

# 1 Overall Policy Framework and Objectives

Consolidation of public budgets is the priority for the coming period. The consolidation focuses not only on reduction of the general government sector deficit but also on the improvement of structural parameters of the system and on strengthening the Czech economy's pro-growth attributes.

The monetary policy conducted by the Czech National Bank (CNB) was changed to a new medium-term inflation objective from 2010, as it was no longer necessary to reflect some of the specific needs of an economy in transition on a convergence path towards more developed economies. CNB's high credibility is reflected in a firm anchoring of inflation expectations in the vicinity of the inflation target.

## 1.1 Fiscal Policy

In May 2010, regular elections to the Chamber of Deputies were held in the Czech Republic, leading to a new coalition government. Up to that time, a so-called interim government had held power but did not have a sufficient mandate to carry out structural reforms. Measures for mitigating the public finance deficit for 2010 and 2011 were conceived more as ad hoc corrections than changes in the system. The main objective in managing public finance was to reduce the deficit of the general government sector.

The Czech Republic was one of the first countries to commence an "exit strategy" and accept a consolidation plan. In 2010, a set of stabilisation measures was approved which should prevent further growth in the deficit and help restrain the rapid rise in indebtedness. The new government professed budget responsibility in its Policy Statement, and one of its first steps in this respect was to tighten the medium-term expenditure frameworks and approve a state budget so that the total general government deficit does not exceed 4.6% of GDP in 2011.

At the same time, intensive work began on structural reforms. These include making the social benefits system simpler and more efficient, introducing a fully funded pillar into the pension system, reforming the health care system, as well as decreasing administrative burdens by modifying the tax system and its administration (for more details see Chapters 6 and 7). Moreover, a reform of tertiary education financing emphasising and supporting science and research is being prepared.

Application of a fiscal targeting regime and adhering to the medium-term expenditure frameworks is the main instrument of fiscal policy in the process of fiscal consolidation in the Czech Republic.

Under the weight of some reform measures which reduced the revenue side, it was necessary to accept further measures on the expenditure side and to support the medium-term expenditure frameworks (more details in Chapter 3.2).

## 1.2 Implementing the Excessive Deficit Procedure

Expecting the general government balance to breach the reference value in 2009, the Excessive Deficit Procedure (EDP) was initiated with the Czech Republic on 2 December 2009. The Council has recommended that the Czech Republic bring the general government deficit below the 3% of GDP limit in a credible and sustainable manner by 2013. Further, the recommendation instructs:

- i) during 2010–2013 to ensure annual average fiscal effort<sup>1</sup> of 1% of GDP;
- ii) to specify the measures necessary to remedy the excessive deficit by 2013, cyclical conditions permitting; and

- iii) to accelerate deficit reduction if economic or budgetary conditions turn out better than originally expected.

In connection with existing experience in adhering to the medium-term expenditure frameworks, the Czech Republic was prompted to enforce the expenditure limits more rigorously and to improve monitoring throughout the entire budget process.

The Council also identified a need for progress in pension and health care reform efforts in order to avert negative implications of population ageing.

### 1.2.1 Measures for 2010

The measures approved for 2010 concentrated especially on the revenue side of public budgets, where the basic and reduced VAT rates and excise taxes were increased, property taxes doubled, and certain anti-

<sup>1</sup> Fiscal effort is defined as a year-on-year change of the cyclically adjusted balance without one-off and temporary measures.

crisis measures already adopted abolished, such as the credit on social security contribution for employers. In addition, the ceilings for health and social security insurance contributions were raised. The expenditure side was adjusted by decreasing certain social benefits, freezing pensions, and cutting the wage bill and positions in the government sector. There was also an overall reduction of expenditures in the state budget's individual chapters. The total extent of discretionary measures for 2010 was 2.8% of GDP (see Table 1.1).

### 1.2.2 Measures for 2011

In accordance with the EDP requirements, another package of changes (about 2.1% of GDP) was prepared for 2011, this time more expenditure side oriented. The wage bill in the state administration was reduced by 10% and the wage bill of judges and institutional officials was also lowered (on the other hand, funds for teachers' wages were increased). Further, some social transfers were eliminated or their extent reduced. Last but not least, general cuts in the state budget were made, thus non-mandatory regular and capital expenditures also decreased. On the revenue side, the amount of social security contributions was maintained and, motorway toll rates were increased. The basic structure of the active measures carried out is summarised in Table 1.1, and a more detailed description of some items is included in Chapter 6.

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

|                                | 2010       | 2011       |
|--------------------------------|------------|------------|
| <b>Direct taxes</b>            | <b>1.0</b> | <b>0.5</b> |
| <b>Indirect taxes</b>          | <b>0.8</b> | <b>0.0</b> |
| <b>Other revenues</b>          | <b>0.0</b> | <b>0.0</b> |
| <b>Social benefits</b>         | <b>0.3</b> | <b>0.3</b> |
| <b>Government sector wages</b> | <b>0.1</b> | <b>0.3</b> |
| <b>Other expenditures</b>      | <b>0.7</b> | <b>0.9</b> |
| <b>Total impact on balance</b> | <b>2.8</b> | <b>2.1</b> |

Source: MF CR.

### 1.2.3 Plan and Objectives of Fiscal Consolidation

The government has unambiguously declared that the approved medium-term expenditure frameworks will

not be surpassed and the objective for the general government deficits objective will be upheld, with the intention not to surpass 2.9% of GDP in 2013. For 2014, the government approved a new objective at 1.9% of GDP, which is about CZK 84 billion, including adjustments and interest rate derivatives. The deficit trajectory has been ambitiously established so that a balanced general government budget will be attained in 2016, which should allow fulfilling the medium-term objective (MTO) of a structural deficit at 1% of GDP in that year.

**Table 1.2: Fiscal Consolidation Plan**  
(in % of GDP)

|                       | 2012       | 2013       | 2014       |
|-----------------------|------------|------------|------------|
| <b>Deficit target</b> | <b>3.5</b> | <b>2.9</b> | <b>1.9</b> |

Note: Deficit objectives designate net borrowing of the general government sector by the method applicable for EDP (EDP B.9).

Source: MF CR.

Further development of public finances in the Czech Republic is highly conditioned upon development of the domestic and foreign economies, i.e. the speed and extent of recovery in domestic and foreign markets, as well as the government's reform effort.

The government is oriented to structural and long-term reforms, which will not only be reflected in change of the general government balance now or in the years immediately to follow, but also in the medium- and long-term horizons. In recent months, parameters of the pension and health care system reforms are being discussed. Both take into account the Council's recommendations and are prepared in the context of anticipated population ageing and of higher government sector expenditures and lower revenues.

The impacts on revenues and expenditures are discussed in Chapter 3.2, Medium-term Budgetary Outlook, while Chapters 5.2, The Government's Strategy – Reforms and 6, Quality of Public Finances describe the reforms.

## 1.3 Monetary Policy

The CNB will continue to conduct monetary policy aided by the inflation-targeting regime. Since 1 January 2010, a new inflation target has been in effect, expressed as annual growth in the consumer price index of 2% with a tolerance band of  $\pm 1$  percentage point. The CNB continues to view its inflation targets as medium-term in nature. Real inflation may temporarily deviate from them, for example as a result of changes to indirect taxes. As a matter of course,

monetary policy does not react to the first-round effects of such changes but concentrates only on their second-round effects.

The current low-inflationary environment of the Czech economy and CNB's high credibility are reflected in inflation expectations anchored at levels close to the inflation target. Nevertheless, the impact of the contemplated changes to indirect taxes represents a risk for the Maastricht price stability criterion. It will also

depend on the conditions used to exclude countries when calculating the criterion's reference value.

Gradual increase in short-term interest rates is consistent with the macroeconomic scenario while counting on continuing recovery in economic activity and on closing the negative output gap.

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

nance of the Czech Republic and the CNB "Assessment of the Fulfilment of the Maastricht Convergence Criteria and the Degree of Economic Alignment of the Czech Republic with Euro-Area", approved by the government on 22 December 2010, states that meeting all Maastricht convergence criteria is very improbable under current conditions. The major barrier to entering the monetary union will be a general government deficit higher than 3% of GDP. There also remains uncertainty as to whether the Czech economy will maintain, and will be able to further increase the degree of its alignment with the euro area. In the current situation, the government has decided not to adopt a target date for accession to the euro zone. This also implies that the Czech Republic will not strive for entry into the ERM II mechanism during 2011.

## 1.4 Structural Policies

A detailed outline of priorities and measures adopted in the area of structural policies is presented in the Czech Republic's National Reform Programme for 2011 (GO, 2011), which was sent to the European Commission in April 2011. In this section, therefore, only a selection of the most important measures is presented.

### 1.4.1 Labour Market

In the coming years, the Czech Republic will focus especially on decreasing structural unemployment and on increasing the labour force participation. In this context, a complex reform of social policy will be carried out, which will make social benefits more targeted and will increase the motivation of the economically inactive to enter the labour market. At the same time, the Czech Republic intends to significantly increase labour law flexibility, especially by lengthening the probation period, changing reasons for termination and severance pay, expanding the maximum extent of employment based on a contract for services, and introducing the possibility to temporarily allocate an employee for performing work at a different employer (see Chapter 6.2).

### 1.4.2 Business Environment

Measures to further improve the business environment will be targeted at removing administrative and regulatory obstacles to business, to increase broadband internet access and to further enhance eGovernment. Toward this end, entrepreneurs' administrative burdens will be measured, and on that basis particular adjustments to legal regulations will be proposed. In the eGovernment area, basic information registers in the public administration will be completed and opportunities explored how to further

develop the system of secure data exchange boxes and of public administration contact points "Czech POINT".

### 1.4.3 Education

One of the aims of the planned measures is also to improve the efficiency of the education system and to adjust it to the needs of the Czech economy, which is markedly oriented to industry and export. In this respect, reform of tertiary education seems crucial. The reform will newly define basic types of institutions of higher learning, balance the competence of public schools' main administrative bodies, and ensure comprehensive regulation of the relationship between state and institutions of higher learning. It will emphasise diversification of universities and improvement of their quality. Last but not least, tuition fees to cover expenses for studies will be introduced.

### 1.4.4 Research, Development and Innovation

In the science, research, development and innovation area, attention will be drawn especially to an overall increase in quality and output while improving the interconnectedness of this area with the business sphere. The main measures planned include an increase in public spending for this high-priority area, support for private financing by making purchases of the results of research activity tax deductible, and preparation of a new National Policy of Research, Development and Innovations.

### 1.4.5 Energy Industry and Climate Change

The Czech Republic strives to increase energy efficiency and the proportion of energy generated from renewable sources as well as to decrease greenhouse gas emissions. Towards these ends, the Czech Republic

will continue to financially support projects that contribute to decreasing energy intensity of buildings, industry and transport, as well as projects contributing to an increased share of renewable sources of energy.

#### **1.4.6 Transport Infrastructure**

The Czech Republic's main aims in transport infrastructure are to increase its capacity and quality and a more effective interconnection of all forms of trans-

port. The transport strategy to 2025 will be updated, and priority projects will be determined on its basis. The completion of the motorway network and of the transit railway corridors together with modernisation of the existing railway network are among the highest priorities. Last but not least, alternative sources of financing the construction of transport infrastructure will be employed.