

# 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.