (nominal)	P.3	21.2	20.0	19.1	18.2	17.4

(1) Estimate

(2) Outlook

Source: Czech Statistical Office (2006), Ministry of Finance

## Box 5.2: Changes in social security

### Adjustments to social and health insurance

The effective date of the new Act on **Sickness Insurance** was postponed until 1 January 2009. On the basis of the Act on Stabilisation of Public Finances, the following measures will be taken as of 1 January 2008: the entitlement to sickness benefits, salary or service income for the armed forces for the first three days of work disability will be cancelled for sickness insurance. From the 4<sup>th</sup> to 30<sup>th</sup> calendar day of work disability, the sickness benefit is calculated as 60% of the daily assessment base, from the 31<sup>st</sup> to 60<sup>th</sup> day 66%, and from the 61<sup>st</sup> day 72% of the assessment base. The maximum monthly sickness benefit will also be reduced (according to income, up to CZK 3,500). The amount of support when treating a family member is 60% of the assessment base, and the monetary assistance for maternity leave 69% of the assessment base. Considering the fact that the expected impact of the new Act on Sickness Insurance on the revenue side of the budgets will increase over time, the savings related to postponing the act one year against last year's budgetary outlook will be ca CZK 10 billion in 2008 and also in 2009.

Incorporating parametric changes decisive for the payment of benefits into the existing act will produce savings of CZK 6.8 billion in 2008 on the expenditure side. Incorporating parametric changes into the new act effective on 1 January 2009 will generate savings of CZK 2.6 billion in 2009 and CZK 6.5 billion in 2010.

The effective date of the Act on **Casualty Insurance** has been postponed for two years to 1 January 2010. By delaying this act, the deficit for the general government will increase by CZK 2.5 billion in 2008 and by CZK 1.6 billion in 2009 against last year's budgetary outlook. On the contrary, there should be a positive impact on the balance of CZK 1 billion in 2010.

As of 1 January 2008, an annual maximum assessment base for the payment of premiums will be introduced (which has so far only been introduced for self-employed individuals) for employees and self-employed individuals amounting to 48 times the monthly wage per calendar year (i.e. four times the average annual wage in the national economy).

For health insurance, the assessment base relating to the state budget payment, in which the state is the contributor, has been revised. This rate will remain 25% of the average wage, however, without increasing it by the calculation coefficient. In this respect, **expenditure growth for the state payment to the public health insurance system has been frozen**. As a result of this measure, the estimate of savings against expenditures in the outlook are CZK 3.4 billion in 2008, CZK 6.4 billion in 2009 and CZK 2.0 billion in 2010. The government anticipates additional austerity measures in 2010 amounting to CZK 6.6 billion. Nevertheless, the relevant legislative changes have not yet been approved for this year.

The overall impact of the measures for social and health insurance on the general government balance amount to approximately CZK 12.4 billion in 2008 (0.3% of GDP), CZK 10.6 billion in 2009 (0.3% of GDP), and CZK 8.9 billion in 2010 (0.2% of GDP).

In additions to these effects, **introducing service charges** to the healthcare system (see Box 6.1) can be expected to limit fund drawing for healthcare, which results in savings of around CZK 4 billion per year for social transfers in kind.

### Government welfare benefits

**Child benefits** will be paid as a fixed amount, increasing as the child gets older. CZK 500 per month will be paid out for the first age category up to six year old, CZK 610 for the six to 15 year category, and CZK 700 for children 15 to 26 years old. The entitlement is restricted by income to 2.4 times the minimum subsistence level of a family for all age categories.

As for **social care benefits**, the entitlement limit will be reduced from 2.2 to 2 times the minimum subsistence level of a family. The amount of the benefit will be further reduced as the income of the family increases. The lowest payment will still be CZK 50 per month.

**Parental contributions** have been proposed as a “three-speed” system. The monthly benefits may be paid out as CZK 11,400 for a period of 24 months (faster drawdown), CZK 7,600 for a period of 36 months (classical drawdown), or the four-year option where CZK 7,600 will be paid out for a period of 21 months and then CZK 3,800 for the remaining time (slower drawdown). Parents may initially choose the payment option but may not change their mind during the process. For parents caring for disabled children, the parental contribution will be kept at the base rate (i.e. CZK 7,600) for a period of seven years.

**Maternity benefits** are set as one payment of CZK 13,000 for each child born as of the effective date of the act, regardless of the number of children born or the order in which they are born.

**Foster care benefits** are set as a fixed payment of CZK 8,000, CZK 9,000, and CZK 10,000 increasing with the age of the child in three age categories (see child benefits for the age categories).

**The benefits for school supplies** will be cancelled.

**Funeral benefits** set as a fixed amount will not be adjusted and will only be paid in exceptional cases (e.g. funerals for unsupported children).

The total savings on the expenditure side relating to the above measures is estimated to be ca CZK 8.5 billion in 2008, ca CZK 10 billion in 2009 and ca CZK 13 billion in 2010.

### Other adjustments in the social sphere

**The automatic indexation of most social care benefits has been abolished insofar that the benefit amounts are no longer derived from the minimum subsistence level (set as a fixed amount in CZK). The automatic annual indexation of the amounts for the minimum subsistence and existence levels themselves will also be cancelled.** The government may optionally set the terms and hence influence the benefit amounts as well, especially for poverty relief assistance, which will still be derived from the minimum subsistence level. The existing indexation scheme will be maintained for pensions.

With respect to the **benefits for poverty relief assistance**, the terms for paying benefits will be more stringent for persons who have been unemployed long-term and who have not made any or very little effort to earn an income (e.g. requalification, participation in further education projects, etc.). Should these persons not work for 12 months or more, they will be paid the minimum existence level set by law (now CZK 2,020 per month) instead of the minimum subsistence level. This regulation does not apply to persons over 55 years of age, partially disabled persons and parents caring for children younger than 12 years of age.

A person who is laid off due to a gross breach of work discipline is not entitled to **unemployment benefits**. In addition, a job applicant removed from the applicant list due to illegal work activities may be again added to the list after a lapse of a period of six months.

For **social care benefits**, the changes relate, in particular, to making the payment of these benefits more effective. Duplicity will be eliminated. If the recipient of the benefits is hospitalised for an entire calendar month or is placed in a correction facility or treatment facility, these benefits will be cancelled. In addition, the supervision of benefit payments will be tightened.



**Table 5.4: The impact of changes in the social legislation**

CZK bn	Year 2008	Year 2009	Year 2010
<b>Impacts on revenue</b>			
Introduction of maximum assesment base for social contributions	-6.6	-6.9	-7.2
Postponement of the act on casualty insurance	-5.9	-5.1	1.0
Postponement of the act on sickness insurance	11.3	10.1	0.0
<b>Total impact on revenue</b>	<b>-1.1</b>	<b>-1.9</b>	<b>-6.2</b>
<b>Impacts on expenditures</b>			
Postponement of the act on casualty insurance	-3.4	-3.5	0.0
Parametric changes to sickness insurance benefits	-6.8	-2.6	-6.5
Government welfare benefits	-8.5	-9.8	-13.1
State's payment into the public health insurance system	-3.4	-6.4	-8.6
Introduction of regulatory fees in health care system	-4.0	-4.0	-4.0
Pension insurance benefits	-1.6	-1.1	0.0
Other changes in the social area	-1.6	-7.1	-6.7
<b>Total impact on expenditure</b>	<b>-29.3</b>	<b>-34.5</b>	<b>-38.9</b>
<b>Impact on balance</b>			
<b>Total impact on balance</b>	<b>28.2</b>	<b>32.6</b>	<b>32.7</b>
<b>Total impact on balance (% of GDP)</b>	<b>0.7</b>	<b>0.8</b>	<b>0.7</b>

Source: Ministry of Finance

In Table 5.5 and Chart 5.1, the increase in the share of expenditures in general public services, defence and education is explicit in the structure of general government expenditures by function (COFOG). On the contrary, the expenditures for the economic affairs of the country and social matters have registered a decline over time. The expenditures for the sector of government institutions, expressed by the share in GDP, have shown a relatively stable value of around 44% during the past two monitored years with a slight declining tendency.

**Table 5.5: General government expenditures by function**

% of GDP	ESA code	Year 2001	Year 2002	Year 2003	Year 2004	Year 2005
1. General public services	1	4.2	5.0	5.2	5.0	5.5
2. Defence	2	1.6	1.6	1.9	1.4	1.8
3. Public order and safety	3	2.2	2.1	2.2	2.2	2.2
4. Economic affairs	4	9.4	8.6	8.4	7.5	6.9
5. Environmental protection	5	1.0	1.0	1.2	1.1	1.2
6. Housing and community amenities	6	1.2	0.7	1.3	0.9	1.4
7. Health	7	6.0	6.3	6.4	6.2	6.1
8. Recreation, culture and religion	8	1.1	1.3	1.3	1.2	1.2
9. Education	9	4.4	5.2	5.2	4.8	4.8
10. Social protection	10	13.3	14.5	14.3	13.6	12.8
<b>Total expenditure</b>	<b>TE</b>	<b>44.5</b>	<b>46.3</b>	<b>47.3</b>	<b>43.9</b>	<b>43.8</b>

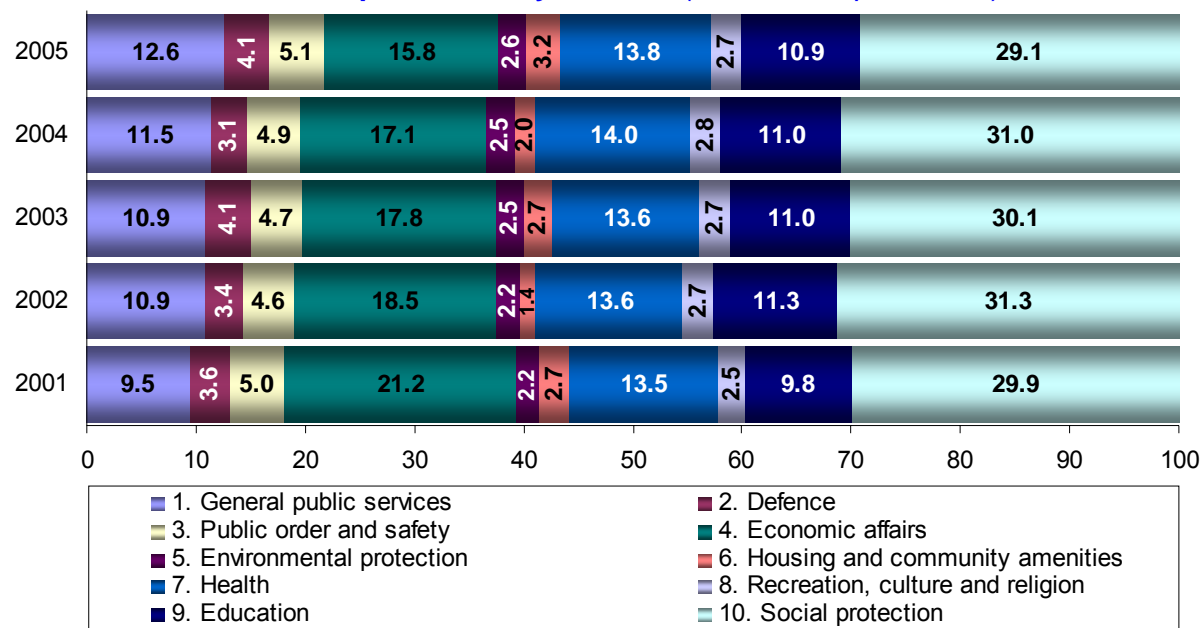
Note: Total expenditures do not correspond exactly to the current version of the annual national accounts. This is due to the different periodicity of publishing the main aggregates of the annual national accounts (every half year in April and October) and the expenditures of general government institutions by function (once a year in December).

Source: Czech Statistical Office

## 5 Quality of Public Finances – Revenues and Expenditures

In the following chart, the data for expenditures relating to special purposes are expressed by the share in total expenditures for the sector of general government institutions.

**Chart 5.1: Government expenditures by function (% of total expenditures)**



Source: Czech Statistical Office



## 6 Sustainability of Public Finances

### 6.1 The Government's Strategy

Long-term sustainability is one of the weak spots of public finances. The most serious risk is the expected demographic development, which will somewhat dramatically increase the share of persons at retirement age in the working population over the next several decades. Currently, the government is intensively engaged in the issue of an ageing population and its impact on the long-term sustainability of public finances, and the preparations for reforming the pension system and the healthcare system are taking on a more concrete form.

#### The pension system

The approach to resolving the pension system issue has been divided into three phases. The first phase has already been prepared. The proposal contains stabilising parametric adjustments to the current pay-as-you-go scheme. The main points include continuing to increase the retirement age gradually to 65 years old, coordinating the age for entitlement to “permanent” widow’s or widower’s pension based on retirement age, and converting full disability pension into old-age pension at the age of 65. After implementing these measures, there should be savings of about 1 percentage point of GDP for the pension system’s expenditures in 2050. It has also been proposed to extend the minimum insurance period, to limit its non-contributory periods, to modify the current definition of disability and to create a reserve account for pension reform.

The second phase will involve separation of the assets of shareholders and clients in the voluntary supplementary pension insurance scheme and additional adjustments geared to increasing the motivation of clients and the participation of employers in supporting supplementary pension insurance. A guarantee of minimum income for pensioners in the amount of the minimum subsistence level will also be introduced.

During the third phase, an additional voluntary savings pillar for the pension system will be created based on a scheme to “opt out” (or partially opt out) of the state pay-as-you-go system.

In addition, the political debate over the strategic issues concerning the pension system was reopened. In June 2007, a team made up of the leaders of the parliamentary parties met for the first time to discuss the long-term issue of pension reform. The task of the team is to negotiate a generally acceptable proposal for pension reform based on the input of the executive team in 2005<sup>13</sup>. At the same time, an expert discussion took place on the options for resolving the separation of shareholder and client assets in pension funds, which should allow the funds to be used for introducing an opt-out system.

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<sup>13</sup> An independent expert team carried out an in-depth analysis of the current state of the pension system and assessed the fiscal impact of the reform scenarios proposed by the main political parties. The team prepared comprehensive background materials for deciding on the concept of pension reform.

## The healthcare system

The healthcare system reform has also been divided into phases. The first phase has already been launched and incorporated into the set of measures for stabilising public finances (measures already approved, see Box 6.1)

### Box 6.1: Adjustments to the healthcare system

The amendment to the Act on Public Health Insurance will come into effect on 1 January 2008 and will introduce **service charges** for doctor's visits, for items on a prescription, and for the number of days spent at healthcare facilities. The amount of the charges for doctor's visits, prescription items and certain supplementary payments for medication paid by one person is limited to CZK 5,000 per year. Additional legislative changes have been made with respect to **setting prices and the payment of medication**.

The income gained by healthcare facilities from the services charges are estimated at CZK 4.4 billion. Moreover, savings in health insurance expenditures are expected to be around CZK 4 billion, thanks, for example, to motivating the public to limit their doctor's visits and limiting the duplication of treatment at specialists. The savings effect will be partly reduced by the increased administrative expenditures and expenditures associated with returning a part of the charges to the insured persons exceeding the CZK 5,000 limit.

The state budget's mandatory expenditures for healthcare will be reduced by a temporary **freeze of the government payment for state insurance** (see Box 5.2).

Specific systemic changes aimed at strengthening fair competition in healthcare facilities are being prepared at this time, including the conversion of health insurance companies into joint-stock companies with increased operating transparency. The scope of health insurance will also be revised and the option of choosing more comprehensive insurance will be introduced with the possibility of paying for higher standard care (or arranging supplementary health insurance).

With its resolution of June 2007, the government established a committee of independent experts (similar to the pension reform executive team) who will assess the current state of the healthcare system and its outlook. The committee should also analyse the strategic reform proposals of the political parties. However, implementation of the results of this committee's work will most likely not occur until the next election term.

## 6.2 The Fiscal Consequences of an Ageing Population – a Long-Term Projection

The analysis of public expenditure development over the long term is primarily based on the common assumptions and methodology discussed by the EPC's Working Group on the Ageing Population (AWG) and on the Czech Ministry of Finance's medium-term macroeconomic prediction. The long-term prediction does not include any of the unapproved measures planned as a part of the pension and healthcare system reform discussed in the previous sub-section.

**Table 6.1: Macroeconomic projection assumptions**

% of GDP	Year 2006	Year 2010	Year 2020	Year 2030	Year 2040	Year 2050
Labour productivity growth	5.0	5.1	3.0	2.7	1.9	1.7
Real GDP growth	6.4	5.3	2.5	1.9	0.4	0.8
Participation rate males (aged 20–64)	83.2	84.6	87.4	87.1	84.4	85.6
Participation rates females (aged 20–64)	68.5	70.6	76.4	76.1	72.9	74.0
Total participation rates (aged 20–64)	75.8	77.6	81.9	81.6	78.7	79.8
Unemployment rate	7.1	4.5	6.5	6.5	6.5	6.5
Population aged 65+ over total population	14.4	15.5	20.8	23.6	26.8	31.0

Source: Czech Statistical Office (2006), Ministry of Finance, AWG

The estimates of the effects of population changes have not changed substantially with respect to last year's CP update. They point to increasing pressures, especially in the area of expenditures sensitive to the age structure of the population. These expenditures are estimated to increase by almost 8 percentage points of GDP between 2006 and 2050. Old-age pensions (an increase in the same period of 6.0 percentage points of GDP) and expenditures for healthcare and long-term care (an increase of 2.4 percentage points of GDP) will contribute most to this rise.

**Table 6.2: Long-term projection of general government revenues and expenditures**

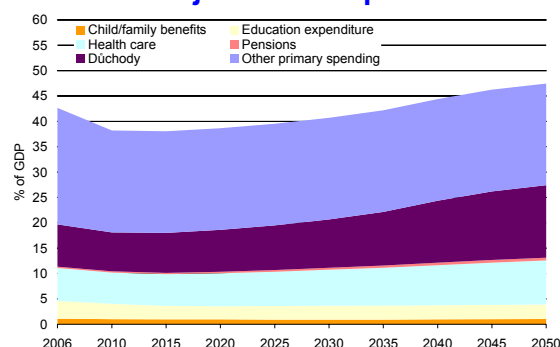
% of GDP	Year 2006	Year 2010	Year 2020	Year 2030	Year 2040	Year 2050
Total expenditure	43.6	39.4	39.8	42.7	48.4	55.5
of which: Age-related expenditure	19.7	18.1	18.6	20.7	24.3	27.4
Pension Expenditure	8.3	7.7	8.3	9.5	12.2	14.3
Social security pensions	8.3	7.7	8.3	9.5	12.2	14.3
Old-age and early pensions	7.5	7.0	7.5	8.7	11.5	13.6
Other pensions	0.8	0.7	0.7	0.8	0.7	0.7
Occupational pensions	0.0	0.0	0.0	0.0	0.0	0.0
Health care	6.5	6.2	6.5	7.1	7.9	8.7
Long-term care	0.3	0.3	0.3	0.4	0.5	0.5
Education expenditure	3.5	3.0	2.6	2.7	2.8	2.9
Other age-related expenditures	1.1	1.0	0.9	0.9	1.0	1.0
of which: Interest expenditure	1.1	1.2	1.2	2.0	4.1	8.0
Total revenue	40.7	37.1	37.1	37.1	37.1	37.1
of which: Property income	0.8	0.4	0.4	0.4	0.4	0.4
of which: From pension contributions (or social contributions if appropriate)	8.7	8.7	8.7	8.7	8.7	8.7
Pension reserve fund assets <sup>(a)</sup>	0.2	3.3	10.6	8.9	0.0	0.0
of which: Consolidated public pension fund assets (assets other than government liabilities)	0.0	0.0	0.0	0.0	0.0	0.0

(a) The cumulative positive balance on the pension account (assets of pension security funds) will be depleted between 2030 and 2040.

Source: Ministry of Finance

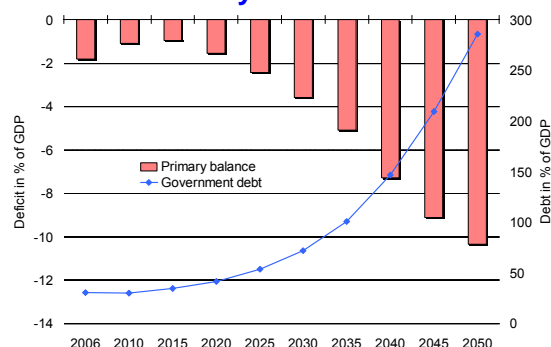
A substantial increase in these expenditures, under the assumption of a stable political environment, would cause deterioration of the primary deficit, a rise in interest payments and a rapid accumulation of government debt.

Chart 6.1: Projection of expenditures



Source: Ministry of Finance

Chart 6.2: Primary deficit and debt



The deviations of the projected development from the compliance requirements of the Stability and Growth Pact, i.e. maintaining the debt at a maximum level of 60% of GDP, are assessed on the basis of these predictions.

The analysis identifies the scope of fiscal consolidation, under the assumption of a stable political environment, that would be needed to meet this requirement by 2050. The Czech Republic would need to implement measures reducing the share of expenditures or increasing the share of revenues in GDP by 3.8 percentage points in 2010 (i.e. the S1 indicator). This means that the overall general government balance should register a surplus in 2010 of 1.5% of GDP. In order to ensure the permanent solvency of the general government, a fiscal correction of, in fact, 7.9% of GDP would be needed in 2010 (i.e. the S2 indicator).

Table 6.3: Scope of needed fiscal consolidation

% of GDP	Year 2010	Year 2011	Year 2012
1. Revenues	37.1	37.1	37.1
2. Primary expenditures	38.2	38.2	38.1
3. Primary balance (1-2)	-1.1	-1.1	-1.0
4. Sustainability gap S1 <sup>(1)</sup>	3.8	3.9	4.0
5. Required primary balance (3+4)	2.7	2.8	3.0
6. Required total balance	1.5	2.0	2.1
Sustainability gap S2 <sup>(2)</sup>	7.9	8.0	8.1

<sup>(1)</sup> Permanent fiscal consolidation (S1) expresses the percentage of GDP needed to permanently increase taxes (from the given year) or reduce expenditures in order to achieve a government debt of 60% of GDP at the end of the projection period.

<sup>(2)</sup> Permanent fiscal consolidation (S2) expresses the percentage of GDP needed to permanently increase taxes (from the given year) or reduce expenditures in order to keep the general government solvent for an indefinite period of time (i.e. meeting the inter-temporal budget restrictions).

Source: Ministry of Finance

## 7 Changes to the Institutional Framework for Fiscal Policy

In 2004, the process of reform measures was launched in the Czech Republic. This process introduced to the budgetary process the medium-term horizon and measures aimed at increasing the motivation of budgetary units to more effectively deal with public resources. The legal and institutional framework for public finance reform created conditions for meeting the fiscal consolidation targets and increasing the transparency of public finances. Improvements are gradually being made to this framework, which reflect the actual problems of public finances.

### 7.1 Changes to Budgetary Legislation

#### Reserve funds

Introducing unlimited transfers of accumulated budgetary resources to the reserve funds of the budgetary units should contribute to an increase in the economic efficiency of public resources. Therefore, since the end of 2004, the state budgetary units have been able to draw not only on budget expenditures up to the end of the budget year, but also in future periods. The difference between the adjusted expenditure budget for each year and the actual expenditures of a given year is carried over to the reserve funds to be used in future years above and beyond the budgeted expenditures.

The current method of drawing on accumulated resources in the reserve funds causes state budget performance to worsen in the year that these funds are recorded due to transfers to the reserve funds of the budgetary units realised via expenditures. Therefore, during the year of the drawdown, these resources from the reserve funds are transferred to revenues and also used by way of expenditures, i.e. the state budget balance is not affected. In the current state, expenditures in the budgetary year and revenues in the year the expenditure is realised are artificially increased. As a result, a distorted picture is given of the state budget balance recorded using the national methodology.

This distortion of state budget performance will be eliminated starting in 2008. The approved measures will help to lower expenditures that are transferred to the reserve funds in the second half of December by the budgetary units. Transfers of this kind will no longer take place. Instead, claims to accrued expenditures will be generated on the basis of accumulated funds. These claims will no longer be covered by the transfers from the reserve funds during the year of the drawdown, so there will be less of a need to issue government bonds, and as a result, it will create savings relating to the lower costs of debt service generated from the budget's deficit performance.

Allocated expenditures transferred to the reserve funds will be classified as “profiling”, including, for example, co-financed expenditures from the EU budget, expenditures for research and development or expenditures for investment programmes, and as other “non-profiling”, which is an insignificant part of the transferred expenditures. In general, the budgetary units may use the transferred profiling expenditures only in compliance with the original purpose. In the event of a massive accumulation of unused expenditures, the

## 7 Changes to the Institutional Framework for Fiscal Policy

government is authorised to restrict them under the budgetary legislation. The budgetary units will keep records of the claims to the accumulated expenditures.

In view of the fact that the accumulated resources transferred to the reserve funds have so far been higher than the expenditures from them each year, the volume of these resources have increased substantially. Until now, the budgetary units could use these expenditures to cover their extra expenditures. As a result, it was very difficult to predict the impact of these expenditures on the final economic results.

**Table 7.1: Transfers to and from the reserve funds**

in CZK million	Year 2004	Year 2005	Year 2006	Year 2007 <sup>(1)</sup>
<b>Transfers from RF and fund of state guarantees</b> <i>(decrease of state budget revenues)</i>	4 325	43 676	46 892	54 900
<b>Transfers to RF and state guarantees fund</b> <i>(decrease of state budget expenditure)</i>	29 038	68 936	57 090	46 162
Balance improvement (+), worsening (-)	24 713	25 260	10 198	-8 738
<i>RF and state guarantee fund balance at the end of year</i>	32 337	58 584	70 232	61 494

(1) Estimate

In addition to the above-mentioned measures valid from the beginning of 2008, the government has implemented other measures to start eliminating this problem in 2007 as well. A government resolution was passed that set out the maximum amount to be used from the reserve funds for 2007 (except for drawing on funds intended for pre-financing projects co-financed from the EU budget, investment programmes, eliminating flood damages, and social benefits). In addition, a part of the reserve funds was used to increase the expenditures of the budget headings of the Ministry of Defence, the Ministry of Health and the Ministry of Transport. These measures did not fully eliminate the possibility of making transfers to and from the reserve funds, however, they did partially reduce the volume of the reserve funds. Furthermore, the process of setting the real fiscal targets was simplified to some extent. In the ESA95 methodology, transferred funds from the reserve funds are not treated as revenue and transfers to the reserve funds as expenditures. Expenditures realised from these funds are counted in the expenditures of the given year.

### 7.2 Ending the Activities of the Czech Consolidation Agency

The government continues to gradually integrate and terminate the so-called off-budget institutions, which were one of the main sources of fiscal risk in the 1990s and often reduced considerably the transparency of overall public finance performance.

By the end of 2007, one of the largest transformation institutions, the Czech Consolidation Agency (CKA) will be terminated by law. The agency was involved in resolving a wide range of tasks related to the transformation process. Its activities will be terminated without liquidation. The legal successor of CKA will be the Czech government represented by the Ministry of Finance, which will take over the agency's rights and obligations on the day of its termination.

CKA's portfolio will be divided into three groups according to the quality of assets. Assets having a strategic interest for the government and the residual assets of CKA will be transferred to the Ministry of Finance. The bad quality assets will be transferred to CKA's

subsidiary company – SPV, which will be sold by the end of 2007. Prior to termination, CKA will prepare a detailed summary of its economic results for the entire period of its operations and will submit it to the government.

### 7.3 Simplifying the System of Tax Administration

A draft proposal, which the government has taken into consideration, for combining the collection of taxes, customs and premiums for public insurance should help to improve the tax administration system. The tax and customs authorities for the collection of taxes and customs duties should be gradually integrated. This should come into effect on 1 January 2010. In the other phases of this project, consideration will be given as well to integrating the collection of social security and health insurance payments. These measures should significantly reduce the administrative burden for tax and insurance payers, who would only need to deal with one authority. Upon implementation of the above measures, legal regulation, the organisational structure, the manner of financing and the information systems for the collection of taxes and customs would be harmonised.

As a measure to reduce the administrative burden, approval was given to cancelling the duty to use cash registers with accounting programs and other related obligations. In addition, expanding the principle of binding assessments (i.e. the duty to provide expert opinions) will contribute to reducing the administrative burden and to strengthening the legal security of entrepreneurs.



## 8 Annexes

### 8.1 Table Annex

Source: Czech Statistical Office, Czech National Bank, Ministry of Finance

**Table 8.1: Economic growth (from quarterly accounts, CZK billion, increase in %)**

	ESA code	Year 2006 level <sup>1)</sup>	Year 2006 rate of change	Year 2007 rate of change	Year 2008 rate of change	Year 2009 rate of change	Year 2010 rate of change
1. Real GDP	B1*g	3186	6.4	5.9	5.0	5.1	5.3
2. Nominal GDP	B1*g	3220	7.5	9.6	8.3	7.6	7.6
<b>Components of real GDP</b>							
3. Private consumption expenditure	P.3	1530	4.4	6.5	4.2	4.6	4.2
4. Government consumption expenditure	P.3	669	1.1	-0.6	-0.4	-0.3	-0.5
5. Gross fixed capital formation	P.51	803	7.6	6.0	9.0	7.8	7.2
6. Changes in inventories and net acquisition of valuables (% of GDP) <sup>2)</sup>	P.52+P.53	61	1.9	3.0	3.7	3.8	3.6
7. Exports of goods and services	P.6	2497	15.9	13.2	11.9	12.9	13.5
8. Imports of goods and services	P.7	2374	15.2	13.9	12.7	12.4	12.4
<b>Contribution to real GDP growth</b>							
9. Final domestic demand			4.3	4.5	4.2	4.1	3.7
10. Change in inventories and net acquisition of valuables	P.52+P.53		1.1	1.5	0.9	0.0	0.0
11. External balance of goods and services	B.11		1.0	-0.1	-0.1	1.0	1.5

<sup>1)</sup> Real level in 2005 prices

<sup>2)</sup> In current prices

**Table 8.2: Price development (%)**

	ESA code	Year 2006 level <sup>1)</sup>	Year 2006 rate of change	Year 2007 rate of change	Year 2008 rate of change	Year 2009 rate of change	Year 2010 rate of change
1. GDP deflator		114.8	1.1	3.5	3.1	2.3	2.2
2. Private consumption deflator		110.9	1.6	2.0	3.5	2.1	2.2
3. HICP		102.1	2.1	2.4	3.9	2.3	2.1
4. Public consumption deflator		125.9	3.1	3.7	3.4	3.2	2.9
5. Investment deflator		103.1	1.3	1.5	0.7	0.7	0.7
6. Export price deflator (goods and services)		92.7	-2.0	0.8	0.0	-0.3	-0.3
7. Import price deflator (goods and services)		88.4	-1.2	-1.0	-0.7	-0.7	-0.7

<sup>1)</sup> 2000 = 100; for the HICP, 2005 = 100

**Table 8.3: Labour market development**

	ESA code	Year 2006 level	Year 2006 rate of change	Year 2007 rate of change	Year 2008 rate of change	Year 2009 rate of change	Year 2010 rate of change
1. Employment (thous. persons) <sup>1)</sup>		5071	1.7	1.5	1.1	0.5	0.2
2. Employment (mill. hours worked) <sup>2)</sup>		9949	1.4	1.5	1.1	0.5	0.2
3. Unemployment rate (%) <sup>3)</sup>		7.1	7.1	5.5	4.8	4.5	4.5
4. Labour productivity (thous. CZK/person) <sup>4)</sup>		628	4.7	4.4	3.8	4.6	5.1
5. Labour productivity (thous. CZK/hour) <sup>5)</sup>		320	4.9	4.4	3.8	4.6	5.1
6. Compensation of employees (bill. CZK)	D.1	1383	7.8	9.2	7.3	7.1	7.0
7. Compensation per employee (thous. CZK/person)		331.6	5.7	7.7	6.5	6.9	7.0

<sup>1)</sup> Employed population, domestic concept in national accounts definition

<sup>2)</sup> Definition according to national accounts

<sup>3)</sup> Harmonised definition, Eurostat; level

<sup>4)</sup> Real GDP per employed person (in 2005 prices)

<sup>5)</sup> Real GDP per hour worked (in 2005 prices)



**Table 8.4: Analysis of the change in the net financial position**

% of GDP	ESA code	Year 2006	Year 2007	Year 2008	Year 2009	Year 2010
1. Net lending/borrowing vis-a-vis the rest of the world of which	B.9	-2.7	-2.4	-1.6	-0.4	1.5
- Balance on goods and services		3.2	4.2	4.3	5.2	6.6
- Balance of primary incomes and transfers		-6.1	-6.8	-6.5	-6.4	-6.1
- Capital account		0.3	0.2	0.7	0.9	1.0
2. Net lending/borrowing of the private sector	B.9	0.2	1.5	1.4	2.2	3.8
3. Net lending/borrowing of general government	EDP B.9	-2.9	-4.0	-2.9	-2.6	-2.3
4. Statistical discrepancy		0.0	0.0	0.0	0.0	0.0

**Table 8.5: General government budget**

Table 0.9: General government budget							
	ESA code	Year 2006	Year 2006	Year 2007 (1)	Year 2008 (2)	Year 2009 (2)	Year 2010 (2)
		CZK bn		% of GDP			
Net lending (+)/borrowing (-) (EDP B.9) by sub-sectors							
1. General government	S.13	-95.0	-2.9	-3.4	-2.9	-2.6	-2.3
2. Central government	S.1311	-92.1	-2.8	-3.5	-2.9	-2.5	-2.2
3. State government	S.1312	-	-	-	-	-	-
4. Local government	S.1313	-14.7	-0.5	-0.2	-0.1	-0.1	-0.1
5. Social security funds	S.1314	11.8	0.4	0.3	0.0	0.0	0.0
General government (S.13)							
6. Total revenue	TR	1 314.7	40.7	39.8	39.5	38.1	37.1
7. Total expenditure	TE <sup>(3)</sup>	1 409.7	43.6	43.3	42.4	40.7	39.4
8. Net lending (+)/borrowing (-)	EDP B.9	-95.0	-2.9	-3.4	-2.9	-2.6	-2.3
9. Interest expenditure	EDP D.41	35.9	1.1	1.2	1.3	1.2	1.2
10. Primary balance		-59.0	-1.8	-2.3	-1.7	-1.3	-1.1
11. One-off and other temporary measures		-6.4	-0.2	0.0	0.0	0.0	0.0
Components of revenues							
12. Total taxes		637.2	19.7	19.7	19.7	18.9	18.3
12a. Taxes on production and imports	D.2	351.4	10.9	10.9	11.5	11.1	10.8
12b. Current taxes on income, wealth etc.	D.5	284.8	8.8	8.8	8.2	7.7	7.5
12c. Capital taxes	D.91	0.9	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	524.8	16.2	16.2	15.9	15.4	15.0
14. Property income	D.4	25.6	0.8	0.6	0.5	0.5	0.4
15. Other		127.2	3.9	3.3	3.3	3.3	3.4
16. Total revenue	TR	1 314.7	40.7	39.8	39.5	38.1	37.1
p.m.: Tax burden		1 162.0	36.0	35.9	35.7	34.3	33.3
Components of expenditures							
17. Compensation of employees	D.1	251.0	7.8	7.6	7.3	7.0	6.7
18. Intermediate consumption	P.2	214.4	6.6	5.8	5.5	5.1	4.8
19. Social payments		578.6	17.9	18.2	17.4	16.8	16.3
	D.6311, D.63121,						
19a. Social transfers in kind supplied via market producers	D.63131	171.2	5.3	5.2	5.1	5.0	4.8
19b. Social transfers other than in kind	D.62	407.4	12.6	13.0	12.3	11.8	11.5
20. Interest expenditure	EDP D.41	35.9	1.1	1.2	1.3	1.2	1.2
21. Subsidies	D.3	62.0	1.9	2.0	2.2	1.9	1.8
22. Gross fixed capital formation	P.51	161.5	5.0	5.1	5.3	5.4	5.6
23. Other		106.2	3.3	3.4	3.6	3.3	3.1
24. Total expenditures	TE <sup>(3)</sup>	1 409.7	43.6	43.3	42.4	40.7	39.4
p.m.: Government consumption (nominal)	P.3	685.4	21.2	20.0	19.1	18.2	17.4

(1) Estimate

(2) Outlook

(3) Expenditures are adjusted for interest on swap transactions so that TR-TE = EDP B.9.

Table 8.6: General government debt

% of GDP	Year 2006	Year 2007 (1)	Year 2008 (2)	Year 2009 (2)	Year 2010 (2)
<b>1. Gross debt</b>	30.1	30.4	30.3	30.2	30.0
<b>2. Change in gross debt ratio</b>	-0.1	0.2	0.0	-0.1	-0.2
<b>Contributions to change in gross debt</b>					
<b>3. Primary balance</b>	1.8	2.3	1.7	1.3	1.1
<b>4. Interest expenditure</b>	1.1	1.2	1.3	1.2	1.2
<b>5. Nominal GDP growth</b>	-2.3	-2.5	-2.3	-2.1	-2.1
<b>6. Stock-flow adjustment</b>	-0.8	-0.7	-0.6	-0.6	-0.3
- Difference between cash and accruals	0.0	0.0	-0.3	-0.2	0.0
- Net accumulation of financial assets	-0.8	-0.7	-0.4	-0.3	-0.3
<i>of which: Privatisation proceeds</i>	0.1	0.9	0.0	0.0	0.0
- Revaluation effects and other	0.0	0.0	0.0	0.0	0.0
<b>p.m. implicit interest rate on debt</b>	3.6	3.9	4.2	4.1	4.0
<b>7. Liquid financial assets</b>	-	-	-	-	-
<b>8. Net financial debt</b>	-	-	-	-	-

(1) Estimate

(2) Outlook

Table 8.7: Cyclical development

% of GDP	ESA code	Year 2006	Year 2007 (1)	Year 2008 (2)	Year 2009 (2)	Year 2010 (2)
<b>1. Real GDP growth (%)</b>		6.4	5.9	5.0	5.1	5.3
<b>2. Net lending of general government</b>	<b>EDP B.9</b>	-2.9	-3.4	-2.9	-2.6	-2.3
<b>3. Interest expenditure</b>	<b>EDP D.41</b>	1.1	1.2	1.3	1.2	1.2
<b>4. One-off and other temporary measures</b>		-0.2	0.0	0.0	0.0	0.0
<b>5. Potential GDP growth (%)</b>		5.3	5.2	5.5	5.6	5.7
<i>contributions:</i>						
- total factor productivity		4.1	4.2	4.2	4.2	4.5
- labour		0.3	0.0	0.1	0.1	0.0
- capital		0.9	1.0	1.1	1.2	1.3
<b>6. Output gap</b>		0.7	1.3	0.9	0.4	0.0
<b>7. Cyclical budgetary component</b>		0.2	0.3	0.2	0.1	0.0
<b>8. Cyclically-adjusted balance (2 – 7)</b>		-3.2	-3.8	-3.2	-2.7	-2.3
<b>9. Cyclically-adjusted primary balance (8 + 3)</b>		-2.1	-2.6	-1.9	-1.5	-1.1
<b>10. Structural balance (8 – 4)</b>		-3.0	-3.7	-3.1	-2.7	-2.3

(1) Estimate

(2) Outlook

Table 8.8: Divergence from the previous update

% of GDP	ESA code	Year 2006	Year 2007 (1)	Year 2008 (2)	Year 2009 (2)	Year 2010 (2)
<b>Real GDP growth (%)</b>						
Previous update		6.0	4.9	4.8	4.8	.
Current update		6.4	5.9	5.0	5.1	5.3
Difference		0.4	1.0	0.2	0.3	.
<b>General government net lending (% of GDP)</b>						
Previous update	EDP B.9	-3.5	-4.0	-3.5	-3.2	.
Current update	EDP B.9	-2.9	-3.4	-2.9	-2.6	-2.3
Difference		0.6	0.6	0.6	0.6	.
<b>General government gross debt (% of GDP)</b>						
Previous update		30.6	30.5	31.3	32.2	.
Current update		30.1	30.4	30.3	30.2	30.0
Difference		-0.5	-0.1	-1.0	-2.0	.

(1) Estimate

(2) Outlook

Table 8.9: Long-term sustainability of public finances

% of GDP	Year 2006	Year 2010	Year 2020	Year 2030	Year 2040	Year 2050
<b>Total expenditure</b>	43.6	39.4	39.8	42.7	48.4	55.5
of which: Age-related expenditure	19.7	18.1	18.6	20.7	24.3	27.4
Pension Expenditure	8.3	7.7	8.3	9.5	12.2	14.3
Social security pensions	8.3	7.7	8.3	9.5	12.2	14.3
Old-age and early pensions	7.5	7.0	7.5	8.7	11.5	13.6
Other pensions	0.8	0.7	0.7	0.8	0.7	0.7
Occupational pensions	0.0	0.0	0.0	0.0	0.0	0.0
Health care	6.5	6.2	6.5	7.1	7.9	8.7
Long-term care	0.3	0.3	0.3	0.4	0.5	0.5
Education expenditure	3.5	3.0	2.6	2.7	2.8	2.9
Other age-related expenditures	1.1	1.0	0.9	0.9	1.0	1.0
Interest expenditure	1.1	1.2	1.2	2.0	4.1	8.0
<b>Total revenue</b>	40.7	37.1	37.1	37.1	37.1	37.1
of which: Property income	0.8	0.4	0.4	0.4	0.4	0.4
of which: From pension contributions (or social contributions if appropriate)	8.7	8.7	8.7	8.7	8.7	8.7
<b>Pension reserve fund assets</b>	0.2	3.3	10.6	8.9	0.0	0.0
of which: Consolidated public pension fund assets (assets other than government liabilities)	0.0	0.0	0.0	0.0	0.0	0.0
<b>Labour productivity growth</b>	5.0	5.1	3.0	2.7	1.9	1.7
<b>Real GDP growth</b>	6.4	5.3	2.5	1.9	0.4	0.8
<b>Participation rate males (aged 20–64)</b>	83.2	84.6	87.4	87.1	84.4	85.6
<b>Participation rate females (aged 20–64)</b>	68.5	70.6	76.4	76.1	72.9	74.0
<b>Total participation rates (aged 20–64)</b>	75.8	77.6	81.9	81.6	78.7	79.8
<b>Unemployment rate</b>	7.1	4.5	6.5	6.5	6.5	6.5
<b>Population aged 65+ over total population</b>	14.4	15.5	20.8	23.6	26.8	31.0

(a) The cumulative positive balance on the pension account (assets of pension security funds) will be drawn between 2030 and 2040.

Table 8.10: Basic assumptions

	Year 2006	Year 2007	Year 2008	Year 2009	Year 2010
Short-term interest rate (CZ) (annual average)	2.3	3.0	3.6	3.3	3.4
Long-term interest rate (CZ) (annual average)	3.8	4.4	5.1	4.5	4.6
Nominal effective exchange rate (2005 = 100)	104.8	106.0	108.0	111.0	115.0
Exchange rate CZK/EUR (annual average)	28.3	28.0	27.4	26.6	25.8
World excluding EU, GDP growth	5.2	5.0	4.9	4.8	5.0
EU-27 GDP growth	3.0	2.7	2.5	2.5	2.5
Growth of relevant foreign markets	11.8	6.3	7.6	7.7	8.0
World import volumes, excluding EU	9.0	7.8	7.5	7.5	7.8
Oil prices (Brent, USD/barrel)	65.4	67.8	72.5	66.8	65.0