Ministry of Finance
Czech Republic

Convergence Programme
of the Czech Republic

April 2020

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List of Abbreviations

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

Symbols Used in Tables

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

Cut-off Date for Data Sources

Macroeconomic data used pertain to the 31 March 2020 release and fiscal data and policies to the 22 April 2020 release. Notification of general government deficit and debt was specified and approved by Eurostat on 22 April 2020.

Note

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

Introduction and Summary

The situation surrounding this year's Convergence Programme is unprecedented. Uncertainties regarding the duration of the pandemic of the new type of coronavirus, the duration of the various measures already taken, the list of possible new measures and the overall estimate of economic damage, social costs and the resulting repercussions for public finances will evidently not become clear until the end of 2020.

The European Commission is fully aware of these aspects. The requirements concerning the content of the convergence and stability programmes have been significantly reduced so that data is only needed for 2020 and 2021. The reasons for keeping to the original deadlines are essentially purely legal in nature. The deadlines cannot be extended under European Union regulations in force. It is therefore likely that the Convergence Programme can be outdated by the time it is approved by the government and sent to the European Commission. At the same time, the individual recommendations made by the Council of the European Union to Member States will reflect the situation in the fight against the pandemic more than strict adherence to compliance with fiscal rules in 2020. The consolidation of public finances must wait until the risk of the further spread of COVID-19 is under control. This Convergence Programme therefore needs to be viewed through a different lens. It contains a macroeconomic scenario that we were able to put together based on knowledge at the end of March 2020. In doing so, we took account only of those fiscal measures that had been at least approved by the government as at 22 April 2020.

On 20 March 2020, the Czech government discussed an amendment to the Central Government Budget Act for 2020. Within the framework of legislative emergency powers, this amendment was approved four days later by the Chamber of Deputies (the lower parliamentary house). Taking into account the year-on-year decline in gross domestic product by more than 5% and the subsequent decline in income, as well as the need to take further measures to support households and businesses, it increased the originally approved central government budget deficit of CZK 40 billion by another CZK 160 billion. The CZK 200 billion deficit was to enable the Czech government to make an adequate response to the consequences of the pandemic in the Czech Republic. However, dynamic developments have shown that the original fiscal space will not be sufficient. For this reason, on 20 April 2020, the government approved the second amendment to the state budget law, which increases the deficit to CZK 300 billion. The increase in the deficit was then confirmed by the Chamber of Deputies on 22 April.

The macroeconomic scenario for this year's Convergence Programme anticipates a 5.6% decline in real gross domestic product, and more than 2% in nominal terms. The deepest decline is expected in foreign trade and fixed capital investment. Household consumption should also be lower. In this year's forecast, we assume that economic activity should pick up from the second half of 2020. Although restrictions will be eased in a number of European Union countries or the United States probably later than in the Czech Republic, the shock to aggregate demand and supply should be largely directed to the first half of 2020.

There will be both supply and demand effects on prices, so they should largely cancel each other out. Taking into account the labour market situation, the number of job vacancies, and the measures taken by the Czech government to maintain high employment, on average the unemployment rate is not expected to increase dramatically.

Czech public finances are relatively well prepared for the consequences of the pandemic, at least in a European context. At the end of 2019, general government debt was 30.8% of GDP, i.e. only slightly above the level of 2008, when the global financial and economic crisis started. On the other hand, expressed in terms of the structural balance, the situation for public finances is better. The general government balance was 0.3% of GDP in 2019. Adjusted for the business cycle and one-off measures, it reached exactly the medium-term budgetary objective for the year. In any event, the impact of the pandemic, including government measures to limit its impact on the economy and on the health of the population, will significantly affect the entire general government sector, especially the state budget. There will be a revenue shortfall due to the downturn in economic activity, while some measures such as electronic registration of sales, digital tax or auctions for rights to use radio frequencies are being postponed or cancelled. On the expenditure side, the opportunities for the payment of certain social benefits, in particular those under sickness insurance, have expanded. We currently estimate that the general government sector will be managing a deficit of 5.1% of GDP and that general government debt should increase to 37% of GDP in 2020.

In addition to measures to stabilise the economy in the short or medium term, a number of measures to improve the quality of public finances were implemented last year. Work is continuing on the digitalisation of tax administration, and the system of centralised public procurement or state property management is being streamlined. However, long-term pressure on public finances, mainly due to demographic changes in the population structure, remains a challenge.

1 Economic Policy Intentions and Objectives

Prior to the outbreak of the new coronavirus pandemic, the government was taking steps aimed at massive support for investment, both from national sources and co-financed by European funds. To that end, the National Investment Plan was drawn up and an initial agreement was reached with bank representatives to set up a National Development Fund as a vehicle to implement part of the plan. Investment needs are linked to the broader economic vision which began to crystallise with the principles underpinning the 2020–2030 Economic Strategy of the Czech Republic. This vision will give rise to a fully-fledged economic strategy that will not only create synergies from individual strategic objectives and make one homogeneous whole out of them, but will also determine the Czech Republic's longer-term path towards a "country for the future".

However, at the moment, the main focus of economic policies is on measures to support households and businesses affected by the global health and economic crisis, with the aim of maintaining high employment, minimising insolvency and providing broad relief to the private sector.

1.1 Fiscal Policy

Public budgets this year will be severely affected by the global pandemic crisis and the measures taken by the Czech Republic and other countries with which our economy is directly or indirectly linked economically. In addition to a raft of measures, the Czech government prepared an amendment to the State Budget Act, which was approved by the Chamber of Deputies on 24 March 2020. During April, it turned out that the originally planned increase in the deficit to CZK 200 billion would not be sufficient. For this reason, on 20 April 2020, the government approved the second amendment to the state budget law. The state budget deficit originally approved was CZK 40 billion, but it should now come to CZK 300 billion this year. Both amendments take into account both the estimated decline in revenues caused by the economic downturn and the measures adopted so far on the revenue and expenditure sides. Discretionary measures affecting the amount of revenue or expenditure for subsequent years but not taken in response to the crisis are currently limited, on the revenue side, to the preparation of rate hikes for excise duty on tobacco products, while on the expenditure side there are plans to meet government commitments to education sector staff and pensioners. The government also approved an increase in payments for state insured persons by a total of CZK 50 billion for 2020 and 2021.

Since 2017, budgetary and fiscal policy for the forthcoming medium-term horizon has been subject to the principles and rules laid down by Act No 23/2017 on the rules of fiscal responsibility. In the case of the state budget and state funds, after taking into account the balances of all other components of the general government sector, the policy focuses on conformity with the medium-term budgetary objective set by the Czech Republic in 2019 at −0.75% of GDP for the period of 2020–2022. In response to the current crisis and its order of magnitude, an amendment (Act No. 207/2020 Coll.) to the Act on the Rules of Fiscal Responsibility was adopted that changes the method used to set expenditure frameworks for the period from 2021 to 2028. Adherence to the original method for calculating expenditure frameworks would require a substantial fiscal restriction amounting to hundreds of billions of CZK which would not be desirable from an economic perspective. Not to mention how counter-productive it would be in view of the already implemented or planned measures aimed at reducing the extent and duration of the recession this year. Such a severe restriction would make avoiding a further economic downturn unlikely. Moreover, without any shadow of a doubt the current situation will have a heavy impact on public finances in the coming years, for example in the form of tax losses from 2020 or higher social spending. Therefore, the expenditure frameworks for 2021 should be set on the basis of a structural balance that will allow for sufficient absorption of the current negative shock. The amendment set this value at −4% of GDP. Between 2022 and 2028, the structural balance should improve annually by at least 0.5 pp year-on-year. A consolidation trajectory in this range is realistic, does not endanger economic recovery, and is fully in line with EU rules.

A summary quantification of the impacts of measures taken by the government up to 22 April 2020 in response to the spread of COVID-19 is provided in subchapter 3.2.3.

1.2 Monetary Policy

Since 1998, the CNB's monetary policy has been inflation-targeted. Since 1 January 2010, the inflation target has been defined as year-on-year consumer price index growth of 2% with a tolerance band of ±1 pp. The CNB defines the inflation target as a medium-term target and therefore tolerates certain temporary deviations by actual inflation from the inflation target (e.g. as a result of adjustments to indirect taxes). Monetary policy does not normally respond to the primary effects of those deviations, instead concentrating solely on the secondary effects.

In 2019, the CNB only changed its two-week repo rate in May, pushing it up by 0.25 pp to 2.00%. In February 2020, it made a further increase of 0.25 pp to 2.25%. In both cases, it was responding to continuing strong domestic inflationary pressures (especially the development of unit labour costs and strong domestic demand growth in the environment of a positive output gap). However, with an eye to the pandemic of the new type of coronavirus, the CNB lowered the two-week repo rate, first by 0.50 pp at an extraordinary session on 16 March 2020 and then by 0.75 pp at an ordinary session on 26 March. The two-week repo rate was thus cut to 1.00%. As of 1 April 2020, within the scope of macroprudential policy the CNB reduced its countercyclical capital buffer from the 1.75% to 1.00%. This reduction was aimed at supporting the liquidity of the banks and financial stability.

The exchange rate of the koruna versus the euro was extremely volatile during the first quarter of 2020. Having slipped below CZK 25 per EUR in mid-February, a month later it was verging on CZK 28 per EUR. The pronounced depreciation at the end of the first quarter helped to ease monetary conditions. The exchange rate is expected to remain at around CZK 27 per EUR in the second quarter of 2020, after which the trend of a modestly appreciating nominal exchange rate should be restored thanks to the projected stabilisation of the situation surrounding the coronavirus pandemic.

The "Assessment of the fulfilment of the Maastricht convergence criteria and the degree of economic alignment of the Czech Republic with the euro area", a joint document of the Ministry of Finance and the CNB approved by the Czech government in December 2018 (under Resolution 834/2018), recommended not to set a target date for euro area entry. According to that document, the Czech Republic's own preparedness to adopt the euro improved compared to previous years, but certain shortcomings persisted. The unfinished process of real economic convergence towards the euro area average was viewed as the main obstacle to joining the monetary union, although this has picked up again in recent years. However, the gap reported for most key indicators, especially price and wage levels, remained significant. Stark differences with the euro area in terms of the structure of the Czech economy also persisted. Due to the ageing population, the problem of the long-term sustainability of public finances has yet to be resolved. Another obstacle to euro adoption was the mismatch between the financial cycles of the Czech Republic and the euro area. Over the last few years, the institutions and the rules of the euro area have changed significantly, with negotiations on the deepening of integration ongoing. In the light of these unresolved problems, the absence of domestic monetary and exchange-rate policy would reduce the effectiveness of monetary policy and sufficient room for the stabilising function of public finances may not be created. In view of these facts, the Czech government has not yet set a target date to join the euro area and, for the time being, will not be seeking to enter the European Exchange Rate Mechanism II. The updated document and recommendations will be submitted to the government by the end of 2020.

2 Macroeconomic Scenario

In the first half of this year, the Czech economy will be substantially negatively affected by the pandemic of a new type of coronavirus and by measures that individual countries are putting in place to limit the spread of the disease. Though economic activity is expected to recover in the second half of the year, real GDP can still be expected to fall in 2020 as a whole, experiencing a downturn at least comparable in depth to 2009. Because the situation is evolving so dynamically, it is extremely difficult to quantify, even generally, what the economic impacts will be and over what sort of timeframe they will be felt. It is likely that assessments will only be possible retrospectively and with a certain hindsight.

2.1 Global Economy and Technical Assumptions

Growth in world trade in goods was slowing during 2019. The imposition of tariffs in reciprocal trade between the United States and China increased the uncertainty surrounding trade relations. Along with concerns about the UK's exit from the EU, the increased level of risk has had a negative impact, particularly on foreign trade and investment activity. Consequently, most major economies experienced a noticeable slowdown. US GDP growth declined to 2.3%, while the euro area economy saw growth slow to 1.2%.

The EU's real GDP increased by 1.5% in 2019. The labour market remained tense, with the unemployment rate in many countries falling to long-term lows. Owing in part to low interest rates, household consumption thus continued to underpin economic growth, while net exports had the opposite effect.

The coronavirus pandemic will most probably be this year's main macroeconomic shock to the performance of the global and European economy. The deteriorating sentiment has hit the financial markets hard and is likely to have a significant impact on all GDP expenditure components. We expect EU GDP to decrease by 5.5% in 2020. The EU's economic growth next year could reach 2.8%. Over the medium term, there could be a gradual resumption of supplier-and-customer relations and an increase in the intensity of world trade. However, many countries face problems such as high levels of structural unemployment, high general government debt and low labour productivity growth.

In 2019, the average price per barrel of Brent crude oil was USD 64. Bearing in mind developments in the first quarter of 2020 pushing it down below USD 30 and the price curve of futures contracts, we expect the price of oil to be much lower over the whole timeframe of the Convergence Programme. In 2020 and 2021, Brent crude oil should be trading at an average of USD 38 USD per barrel and USD 40 per barrel, respectively (in line with the European Commission's assumptions).

Based on recent developments in the USD/EUR exchange rate, we chose a technical assumption of exchange rate stability of USD 1.09 per EUR for the period from second quarter of 2020 to 2021; the European Commission envisages this rate for the whole period of 2020–2021.

The exchange rate of the koruna versus the euro averaged CZK 25.7 per EUR in 2019, i.e. the koruna more or less stagnated (depreciating by 0.1%). This year, the koruna should weaken to CZK 26.5 per EUR due to the developments in the first half of the year. In the period ahead, the exchange rate should gradually appreciate as real economic convergence continues.

Taking into account the expected inflation developments and the projected monetary policy settings of the CNB and the European Central Bank, we expect long-term interest rates of 1.5%.

Table 2.1.1: Assumptions of the Scenario

		2019	2020	2021
USD/EUR exchange rate	*annual average*	1.12	1.10	1.09
CZK/EUR exchange rate	*annual average*	25.7	26.5	26.2
Government bond yield to maturity 10Y	*in % p.a.*	1.5	1.5	1.5
PRIBOR 3M	*in % p.a.*	2.1	0.8	0.3
GDP EU27	*real growth in %*	1.5	-5.5	2.8
Oil prices (Brent)	*USD/barrel*	64	38	40

Source: CNB (2020a), EIA (2020), Eurostat (2020). MF CR calculations.

2.2 Current Developments and a Medium-term Scenario

2.2.1 Economic Growth and the Demand Side

In 2019, real GDP growth decelerated to 2.6%. Household consumption was the main pro-growth factor, but the economy was also supported by gross fixed capital formation and general government consumption. As the momentum of both exports and imports slowed, the external balance dampened economic growth slightly. In 2020, economic activity will be severely affected by the fallout from the handling of the global pandemic of the new type of coronavirus. However, the assumption is that this economic shock should only be temporary and short-term.

Household consumption increased by 3.0% in 2019. This year, it will be negatively affected by a decline in real disposable income, despite the fact that numerous socially-related discretionary changes will be positively reflected in its momentum. Measures related to the declaration of a state of emergency should affect expenditure on services in particular. The decline in disposable income and increased labour market insecurity will also translate into reduced spending on consumer durables. Taking into account the forecasted year-on-year drop in the savings rate, associated with consumption smoothing, real household consumption should decline by 1.5%. In 2021, household consumption could increase by 0.8% due to renewed growth in disposable income.

This year, real general government final consumption expenditure should grow by 2.6%. The momentum of social transfers in kind, intermediate consumption and employment will contribute to this (see chapter 3).

Growth in gross fixed capital formation slowed noticeably to 2.8% in 2019. It was driven by private investment activity, though general government investment also made a positive contribution (see sub-chapter 3.1). Gross fixed capital formation in 2020 should sag by 13.6% under the weight of recession in the countries of our main trading partners and the strongly escalating uncertainty surrounding the spread of coronavirus in the Czech Republic and abroad. By contrast, monetary conditions should have a positive impact on the momentum of investment activity. In 2021, this factor should be compounded by renewed economic growth abroad, which is expected to help the private investment to rise again after the slump in 2020. However, the forecast recovery of investment by more than 3% in 2021 is burdened by significant external risks. In the case of general government investment in 2020, we predict a decline in nationally sourced investment expenditure as measures to prevent the spread of coronavirus will shorten the time available for implementation. In the coming years, however, we forecast renewed public investment activity supported by projects co-financed from EU funds (for more details, see chapter 3).

In 2019, net exports reduced real GDP growth by 0.3 pp. The negative contribution of net exports to GDP growth in 2020 is consistent with developments expected in export markets and the competitiveness of Czech firms on foreign markets (growth in unit labour costs). Subsequently, the external balance should have a positive effect on economic growth.

Considering trends in the individual expenditure components of GDP, we expect the economy to contract by 5.6% in 2020; in 2021, GDP could grow by 3.1%.

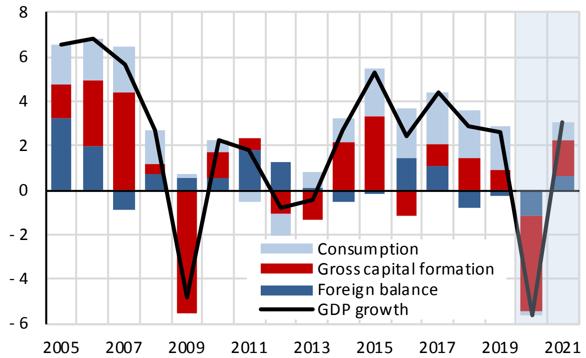
2.2.2 Potential Output and the Position of the Economy in the Cycle

Potential output growth declined to 1.3% in 2019. The most important component was the increase in total factor productivity, with a contribution of 0.8 pp. Capital stock maintains a relatively stable contribution of around 0.7 pp. Population ageing, manifested by a decrease in the number of people of working age, reduced the potential output momentum by approximately 0.3 pp, although this was cancelled out by an equal increase in the participation rate. The contribution made by the number of hours usually worked is slightly negative.

In 2019, the Czech economy was characterised by a positive output gap amounting to 3.6% of potential output. Against the background of the economic downturn due to the coronavirus pandemic, in early 2020 the positive output gap can be expected to close, with a very sharp reduction in economic performance well below potential output.

Graph 2.2.1: Decomposition of GDP Growth

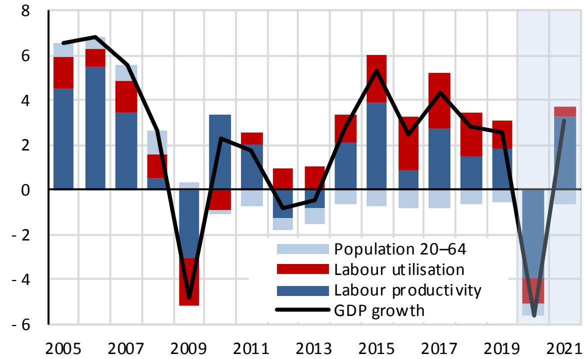
growth in %, contributions to growth in percentage points



Source: CZSO (2020a), MF CR (2020). MF CR calculations and forecast.

Graph 2.2.2: Contributions to GDP Growth

growth in %, contributions to growth in percentage points



Note: The labour utilisation is the ratio of employment to population of 20–64.

Source: CZSO (2020a), MF CR (2020). MF CR calculations and forecast.

Table 2.2.1: Economic Output

levels in CZK billions, increases in %, contributions to growth in percentage points

	ESA Code	2019	2019	2020	2021
		Level	*Rate of change*		
Real GDP	B1*g	**5460**	**2.6**	**-5.6**	**3.1**
Nominal GDP	B1*g	**5653**	**6.2**	**-2.2**	**4.5**
Components of real GDP					
Private consumption expenditure	P.3	**2603**	**3.0**	**-1.5**	**0.8**
Government consumption expenditure	P.3	**1086**	**2.6**	**2.6**	**2.0**
Gross fixed capital formation	P.51g	**1402**	**2.8**	**-13.6**	**3.2**
Changes in inventories and net acquis. of valuables (% of GDP)	P.52+P.53	**44**	**0.8**	**0.1**	**0.7**
Exports of goods and services	P.6	**4226**	**1.2**	**-17.0**	**6.8**
Imports of goods and services	P.7	**3900**	**1.7**	**-16.8**	**6.3**
Contributions to real GDP growth					
Final domestic demand		-	**2.7**	**-3.6**	**1.6**
Changes in inventories and net acquis. of valuables	P.52+P.53	-	**0.2**	**-0.8**	**0.8**
External balance of goods and services	B.11	-	**-0.3**	**-1.2**	**0.7**

Note: Real levels are in 2018 prices. Changes in inventories and net acquisition of valuables on the sixth row express change in inventories as a per cent of GDP in current prices. The contribution of the change in inventories and net acquisition of valuables is calculated from real values.
Source: CZSO (2020a), MF CR (2020). MF CR calculations and forecast.

2.2.3 Prices

The inflation rate, as measured by the Harmonised Index of Consumer Prices, amounted to 2.6% in 2019. During 2019, year-on-year inflation accelerated from 2.0% in January to 3.2% in December. In early 2020, it recorded another significant rise.

The effect of unit labour costs on inflation should differ significantly from year to year. Extraordinary growth in these costs is expected in 2020, which is likely to turn into a marked decline in 2021. The exchange rate should contribute to consumer price growth in 2020. In the coming years, we expect it to have an anti-inflationary effect, given the projected appreciation. The slump in oil prices should be the decisive downside factor for inflation in 2020. According to the adopted scenario, oil prices should grow in the period ahead.

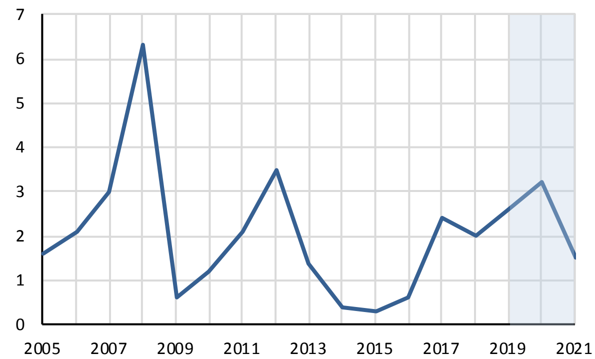
The contribution made by regulated prices to the average inflation rate should be positive in 2020 and 2021. In the field of indirect tax changes, excise duty on spirits and tobacco products has been increased and value added tax on heat has been reduced in 2020. In connection with the plan to expand the scope of electronic registration of sales, value added tax on selected goods will be reduced by transferring them to the second reduced rate. We estimate the effective price impact of these measures on the average inflation rate this year to be 0.4 pp. This is more than their precise pass-through to prices, as we consider some prices to be sticky downward. In 2021, prices will reflect a further increase in excise duty on tobacco products, though less than in 2020.

The Harmonised Index of Consumer Prices should thus increase by 3.2% this year; in 2021, inflation could slow to 1.5%.

In 2020, the GDP deflator should increase by 3.7%. This growth should be due mainly to the household consumption deflator; terms of trade should grow much more slowly than the GDP deflator. In 2021, we expect the GDP deflator's growth to slow down to 1.4%.

Graph 2.2.3: Harmonised Index of Consumer Prices

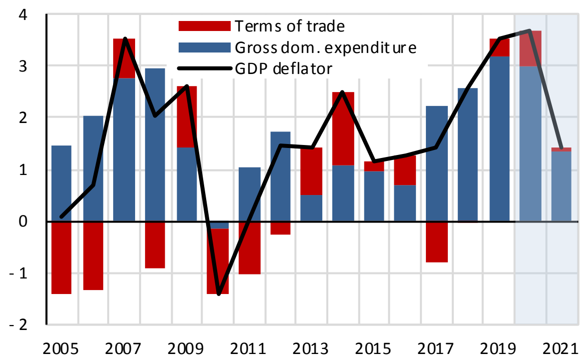
year-on-year growth in %



Source: Eurostat (2020a). MF CR calculations and forecast.

Graph 2.2.4: GDP Deflator

year-on-year change in %, contributions in percentage points



Source: CZSO (2020a). MF CR calculations and forecast.

Table 2.2.2: Prices of Goods and Services
indices 2010=100, rate of change in %

	2019	2019	2020	2021
	Level	*Rate of change*		
GDP deflator	116.4	3.5	3.7	1.4
Private consumption deflator	114.4	3.0	3.2	1.6
Harmonised index of consumer prices	116.4	2.6	3.2	1.5
Public consumption deflator	125.4	5.4	3.1	2.0
Investment deflator	111.3	2.7	2.8	1.1
Export price deflator (goods and services)	105.5	1.0	3.2	-0.2
Import price deflator (goods and services)	104.1	0.6	2.3	-0.4
Average rate of inflation according to national consumer price index	116.5	2.8	3.2	1.6

Source: CZSO (2020a), Eurostat (2020). MF CR calculations and forecast.

2.2.4 Labour Market and Wages

Although labour shortages remained a significant obstacle to extensive growth in production, some indicators signalled that the labour market was starting to cool. Employment growth slowed down considerably as labour demand weakened and came to 0.7% in 2019. The unemployment rate was around 2% during the year, easily the lowest in the EU. The momentum of the compensation of employees, after exceptionally high growth in the previous year, slowed down to 7.1%; despite this rate being still well above average. Earnings increased most in low- and medium-income groups. The high increase in labour income boosted household consumption.

Weaker labour demand due to constraints in the economy as a result of dealing with the coronavirus pandemic, a slump in economic activity and previous investment enhancing labour productivity should have the effect of increasing unemployment. Government measures to support job retention, the high number of vacancies and foreign employment should dampen any heavier impact. The supply effects of the pandemic will rather translate into a temporary decline in working time in the short term. The unemployment rate could rise to 3.3% this year and then to 3.5% in 2021. Employment could decrease by 1.7% in 2020 and subsequently more or less stagnate.

The higher population representation of age brackets with a naturally high rate of economic activity, combined with strong wage and salary momentum, is significantly increasing the participation rate. However, these factors will gradually diminish, along with a decline in the population in the working age group of 20–64 years. The participation rate should increase only slightly this year.

Despite the slowing wage dynamics in market sectors, the wage bill in 2019 was supported by an increase in salary tariffs in the general government sector and an increase in the minimum and guaranteed wage. The contribution of salaries should slow this year, due in part to changes in the structure of central government budget expenditures in response to the coronavirus pandemic. The earnings momentum could slow to 2.6% in 2020 and decrease further next year.

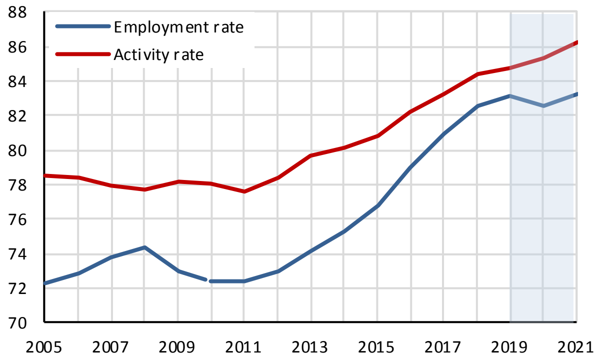
Table 2.2.3: Employment and Compensation of Employees
price levels in current prices, rate of change in %

	ESA Code	2019	2019	2020	2021
		Level	*Rate of change*		
Employment (thous. of persons)		5454.9	0.7	-1.7	-0.2
Employment (bn. hours worked)		9.8	0.8	-1.6	-0.2
Unemployment rate (%)		2.0	2.0	3.3	3.5
Labour productivity (thous. CZK/person)		1001.0	1.9	-4.0	3.2
Labour productivity (CZK/hours)		558.3	1.8	-4.1	3.2
Compensation of employees (bn. CZK)	D.1	2454.9	7.1	2.6	0.8
Compensation per employee (thous. CZK/person)		523.1	6.2	4.0	0.9

Note: Employment and compensation of employees are based on domestic concept of national accounts. Unemployment rate is based on the Labour Force Survey methodology. Labour productivity is calculated as real GDP (in 2018 prices) per employed person or hour worked.
Source: CZSO (2020a, 2020c). MF CR calculations and forecast.

Graph 2.2.5: Employment and Participation Rates

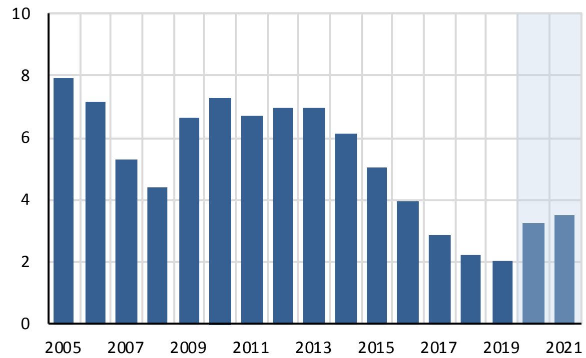
in %



Source: CZSO (2020c). MF CR calculations and forecast.

Graph 2.2.6: Unemployment Rate

in %



Source: CZSO (2020c). MF CR calculations and forecast.

2.3 Foreign Relations and Sectoral Balances

This sub-chapter is drawn up according to national account methodology, which, based on the relationship between investment and savings, enables the surplus or deficit in foreign relations to be divided fully among individual economic sectors. It differs from the analogous and commonly used balance of payments methodology, for example, in the way how underlying data is processed or certain items are classified.

Since 2013, the Czech economy has consistently reported a stable net lending/borrowing surplus of around 1% of GDP in relation to non-residents. In 2019, this surplus was 1.1% of GDP.

The individual items of the balance of current transactions developed along very different lines. The goods and services surplus declined slightly to 6.1% of GDP in 2019, mainly as a result of a massive increase in imports of services.

On the other hand, the trend towards improvements in the long-term deficit balance of primary income continued. This is mainly influenced by the distributed income of foreign-controlled companies. The primary income deficit decreased from 5.5% of GDP to 4.5% of GDP. This was mainly due to a decline in profits derived from foreign direct investment, while the volume of the reinvested income of foreign-controlled companies fell by 0.9% of GDP. At the same time, reinvestments by Czech companies abroad increased by 0.7% of GDP. Factors acting in the opposite direction included an increase in the outflow of the compensation of employees by 0.3% of GDP due to growth in foreign employment in the Czech Republic.

Consequently, the balance of current transactions with non-residents (corresponding to the current account of the balance of payments) recorded a surplus of 0.7% of GDP, compared to a deficit of 0.1% of GDP in 2018.

The capital transfer surplus came to 1.0% of GDP, similar to 2018. However, net lending/borrowing was reduced significantly by the high net acquisition of non-financial assets (e.g. patents or licences) at a level of 0.6% of GDP.

Developments projected in the coming years are burdened by enormous risks due to the dramatic slowdown in external trade as a result of the coronavirus pandemic and the associated global recession. The scenario outlined for 2020 envisages a further reduction in the goods and services surplus and the primary income deficit. In the subsequent period, developments could be stable.

From the perspective of sectoral balances, bearing in mind the general government trajectory, the private sector balance should report high surpluses. In 2020, the main cause should be the steep fall in private investment, while in the years ahead a gradual increase in the share of the gross operating surplus in GDP should be established as private investment activity slowly recovers.

Table 2.3.1: Sectoral Balances

in % of GDP

	ESA Code	2019	2020	2021
Net lending/borrowing vis-à-vis the rest of the world	B.9	**1.1**	**1.7**	**1.8**
Balance of goods and services		6.1	5.9	6.0
Balance of primary incomes and transfers		-5.4	-4.7	-4.8
Capital account		1.0	1.0	1.2
Net lending/borrowing of the private sector	B.9	**0.8**	**6.8**	**5.9**
Net lending/borrowing of general government	B.9	**0.3**	**-5.1**	**-4.1**
Statistical discrepancy		**0.0**	**0.0**	**0.0**

Note: National Accounts Methodology. Net lending/borrowing of the general government for 2019–2020 notification, year 2021 outlook.
Source: CZSO (2020a). MF CR calculations and forecast.

2.4 Convergence

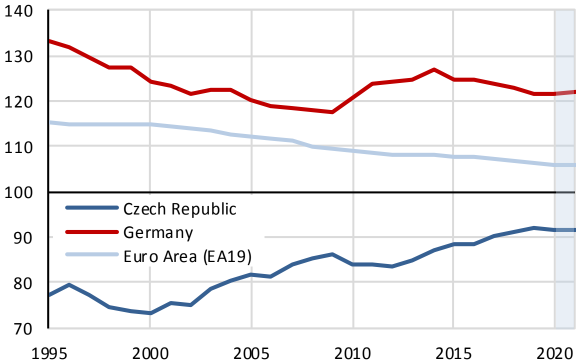
According to preliminary estimates, the economic level of the Czech Republic, expressed as GDP per capita in current purchasing power parity, stood at approximately 92% of the EU economic level and 75% of Germany's level in 2019. Strong economic growth during the boom in 2000–2008 was reflected in a fast pace of convergence towards the EU's economic development, as the relative economic level increased by 12 pp. After this, the convergence process stalled until 2013 as a result of recessions and the very modest recovery in economic activity (see Graph 2.4.1). The convergence process resumed in 2014, but is now likely to halt.

The comparative GDP price level showed a steady upward trend until 2008, when it reached 72% of the EU average (see Graph 2.4.2). This was followed by a period of relative price stability at about 70% of the EU average in 2009–2012. Subsequently, the comparative price level fell to 64% of the EU average in 2014 due to the depreciation of the CZK/EUR exchange rate, which was driven by monetary policy and helped to improve the price competitiveness of the Czech economy. Since 2017, when the exchange-rate commitment ended, the price level has started to approach the EU average again due to the appreciation of the exchange rate.

The convergence of the average private sector wage came to a temporarily stop at around 45% of the EU average wage after 2008. It resumed in 2015 as a result of the economic boom and increases in minimum and guaranteed wages, gradually rising to 50% of the EU average in 2019. It could stay near this level for some time.

Graph 2.4.1: Relative Economic Level

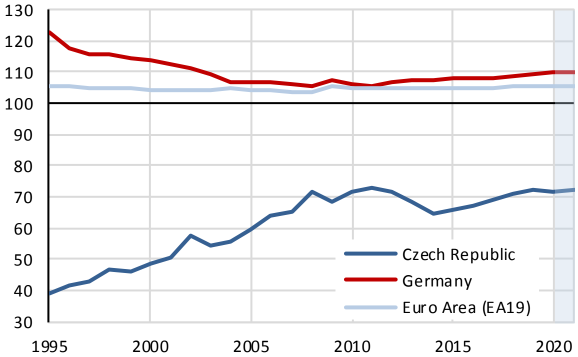
EU27=100, GDP per capita in current purchasing power parities



Source: CZSO (2020a), Eurostat (2020). MF CR calculations and forecast.

Graph 2.4.2: Comparative Price Level

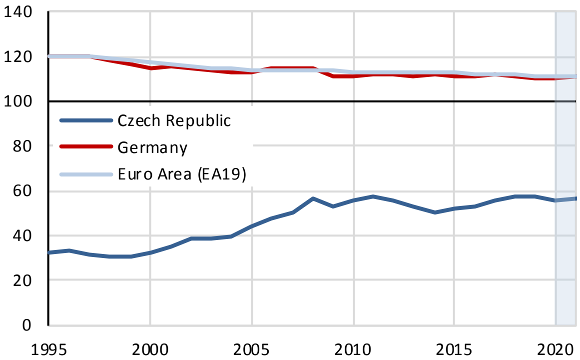
EU27=100



Source: CZSO (2020a), Eurostat (2020). MF CR calculations and forecast.

Graph 2.4.3: Real Labour Productivity

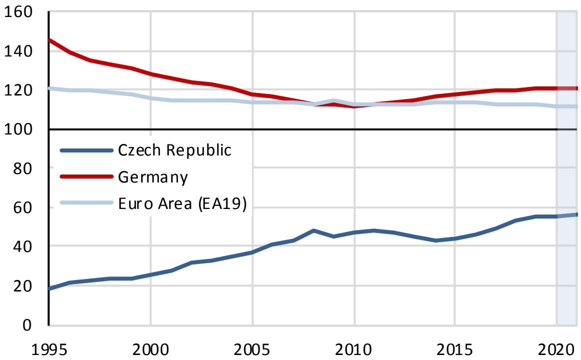
EU27=100, constant prices of 2010, per worker



Source: Eurostat (2020). MF CR and AMECO (2020) calculations and forecast.

Graph 2.4.4: Average Compensation of Employee

EU27=100



Source: AMECO (2020), Eurostat (2020). MF CR calculations and forecast.

3 General Government Sector Finances

In 2019, the Czech general government sector reached a surplus of 0.3% of GDP. Local governments and health insurance companies participated by the positive balances on the surplus. The rise in tax revenues and social security contributions was more than 6%. On the expenditure side, the strongest dynamics was reported by investments financed from purely national resources which grew by more than 12%. With a structural balance of −1% of GDP in previous year, the Czech Republic was among those EU Member States that fulfilled their medium-term budgetary objective and excelled in their overall fiscal discipline. The forecast for 2020 and 2021 is currently difficult to quantify due to the pandemic of the new type of coronavirus.

3.1 Current Developments of the General Government Sector

3.1.1 Economic Management in 2019

According to Czech Statistical Office data, the general government sector reached a surplus of CZK 15.4 billion (i.e. 0.3% of GDP) in 2019, while the negative central government balance was outweighed by the positive balances of local governments and social security funds (health insurance companies). This was the fourth consecutive year to report a surplus. The balance adjusted for the impact of the business cycle and one-off or other temporary measures achieved the medium-term budgetary objective for the Czech Republic, which was set at −1.0% of GDP for 2019.

General government revenue increased by 6.1% year-on-year to 42.1% of GDP. Tax revenues including social security contributions were determining factor with 6.6% growth. The overall tax-to-GDP ratio rose just slightly to 36.6% of GDP.

High dynamics was preserved primarily by personal income tax and social security contributions, i.e. revenues dependent in particular on wage bill development. Personal income tax revenue increased by 9% year-on-year. In addition to the effect of the growing wage bill (7.1%), there were also changes in their distribution following an increase in the minimum and guaranteed wage. The approval of Act No. 80/2019 Coll. again double increased the limit of flat-rate cost deduction for self-employed persons. The measure, which can be applied for the first time in 2019, i.e. in the tax declaration filed in 2020, should result in year-on-year lower tax revenue by CZK 1.5 billion. The abolition of the "qualifying period" for sick pay since 1 July 2019, accompanied by a 0.2 pp reduction in the sickness insurance rate, i.e. a lower tax base, resulted in an impact of approximately CZK −0.2 billion (Act No. 32/2019 Coll.). Another discretionary measure in the form of the long-term care allowance, applicable since mid-2018 (Act No. 310/2017 Coll.), was negatively reflected in personal income tax revenue to a similar extent. In connection with the revision of the methodological reporting of tax bonus, there has been a constant level increase in personal income tax revenues since 2016 (by approximately CZK 30 billion in 2019). The tax credit for a dependent child is newly reported in its full amount on both the revenue and expenditure side (cash social benefits), i.e. it is applied both in the form of a tax credit and a possible tax bonus.

Corporate income tax revenue slightly increased by0.3%. The economic performance of companies mainly reflected the growing share of the compensation of employees in GDP.

Factors similar to those in the case of personal income tax also determined the trend for social security contributions; moreover an increase in state payments for state-insured persons by CZK 3.5 billion was also reflected. A negative discretionary impact of CZK 1.8 billion was associated with a 0.2 pp reduction in the sickness insurance rate as a compensation for costs incurred by employers in connection with the obligation to pay employees for the first three days of their incapacity for work effective from 1 July 2019 (Act No. 32/2019 Coll.). The decrease in the momentum of social security contributions was also associated with the payment of long-term care allowance (Act No. 310/2017 Coll.), which had an impact of approximately CZK −0.4 billion. On aggregate, all these factors contributed to a 7.3% year-on-year increase in social security contributions.

Revenue from taxes on production and imports increased by 6.5%. This growth was mainly due to value added tax, with dynamics of 6.6%. With effect from 1 February 2019, an amendment to the Value Added Tax Act (Act No. 6/2019 Coll.) reduced the tax rate for land and water regular passenger mass transport from 15% to 10%, with an estimated impact of CZK −0.9 billion.

Excise duties (excluding subsidies for renewable energy sources) were up by 1.7%. The commencement of the third period of excise tax refund on diesel fuel and its unification for all agricultural primary production activities (Act No. 453/2016 Coll.) had an impact of CZK −0.3 billion. On the contrary, the newly introduced taxation on heated tobacco products (Act No. 80/2019 Coll.) yielded a positive impact of CZK 0.9 billion. A methodological change in the reporting of revenues from the sales of emission allowances, consisting of the accrualisation of cash income by a one-year backward shift, was also reflected in the development of excise duties.

As regards other revenues, property income recorded a 6.7% year-on-year decline, due to lower dividends from state-owned enterprises and other enterprises in which the state has an interest.

General government expenditure increased by 7.7% to 41.9% of GDP (by 0.6 pp year-on-year).

Despite a 1.3 pp slowdown, general government expenditure on final consumption maintained significant momentum of 8.1%. This was mainly due to the compensation of employees, which grew by more than 10% for the third consecutive year (10.3% in 2019). The increase in salaries concerned practically all employees in the general government sector, in particular teachers; higher volume of salaries in education was the result of both increasing salary scales and the arrangement of regional education funding reform (for more details, see Box 1).

Besides the compensation of employees, social transfers in kind also increased at a double-digit rate (10.5%). The dynamics was primarily driven by the increase in health system expenditure. The growth in social transfers in kind also includes the 75% discount on the fare on buses and trains for pupils, students up to 26 years of age and seniors over 65 years of age (Government Resolution No. 206/2018), which already partially affected the 2018 results (it was introduced in September 2018). In 2019, this amounted to additional year-on-year expenditure of CZK 4.2 billion.

Intermediate consumption growth slowed down considerably to 3.9% year-on-year, mainly due to central government purchases of goods and services.

There was a significant increase in the cash social benefits (7.5%), reflecting both approved measures (especially in pension benefits) and economic developments. With effect from 1 January 2019, the assessment for the flat rate component of pension benefits increased from 9% to 10% of the average wage. At the same time, the earnings-related part of pensions for recipients aged 85 and more increased by CZK 1,000 (Act No. 191/2018 Coll.). The impact of these discretionary measures exceeded CZK 14 billion. Other measures that pushed up social expenditures included long-term care allowance, with an impact of CZK 0.6 billion (Act No. 310/2017 Coll.), and the increase in the care allowance for the dependence grades 3 and 4, with additional expenditure of CZK 2.8 billion. (Act No. 47/2019 Coll.).

Compared to 2018, the investment expenditure growth slowed down; nevertheless kept significant momentum of almost 11%. This development was driven by investments financed from purely national resources.

The pace of interest expenditure slowed year-on-year to 1.5%, resulting in a decrease in their ratio to GDP to the 2017 level (0.7% of GDP). This development reflected the repayment of relatively high-interest issues and their replacement with new lower-interest issues, as well as efficient treasury liquidity management.

As regards other expenditures, capital transfers fell by 11%, due to high assessment base in 2018.

3.1.2 Economic Management in 2020

In 2020, the economic management of the general government sector will be largely influenced by the situation arising from the coronavirus pandemic, which has led to a significant slump in economic activity and thus a decline in tax revenues, including social security contributions, as well as the need to increase spending to fight the spread of the pandemic and mitigate its health, economic and social impacts. We therefore expect a significantly general government deficit of 5.1% of GDP, which will mainly be borne by central government, specifically the state budget. Taking into account higher payment for state insured persons, the public health system can be expected to report around balanced budget. By contrast, local governments should again reach a surplus, despite a significant fall in revenues.

General government revenue should decrease by 2.9% year-on-year and reach 41.8% of GDP. We expect tax revenues, including social security contributions, to be lower by 3.8% year-on-year, with the steepest year-on-year slump predicted in corporate income tax revenue. The overall tax-to-GDP ratio should also show a decline to 36.0% of GDP.

Value added tax revenues are expected to moderately decrease by 0.5%. The year-on-year momentum should significantly slow down due to the slower growth of nominal household consumption and the corresponding area of general government expenditure. Furthermore, a significant decrease in sales from purchases of foreign tourists should have a negative impact. The originally estimated positive effect on tax revenues from the launch of the remaining phases of the electronic registration of sales will not be achieved due to the suspension of the whole system of electronic registration of sales during the state of emergency, and the next three months following the end of the state of emergency, which the Czech government has approached with regard to current economic developments (Act No. 137/2020 Coll.). An amendment to the Registration of Sales Act (Act No. 256/2019 Coll.) will reassign some services and commodities to the second reduced rate (see sub-chapter 6.1.1), which should push down revenues by CZK 2.3 billion. The tax rate for heat and cold supplies has been changed from 15% to 10% with effect from 1 January 2020 (Act No. 80/2019 Coll.). This measure compensating for increased costs due to a rise in emission allowance prices, will mean a decrease in revenues by CZK 2 billion.

Excise duties (excluding subsidies for renewable energy sources) should decrease by more than 5%. Excise tax on mineral oils will be influenced by a fall in diesel and petrol consumption due to the real economic downturn; and the expected household consumption development respectively. Excise duty on tobacco products will be affected considerably by the volume of cross-border purchases and tourism, which will be severely constrained by measures approved to combat the COVID-19 pandemic. At the same time, consumption is expected to fall as a result of restrictions on the free movement of persons. Subdued tourism and all social activities will likely have an impact on beer and alcohol consumption. On the contrary, a change in tax rates on tobacco products and alcohol should have a positive discretionary effect, with an expected impact of approximately CZK 10 billion (Act No. 364/2019 Coll.). The excise tax on heated tobacco products introduced in 2019 should bring an additional CZK 0.4 billion (Act No. 80/2019 Coll.). The forecast includes also the introduction of the digital tax, with a budgeted impact of CZK 0.8 billion in 2020 (Chamber of Deputies Print No. 658). Within the taxes on production and imports, the rate of the gambling tax has been increased with the positive impact of less than CZK 1 billion (Act No. 364/2019 Coll.).

According to the current forecast, revenue from income taxes will report a year-on-year decline of almost 18%, mainly due to the loss of corporate income tax revenue. Forced constraints on production and service provision, closures and the overall economic downturn linked to the pandemic will have a significant impact on the economic performance of businesses which should pay almost 24% less in payments on corporate income tax to public budgets. As regards discretionary measures, the forecast includes the exemption of state and regional dividends from corporate income tax with an impact of CZK −1.8 billion (Act No. 364/2019 Coll.). Conversely, a change in the method of creation and tax deductibility of technical reserves of insurance companies (Act No. 364/2019 Coll.) should have a positive impact of CZK 5.3 billion. The measures approved within the Liberation Package I (Government Resolution No. 225) to help economic entities to get over the state of emergency declared in response to the spread of COVID-19 consist mainly of the remission of penalties for the late filing of tax declaration or interest on arrears. This is essentially a statement of greater leniency of the tax authorities between March and July 2020. Then there is Liberation Package II, which introduces further tax allowances, such as the remission of the June advance on income tax (Government Resolution No. 295).

The personal income tax revenue is expected to decrease by almost 15%. The launch of the remaining phases of electronic registration of sales (Act No. 112/2016 Coll.), which should have come into force in May 2020, will shift after three months following the end of the state of emergency (Act No. 137/2020 Coll.). Discretionary measures include the introduction of a limit of CZK 1 million for the exemption of gambling winnings and a change in rounding when determining the tax base for income from bonds issued before 1 January 2013 (Act No. 364/2019 Coll.), with a total expected positive impact of CZK 0.6 billion. The reduction in the sickness insurance rate in connection with the abolition of the qualifying period for sick pay since July 2019 should have an impact of approximately CZK −0.3 billion (Act No. 32/2019 Coll.). Direct one-off support for self-employed persons in the amount of CZK 500 per day (subject to certain conditions), intended to mitigate the negative impact of the emergency measures on these persons and their business activities due to the pandemic, will necessitate expenditure reducing personal income tax revenue of approximately CZK 31.1 billion (Act No. 159/2020 Coll., Chamber of Deputies Print No. 830). Like to companies, numerous measures approved in the liberation packages also apply to individuals (see above).

Development of social security contributions, much like personal income tax, should be determined by the forecast wage bill growth (2.6%). In addition, there will be a significant increase in state payments for state-insured persons by approximately CZK 27 billion. Within emergency measures to support the self-employed during the pandemic, there has been approved the remission of minimum social and health insurance advance payments for this group of people for six months, i.e. for the period from March to August 2020, with an estimated impact of CZK −23.1 billion (Act No. 136/2020 Coll. and Act No. 134/2020 Coll.). The revenue of the social insurance system should also be adversely affected by a reduction in the contribution rate of the sickness insurance as a compensation for the abolition of the qualifying period in the first three days of sickness (Act No. 32/2019 Coll.), with an impact of CZK −1.8 billion. All of these factors, on aggregate, are behind the dynamics of social security contributions at 2.6%.

In property income, we expect a 26.8% year-on-year increase in dividends, despite the assumption of a zero dividend from Prague Airport, which will be significantly affected by the global pandemic and the associated air traffic restrictions. At the same time, no revenue is expected from the auction of radio frequencies for 5G networks with annual accrual revenue of CZK 0.5 billion (totalling CZK 7 billion).

General government expenditure should increase by 9.6% and reach 46.9% of GDP (up by 5.1 pp year-on-year). The expenditure side will be heavily influenced by measures approved for combating COVID-19 and programmes to mitigate its economic impacts.

General government final consumption, with expected year-on-year growth of 5.8%, should be driven primarily by social transfers in kind. Their above-average 7% growth anticipates the higher healthcare expenditure necessitated by the current situation. On the contrary, the forecast includes savings of CZK 1.5 billion due to lower use of discounts on the fare on buses and trains for pupils, students and seniors at a time of limited travel opportunities.

The momentum of the compensation of employees should slow down year-on-year to 6.4% after double-digit growth. The growth is associated with the 10% increase in salaries for staff in educational system; the rest of the general government sector employees get an increase in salary scales by CZK 1,500 per person. We take also into account an increase in salaries for employees of regional hygiene stations and other employees within the Ministry of Health compensating for the additional expenditure associated with the suppression of the spread of COVID-19 (Government Resolution No. 268). An increase in salaries for security forces is also envisaged.

The growth of the intermediate consumption (6.2%) should be slightly slower than the compensation of employees, due to both real consumption (mainly higher expenditure on medical supplies and protective equipment) and higher year-on-year expected inflation rate.

We expect a significant rise in cash social benefits in 2020, reflecting both already approved measures (in particular for pension benefits and state social security benefits) and economic development. In addition, cash social benefits are being increased by an emergency measure in the form of a care allowance at 80% of the daily assessment basis in the period from 1 April to 30 June 2020, which is intended for parents of children up to 13 years of age if they are unable to work because they need to look after their children for the duration of school closures (but no later than 30 June 2020), as well as for those caring for individuals in day-care and weekly social service facilities (Act No. 133/2020 Coll., Chamber of Deputies Print No. 828). The impact of this measure is expected at approximately CZK 11 billion.

The average old-age pension increased by CZK 900 with effect from 1 January 2020 (Act No. 244/2019 Coll.). The impact of the discretion itself over the statutory indexation formula is approximately CZK 6 billion. Another measure, pushing up cash social benefits by CZK 8.6 billion, is increase of the parental allowance for all households with a child up to 4 years of age who are actively receiving this benefit (Act No. 363/2019 Coll.). The impact of the increase in the care allowance for dependence levels 3 and 4 is estimated at CZK 1.9 billion. In the same amount as for social security contributions on the revenue side, the increase in state payments for the state-insured persons is reflected here. In total, cash social benefits should therefore increase by almost 12%.

The higher gross borrowing requirement in order to finance the increased state budget deficit (Act No. 129/2020 Coll., Act No. 208/2020 Coll.) will result in an estimated rise in interest expenditure by more than 23% to 0.9% of GDP, despite the expected very low government bond yields.

Gross fixed capital formation should decline slightly by 1.2% year-on-year after three years of double-digit growth, with over 80% to be financed from national resources (including the national funding of European projects). We assume that measures to prevent the spread of COVID-19, resulting in production constraints and a reduction in the number of foreign workers, will result in a decrease in investment activity. By postponing certain purchases of military equipment that, given the current situation, is not essential for the state's defence capabilities, investment expenditure will fall by CZK 1.8 billion compared to the originally budgeted amount (Act No. 129/2020 Coll.).

We expect more than 53% increase in transfers. This calculation includes resources to support various groups of economic entities affected by the pandemic (or more precisely by measures taken to prevent its spread). Measures already approved include the Antivirus programme, under which contributions are disbursed to employers to compensate for wages paid due to obstacles at work for an employee or employer caused by quarantine measures or other obstructions directly related to COVID-19. For the period of duration of the school closures, the support of CZK 424 per day for self-employed who care for a child up to 13 years of age or a disabled person is paid out to cover the financial loss in their business activities as a result of having to care for such a person (Government Resolution No. 311). Other projects and support schemes, as well as other measures to prevent the spread of the pandemic and mitigating its effects, are at the drafting or preparation stage and therefore funds have not yet been specifically allocated to them, but are only budgeted for within the framework of a government budget reserve.

Box 1: New Model of Regional Education Funding

Regional education in the Czech Republic encompasses nursery, elementary, secondary and tertiary professional education. It is financed both by the state budget and by the founders of schools, i.e. the budgets of regions, municipalities or associations of municipalities. While the founders are involved in financing the operating costs and capital expenditure of a school or school facilities concerned, the state budget (via the budget heading of the Ministry of Education, Youth and Sports) covers the direct costs of education defined by the Act No. 561/2004 Coll. (School Act). These include, in particular, wages and salaries, including social security contributions, expenditure on teaching aids, the training of teaching staff, pupils' special-interest activities, etc.

Original Model of Regional Education Funding

Until 2020, funding from the state budget was realized via a system of national and regional norms per-child, -pupil or -student basis at all types of schools and school facilities. National norms were set centrally by the Ministry of Education, Youth and Sports as an education cost per child, pupil or student in a given age category at a given level of education. The total budget was obtained by multiplying the number of pupils in each educational group and was then distributed to individual regions. On the basis of Decree No. 492/2005 Coll., on Regional Norms, the regional authority set regional norms per child, pupil or student in individual fields of study and education at the schools within its territorial competence. The amount depended mainly on the number of pupils per teacher, his/her average monthly salary, and the amount of other non-investment costs per pupil.

This funding model resulted in major regional differences in the level of norms for similar activities, nor did it take into account the age structure of teaching staff, which had an impact on salary scales and incentive components of salaries. Likewise, the per-pupil standard impaired the quality of education provided at, for example, secondary vocational schools.

New Model of Regional Education Funding

The change in the funding of the public regional education system aims to reduce inter-regional disparities and to separate the funds for schools founded by municipalities from those for schools founded by the region. The reform is also focused on improving the quality of teaching via lessons for smaller numbers of pupils with no impact on funding.

The changes in funding were originally introduced with effect from 1 September 2018 by the adoption of Act No. 101/2017 Coll. amending Act No. 561/2004 Coll. on nursery, elementary, secondary, tertiary professional and other education (the School Act). Act No. 167/2018 Coll. subsequently shifted the effectiveness of the changes to 1 January 2020. In 2019, schools were funded according to the original model, supplemented by development programmes aimed at closing the gap between regions and introducing the new funding method.

The new model does not overhaul the entire system, but differently allocates funds from the state budget for the salaries (including social security contributions) of teaching and non-teaching staff, textbooks and school supplies, or for the further training of teaching staff. In the funding of pedagogical work, a parameter is introduced for individual fields of education in the form of a maximum weekly extent of classroom teaching covered by the state budget depending on class sizes (the "PHmax" value). These limit values are set for primary and secondary schools by Government Regulation No. 123/2018 Coll. and for nursery education by Decree No. 14/2005 Coll. The competent regional authority then allocates individual schools funds from the state budget at the amount of the school's individual PH value, calculated on the basis of the new reporting on teaching staff, but up to a maximum of the PHmax value. If the PHmax is not exceeded, the school is granted the real amount of salaries scales. Other components of direct education costs are financed according to a norm established per person educated. The amount of this norm is set centrally.

Table 3.1.1: Funding of Regional Education by Type of School

School type	Financing method
Pedagogical work	
nursery, elementary and secondary schools, conservatoires	new financing model based on the PHmax parameter
elementary art schools, tertiary professional schools	centrally setting the norm per pupil
private and church schools	old financing model based on the Act No. 306/1999 Coll.
Non-pedagogical work	
nursery schools, elementary and secondary schools	centrally setting the norm per school, workplace and class
tertiary professional schools, conservatoires	centrally setting the norm per school, workplace and pupil
elementary art schools	centrally setting the departmental norm per pupil
other schools	old financing model based on countrywide and regional norms

Source: MEYS (2020). MF CR adjustment.

The main advantages of the new model for the funding of regional education are:

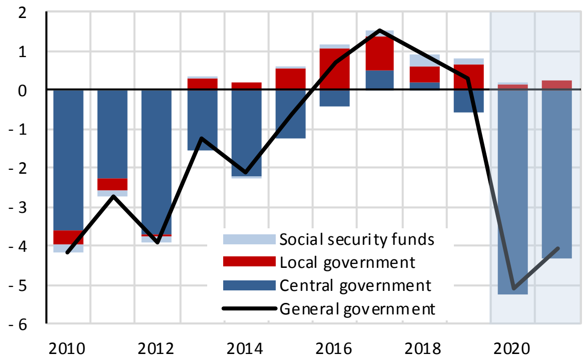
- transparency and predictability in funding;
- consideration for the different salary classifications of teaching staff;
- reduction in the dependence of state budget funds on the number of pupils.

3.2 Forecast of the General Government Sector Finances for 2021

The current fiscal policy setting which serves as a basis for the outlook, is mainly driven by the expenditure of the state budget and state funds. The initial level is significantly affected by amendments to the Act on State budget, which gradually increased the deficit to CZK 300 billion.

Graph 3.2.1: Government Balance by Sub-sectors

in % of GDP



Note: Year 2019 notification, years 2020–2021 forecast.
Source: CZSO (2020b). MF CR calculations and forecast.

For local governments, we envisage continuing surpluses. We expect both local governments' management will be prudent in response to the rapid fall in revenue in 2020, and in the future the rationalisation of the expenditure and investments slowdown, which was already evident in 2019. The estimated financial results of social security funds are based mainly on the predicted wage bill in the economy, which is a crucial determinant of the future growth in the social security contributions. With regard to its momentum (see sub-chapter 2.2.4), the distribution of discretionary measures including development of the state payment for the state-insured persons, and the assumption of a relatively lower growth in expenditure , we expect financial results of health insurance companies hover at balanced values. The units of central government outside the state budget and state funds as a whole should see slight surpluses on average.

3.2.1 General Government Revenue Forecast

General government revenue is affected primarily by the macroeconomic development. However, the forecast for 2021 is significantly influenced by the approved discretionary measures. We expect general government revenue to increase by 6.2% in 2021, of which tax revenues, including social security contributions, should increase by 7.2%.

For the following year, we predict that the personal income tax revenue will grow by almost 12%. Compared to the wage bill development, the higher dynamics is related to the expiration of one-off anti-crisis measures introduced for 2020. The year 2021 should also be affected by a new flat tax for entrepreneurs and the food ticket flat tax (for more information on both measures, see sub-chapter 6.1.1), which together will account for low units of billions CZK. In the current situation, the impacts of electronic registration of sales, which was postponed due to the state of emergency in the Czech Republic, cannot be properly quantified. This naturally applies to all areas of tax that are affected by the electronic registration of sales (i.e. not just personal income tax, but also, in particular, value added tax and corporate income tax).

Social security contributions should also evolve in line with the growth in wage bill in the economy and with the approved one-off measures to support employment in 2020. Other factor is increasing state payment for state-insured persons by CZK 30 billion. The dynamics should be slowed down by an introduction of food ticket flat tax with impact of low units of billions CZK. The growth of social security contributions should come to 6.4%.

Corporate income tax revenue should increase by more than 11%, which is mainly due to basis effect again. The impact of the food ticket flat tax is relatively negligible.

Value added tax revenues are predicted to rise by 3.5%. This autonomous development corresponds to the growth of nominal household consumption, the relevant part of general government consumption, and the development of the general government investments. Next year, tax revenue will be affected by an amendment to the Registration of Sales Act, which, in addition to expanding the range of entities that are subject to electronic registration of sales, reassigns selected commodities to lower tax rates. The total impact is CZK −1.2 billion.

Excise duty revenue should be positively influenced by the launch of the taxation of digital services and further increases in the tax rates on tobacco products. The aggregate impact of these measures is calculated at around CZK 5 billion.

As regards other revenues, we anticipate an increase in investment subsidies in particular, in line with the approaching end of the possible implementation of EU-funded projects in the 2014–2020 programming period.

3.2.2 Expected Expenditure Developments

In 2021, we estimate that general government expenditure will increase by 3.8%. In relation to GDP, expenditure should fall to 46.6% of GDP.

We expect a significant increase in cash social benefits which fully reflects autonomous developments and increasing of the state payment for state-insured persons. The most important growth item in cash social benefits is the increase in the volume of funds for pensions. As a result of the inflation rate above the CNB's inflation target and, the higher real wages growth in recent years, we expect pension indexation of around 5.5% in 2021. The increase in the unemployment rate will also increase social expenditure. The cash social benefits should rise by 8%.

The relatively lower dynamics of general government final consumption (4.9%) can be attributed to the higher base this year. The growth in the compensation of employees at 5% should be driven by increasing salaries in education in line with the government's policy statement. We also assume relatively higher increase in salaries in the health system in comparison with the rest of the general government sector. However, the issue of earnings across the salary sector is still to be discussed and is not decided yet.

The growth in social transfers in kind should slow down to about 5%. Much of this slowdown can be explained by the effect of the 2020 base deriving from essential pandemic-related health expenditure.

The growth of intermediate consumption should be about 6%, which corresponds with the prediction of the inflation rate and real growth in purchases of goods and material mainly in the health-care system. On the contrary, the current course of the 2014–2020 European Financial Perspective, where operational programmes focused on non-investment projects show a high success rate. We therefore assume that further funding of expenditure from these programmes will be distributed more evenly and will not drag intermediate consumption too high.

For the gross fixed capital formation, we predict accelerating dynamics which should be similar to the previous programming period to some extent. This should in particular relate to investments co-financed by the EU funds, and, to a lesser extent, also to investments from national sources which are, however, significantly higher in volume. A similar course was also apparent at the end of the previous financial perspective in 2014 and 2015. The general government investment should increase by around 7%. Financial resources from EU funds should complement national resources mainly in the areas of investment in transport infrastructure and in science and research.

In line with the monetary policy assumptions and interest rate developments, we estimate that interest expenditure will increase by approximately CZK 6 billion year-on-year. The development reflects the forecast of the general government balance and the corresponding change in the absolute amount of the general government debt. In relative terms, interest expenditure should reach at 1% of GDP (see sub-chapter 3.3 for more details).

Table 3.2.1: A Structure of Approved Discretionary Measures in 2020 and 2021 (Anti-Crisis Measures not included)
year-on-year discretional change, in CZK billion

	2020	2021
Revenue Discretioanry Measures	**22.8**	**4.0**
Personal income tax	2.7	-0.6
Corporate income tax	3.7	-0.7
Social security contributions	6.7	2.7
Value added tax	-4.5	-1.2
Excise duties	12.2	5.0
Other revenue measures	2.0	-1.2
Expenditure Discretionary Measures	**-42.3**	**-11.5**
Cash social benefits	-17.4	-
Compensation of employees	-18.8	-11.5
Health care	-6.1	-
Total	**-19.5**	**-7.5**
% of GDP	-0.4	-0.1

Source: MF CR calculations and forecast.

3.2.3 Quantification of Anti-Crisis Measures

In the current situation, it is difficult to identify autonomous developments and any alternative scenario. The discretionary measures currently being discussed and adopted by the government have been necessitated by the current situation in the economy and the need to resolve it. There are not many alternatives to the payment of support to businesses that have lost their source of income as a result of preventive measures or the changing behaviour of the population. There could be alternative amounts of such support, for example, but such a scenario would be highly arbitrary and inherently meaningless.

Table 3.2.2 presents the extent of the impact on the baseline scenario of the fiscal forecast, including autonomous developments and the effect of at least the government-approved discretionary measures, and the hypothetical alternative scenario without measures to combat the pandemic of the new type of coronavirus. The purpose of the alternative scenario, then, is not to provide another fiscal scenario, but only to quantify the extent of the measures approved up to 22 April 2020, including the implications for public finance known at that time. Therefore, the list of measures and the quantification of the impacts is by no means definitive.

On the revenue side, in 2020 there is a one-off compensatory bonus for self-employed persons in the amount of CZK 500 per day in the period from 12 March to 8 June 2020 provided that they have been affected by anti-crisis measures and satisfy other conditions stipulated by law. The second measure with significant budgetary impact is the remission of social and health insurance advances for the self-employed for six months. In terms of budgetary impact the remission of June income tax advances is the most significant measure. The aggregate impact of revenue measures is around 1.8% of GDP. Apart from above measures many changes in taxes like liberation packages, postponement of the electronic registration of sales etc. were approved (see sub-chapter 3.1.2).

Table 3.2.2: Impact of Anti-Crisis Measures on Public Budgets
In CZK billion

	2020	Note
Personal income tax	**-34.8**	
One-off support for self-empoyed in the amount of CZK 500 per day - compensatory bonus I	-17.5	12.3.-13.4.2020
Extension of support for self-empoyed in the amount of CZK 500 per day - compensatory bonus II	-13.6	1.5.-8.6.2020
Remission of June personal income tax advance	-3.7	
Corporate income tax	**-39.0**	
Remission of June corporate income tax advance	-39.0	
Social and health insurance	**-15.1**	
Remission of social insurance advances for self-employed persons	-15.1	March to August 2020
Health insurance	**-8.0**	
Remission of social and health insurance advances for self-employed persons up to the amount calculated from the minimum assessment base	-8.0	March to August 2020
Other	**-1.5**	
Lower dividends from the Prague Airport	-1.5	
Revenue measures	**-98.4**	
in % of GDP	-1.8	
Health	**-40.3**	
Debt relief of hospitals	-6.6	
Increasing in payments for state-insured persons (by CZK 500 per month since 1 June)	-21.1	
Increase of funds for salaries of regional hygienic stations and the Ministry of Health	-0.2	
Purchase of protective equipment and medical supplies	-12.0	
"Czech Rise Up" programme to finance new technological solutions combating COVID-19	-0.1	
"Covid Technology" programme - support of medical devices' producers	-0.3	
Social transfers	**-11.3**	
Extension of the care allowance length and increase of the child age ceiling up to 13 years	-8.2	impact for 3 months
Increase of the care allowance from 60% to 80% of the daily assessment basis	-2.8	impact for 3 months
Care Allowance for Self-Employed (CZK 424/day, up to CZK 13 144 per month)	-0.3	according to allocation
Direct support to companies	**-56.1**	
Wage cost compensation ("Antivirus" programme)	-54.5	impact for 2.5 months
"COVID" loan programme for operational financing of tradesmen and SMEs	-0.6	
"COVID II" Guarantee programme - paying interest on the loan	-	not quantifiable
Strengthening the Support and Guarantee Agricultural and Forestry Fund for loan assistance	-1.0	to agriculture
Other	**-13.8**	
Transport disinfection	-0.1	
Implementation of State Fund for Transport Infrastructure projects beyond the budget	-6.5	
Contribution to contributory organizations under the auspices of the Ministry of Culture	-0.3	
Strengthening resources to mitigate the impact on the culture sector	-1.1	
Strengthening resources for the Rural Development Programme for food sovereignty	-3.3	
Strengthening resources for minimisation of impact in forestry and agriculture	-1.2	against bark beetles
Repatriation of Czech citizens from abroad	-0.1	
Temporary reintroduction of protection of the internal borders of the Czech Republic	0.0	
Increase of funds for salaries of the Police, Firemen and Taxmen	-1.2	
Expenditure measures	**-121.5**	
in % of GDP	-2.2	
Overall impact on balance	**-219.9**	
in % of GDP	-4.0	

Source: Explanatory memoranda on the draft measures. MF CR calculations and forecast.

Expenditure measures can be divided into several main groups. The first is an increase in social benefits, mainly extending and increasing the care allowance for employees and its introducing for the self-employed persons (who would not be entitled to this benefit under normal circumstances). The second group of measure is the compensation of the wage costs for employers to maintain employment, and subsidies for affected areas of the national economy, including agriculture and culture. Finally, the last group comprises measures to purchase goods directly related to the prevention of the spread of COVID-19. The aggregate impact of the expenditure measures is 2.2% of GDP as of 22 April 2020.

3.3 General Government Debt, Strategy and Stability of State Debt

At the end of 2020, we expect general government debt to stand at 37% of GDP. The year-on-year increase in debt by 6.2 pp is mainly the result of an increase in government debt in connection with the response to the pandemic (the general government sector's contribution to debt growth is 5.1 pp) and the decline in nominal GDP (a contribution of 0.7 pp).

General government debt has declined significantly in recent years. Between 2013 and 2019, it decreased by 14.1 pp, which ranked the Czech Republic among the least indebted countries in the EU. The Czech Republic thus safely meets the Maastricht debt criterion (60% of GDP). This has created ample room for increased government bond issues to finance the measures taken to support the economy. The debt-to-GDP ratio is also a safe distance away from the limit set under the national rule established by Act No. 23/2017 Coll. on the rules of fiscal responsibility, which assesses the amount of general government debt adjusted for the cash reserve created by financing government debt relative to a level equal to 55% of GDP. For 2019, the debt adjusted in this way amounted to 30.8% of GDP, but is expected to reach 37% of GDP in 2020 (see Table 3.3.1).

Interest expense should hover between 0.9 and 1% of GDP in the years covered by the forecast. Its growth in absolute terms reflects an increase in the nominal general government debt and its financing. For convergence purposes, long-term interest rates should remain at 1.5%. The predicted stagnation reflects the projected monetary policy settings of the CNB and the European Central Bank, inflation, and the flat government bond yield curve for shorter maturities.

The positive perception of the Czech Republic's fiscal discipline on the financial markets is underlined both by international institutions and by rating agencies. Last year, Moody's raised its long-term liabilities rating to Aa3 (the fourth highest level) with a stable outlook, highlighting the positive trend in fiscal indicators (Moody's, 2019). The rating of the Czech Republic's long-term liabilities by ACRA Europe (2020) was also increased from AA− to AA. In January 2020, Fitch Ratings (2020) confirmed its rating of the Czech Republic and expressed appreciation of the excellent public finances, supported by sound fiscal and monetary policy. European Rating Agency and S&P Global Ratings also confirmed their ratings. In the international comparison with EU countries, the Czech Republic has had better rating than the euro area average for several years.

In December 2018, the Ministry of Finance launched the sale of "Republic Bonds" (*Dluhopisy Republiky*) for natural persons. The aim is to increase the share of households holding sovereign debt, enable them to generate revenue (yields) from holding bonds, and contribute to debt stability. In response to public interest, a seventh subscription period was launched in March 2020. Republic Bonds are issued with a maturity of up to six years. The yield of reinvested government bonds with subscription period between December 2019 and March 2020 was set at the level of yields on government bonds traded on the financial market on the date of commencement of the bond subscription. Natural persons may also apply for an anti-inflationary government bond with a yield determined according to consumer price developments plus 0.5% p.a., reinvested once a year.

The current forecast does not envisage any significant privatisation revenues under Act No. 92/1991 Coll. on conditions for the transfer of state assets to other persons, as amended.

After adjusting the general government gross debt for the value of liquid financial assets (defined in ESA 2010 as currency in circulation, deposits and securities, including shares listed on the stock exchange), net financial debt was 16.3% of GDP at the end of 2019. Its development was influenced by the surplus budget balance and growth of the liquid assets of the general government sector, as well as by a decrease in the relative debt of the general government sector. The potential liquid amount for debt repayments would thus hypothetically come to approximately 14.5% of GDP.

The largest share of general government debt is attributable to the central government sub-sector (see Table 3.3.1). This debt is expected to exceed CZK 2,097 billion in 2020, which, after consolidation between sub-sectors, corresponds to approximately 96% of the general government debt. Local government debt accounts for around 4% of total debt. In 2020, we expect it to reach CZK 86.1 billion, and in 2021 it is forecasted to stagnate on account of the predicted moderate economic surplus and, to a certain extent, also due to the effect of Act No. 23/2017 Coll. on the rules of fiscal responsibility. That law sets a minimum amount for principal repayments by local government unit if they are above a prudent level of indebtedness (for details see MF CR, 2016). The social security funds have consistently reported a negligible debt ratio.

As most of the central government debt is state debt, the Ministry of Finance focuses on ensuring its sustainability and stability from the perspective of key risk indicators. It has been crucial to keep these under control, especially at a time of above-average financial market volatility associated with debt crisis in euro area countries, and this is particularly important given the current high levels of uncertainty and fluctuations in the financial markets linked to the world economy's slump. Debt portfolio management continues to contribute to a prudent approach to debt sustainability, and increases the country's transparency on the government bond market. When the medium-term strategy for government debt management (MF CR, 2019b) is drawn, an emphasis is placed on refinancing, interest-rate and currency risks as the most important sources of uncertainty. The strategy was issued towards the end of 2019. However, due to the Act on the State Budget of the Czech Republic for 2020 amendments adopted (Act No. 129/2020 Coll. and Act No. 208/2020 Coll.), it will be updated during the first half of 2020.

Table 3.3.1: General Government Debt by Sub-sectors

in % of GDP

	ESA Code	2018	2019	2020	2021
General government	S.13	**32.6**	**30.8**	**37.0**	**40.0**
Central government	S.1311	32.9	31.7	37.9	40.9
Local government	S.1313	1.6	1.5	1.6	1.5
Social security funds	S.1314	0.0	0.0	0.0	0.0
Net financial debt [1)]		17.7	16.3	21.8	24.9
Public sector institutions debt according to Act No. 23/2017 Coll., art. 13 [2)]		**32.6**	**30.8**	**37.0**	**40.0**

1) Net financial debt is the difference between gross debt and liquid financial assets (monetary gold, Special Drawing Rights, currency and deposits, securities other than shares (consolidated at market value), shares and other equity quoted in stock exchange).

2) Public sector institutions debt according to Act No. 23/2017 Coll. is defined as the difference between the general government debt and disposable cash reserves created according to Act No. 218/2000 Coll.

Source: CZSO (2020b). MF CR calculations and forecast.

4 Comparison with the Previous Convergence Programme of the Czech Republic and Sensitivity Analysis

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

The scenarios for the 2019 and 2020 Convergence Programme updates are completely different. Last year's macroeconomic scenario was based on the trajectory of a gentle economic slowdown resulting from the gradual closing of the positive output gap and a return to equilibrium.

The 2020 Convergence Programme reflects the pandemic of the new type of coronavirus, which has been hitting the global economy hard in the first half of 2020. In the baseline scenario of the 2020 Convergence Programme, we presume the effects of the coronavirus pandemic, or more precisely the measures taken to prevent the spread of the disease, will be temporary and one-off. Even so, the forecast for almost all of the scenario's indicators is fundamentally skewed by this, so drawing conclusions from a comparison with last year's scenario would be misleading.

For similar reasons, a comparison of the 2019 and 2020 Convergence Programmes' fiscal scenarios is essentially out of the question. Last year, the conditions were entirely different, and at the time the output gap was closing, public finances were set to meet the medium-term budgetary objective over the entire forecast and outlook horizon. The current scenario reflects the effects of the impaired macroeconomic situation, as well as the anti-crisis measures taken. The impacts of these measures cannot be quantified with certainty at present as it is unclear how long the situation will last. The entire forecast and outlook are surrounded by even greater uncertainty than usual.

4.2 Sensitivity Analysis

The sensitivity analysis is calculated using the Ministry of Finance's dynamic stochastic general equilibrium model. Alternative scenarios focus on certain current issues of possible future developments. The first scenario contemplates lower economic growth in the EU and its effects on the highly open Czech economy, which is dependent on the external environment. Another alternative scenario assesses a possible sudden increase in interest rates. The latest analysis responds to the uncertainty regarding the future of oil prices and analyses the situation of their sharp surge. All alternative scenarios are derived from the Convergence Programme's baseline scenario described in chapters 2 and 3. In the alternative scenarios, we assume different developments from the baseline scenario, always starting with the first quarter of 2021.

4.2.1 Lower GDP Growth in the EU in 2021

Economic developments of EU trading partners are a pivotal factor for the economic growth of the Czech Republic's small open economy. This scenario assumes slower GDP growth in the EU by 2 pp in 2021, in line with the standard deviation of EU GDP development from 2002 to 2019.

At the first stage, the decline of foreign demand for domestic products would negatively affect net exports. However, subsequent pressure on currency depreciation would mitigate the decline in net exports by making imports more expensive. The adverse effect of the shock on the foreign trade balance would slow the growth of the Czech Republic's real GDP by 0.6 pp in 2021 compared to the baseline scenario. Lower growth in corporate profits due to weaker exports would see investment growth decelerate by 0.1 pp. The lower output of firms would also have a negative impact on labour demand and, subsequently, lead to lower nominal wage growth. A negative income effect in the form of relatively lower wages and returns on capital would contract household consumption growth by 0.1 pp.

The slowdown of aggregate demand growth would lessen the tax revenue, resulting in a reduction in the general government balance by 0.1 pp, with a consequent faster increase in the general government debt relative to GDP.

4.2.2 Rise in the National Interest Rate

The dynamic model in this scenario simulates the additional tightening of monetary policy in 2021 by 1.2 pp above the baseline scenario. A value of 1.2 pp is consistent with the standard deviation of developments in the short-term interest rate in the period from 2002 to 2019.

A more restrictive monetary policy would have a negative effect on economic developments. Pressure on the Czech currency to appreciate would increase the price of exports, while imported goods would become relatively cheaper. On the other hand, the sizeable import intensity of exports would, with exports declining, exert according downward pressure on imports. Lower income and a decline in corporate profits in a period of slowing economic growth would have a similar effect. The result would be a slight decline in import growth by 0.1 pp compared to the baseline scenario.

Table 4.2.1: Basic Macroeconomic Indicators – Sensitivity Scenarios

		2020	2021
Baseline Scenario			
Gross domestic product	*Y-o-Y in %*	**-5.6**	**3.1**
Private consumption	*Y-o-Y in %*	-1.5	0.8
Gross fixed capital formation	*Y-o-Y in %*	-13.6	3.2
Exports of goods and services	*Y-o-Y in %*	-17.0	6.8
Imports of goods and services	*Y-o-Y in %*	-16.8	6.3
Harmonised index of consumer prices	*Y-o-Y in %*	**3.2**	**1.5**
Unemployment rate	*in %*	**3.3**	**3.5**
General government balance	*% of GDP*	**-5.1**	**-4.1**
Gross government debt	*% of GDP*	**37.0**	**40.0**
Alternative Scenario I - Lower GDP Growth in EU in 2021			
Gross domestic product	*Y-o-Y in %*	**-5.6**	**2.5**
Private consumption	*Y-o-Y in %*	-1.5	0.7
Gross fixed capital formation	*Y-o-Y in %*	-13.6	3.1
Exports of goods and services	*Y-o-Y in %*	-17.0	5.0
Imports of goods and services	*Y-o-Y in %*	-16.8	5.3
Harmonised index of consumer prices	*Y-o-Y in %*	**3.2**	**1.5**
Unemployment rate	*in %*	**3.3**	**3.9**
General government balance	*% of GDP*	**-5.1**	**-4.2**
Gross government debt	*% of GDP*	**37.0**	**40.1**
Alternative Scenario II - Higher interest rates			
Gross domestic product	*Y-o-Y in %*	**-5.6**	**2.9**
Private consumption	*Y-o-Y in %*	-1.5	0.7
Gross fixed capital formation	*Y-o-Y in %*	-13.6	3.0
Exports of goods and services	*Y-o-Y in %*	-17.0	6.6
Imports of goods and services	*Y-o-Y in %*	-16.8	6.2
Harmonised index of consumer prices	*Y-o-Y in %*	**3.2**	**1.4**
Unemployment rate	*in %*	**3.3**	**3.8**
General government balance	*% of GDP*	**-5.1**	**-4.3**
Gross government debt	*% of GDP*	**37.0**	**40.3**
Alternative Scenario III - Higher oil prices			
Gross domestic product	*Y-o-Y in %*	**-5.6**	**2.7**
Private consumption	*Y-o-Y in %*	-1.5	0.3
Gross fixed capital formation	*Y-o-Y in %*	-13.6	2.9
Exports of goods and services	*Y-o-Y in %*	-17.0	6.4
Imports of goods and services	*Y-o-Y in %*	-16.8	5.9
Harmonised index of consumer prices	*Y-o-Y in %*	**3.2**	**2.6**
Unemployment rate	*in %*	**3.3**	**3.6**
General government balance	*% of GDP*	**-5.1**	**-4.2**
Gross government debt	*% of GDP*	**37.0**	**40.2**

Note: Different values in the text and in the table are caused by the rounding of values to one decimal place.
Source: CZSO (2020a), EIA (2020), Eurostat (2020), MF CR calculations.

Lower household incomes due to lower wage growth would also affect consumption adversely. In addition, a higher interest rate motivates individuals to save and thus postpone consumption to the future. As a result, restrictive monetary policy would lead to a slowdown in household consumption growth by 0.1 pp.

Businesses would see their profitability decrease due to a decline in both foreign and domestic demand. They would respond to the drop in profits and the increase in the cost of borrowing by cutting investment growth by approximately 0.1 pp. A slowdown in aggregate demand would also increase the unemployment rate by 0.3 pp compared to the baseline scenario. This in turn would foster the reduction of the wage growth.

Due to the negative impact of higher interest rates on investments, consumption and exports, the resulting effect on GDP growth would also be negative by 0.2 pp. Slowdown of economic growth would lead to disinflationary pressures of 0.1 pp.

Lower household income and corporate profits would reduce tax revenue. This would worsen the general government balance and push up the interest expenditure of debt servicing, which in turn would hasten the growth of the debt-to-GDP ratio.

4.2.3 Higher Oil Prices

The alternative scenario for oil prices is based on the assumption that the average price in 2021 will be 50% higher than in the baseline scenario (USD 59.7 per barrel versus USD 39.8 per barrel). Higher oil prices would be reflected in higher import prices and more expensive inputs. Companies facing higher energy costs would consequently increase the prices of their final products. Inflation would thus increase by about 1.0 pp. Higher prices would lessen consumption growth by up to 0.5 pp.

Declining aggregate demand would adversely affect domestic production. Companies would also become less profitable due to increased energy costs and lower export opportunities. There would also be downturn in investment activity by 0.3 pp. Another effect of contracted production activity would be lower labour demand and a slight increase in the unemployment rate. Overall, higher oil prices would slow down real GDP growth by 0.3 pp.

Lower tax revenue would impair the general government balance. The effect on general government expenditure would be negligible.

5 Sustainability of Public Finance

Long-term sustainability belongs among frequently discussed issues in relation to Czech public finances. The greatest risk is associated with expected demographic development, as the number of people of retirement age relative to the working-age population will evidently increase significantly in the next few decades. In fact, the population ageing is not a matter of the distant future, but is already happening. This puts pressure on public finances and hence the need to reform social systems. In the past, several expert groups have been established in the Czech Republic with the aim of reforming the pension system, but so far no broad political consensus has been found for comprehensive reform. For this reason, the government has decided to take up an offer from the Organisation for Economic Cooperation and Development to conduct an independent study that will assess the current situation and offer possible solutions. Population ageing is a phenomenon not only related to old-age pensions, but also to other parts of public finances, such as health care, long-term care and education.

5.1 Government Strategy and Implemented Reforms

5.1.1 Current State of the Public Pension System

The pay-as-you-go pension insurance system regulated by Act No. 155/1995 Coll. has undergone many changes since its inception. These have mainly concerned the adjustments to the retirement age, the calculation of pensions, and the method or amount of indexation. The way of pension calculation was last changed with effect from 30 September 2011, when the reduction limits affecting the basis of assessment for insured persons were adjusted. Since 2015, the income level relevant to the calculation of pensions has been included in full up to 44% of the average wage. From 45% to 400% of the average wage, only 26% of that income is included. Income above 400% of the average wage does not affect the basis of assessment for the pension calculation; this is fully in line with the social insurance ceiling at the same amount.

The latest adjustment to the pension system, concerning the retirement age, has applied with effect from 1 January 2018 (Act No. 203/2017 Coll.). The retirement age of both men and women is increasing until it is unified at 65 years in around 2030. The Ministry of Labour and Social Affairs is also required by law to report to the government on the pension system at five-year intervals (the first report was discussed by the government in September 2019). The aim of the reports is to assess the current retirement age and, if appropriate, to propose an adjustment to it so that persons insured under the system can spend, on average, a quarter of their life in retirement. Changes to the retirement age do not apply to persons who are over 55 at the time of the revision. However, the revision mechanism does not impose any obligations on the government. Instead, it only serves as a recommendation for the government to submit a proposal for a change in retirement age to the Czech Parliament for approval. The government has taken advantage of this rule by deciding to leave the retirement age as it is for the time being. The statutory retirement age also affects the conditions pertaining to permanent widow and widower pensions, as the age limit here is tied to old-age pensions. For early retirement, the threshold is gradually shifting from three to five years before the statutory retirement age. This maximum period of five years may, at the cost of significant penalties, be used by those whose statutory retirement age is at least 65 years.

Early retirement entails several permanent penalty rates, which progressively reduce the resulting pension benefit. Up to 360 days before the statutory retirement age is reached, a reduction of 0.9% applies to the basis of calculation; for the period from 361 to 720 days before reaching the retirement age, the reduction is 1.2%; finally, for periods exceeding 720 days (up to the limit permitted by law), the reduction is 1.5%. The earnings-related part of the old-age pension is then reduced by these amounts for every 90 days inclusive.

In addition, there is a pre-retirement scheme that allows those participating in supplementary pension savings (the 3rd pillar) to draw their funds without penalty as many as five years before reaching the statutory retirement age. However, a condition of pre-retirement is that funds accumulated under the private 3rd pillar must ensure a monthly pension of at least 30% of the average wage. The old-age pension is not reduced for those years in which pre-retirement is used. By the end of 2019, the possibility of drawing pre-retirement was only used by 4,455 persons with an average benefit of CZK 9,929.

As for disability pensions, there are three groups in the Czech Republic, classified according to the degree of disability. A disability pension can be awarded to someone whose work capacity has decreased by at least 35% due to long-term adverse health conditions. The first degree of disability applies to a decline in capacity from 35% to 49%, the second degree from 50% to 69%, and the third degree from 70%.

The indexation of pensions paid out of the pay-as-you-go system is determined by the sum of the growth of the consumer price index, or the pensioner cost of living index (whichever is higher), and one half of real wage growth. The rule has applied since 1 January 2018 (Act No. 203/2017 Coll.). In addition, for periods of low inflation and/or low real wage growth, a change in pension indexation has been approved so that, with effect from 2017, the government again wields a limited amount of discretion

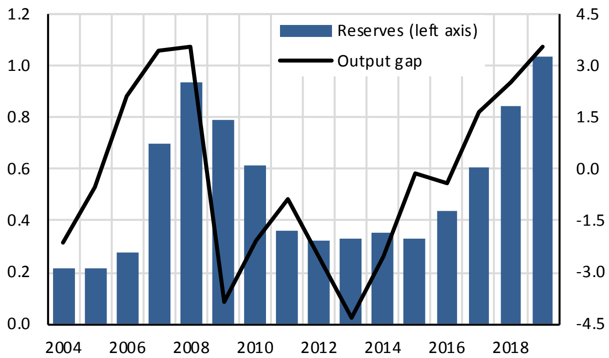
(Act No. 212/2016 Coll.). In this respect, if the increase in the average pension according to the standard indexation formula is less than 2.7%, the government is entitled issue a regulation for the indexation of pensions up to this value. In other cases, the statutory indexation formula is adhered to strictly. Naturally, this does not exclude the possibility of different indexation by way of a special law (most recently Act No. 244/2019 Coll.). In addition, for persons over certain age, there is the increase in the earnings-related part of pension benefit by the fixed amount (by CZK 1,000 per month for persons over 85 years and by a further CZK 1,000 per month for persons over 100 – this rule was introduced by Act No. 191/2018 Coll., which took effect on 1 January 2019).

5.1.2 Developments in the Healthcare System

In the public health insurance system, the balances of health insurance companies in bank accounts in 2016–2019 averaged 13% of total expenditure on health, while in 2004–2015 this ratio had averaged 8.6%. Consequently, the short-term resilience of the public health insurance system to negative shocks improved. At the end of 2019, it was agreed, beyond the scope of the reimbursement ordinance, to use health insurance companies' balances amounting to approximately CZK 6 billion in all segments of health care to improve the quality and availability of care (especially to the benefit of small hospitals in areas where care was not so readily accessible and to support primary, after and home care). However, due to the fall in revenues of the public health insurance system, greater involvement of reserves in health care financing is probable.

Graph 5.1.1: Health Insurance Companies' Balances

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



Note: "Reserves" stand for the reserves on health insurance companies' balance accounts.

Source: Statements of Health insurance Companies, MF CR.

In the preparation of outlooks, health insurance companies tend to set slower growth in health care expenditure in relation to revenue, otherwise the medium-term stability of the public health insurance system would be jeopardised. Establishing a trend of lower momentum for expenditure versus revenues in the system is desirable not only in the medium term, but also, and especially, in the long term. This is due to population ageing, which, from the perspective of sustainability, makes the risks faced by the current public health insurance system indispensable in the long run. Measures will therefore evidently have to be implemented to address the resources available to the public health insurance system, including the structure of the sources of funding. These problems are reflected in the government-approved Strategic Framework for the Advancement of Health Care in the Czech Republic until 2030 (Government Resolution No. 817/2019), which is aimed at optimising the health care system from the point of view of organising the health care functioning, including its financing, and at improving the population's state of health.

Only partial changes are being made to the sources of healthcare funding. From 1 January 2020, the assessment base for the payment for state-insured persons increased to CZK 7,903 (Act No. 297/2017 Coll.). From June 2020, further increase to CZK 11,607 occurs. For the following year, with effect from 1 January 2021, the assessment base will be increased to CZK 13,088 (Chamber of Deputies No. 829). Due to these increases in the assessment base for the payment for state-insured persons, the resources of the public health insurance system will be strengthened by a total of 1% of GDP. However, beyond the horizon of 2021 no legal mechanism has yet been adopted to regulate payments for state-insured persons. As a result of the increase in the minimum wage (Government Regulation No. 347/2019 Coll.), the monthly amount of contributions for persons without taxable income also increased to CZK 1,971 as of 1 January 2020. However, the impact of this increase is negligible from the aspect of the system's overall resources.

In line with a recommendation from the Organisation for Economic Cooperation and Development (OECD, 2018), the reform of primary care is moving forward with a view, in particular, to strengthening the gate-keeping role of general practitioners and their involvement in prevention programmes. The reimbursement mechanism for primary care should also be changed, with an emphasis on strengthening the performance service component while keeping to a fixed capitation payment.

In the segment of inpatient care, the DRG Restart project, planned for completion in 2021, continues to be implemented. The aim of this project is to create a long-term sustainable data, information and personnel base for optimising the system of inpatient care reimbursement in the Czech Republic. The change in the method of reimbursement should make the financing of inpatient care more efficient as the system will reflect the real cost of procedures. Last year, a new version of the classification system for acute inpatient care (CZ-DRG version 2.0) was introduced, in which, for example, the structures of DRG groups were updated. This year, the applicability of this classification to care reimbursement payments is being pilot tested (covering approximately 0.5% of the total care volume). Data will be also collected again from reference hospitals for 2019. This will be crucial for the implementation of CZ-DRG (in the upcoming new version 3.0) for the reimbursement of acute inpatient care under the Reimbursement Ordinance for 2021.

5.2 Fiscal Impacts of Population Ageing

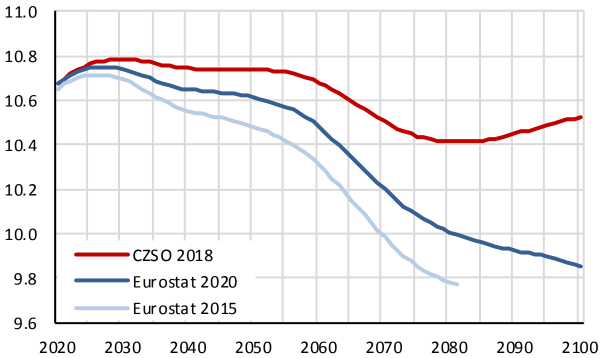
The results of the impacts of population ageing are based on long-term projections drawn up in cooperation with the Ageing Working Group of the Council of the European Union's Economic Policy Committee. The analyses are based on assumptions about demographic developments and a methodologically consistent macroeconomic framework for EU countries, the UK and Norway (European Commission, 2017). Therefore, these projections do not reflect the current medium-term macroeconomic and fiscal outlook of the Czech Republic. The projections are conducted on the assumption that policies will remain unchanged. As such, they shed light on the legally enshrined system at the time of the projection, taking into account current practices, if discretion is allowed in the given legal order. Long-term analyses do not aim to predict specific values, but to point out trends and dynamics in the long run up to 2070.

The long-term projections were last updated in autumn 2017 in connection with the 2018 Ageing Report (European Commission, 2018). The projections thus reflect only the changes approved in the pension system with effect from 1 January 2018, as set out in Act No. 203/2017 Coll. The long-term projections that include measures adopted since then, as laid down by Act No. 191/2018 Coll. (in particular, in addition to an adjustment to indexation, an increase in the flat-rate component of pension benefits from 9 to 10% of the average wage) and Act No. 244/2019 Coll. were drawn up in the MF CR (2019c).

Eurostat population projections (European Commission, 2017) underpin the current results of long-term projections. Recently, however, two new demographic projections have emerged. The Czech Statistical Office published an update at the end of November 2018 (Czech Statistical Office, 2018), followed in February 2020 by Eurostat (2020). The latter will serve as a basis for updating the fiscal implications of population ageing, to be published as part of the three-year cycle in the preparation of the 2021 Ageing Report.

Graph 5.2.1: Czech population in different projections

millions of persons



Source: CZSO (2018), EC (2017), Eurostat (2020).

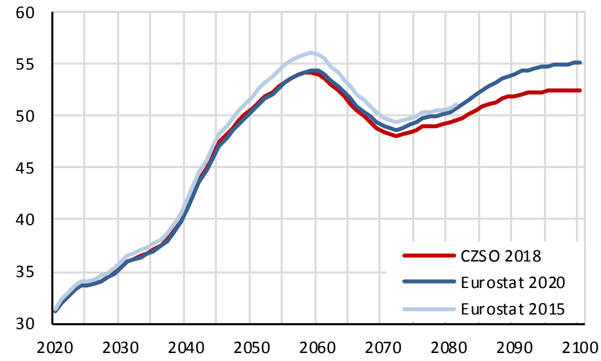
A basic comparison of these demographic projections shows that, in the long term, a decrease in the Czech population can be expected. Relatively speaking, the most optimistic projection is that of the Czech Statistical Office, and the new Eurostat projection comes closer to that. The difference between the two scenarios stems almost entirely from a different assumption of net migration. While the Czech Statistical Office projects a constant net influx of 26,000 persons per year over time, Eurostat's update foresees a gradual decline from the current approximately 24,000 to around 8,000 persons per year.

However, the population structure is particularly important for projections of expenditure within the social and health care systems. The dependency ratio, measured as the ratio of the number of persons over 65 years of age to the number of persons of working age (15–64 years), is developing along very similar lines when viewed from the point of view of individual projections. It should almost double by 2060 to reach around 55% (see Graph 5.2.2).

Naturally, this can be attributed not only to a decline in the number of working-age people, but also to an increase in average life expectancy. The share of persons aged 85 and over in the number of persons aged 65 and over is expected to more than double within the projection horizon. In subsequent decades of projections, there should only be a temporary reduction in the dependency ratio. The main reason for strong growth after 2035 and a peak in the period between 2045 and 2060 is the baby boom generation born in the 1970s. After 2060, its influence should weaken, but in the subsequent period the dependency ratio will be influenced by the fact that current birth rate is relatively strong.

Graph 5.2.2: Old-age Dependency Ratio

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



Source: CZSO (2018), EC (2017), Eurostat (2020).

The economic activity rates for age cohorts over 54 years are projected to increase until 2030 as the statutory retirement age goes up. However, they remain more or less constant after 2030, reflecting the current institutional setup of the pension system. Although the revision mechanism is part of the pension system, it does not impose any obligation on the government. Instead, it only serves as a recommendation for the government to submit a proposal for a change in retirement age to the Czech Parliament for approval. Consequently, the European

Commission refused the revision mechanism in long-term projections to be applied. The projection therefore works with a retirement age that has a fixed ceiling of 65 years from 2030 onwards.

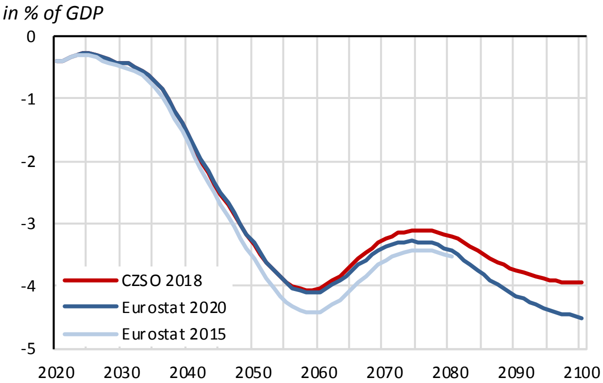
Developments in pension expenditure relative to GDP have been quite favourable in recent years, mainly due to the macroeconomic environment. The initial value of expenditure in past projections was 9.0% of GDP in 2013, while in 2016 pension expenditure was 0.8 pp lower. On the other hand, the revenue side of the system has risen dynamically on the back of the higher growth in wages and salaries, employment and the participation rate. This positively influenced the system's balance, which in 2016 (the base year of the projections) came to −0.3% of GDP. In subsequent years, the balance improved further, and since 2018 it has had a surplus (0.3% of GDP in both 2018 and 2019).

The trend in pension projection expenditure is primarily determined by demographics and the statutory retirement age. These underlying conditions imply that, relative to GDP, up to 2030 pension expenditure should be broadly stable at the level of the 2016 base year (Table 5.2.1). After 2030, however, the rise in the retirement age will stop and those baby boomers born in the 1970s will gradually retire. This will quite dramatically increase expenditure to 11.7% of GDP just before 2060, followed by a decline in expenditure to 10.9% of GDP at the end of the projection horizon in 2070. The decline in the expenditure-to-GDP ratio is again due to demographic factors, when those born in the demographic trough in the 1990s or later will retire and replace those born during the demographic bulge.

The revenue of the pension system relative to GDP is considered to be constant over the projection horizon. This stems from assumption about trends in wages and salaries in the economy, which should develop in line with labour productivity in the longer term. As a result, the fixed share of the remuneration of the labour factor of production in GDP, from which a constant pension insurance rate of 28% of the gross wage or salary is derived, is maintained. The system's revenue thus attains the level of the 2016 base year and amounts to 7.9% of GDP.

Graph 5.2.3: Projection of Pension Account Balances

in % of GDP



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

Due to the constant relative revenue, the resulting projection of the pension system balance (see Graph 5.2.3) mirrors the course of pension expenditure. We expect the balance to be relatively stable by 2030, while in subsequent period the balance will deteriorate and bottom out at almost −4% of GDP around 2060. This means there has been a marked deterioration compared to the Commission's projection (2015), where the balance fell to a minimum level of less than −2% of GDP shortly before the end of the projection.

As the modelling of pension expenditure has remained unchanged since the last round of projections, the effects of the deterioration in the pension system balance can be divided into two groups. The first group comprises external factors (e.g. different demographic trends); the second consists of changes in the pension system (a different indexation formula and the retirement age ceiling).

Although the update of projection assumptions plays a role in the momentum of expenditure over time, it is counteracted by more favourable developments in recent years. Therefore, although expenditure in the new projection is growing more dynamically, it is increasing from a lower basis and in 2060 ends at virtually the same level as the previous projection (9.7% of GDP). The main reason for the higher deficit is thus a change in the system. Furthermore, the pension system balance in 2060 is most exacerbated by the retirement age ceiling (an impact of about 1.6 pp), whereas the change in the indexation formula (half instead of a third of real wage growth) increases expenditure by about 0.3 pp. In other words, the absolute ceiling of the retirement age resulted in an increase in annual pension expenditure of about CZK 75 billion in current terms and a change in the indexation formula will increase expenditure by another approximately CZK 15 billion.

The situation in health care and long-term care is similar to previous projections from the perspective of the growth momentum of expenditure. The baseline scenario anticipates an increase of one fifth for health care (from 5.4% of GDP in 2016 to 6.5% of GDP in 2070) and of more than double for long-term care (from 1.3% of GDP in 2016 to 2.9% of GDP in 2070). Compared to the previous projections, however, there is a difference in the baseline levels, specifically in the level of long-term care, which is almost double that of the 2015 Ageing Report (for more details, see MF CR, 2018).

The reference scenario differs from the purely demographic scenario in several respects. As far as health care is concerned, there is higher income elasticity, with demand for health services initially rising a tenth faster than the standard of living measured by GDP per capita. Furthermore, in terms of increased life expectancy, half is expected to be spent in good health (as opposed to any increase in poor health in the baseline scenario). Moreover, the reference scenario for long-term care includes the assumption of higher growth in the compensation of employees in social services as labour productivity in the economy increases (instead of GDP per capita growth, which is lower).

Demographic impacts increase health care expenditure by 1.4 pp, higher income elasticity by another 0.3 pp, while the effect of good health in the extra life expectancy reduces the increase of expenditure in the reference scenario by 0.6 pp. For long-term care, the impact of demographic development is quantified at 1.4 pp, and higher compensation of employees at additional 0.3 pp. The effect of good health in half of the additional life expectancy in the projection outweighs the higher income elasticity, thus moderating the increase of expenditure slightly by 0.1 pp.

Finally, the last major item of long-term expenditure, education, should grow from 3.2% of GDP in 2016 to 4% of GDP in 2070. This is basically the same as in the previous projections and, at the same time, it is the highest increase in the EU as a whole. The increase is due to higher growth in the compensation of employees in education relative to the projected economic growth.

The total increase in expenditure between 2016 and 2070 is more than 6 pp, as shown in Table 5.2.1. The increase for health care, long-term care and education, taken together, is 3.5 pp. However, these are just the baseline scenarios. With health care and long-term care in particular, most alternative (sensitivity) scenarios show an increase that, for the most part, is higher (see European Commission, 2018). The only exception is scenarios that include the impact of a healthier lifestyle.

Table 5.2.1: Age-related Expenditure Projection – Reference Scenarios
in % of GDP

	2016	2020	2030	2040	2050	2060	2070
Age-related expenditure	**18.1**	**18.3**	**19.6**	**21.1**	**23.4**	**25.1**	**24.3**
Pensions	8.2	8.1	8.2	9.2	10.8	11.6	10.9
Health-care	5.4	5.6	5.9	6.2	6.5	6.6	6.5
Long-term care	1.3	1.4	1.8	2.1	2.4	2.8	2.9
Education	3.2	3.2	3.7	3.6	3.7	4.1	4.0

Source: EC (2018).

5.3 Sustainability Analysis

A sustainability analysis, identifying the extent of any fiscal consolidation to ensure the stability of public finances, builds on the long-term projections. Sustainability indicators are calculated. These show how far-reaching measures would be needed to reduce the expenditure ratio or increase the revenue-to-GDP ratio accordingly.

The European Commission regularly publishes three sustainability indicators (see the European Commission, 2019). In general, the S1 indicator expresses the percentage of GDP by which the primary structural balance of the general government sector needs to be changed so that general government debt in 2030 is 60% of GDP. This indicator for the Czech Republic currently stands at −2.9% of GDP (European Commission, 2020b). That negative value documents that the increase in age-related expenditure up to 2030 is "cancelled out", in particular, by the relatively low general government debt, compounded by the fact that this debt has fallen in recent years.

The S2 indicator determines the degree of fiscal effort required to achieve equality between discounted revenue and expenditure over an infinite horizon. According to recent calculations, it is 4.8% of GDP. The value of this indicator is fully influenced by the ageing costs, which is at the same level.

The S0 indicator indicates potential fiscal or financial risks in the short term. S0 is therefore different in nature from S1 and S2, in that it quantifies the level of risk. The Czech Republic's current S0 value is 0.22, well below the critical limit of 0.43.

In terms of the long-term sustainability of public finances, the Czech Republic is currently rated as a medium-risk country. In order to return to the low-risk zone, it is necessary to resolve, in particular, future pressure exerted on public finances by demographic changes. This applies to all components of long-term projections, i.e. pensions, health care and long-term care, and education.

Table 5.3.1: Sustainability Indicators S1 and S2
in % of GDP

	S1	S2
Cost of Ageing	0.9	4.8
Initial budgetary position	-1.6	0.0
Impact of current debt	-2.2	-
Total	**-2.9**	**4.8**

Source: EC (2019b).

5.4 General Government Guarantees

The view of the long-term sustainability of public finances is complemented by the issue of guarantees provided by the general government sector to other entities. These guarantees comprise an increase in general government expenditure when debtors are unable to meet the obligations for which the guarantee was provided. The volume of guarantees provided has been steadily declining in recent years. At the end of 2019, they totalled 0.1% of GDP.

The major share of general government guarantees is taken up by guarantees provided by local governments, amounting to 0.1% of GDP. The most important of these is the guarantee made for Prague Public Transit Company and relates to deferred payments for the purchase of trams amounting to CZK 4.5 billion. Other guarantees are provided by local governments for loans related to housing needs (CZK 0.3 billion).

State guarantees have been steadily falling mainly because the financing of infrastructure has not been covered by guarantees since 2001. In 2016, Czechoslovak Trade Bank's rights to activate the guarantee deriving from the takeover of Investment a post Bank expired. Although only a fraction of the guarantee was paid out (CZK 6.1 billion out of a total of CZK 160 billion), the final court case, with a potential claim exceeding CZK 23 billion, has yet to be concluded. In 2019, a credit facility for a programme to improve the condition of international roads in the Czech Republic, from which more than CZK 0.5 billion was drawn, was paid off.

No new state guarantees were provided in 2019. The last state guarantee was provided in 2018 to secure a CNB loan to the International Monetary Fund from its foreign reserve assets (Act No. 179/2018 Coll.) under a new contract. The promised credit line is up to EUR 1.5 billion, but the amount of the guarantee reported depends on the credit drawn. The guarantee has not been drawn yet.

In order to address the crisis inflicted by the pandemic, the government approved the COVID II Guarantee Scheme (Government Resolution No. 260) in March 2020, with a guarantee capacity of CZK 20 billion in the form of state guarantees as indirect support for affected businesses. At the end of April, the COVID III Scheme (Chamber of Deputies Print No. 832) was submitted, which will provide guarantees through the Bohemian-Moravian Guarantee and Development Bank. The scheme guarantees 90% of the principal of a loan up to CZK 45 million for operational financing of a company with up to 250 employees. For an entrepreneur with 250 to 500 employees, it is responsible for 80% of the amount of the operating loan up to CZK 40 million. The program is limited by a portfolio guarantee of 30% multiplying the total of loans which may potentially be guaranteed to CZK 500 billion.

Furthermore, Ministry of Finance and Ministry of Industry and Trade were tasked with preparing guarantees of the Export Guarantee Insurance Corporation for companies with more than 250 employees up to an aggregate insurance capacity (including existing products) of CZK 330 billion (Government Resolution No. 297). On 1 April 2020, the government approved a draft of Act amending Act No. 58/1995 Coll., on the insurance and financing of exports with state aid in order to enable the Export and Guarantee Insurance Corporation to provide guarantees beyond the scope of guarantees related to export activities (Act No. 214/2020 Coll.).

On 20. April 2020, the COVID PRAGUE program was announced as a supplement to COVID II. Under similar conditions, it provides a guarantee capacity of CZK 1.5 billion for Prague entrepreneurs.

Further changes may yet be made to the volume of guarantees provided to businesses affected by the pandemic. However, specific proposals have not yet been approved by the government.

6 Quality of Revenue and Expenditure of Public Finances

The main objectives pursued by the Czech Republic's tax policy are to increase the transparency of the tax environment, including the revision and gradual abolition of certain tax exemptions, and to minimise distortions. An equally important area is the digitalisation of tax collection and easing the administrative burden in this area. For example, this is the aim of the *MOJE daně* (MY Taxes) project and the idea behind the simplification of tax liability administration for sole traders. Tax changes aimed at promoting the health of the population and the fight against tax evasion also remain key government interests.

Several changes were made last year with a view to rationalising expenditure, especially in centralised public procurement, where different systems are being unified. In addition, the information obligation for technology procurement in the information technology area was extended and the processes related to the management of state assets were streamlined.

6.1 Tax Policy Outlook

6.1.1 Upcoming Tax Changes

From 1 May 2020, the last phase of electronic registration of sales (Act No. 256/2019 Coll.), encompassing all remaining sectors (e.g. liberal professions, transport, agriculture, crafts, manufacturing activities, etc.) was meant to take effect. It is associated with the launch of a simplified "paper" registration system, intended to eliminate the disproportionate impact and burden on small businesses. Only natural persons who are not registered for value added tax, engage in business activities with no more than two employees, and have generated sales revenue of not more than CZK 600,000 over the last 12 months (and do not expect to exceed that amount in the next 12 months) may apply for this special sales registration mode. The same law reduces the value added tax rate on selected services with a high share of human labour and on some other goods. These include bicycle repairs, repairs of shoes, leather products and clothing, hairdressing and barber services, household cleaning services, and water supply and wastewater services. In connection with the coronavirus pandemic, on 23 March 2020 (Government Resolution No. 271/2020) the government approved a draft bill postponing the statutory obligations relating to electronic registration of sales. This postponement will remain in place until three months have passed after the state of emergency is lifted.

In keeping with the policy of limiting the affordability of harmful commodities, excise duties on alcohol and tobacco products were raised (Act No. 364/2019 Coll.). Further hikes in excise duty on tobacco products are planned gradually over the years 2021 to 2023.

The Ministry of Finance is submitting a draft bill that will considerably simplify tax liability and reduce the administrative burden of doing business for small-scale sole traders. If these entrepreneurs have an annual income of not more than CZK 1 million, they will be able to meet their personal income tax, social insurance and health insurance obligations by making a single flat-rate payment. The flat-rate tax is planned for introduction from 1 January 2021.

The goals of the forthcoming amendment to the Income Tax Act are to simplify the provision of the meal allowance for employers and to reduce the transaction costs incurred by both employers and entrepreneurs receiving payments via meal vouchers. As a result, the law will allow even small employers to use the meal allowance as an employee benefit, and the scheme will also be open to those who have not joined a meal voucher or card distribution system.

A draft bill on digital services tax (Chamber of Deputies Print No. 658) is passing through the legislative process. It is based on the proposal for a directive on the common system of a digital services tax. The proposal introduces a 7% tax on the placement of targeted advertising on digital interfaces by companies with certain global turnover. It also imposes a tax on the sale of data collected on users and on the use of multilateral digital interfaces. It has been proposed that the unilateral measure be limited in time. The Czech Republic keenly supports work on a global solution within the Organisation for Economic Co-operation and Development.

6.1.2 Effectiveness of Taxation Collection and Digitalisation

The priority is to digitalise tax administration and intensify the pro-client approach. This approach primarily encompasses projects *MOJE daně* (My Taxes) Portal, New Tax Information System, and Data Warehouse. The MY Taxes (Modern and Simple Taxes) project remains the flagship behind the gradual computerisation of tax administration, major client simplification, and a friendly approach towards taxpayers. The portal is expected to be operational by the end of 2020. This project includes the establishment of the MY Taxes portal. This will be a virtual tax office offering taxpayers services such as the option of pre-filled tax forms containing basic information about the taxpayer, payroll input from the employer, and third-party data important for the final establishment of the tax liability (information from banks and/or pension funds). An integral part of the digitalisation of tax administration is the streamlining of tax collection using software (analytical) tools and controlled checking activities in order to reduce the burden on taxable entities. The New Tax Information System project builds a modern, maximum-automated system for tax administration meeting all cyber security requirements and satisfying the conditions of Czech and European eGovernment. Work is under way on proposed variants of the future solution of the system. The timetable for the implementation phase will be specified after the solution is selected. The output of the Data Warehouse project will be used to integrate diverse data from both internal and external source information systems. The Data Warehouse will be part of the overall financial administration architecture and will provide data and information for the various activities of financial administration employees, including decision-making support. The project is expected to be completed in 2023, and analytical preparations for the actual implementation are currently in progress.

6.1.3 International Co-operation against Tax Evasion

The Czech Republic remains committed to introducing a blanket reverse charge mechanism that would fundamentally clamp down on any remaining value added tax evasion. Discussions are being held with the EU on prolonging of the exemption that has been granted.

Another important tool for combating tax evasion on the international stage is the ever-evolving mechanism for the international exchange of information on tax administration. A new range of information is currently being implemented that should be shared by EU Member States as of October 2020 as part of the so-called automatic information exchange system. This will involve standardised information on tax optimisation schemes that are risky in terms of tax liability circumvention.

In support of international standards of proper tax governance, the Czech Republic has undertaken to extend the scope of provisions relating to the taxation of controlled foreign companies (without examining other facts relevant to the application of these provisions) to all companies – controlling entities whose controlled companies are resident in a state or jurisdiction classified among non-cooperative jurisdictions. In this situation, the activities of foreign controlled entities will now be viewed (in terms of income tax) as having been carried out by the Czech controlling company.

6.2 Rationalisation of General Government Expenditure

6.2.1 Act on Management and Control of Public Finances

In 2017, a government draft bill on the management and control of public finances was submitted to the Chamber of Deputies to replace Act No. 320/2001 Coll., on financial control in public administration and amending certain acts (the Financial Control Act), with a view to create a transparent public finance control system encompassing the clearly defined responsibilities of specific persons for authorising and controlling public expenditure. If this bill had been passed, it would also have completed the transposition into Czech law of Council Directive 2011/85/EU, which was largely implemented by the adoption of Act No. 23/2017 Coll. on the rules of budgetary responsibility and Act No. 25/2017 Coll. on the collection of selected data for the monitoring and management of public finances. However, as the government's draft bill did not enter into force, only a technical amendment was approved in 2019 (Act No. 126/2019 Coll.). With effect from 1 January 2020, this amendment extended the scope of entities (voluntary associations of municipalities, related allowance organisations, and the Railway Administration) defined by the term "body of public administration" in accordance with the requirements of the Directive, while the public finance control system itself remains unchanged.

6.2.2 Joint Procurement of the State

Since 2016, two systems of centralised public procurement have existed parallel to each other in the Czech Republic. Since 2012, central government entities with at least two subordinate organisations have been obliged to implement a departmental system of centralised public procurement. Government Resolution No. 24/2016 approved the minimum requirements for their operation and a list of commodities that must be purchased through the centralised system. In 2016, on the basis of Government Resolution No. 924/2014, specific commodities also started to be purchased via the system of central state purchases, which is administered for general government entities by the Ministry of Finance and the Ministry of Interior. According to the 2018 Report on the Assessment of Central State Purchasing and Departmental Systems of Centralised Procurement (MF CR, 2019d), central state purchases totalling CZK 1.2 billion were made in 2018. In 2016–2018, the total savings generated by central government purchases amounted to CZK 3.1 billion. In 2018, purchases worth CZK 4.5 billion were made under departmental centralised procurement systems. This system resulted in total savings of CZK 3.3 billion in 2014–2018.

Under Government Resolution No. 487/2019, both systems of centralised public procurement are replaced by "joint procurement", with the aim of spending public funds economically and using administrative capacities efficiently. This system unifies the central state purchasing, the departmental system of centralised procurement, and interdepartmental joint purchasing, enabling a delegating contracting authority to make joint purchases via a central contracting authority on a voluntary basis. Joint purchasing is managed and coordinated by an interdepartmental coordination group under the control of the Ministry of Finance and the Ministry of Interior. This group approves technical standards that are binding for all public contracts carried out by ministries and their subordinate organisations, regardless of who the contracting authority is. Technical standards for passenger cars, office supplies, cleaning services and ICT commodities have been published.

6.2.3 Public Procurement in the Field of Digitalisation and Information Technology

Since 2016, public administration projects related to information and communication technologies have been assessed by the Service of the Chief eGovernment Architect at the Ministry of Interior (Government Resolution No. 889/2015) before a public tender is announced or a contract is signed. Consequently, project authors are not allowed to enter into a contract or to complete the preparation of the tender dossier before receiving an affirmative opinion from that service. This obligation applied to projects with an estimated value of more than CZK 6 million per year, or CZK 30 million over five years, and related to ministries, central administrative authorities, other organisational units of the state, and the Office of the Chamber of Deputies and the Office of the Senate. Because this procedure identifies shortcomings in the submitted projects, inefficiencies in future implementation were avoided to a total amount of approximately CZK 2.7 billion in 2016–2019. According to Government Resolution No. 86/2020, since February 2020 the information obligation has applied to all expenditure related to digitalisation and information and communication technologies, where this expenditure is intended for the acquisition or technical enhancement of a designated public administration information system, or is expected to entail performance exceeding CZK 6 million. The scope of liable entities is also being extended to include organisations or legal persons in respect of which the central administrative authority managed by them acts as a founder or sponsor, or which fall within the competence of that authority, and to subordinate organisational units of the state. The Service of the Chief eGovernment Architect will thus gain an overview of the different systems, which can then be interconnected to exploit various synergies.

6.2.4 Budgetary Rules Act

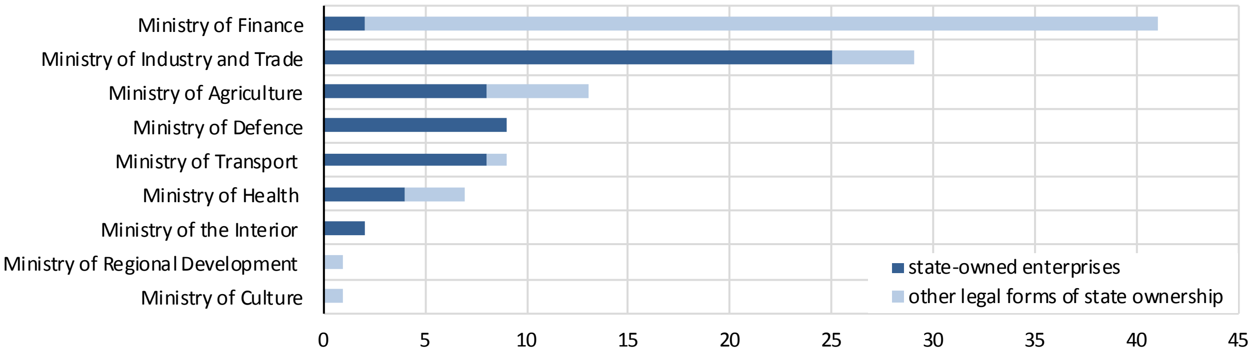
In 2019, the Czech government submitted a draft bill amending Act No. 218/2000 Coll. on budgetary rules to the Chamber of Deputies (Chamber of Deputies Print No. 567). This is a broader amendment to the Act that proposes, among other things, to rationalise state budget spending on the salaries of state employees. The essence of the proposed change is to tie part of the budgetary expenditure to compensation of employees of state organisational units in cases where posts are not occupied; specifically if a position is vacant for all of the calendar days in the calendar month (funds will not be tied to the first month of the vacancy). Vacancies are those that can be filled by an employee, a member of the security corps or a professional soldier and that are budgeted for. However, a position that is not occupied due to an employee’s illness or quarantine will not be treated as a vacancy.

6.2.5 Property of the Czech Republic

In the management of state fixed assets, property worth CZK 1.2 billion was sold or leased in 2019. In 2018, the first ever state electronic auction system for the sale of redundant state movable and immovable property was launched. By the end of 2019, a cumulative amount of CZK 237 million had been generated via the auction system. In 2019, Decree No. 54/2019 Coll. amending Decree No. 62/2001 Coll. on the management of state organisational units and state organisations with state property, as amended, took effect. It requires state institutions to advertise offers of redundant state property via the website of the Office for Government Representation in Property Affairs, thereby centralising all offers of redundant state assets. The number of idle properties registered to defunct or missing state entities is also continuing to decrease thanks to the State Asset Mapping project. To increase efficiency in the use of public funds, the Central Register of Administration Buildings was set up. The system keeps records of all state-owned administration buildings and is helpful in optimising the occupancy of buildings by relocating state institutions to them that had been paying rent to non-public entities. In 2019, there were 83 relocations from private rentals to state buildings leading to savings in rent, operating and maintenance expenses totalling CZK 22 million. Since 2015, 309 relocation plans have been implemented, saving public funds of nearly CZK 150 million per year in rent and more than CZK 42 million in operating and maintenance costs.

In 2020, the government approved the State Ownership Policy Strategy (Government Resolution No. 115/2020), which is based on the Organisation for Economic Cooperation and Development’s Guidelines on Corporate Governance of State-Owned Enterprises (OECD, 2015) and aims to define the principles of state behaviour as the owner or co-owner of companies or state-owned enterprises, and ensure that the state exercises its ownership rights transparently and effectively. According to this Strategy, the state shall own companies only if they are strategically important in order to pursue economic policy objectives, or if they are needed to effectively ensure its functioning or to provide the necessary services to the public. All other companies in which the state has a participating interest or state-owned enterprises should subsequently be privatised or liquidated. The strategic importance of and need for existing companies in which the state has a participating interest and state-owned enterprises will then be continuously evaluated, along with their business strategies.

Graph 6.2.1: Companies in Which the State has a Participating Interest and State-owned Enterprises
No. at the end of 2018



Note: The category "State-owned Enterprise" includes, for simplification, also a National Corporation managed by the Ministry of Agriculture.
Source: CZSO (2020d). MF CR calculations and forecast.

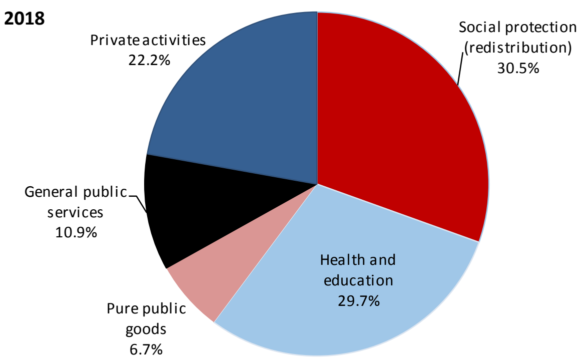
6.3 Composition of General Government Expenditure

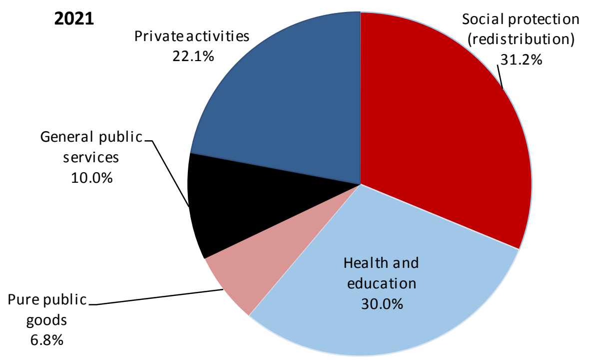
In 2009–2017, with the exception of 2012, the total amount of general government expenditure relative to GDP decreased by an average of 0.6 pp per year. The downtrend in the relative amount of total expenditure versus GDP stopped in 2018, when expenditure grew by 1.8 pp year-on-year. In absolute terms, total expenditure rose by more than CZK 200 billion year-on-year. More than half of this increase was driven by expenditure in the Education section (mainly the compensation of employees and gross fixed capital formation in regional education), in the Social Affairs section (thanks to the growth of cash social benefits in the Old Age group), and in the Health section due to the rise in the compensation of employees in the Hospital Services group.

In 2018–2021, we expect general government expenditure to increase both in absolute terms and relative to GDP (with the exception of 2021). The year-on-year decline in relative expenditure in 2021 is due to the high level of expenditure in 2020, mainly on account of the higher growth of spending in the Social Affairs section (especially in the Old Age, Unemployment, and Family and Children groups) and other various current transfers in connection with the coronavirus pandemic's impact on the economy, and also the decline in the absolute amount of the nominal GDP. In 2021, expenditure relative to GDP should grow by 5.3 pp compared to 2018, and we expect expenditure to increase in all sections (except Recreation and Social Infrastructure, which is expected to stagnate). We estimate that the largest increase will be in the Social Affairs section (by 2.0 pp) mainly due to the increase in cash social benefits. We also predict a significant increase in expenditure in the Health section (by 1.3 pp). In absolute terms, we forecast an average year-on-year growth rate of 7.8% in general government expenditure in 2018–2021, with the highest average contribution to growth being reported in Social Affairs, Health, Economic Affairs and Education.

Graph 6.3.1 shows the structure of expenditure by function relative to total general government expenditure in 2018 and the expected composition thereof in 2021. In 2021, we expect more than half of total general government expenditure to be spent on social security and health care for the population (i.e. 23.4% of GDP, an increase of 3.2 pp compared to 2018).

Graph 6.3.1: Structure of General Government Expenditure, Divided by Function
in % of total expenditure





Note: The category "Pure public goods" includes "Defence" and "Public Order and Security". The category "Private activities" is a sum of "Economic Affairs", "Environmental Protection", "Housing and Community Amenities", and "Recreation, Culture and Religion". For details about the division see ECB (2009).
Source: CZSO (2020d). MF CR calculations and forecast.

7 Changes in the Institutional Framework of Fiscal Policy

A high-quality and credible institutional framework for fiscal and budgetary policy is an essential prerequisite for sound and sustainable public finances. The overall framework for fiscal policymaking is established by clear rules under the Act on the Rules of Fiscal Responsibility. National fiscal rules are compatible with the EU's budgetary discipline requirements for Member States. Measures aimed at extending the competence of the Supreme Audit Office from the point of view of the general government entities it audits, along with the revision of rules on the selection of members of the management and supervisory bodies of legal persons in which the state has a participating interest, should contribute to a further improvement in efficiency. The strengthening of the role played by investments in economic development is symbolised by the creation of the first National Investment Plan for the Czech Republic, as well as the establishment of the National Development Fund.

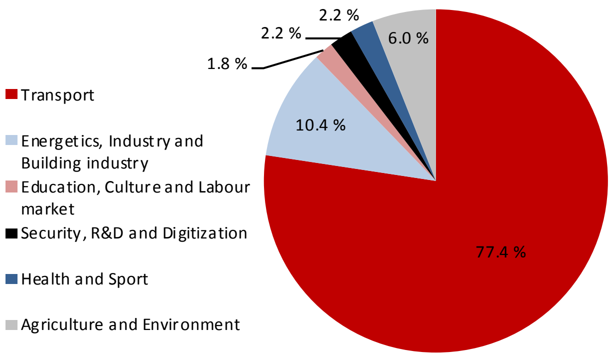
7.1 Changes Related to Investment and the Capital Market

7.1.1 National Investment Plan and National Development Fund

In 2019, the Czech government approved the 2020–2050 National Investment Plan of the Czech Republic (Government Resolution No. 939/2019), which should help to increase the efficiency and economic development of the Czech economy. It encompasses all of the Czech Republic's investment potential feasible up to 2050 and will be interlinked with the Czech Republic's Economic Strategy. It summarises almost 20,000 projects worth a total of approximately CZK 8 trillion, more than three quarters of which deal with transport infrastructure.

Graph 7.1.1: Structure of Investment Projects under the National Investment Plan

in % of planned investment expenditure



Source: Government Office (2019). MF CR adjustment.

Individual projects should gradually be reflected in future state budgets and the budgets of local governments. In 2019, the Government Council on Public Investment (Government Resolution No. 61/2019) was also set up to initiate and oversee the creation of a public investment system and the approval of major strategic projects. A State Expertise Unit will be established to coordinate the preparation of investment projects, the interconnection of individual investors and the creation of methodological and procedural rules for public investment. It will be an advisory body to the Government Council on Public Investment.

In 2019, a memorandum was also concluded between the Czech government and four commercial banks on the establishment of a National Development Fund with the aim of creating conditions for the efficient implementation of long-term public investment projects linked to the Czech Republic's Economic Strategy. Investments are expected to be channelled primarily into transport infrastructure, medical capacities and education. In February 2020, Bohemian-Moravian Guarantee and Development Bank applied to the CNB for a permit to operate the fund (for more details, see Box 2).

7.1.2 Investments of Resources from the Modernisation Fund

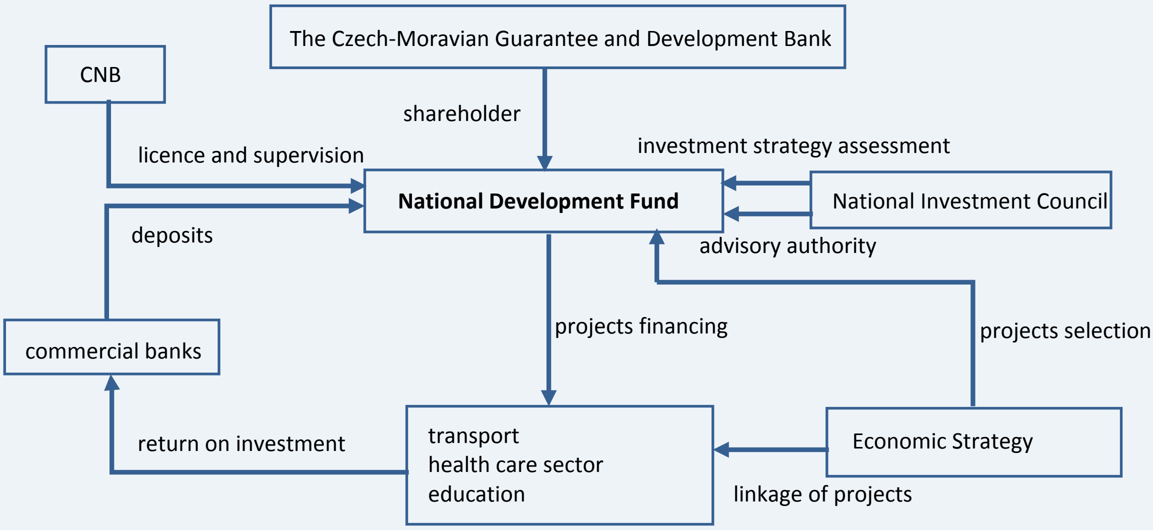
In December 2019, Act No. 1/2020 Coll. amending Act No. 383/2012 Coll., on the conditions of greenhouse gas emission allowance trading, as amended, was approved. This transposes, into Czech law, Directive (EU) 2018/410 of the European Parliament and of the Council of 14 March 2018 amending Directive 2003/87/EC establishing a scheme for greenhouse gas emission allowance trading within the EU. The adoption of the Act introduces the Modernisation Fund, which will be administered by the State Environmental Fund. The resources of the Modernisation Fund will come from all revenues generated by derogation allowances and half of the revenues derived from solidarity allowances. The estimated total volume of revenues for 2021–2030 should be approximately CZK 135 billion. The fund's resources will be used to finance investment projects to reduce emissions, increase energetic efficiency and develop renewable energy sources.

Box 2: Working Principle of the National Development Fund

The first step in establishing the National Development Fund was the signing of a memorandum on 19 September 2019 between the state, Bohemian-Moravian Guarantee and Development Bank and four commercial banks. The fund will be established in accordance with Czech and EU legislation and will function as a structure with a permit to operate under Act No. 240/2013 Coll., on investment companies and investment funds. The Fund will take the form of a joint-stock company with variable capital and will be authorised to accumulate funds, issue investment shares, to be received by the commercial banks and other entities involved in financing, and pursue investments based on an investment strategy. The aim of the fund's investment strategies is, above all, to make a return on investments, to achieve maximum investment efficiency under a particular project, and to increase the yield of the invested funds in order to motivate other investors to join the fund. Investment products will thus complement the private financing available for projects in the public sector. In particular, this will concern subordinated and unsecured debt instruments, and perhaps guarantee products with a higher degree of risk.

A National Investment Council will also be appointed as an advisory body to the fund, with representatives from among the investors, the state and independent experts. The council's activities will include, in particular, assessing investment strategies, running quarterly evaluations of the fund's activities and performance, and nominating members to the fund's bodies.

Graph 7.1.2: Functioning of the National Development Fund



Source: Government of the CR. MF CR adjustment.

7.1.3 Long-term Investment Account

The Ministry of Finance worked out draft bill aimed at implementing legislative measures resulting from the Concept for the Development of the Capital Market in the Czech Republic in 2019–2023, which was approved by the Czech government on 4 March 2019 (Government Resolution No. 156/2019). Among other things, the draft introduces a long-term investment account and an alternative participation fund. The long-term investment account, a new product on the financial market, is an alternative to existing and tax-assisted old-age savings products, such as pension funds and life insurance. Like these products, it is intended to create savings for old age. It is the introduction of a form of "individual savings account". Personal savings accounts of this type are widely used on developed markets and help to motivate investors to build up their savings for old age. In this context, an extension to the Financial Arbitrator's competence is proposed in order to cover long-term investment account managers. Investment opportunities should also be expanded. A new type of participation fund (an "alternative participation fund") is planned to serve as an alternative to existing dynamic funds. The fee policy will be designed to allow pension companies to invest, for example, in private equity funds. In this way, they will be able to offer participants potentially higher returns in the long term, though at the cost of higher risk.

7.2 Increasing Effectiveness and Transparency of Public Finances

7.2.1 Open Data of Public Administration

Open data of public administration have been defined in Czech law since 1 January 2017, when an amendment to Act No. 298/2016 Coll., amending Act No. 106/1999 Coll., on free access to information, as amended, took effect. The list of information to be disclosed is specified in more detail in Government Regulation No. 425/2016 Coll., as amended by Government Regulation No. 184/2018 Coll. Open data is published in a national open data catalogue, managed by the Ministry of Interior. Under Government Regulation No. 425/2016 Coll., information from 24 registers run or administered by state authorities, local governments and their bodies, public institutions and other entities pursuant to Section 2(2) of Act No. 106/1999 Coll. is disclosed mandatorily. With effect from 1 July 2020, the list of information to be disclosed mandatorily as open data should be expanded to include 23 new registers. At present, 39 entities (the Office of the Government of the Czech Republic, 10 ministries, CNB, Czech Radio, the Supreme Audit Office and eight other authorities, eight regions, and 9 municipalities) provide 135,000 datasets to the national open data catalogue on either a mandatory or voluntary basis.

Open data related to public finances is primarily disclosed by the Ministry of Finance, with 57 datasets currently published (e.g. data from the Central Register of Subsidies, the Central Register of Administrative Buildings, and an overview of checks in the field of electronic registration of sales). The open data also includes Monitor, an information portal that provides data on budgetary and accounting information from all levels of state administration and local governments, including illustrative graphical outputs.

7.2.2 Nomination Act

With the adoption of the Nomination Act (Act No. 353/2019 Coll.), from January 2020, persons are selected for the management and supervisory bodies of legal persons in which the state has a participating interest (this concerns companies in which the state has a participating interest, state and national enterprises, and the Railway Administration) transparently based on objective criteria and under public scrutiny. The criteria consist mainly of setting up selection procedures for management bodies and a nomination process for supervisory bodies. Individual nominations made by the ministry responsible for the given legal person in which the state has a participating interest are reviewed by the Nomination Committee established by the government. This is an advisory body to the Czech government – the government appoints and removes committee members according to statutory conditions. The committee's individual assessments are recommendations, i.e. they are not binding on the Czech government. However, for the sake of transparency the whole selection process or nomination of persons and their subsequent assessment must be documented and published.

7.2.3 Supreme Audit Office Act

In December 2018, the Czech government approved a draft bill amending Act No. 166/1993 Coll., on the Supreme Audit Office, as amended (Chamber of Deputies Print No. 360). This law will be an implementing regulation for an amendment to the Constitution of the Czech Republic, currently under discussion, that extends the constitutional framework of supervisory competence wielded by the Supreme Audit Office. The aim of the amendment is for audited entities to include local governments, health insurance companies, public universities, legal persons majority-owned or controlled by the state or a local government, etc. In parallel with the government draft bill, a Chamber of Deputies draft amendment to the Act on the Supreme Audit Office (Chamber of Deputies Print No. 230) was submitted to the Czech Parliament, but it does not cover all entities. Furthermore, the Chamber of Deputies Print No. 626 proposes to extend the Supreme Audit Office's powers to include the auditing of the management of the Czech Television and Czech Radio properties.

7.2.4 Budgetary Rules Act

The government draft amendment to the Budgetary Rules Act (Chamber of Deputies Print No. 567) aims to make a change relating to the withdrawal of subsidies or repayable financial assistance. When a final decision is taken to withdraw a subsidy, any claim to the release of funds not yet paid would be lost. In addition, it would be possible to order the return of part of a subsidy already provided if it is discovered that the decision to grant a subsidy or repayable financial assistance was issued in contravention of national or EU law.

A Chamber of Deputies' draft amendment to the Budgetary Rules Act and the Act on Budgetary Rules of Municipalities (Chamber of Deputies Print No. 319) changes the conditions applicable to those applying for subsidies. The draft includes an obligation to identify the beneficial owner of an applicant for public assistance if the applicant is a legal person. This identification procedure is to be carried out by the subsidy provider. If it is impossible to identify an applicant's beneficial owners on the basis of the registration thereof, public aid cannot be granted. The requirement for beneficial owners to be registered is linked to an amendment to Act No. 304/2013 Coll., on public registers of legal and natural persons, as amended (Chamber of Deputies Print No. 318).

7.2.5 Public Spending Review Project

In its efforts to engage in public spending as efficiently, economically and effectively as possible, the Ministry of Finance has joined EU project focused on spending review. Under the project, the Ministry of Finance will cooperate with the Organisation for Economic Cooperation and Development. The first phase of the project will primarily involve the sharing of information on experience of this instrument in other countries and the development of methodology. A pilot review will then be carried out in a selected area of public expenditure in order to gain practical experience. Afterwards, the review will be extended to other areas of expenditure. The Organisation for Economic Cooperation and Development will also prepare recommendations for the Ministry of Finance on how to implement spending reviews in individual stages of the budgetary process, especially in the preparation of the state budget. It is estimated that the project will last for 18 months, starting in March 2020, when the project was officially approved.

7.3 Budgetary Policy

7.3.1 Use of the State Budget Surplus

In July 2019, the Czech government approved a draft bill amending Act No. 218/2000 Coll., on Budgetary Rules and Amending Certain Related Acts, as amended (Chamber of Deputies Print No. 567). The amendment includes a proposal which, with effect from 1 January 2021, stipulates that any state budget surplus should be used exclusively to reduce the state debt. If the state budget reports a deficit, the procedures to cover that deficit remain unchanged.

7.3.2 Amendment to the Act on the Rules of Fiscal Responsibility

In 2020, the Czech economy is very likely to experience an unprecedented slump. This will result in significant public finance deficits, to which it will be impossible to respond by means of the traditional scheme of fiscal rules. If the current situation is not addressed, in 2021 the government would be forced to carry out fiscal restrictions running to hundreds of billions of koruna. Besides being unrealistic, such restrictions would, naturally, very probably trigger another recession. Therefore, it has been necessary to adopt an amendment to Act No. 23/2017 Coll., on the Rules of Fiscal Responsibility, as amended (Act No. 207/2020 Coll.), and to modify the procedure for deriving expenditure frameworks for the state budget and the budgets of state funds. The aim of the Act is to mitigate the consolidation efforts of public finances, and by extension the state budget, after 2020. It is hence proposed that, for 2021, a fiscal space of up to 4% of GDP be created and that public finances subsequently be consolidated by at least 0.5 pp year-on-year in accordance with the provisions of Council Regulation (EC) No. 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, as amended. This trajectory should ensure gradual convergence towards the current level of the Czech Republic's medium-term budgetary objective and its secure achievement in 2028, without endangering the economy with an excessive one-off negative fiscal shock.

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Table Annex

Table A.1a: Macroeconomic Prospects

levels in CZK billions, growth in %, contributions to growth in percentage points

	ESA Code	2019	2019	2020	2021
		Level	*Rate of change*		
Real GDP	B1*g	5460	2.6	-5.6	3.1
Nominal GDP	B1*g	5653	6.2	-2.2	4.5
Components of real GDP					
Private consumption expenditure	P.3	2603	3.0	-1.5	0.8
Government consumption expenditure	P.3	1086	2.6	2.6	2.0
Gross fixed capital formation	P.51g	1402	2.8	-13.6	3.2
Changes in inventories and net acquis. of valuables (% of GDP)	P.52+P.53	44	0.8	0.1	0.7
Exports of goods and services	P.6	4226	1.2	-17.0	6.8
Imports of goods and services	P.7	3900	1.7	-16.8	6.3
Contributions to real GDP growth					
Final domestic demand		-	2.7	-3.6	1.6
Changes in inventories and net acquis. of valuables	P.52+P.53	-	0.2	-0.8	0.8
External balance of goods and services	B.11	-	-0.3	-1.2	0.7

Note: Real levels are in 2018 prices. Changes in inventories and net acquisition of valuables on the sixth row express change in inventories as a per cent of GDP in current prices. The contribution of the change in inventories and net acquisition of valuables is calculated from real values.
Source: CZSO (2020a), MF CR (2020a). MF CR calculations and forecast.

Table A.1b: Price Developments

indices 2010=100, growth in %

	2019	2019	2020	2021
	Level	*Rate of change*		
GDP deflator	116.4	3.5	3.7	1.4
Private consumption deflator	114.4	3.0	3.2	1.6
Harmonised index of consumer prices	116.4	2.6	3.2	1.5
Public consumption deflator	125.4	5.4	3.1	2.0
Investment deflator	111.3	2.7	2.8	1.1
Export price deflator (goods and services)	105.5	1.0	3.2	-0.2
Import price deflator (goods and services)	104.1	0.6	2.3	-0.4

Source: CZSO (2020a), Eurostat (2020). MF CR calculations and forecast.

Table A.1c: Labour Market Developments

growth in %

	ESA Code	2019	2019	2020	2021
		Level	*Rate of change*		
Employment (thous. of persons)		5454.9	0.7	-1.7	-0.2
Employment (bn. hours worked)		9.8	0.8	-1.6	-0.2
Unemployment rate (%)		2.0	2.0	3.3	3.5
Labour productivity (thous. CZK/person)		1001.0	1.9	-4.0	3.2
Labour productivity (CZK/hours)		558.3	1.8	-4.1	3.2
Compensation of employees (bn. CZK)	D.1	2454.9	7.1	2.6	0.8
Compensation per employee (thous. CZK/person)		523.1	6.2	4.0	0.9

Note: Employment and compensation of employees are based on domestic concept of national accounts. Unemployment rate is based on the Labour Force Survey methodology. Labour productivity is calculated as real GDP (in 2018 prices) per employed person or hour worked.
Source: CZSO (2020a, 2020c). MF CR calculations and forecast.

Table A.1d: Sectoral Balances

in % of GDP

	ESA Code	2019	2020	2021
Net lending/borrowing vis-à-vis the rest of the world	B.9	**1.1**	**1.7**	**1.8**
Balance of goods and services		6.1	5.9	6.0
Balance of primary incomes and transfers		-5.4	-4.7	-4.8
Capital account		1.0	1.0	1.2
Net lending/borrowing of the private sector	B.9	**0.8**	**6.8**	**5.9**
Net lending/borrowing of general government	B.9	**0.3**	**-5.1**	**-4.1**
Statistical discrepancy		**0.0**	**0.0**	**0.0**

Note: Data from national accounts. Net lending/borrowing of the general government for 2019–2020 based on notification, for 2021 outlook.
Source: CZSO (2020b). MF CR calculations and forecast.

Table A.2a: General Government Budgetary Prospects

level in CZK billion, others in % of GDP

	ESA Code	2019	2019	2020	2021
		Level	*In % of GDP*		
Net lending (+)/borrowing (-) (B.9) by sub-sectors					
General government	S.13	**15**	**0.3**	**-5.1**	**-4.1**
Central government	S.1311	-32	-0.6	-5.3	-4.3
State government	S.1312	-	-	-	-
Local government	S.1313	36	0.6	0.2	0.2
Social security funds	S.1314	11	0.2	0.0	0.0
General government (S.13)					
Total revenue	TR	**2381**	**42.1**	**41.8**	**42.5**
Total expenditure	TE	**2366**	**41.9**	**46.9**	**46.6**
Net lending (+)/borrowing (-)	B.9	**15**	**0.3**	**-5.1**	**-4.1**
Interest expenditure	D.41	41	0.7	0.9	1.0
Primary balance		56	1.0	-4.2	-3.1
One-off and other temporary measures		**0**	**0.0**	**-2.2**	**0.0**
Components of revenues					
Total taxes		**1172**	**20.7**	**19.4**	**20.0**
Taxes on production and imports	D.2	689	12.2	12.2	12.4
Current taxes on income, wealth etc.	D.5	482	8.5	7.2	7.6
Capital taxes	D.91	0	0.0	0.0	0.0
Social security contributions	D.61	**895**	**15.8**	**16.6**	**16.9**
Property income	D.4	**32**	**0.6**	**0.6**	**0.5**
Other		**282**	**5.0**	**5.2**	**5.1**
Total revenue	TR	**2381**	**42.1**	**41.8**	**42.5**
p.m.: Tax burden		**2067**	**36.6**	**36.0**	**36.9**
Components of expenditures					
Compensation of employees + Intermediate consumption	D.1+P.2	**913**	**16.1**	**17.5**	**17.7**
Compensation of employees	D.1	574	10.2	11.0	11.1
Intermediate consumption	P.2	338	6.0	6.5	6.6
Social payments		**883**	**15.6**	**17.7**	**18.3**
of which: Unemployment benefits [1)]		10	0.2	0.3	0.3
Social transfers in kind supplied via market producers	D.632	176	3.1	3.4	3.4
Social transfers other than in kind	D.62	707	12.5	14.3	14.8
Interest expenditure	D.41	**41**	**0.7**	**0.9**	**1.0**
Subsidies	D.3	**130**	**2.3**	**2.6**	**2.5**
Gross fixed capital formation	P.51g	**248**	**4.4**	**4.4**	**4.6**
Capital transfers	D.9	**32**	**0.6**	**0.6**	**0.6**
Other		**120**	**2.1**	**3.1**	**2.0**
Total expenditures	TE	**2366**	**41.9**	**46.9**	**46.6**
p.m.: Government consumption (nominal)	P.3	**1145**	**20.2**	**21.9**	**22.0**

Note: Years 2019–2020 notification. Year 2021 outlook.

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

Source: CZSO (2020b). MF CR calculations and forecast.

Table A.2c: Amounts to Be Excluded from the Expenditure Benchmark

level in CZK billion, others in % of GDP

	2019	2019	2020	2021
	Level	*In % of GDP*		
Expenditure on EU programmes fully matched by EU funds revenue	**64**	**1.1**	**1.2**	**1.1**
Non-investment expenditure	20	0.3	0.4	0.3
Investment expenditure	44	0.8	0.8	0.8
Cyclical unemployment benefit expenditure	**-1**	**0.0**	**0.1**	**0.0**
Effect of discretionary revenue measures (year-on-year changes)	**13**	**0.2**	**0.4**	**0.1**
Revenue increases mandated by law	**-**	**-**	**-**	**-**

Note: Revenue increases mandated by law can be defined as revenue increases that occur automatically to offset corresponding increases in specified expenditures (such as an automatic increase of social security contributions in reaction to a surge in social security expenditure).
Source: MF CR.

Table A.3: General Government Expenditure by Function

in % of GDP

	Code	2018	2021
General public services	1	**4.5**	**4.6**
Defence	2	**0.9**	**1.1**
Public order and safety	3	**1.9**	**2.0**
Economic affairs	4	**6.0**	**6.9**
Environmental protection	5	**0.9**	**1.0**
Housing and community amenities	6	**0.8**	**0.9**
Health	7	**7.6**	**8.9**
Recreation, culture and religion	8	**1.5**	**1.5**
Education	9	**4.6**	**5.1**
Social protection	10	**12.6**	**14.5**
Total expenditure	TE	**41.2**	**46.6**

Note: Year 2023 outlook.
Source: CZSO (2020d), MF CR (2020a). MF CR calculations and forecast.

Table A.4: General Government Debt Developments

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

	ESA Code	2019	2020	2021
General government gross debt		**30.8**	**37.0**	**40.0**
Change in gross debt ratio		**-1.8**	**6.2**	**3.1**
Contributions to changes in gross debt				
Primary balance		**1.0**	**-4.2**	**-3.1**
Interest expenditure	D.41	**-0.7**	**-0.9**	**-1.0**
Stock-flow adjustment		**0.3**	**0.4**	**0.6**
Difference between cash and accruals		**0.0**	**0.0**	**0.0**
Net accumulation of financial assets		**0.4**	**0.4**	**0.6**
Privatisation proceeds		**0.0**	**0.0**	**0.0**
Valuation effects and other		**0.0**	**0.0**	**0.0**
p.m.: Implicit interest rate on debt		**-2.3**	**-2.4**	**-2.4**
Liquid financial assets		**14.5**	**15.2**	**15.1**
Net financial debt 1)		**16.3**	**21.8**	**24.9**
Debt amortization (existing bonds) since the end of the previous year 2)		**4.3**	**3.4**	**6.8**
Foreign-currency exposition of the state debt 2), 3)		**2.9**	**3.1**	**2.9**
Average maturity 2)		**6.2**	**5.6**	**5.8**

1) Net financial debt is a difference between gross debt and liquid financial assets (monetary gold, Special Drawing Rights, currency and deposits, securities other than shares (consolidated at market value), shares and other equity quoted in stock exchange).
2) Figures only for the state debt. The state debt represents a debt generated by the state budget financing.
3) The foreign-currency exposure of the state debt is debt denominated in foreign currency, which is exposed in term of foreign-currency Exchange rate movement after being adjusted for the foreign-currency exposure of state financial assets.
Source: CZSO (2020b). State debt data MF CR. MF CR calculations and forecast.

Table A.7: Long-term Sustainability of Public Finances

expenditures and revenues in % of GDP, growth and rates in %

	2016	2020	2030	2040	2050	2060	2070
Total expenditure	39.9	41.2	42.4	43.9	46.8	49.6	50.0
of which: **Age-related expenditures**	18.1	18.3	19.5	21.1	23.4	25.1	24.3
Pension expenditure	8.2	8.1	8.2	9.2	10.8	11.6	10.9
Social security pensions	8.2	8.1	8.2	9.2	10.8	11.6	10.9
Old-age and early pensions	6.8	6.7	6.8	7.7	9.4	10.2	9.5
Other pensions	1.4	1.4	1.4	1.5	1.5	1.5	1.5
Occupational pensions	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Health care	5.4	5.6	5.9	6.2	6.5	6.6	6.5
Long-term care	1.3	1.4	1.8	2.1	2.4	2.8	2.9
Education expenditure	3.2	3.2	3.7	3.6	3.7	4.1	4.0
Other age-related expenditures	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Interest expenditure	0.9	0.8	0.6	0.5	1.1	2.2	3.4
Total revenue	40.7	42.2	42.5	42.5	42.5	42.5	42.5
of which: **Property income**	0.8	0.5	0.5	0.5	0.5	0.5	0.5
of which: **Pension contributions**	7.9	7.9	7.9	7.9	7.9	7.9	7.9
Pension reserve fund assets	0.5	0.0	0.0	0.0	0.0	0.0	0.0
of which: **Consolidated public pension fund assets**	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Systemic Pension Reforms							
Social contributions diverted to mandatory private scheme	-	-	-	-	-	-	-
Pension expenditure paid by mandatory private scheme	-	-	-	-	-	-	-
Assumptions							
Labour productivity growth	1.1	2.0	2.0	1.9	1.7	1.6	1.5
Real GDP growth	2.4	1.6	1.8	1.1	1.1	1.5	1.4
Participation rate of males (aged 20–64)	87.7	87.9	87.0	85.6	86.8	87.5	86.4
Participation rate of females (aged 20–64)	72.0	72.9	73.7	71.8	72.7	74.3	73.0
Total participation rate (aged 20–64)	80.0	80.5	80.4	78.8	79.8	81.0	79.8
Unemployment rate	4.0	3.2	4.2	4.2	4.2	4.2	4.2
Population aged 65+ over total population	18.6	20.3	22.6	25.7	29.1	30.4	28.3

Note: Macroeconomic assumptions are based on long-term projections of the EC and can differ from the medium-term macroeconomic scenario presented in Chapter 2.

Source: EC (2017a, 2018c). MF CR calculations.

Table A.7a: Contingent Liabilities

in % of GDP

	2019
General government sector guarantees	0.1
of which: Linked to the financial sector	0.0

Source: MF CR.

Table A.8: Basic Assumptions

interest rates and growth in %

	2019	2020	2021
Short-term interest rate (CZ) (annual average)	2.1	0.8	0.3
Long-term interest rate (CZ) (annual average)	1.5	1.5	1.5
Nominal effective exchange rate (2010=100)	108.9	105.3	106.6
Exchange rate CZK/EUR (annual average)	25.7	26.5	26.2
World excluding EU, GDP growth	3.8	3.8	3.9
EU GDP growth	1.5	-5.5	2.8
Growth of relevant foreign markets	1.9	-14.7	5.4
World import volumes, excluding EU	3.9	3.6	3.4
Oil prices (Brent, USD/barrel)	64.3	37.9	39.8

Source: CNB (2020a), EIA (2020), Eurostat (2020a). MF CR calculations and forecast.

Glossary of Terms

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

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

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

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

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

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

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

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

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

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

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

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

Fiscal sustainability indicators, proceeding from long-term projections based on demographic and macroeconomic assumptions by the Eurostat and the EC, highlight potential problems in the sustainability of public finances and the extent of the necessary changes. The EC uses three main indicators, S0, S1 and S2. **Indicator S0** is a composite indicator consisting of 28 macro-financial and fiscal indicators and is to detect fiscal risks for the short-term horizon (coming year). **Indicator S1** indicates by how many percent of GDP the primary structural balance must be improved from that year (usually from the year following the EC prediction horizon) for a period of time (usually 5 years) to make the general government sector debt reach 60% of GDP in 2030. **Indicator S2** indicates by how many percent of GDP the primary structural balance must be permanently (from the given year) improved to make the general government debt remain stable in an infinite time horizon (i.e. the condition of intertemporal government budget constraint is fulfilled that the current value of primary balances is equal to the current general government debt).

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

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

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

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

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

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

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

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

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

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

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

PRIBOR 3M is the reference value for the interest rate indicating the average rate, for which banks can borrow on the market for interbank deposits with a maturity of three months.

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

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

Structural balance is the difference between cyclically adjusted balance, and one-off and temporary measures (for both components see above).

Total fertility rate is defined as the number of live-born children per 1 woman, if her fertility throughout her entire reproductive period remained the same as in that year.

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

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