



# Convergence Programme

## Czech Republic

(updated version)

March 2007

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# 1 Introduction

In accordance with the Stability and Growth Pact<sup>1</sup> and as part of the multilateral fiscal surveillance<sup>2</sup>, the Czech Republic hereby submits the updated Convergence Programme (the “CP”). Due to the recent political developments, this year’s update is of a specific character. In June 2006, parliamentary elections took place in the Czech Republic for the Chamber of Deputies. Long and complicated negotiations on the new government had taken place as a result of the close results of the elections. The first government, which was formed in September 2006 by the winner of the elections (Civic Democratic Party – ODS), did not receive a vote of confidence. This did not occur until the second government in January 2007, which was set up as a coalition of ODS, the Christian Democrats and the Green Party.

The submitted CP update was prepared by the first government in November 2006 on the basis of binding legal regulations in accordance with the approved State Budget for 2007, the Medium-Term Budgetary Outlook for 2008 to 2009, the updated National Reform Programme of the Czech Republic and the National Strategic Reference Framework. The update was based on the autumn notifications of the general government deficit and debt and the government macroeconomic forecast, which was used as a macroeconomic framework for the 2007 State Budget and its medium-term outlook. However, as mentioned above, this government did not receive a vote of confidence and thus it did not submit the programme.

Due to time constraints, the new, second government accepted the update and supplemented it with the strategic fiscal objectives of its government declaration, which are presented in Section 9. It should be stressed that the quantitative scenario of fiscal development in Sections 4, 6 and 7 is based on binding legal regulations and comes from the assumption of sustaining the approved budgetary outlook and expenditure frameworks. Section 9 contains the thus far non-quantified objectives of the new government, whose goal is to speed up fiscal consolidation in 2008-2009. These measures will be incorporated into the draft state budget for 2008 and hence will be contained in the next CP update.

Fiscal policy was loosened last year as a consequence of the political cycle, and in spite of a favourable economic period, the Czech Republic will not manage this year to meet the trajectory for lowering the excessive deficit, as recommended by the Council in 2004 and confirmed during the last CP update.

The new government, however, has taken on the ambitious goal of consistent fiscal consolidation to not only halt the adverse development of public finances, but also to reverse this process, especially in the area of mandatory expenditures. Moreover, it is also aware of the need for long-term stabilisation of public finances, which, on the basis of wide political consensus, requires a swift reform of the pension and healthcare systems.

The submitted update was discussed in the relevant committees of both chambers of the Czech Parliament. Last year’s recommendations were submitted to the Czech Parliament for information purposes as a part of the draft state budget for 2007.

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<sup>1</sup> Council Regulation (EC) 1466/97 as amended by Council Regulation (EC) 1055/05

<sup>2</sup> See Article 99 of the Treaty establishing the European Community.

## 2 Economic Policy

### 2.1 Objectives

One of the key objectives of the government's economic policy is the prosperity and stability of the economy. It intends to achieve this by increasing the economy's competitiveness in the context of EU economic integration and globalisation, by promoting long-term sustainable economic growth and by increasing employment. A stable and predictable macroeconomic environment is an essential condition for attaining this objective.

### 2.2 Priorities

#### Fiscal policy

The main priority of the Czech Republic in the macroeconomic area is the consolidation of public finances. Fulfilling the obligation to eliminate the unfavourable public budget deficit tendency implied from the EU fiscal rules is a condition for the successful functioning of the economy after joining the monetary union and contributes to the long-term sustainability of public finances. Despite continued favourable economic growth, there is currently a delay in the originally planned trajectory. In this respect, a priority of fiscal policy is to return to the trend of reducing the public finance deficit as quickly as possible in a sustainable way.

On condition that the same deficit reduction rate is maintained at least at a minimum level of fiscal effort, the Czech Republic could achieve its medium-term budgetary target of -1.0% of GDP by 2013.

#### Monetary policy

Monetary policy aims at sustaining low and stable price growth. Since 1 January 2006, the inflation target has been defined as a 3% year-on-year rise in the CPI with a maximum deviation of plus/minus one percentage point on both sides. This established target maintains the desired space for a slightly positive inflation differential vis-à-vis EU countries. Such target has been met during the past four quarters, and the outlook for the near future is also favourable.

The Czech Republic is preparing to join the Eurozone. Preparations for membership were formally launched in the autumn of 2003 with the adoption of the Czech Republic's Strategy for Eurozone Accession. On the basis of this document, an assessment is made every year on compliance with the Maastricht criteria and on whether the country is prepared for accession.

This year's assessment has indicated that the long-term stabilisation of the general government sector has not been maintained at a level significantly below the 3% reference value. The analyses of the economy's alignment with the Eurozone confirmed that progress is being made in real economic convergence. The traditional weak spot is the labour market's flexibility. The substantial difference in the cyclical development of GDP between the Czech Republic and the Eurozone and in prices levels still persists.

In this respect, a decision was made not to join the ERM II system next year.

As for monetary policy, it was also said that it might be necessary — as soon as there is a political agreement about the date of introducing the euro — to significantly reduce the inflation target set by the Czech National Bank (the “CNB”) from the current rate of 3% in order to safely meet the criterion of price stability in the strict sense of this term as interpreted by the European Commission and the European Central Bank.

### Structural policies

Structural reforms cover a wide spectrum of microeconomic policies that are particularly targeted in the area of competition (the business environment, research and development, innovation, sustainable use of resources, modernisation and development of transport and the ICT network) and the labour market (a flexible market, market integration, education). The Czech Republic’s National Reform Programme (i.e. the National Lisbon Programme 2005–2008) contains a comprehensive overview of the priorities in these areas.

On 25 October 2006, the government approved the first Report on Implementation of the National Lisbon Programme 2005–2008. The Report indicates that progress has been made on improving the legal and business environment (introducing the assessment of the effects of newly adopted legislation, setting up central registration points for entrepreneurs, and adopting a new insolvency act) and promoting employment growth.

In accordance with the government’s objective, public budget expenditures for research and development are gradually increasing and the networking of innovative activities between research institutions, higher education facilities and business is improving.

Reducing the two lowest rate categories for personal income tax and replacing the standard deductible entries with tax credits contributed to a gradual rise in employment for the lower-income group.

The number of study programmes at higher professional schools and universities had increased, and a new regulation promoting life-time education was adopted.

## 3 Macroeconomic Scenario

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

### 3.1 The World Economy and Technical Assumptions

#### The world economy<sup>3</sup>

The state of the external environment of the Czech economy can be summarised as follows:

- The state of the world economy is favourable at this time. The Asian economies, especially China and India, have contributed significantly to global dynamics. Growth in the USA has slightly declined.
- Growth in economic output has accelerated in the EU as well and has reached its highest values since 2000 (2.9% in the EU-25 for Q2 2006). Household consumption and gross fixed capital formation have contributed the most. The enlargement process has a positive impact on the EU as an economic whole. New member states are growing faster than the older members. Free movement of goods and capital with the new member states, more opportunities for cooperation and increased labour force mobility in the enlarged EU have shown to be pro-growth factors.
- The global business cycle is not restricted, even by high commodity prices. USD crude oil prices reached the highest nominal level in history; the average for Q3 2006 was USD 70.1 per barrel of Brent oil.

GDP growth in the EU-25 should be driven in particular by net export and investments during the upcoming period 2007 to 2009. Additional EU enlargement will be a positive stimulus.

A new multi-year EU financial framework up to 2013 will come into effect starting in 2007. For the new member states, this means a significant rise in resources from structural funds and the Cohesion Fund.

We assume that the peak oil price has already been reached, and in 2007, there will be a decline below USD 60/barrel. However, the overall decline will not be substantial due to high demand in developing Asian economies.

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<sup>3</sup> For technical reasons, it was not possible to use the “common assumptions on the external environment” in preparing the CP. The Spring EC Forecast published in May 2005 was already outdated and the assumptions of the Autumn Forecast were not yet known at the time of preparing the macroeconomic scenario (September 2005). Therefore, the CP was supplemented by a sensitivity analysis of certain macro-indicators based on the exogenous variables in Section 5.



**Table 3.1: Assumptions on the external environment**

		Year 2005	Year 2006	Year 2007	Year 2008	Year 2009
<b>USD/EUR exchange rate</b>	<i>(annual average)</i>	1,24	1,25	1,26	1,26	1,26
<b>EU-25 GDP</b>	<i>(real GDP growth, y/y, in %)</i>	1,7	2,7	2,2	2,3	2,4
<b>Germany GDP</b>	<i>(real GDP growth, y/y, in %)</i>	0,9	2,2	1,4	1,8	2,2
<b>Oil prices</b>	<i>(Brent, USD/barrel)</i>	54,4	67,5	59,8	55,0	52,0

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

Any unpredictable event with global impact further escalating the geopolitical climate and the instability of world commodities and financial markets could be a potential risk to this favourable scenario. Another risk, which causes exchange rate uncertainty, is the expanding current account deficit in the USA.

As for the impact on the Czech economy, the growing dynamics of GDP indicate that the advantages associated with joining the EU common market and with improving the institutional environment have paid off. The favourable effect of the external environment, including declining oil prices, should help to promote positive macroeconomic development in the Czech Republic in the future.

### Technical assumptions

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

In the exchange rate area, the scenario is based on the assumption of a continued long-term trend towards real exchange rate appreciation, which continues with practically no interruption throughout the transition process alongside real convergence. From 1999 to 2005, the real exchange rate vis-à-vis the euro (deflated by the GDP deflator) appreciated on average by about 6% per year. From 2006 to 2009, we expect average real appreciation of around 4% per year, which during low inflation, would tend to cause nominal appreciation of the CZK/EUR exchange rate.

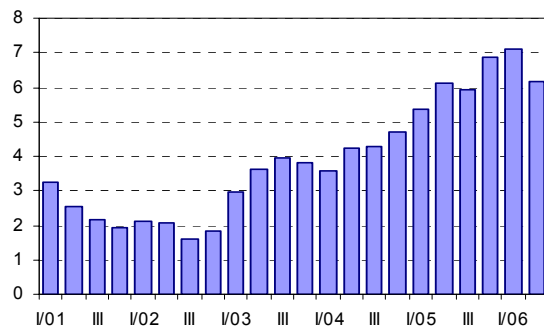
## 3.2 Current Macroeconomic Development<sup>4</sup>

For the sixth quarter in a row, year-on-year growth of the Czech economy has exceeded 5%, reaching 6.6% in the first half of 2006. In 2005, net export's contribution to GDP growth was at 4 percentage points, which is not only a record level for the Czech Republic, but also an exceptional achievement in comparison with other countries. Domestic demand's contribution will be more perceptible in 2006, particularly investments.

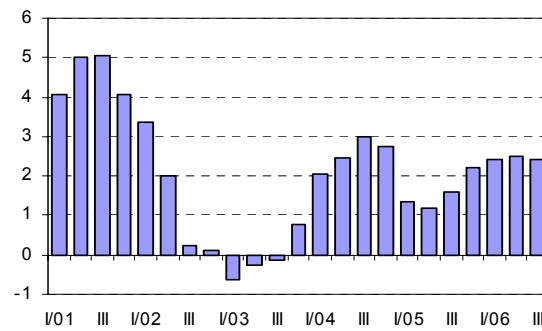
<sup>4</sup> Based on the available data as of 15 October 2006

**Chart 3.1: Real GDP**

y-o-y growth in %

**Chart 3.2: Inflation rate (HICP)**

y-o-y growth in %

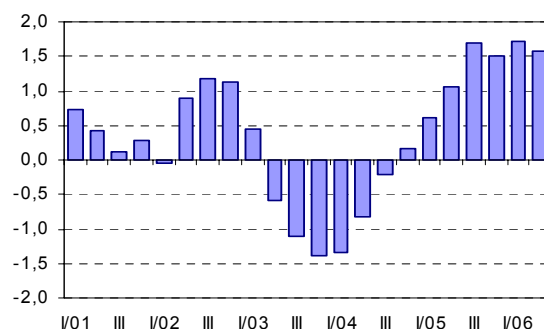


Source: Czech Statistical Office

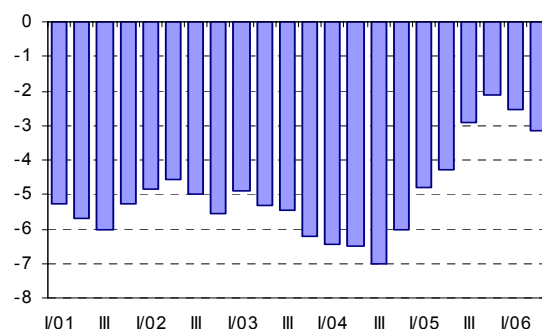
In 2005, the low-inflationary environment in the Czech Republic was reflected in an average annual inflation rate of 1.6% (based on the HICP). The slight acceleration in inflation for 2006 was prompted by administrative measures and especially energy and food prices. In September 2006, the HICP reached 2.2% year-on-year. The effects of the record world prices for raw materials are partially offset by the strengthening CZK exchange rate. The highly competitive environment on the consumer market also plays a significant role.

**Chart 3.3: Employment (according to LFS)**

y-o-y growth in %

**Chart 3.4: Current account/GDP**

in %



Source: Czech Statistical Office, Czech National Bank  
LFS = Labour Force Survey

Moreover, labour market development is positive. Employment, according to the Labour Force Survey, has increased since Q4 2004. In Q2 2006, employment growth reached 1.6%, while the most significant increase was registered in the manufacturing industry. The dynamic growth of labour productivity continued. Since reaching its peak in Q1 2004 (8.7%), the unemployment rate has continually declined to 7.1% in Q2 2006. The main cause of this decline is cyclical development. The improvements in the structural characteristics of the labour market are apparently only limited in nature.

The external balance has been improving since Q3 2004. In Q2 2006, the current account deficit reached 3.1% of GDP. The main factor behind this development is the improvement in the trade balance as a result of the free movement of goods within the EU and export-oriented investments. Despite the adverse effect of high prices for oil and metals on world markets, the trade balance registered a surplus of 1.2% of GDP in Q2 2006.

### 3.3 The Medium-Term Scenario

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

The dynamisation of economic growth is structural as well as cyclical in nature. According to our estimate based on the Cobb-Douglas production function<sup>5</sup>, the growth rate of potential GDP has significantly accelerated since 2000 and is currently around 5% according to our calculations.

The main factor behind this is accelerated growth of the trend components of total factor productivity. In addition, the negative output gap had closed in mid-2005, and economic output is now ca 1% above potential GDP.

Chart 3.5: Output gap

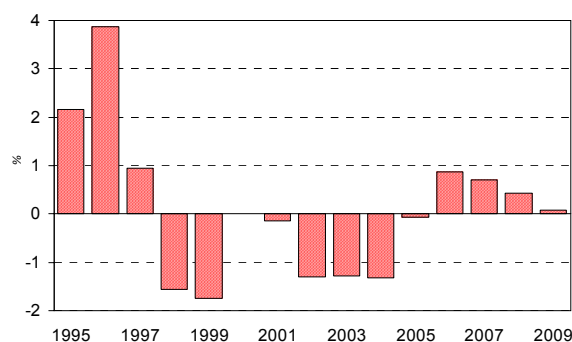
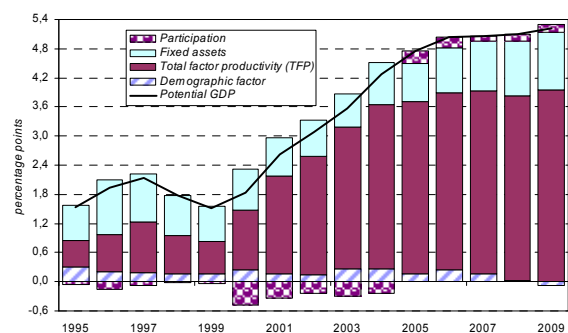


Chart 3.6: Potential GDP growth



Source: Calculations of the Ministry of Finance

We do not believe that it is possible to maintain such acceleration of potential GDP growth during the CP horizon. Therefore, the programme's scenario is based on the assumption that the rate of potential growth will only slightly increase and reach 5.2% in 2009 due to higher total factor productivity. Productivity growth should in particular be generated from an improvement in the institutional parameters of the economy and the quality of the business environment as well as from introducing new technology associated with an inflow of foreign direct investment. The ongoing integration into the EU economic structures continues to be a long-term growth factor.

The contributions of fixed assets stocks and the labour force have remained stable. The declining benefit of demographic development will be offset by a rising participation rate.

Structural policy measures could help to accelerate the growth rate of potential GDP above the projected dynamics. However, there is also a perceptible risk of development in the opposite direction relating to possible complications on the commodities markets or on the markets of our trade partners. A significant risk is posed by public finances.

We assume that macroeconomic policies will be set in such a way that economic performance at the end of the period in 2009 will be near the level of potential GDP.

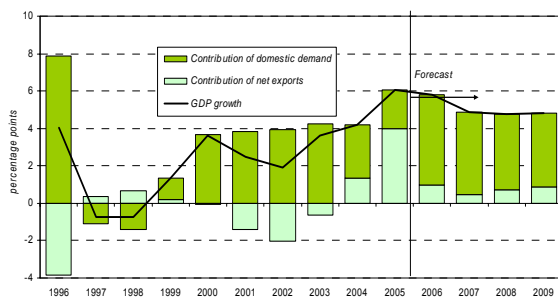
<sup>5</sup> Calculations of potential GDP and the output gap are currently made using the national methodology described in the 2002 Pre-Accession Economic Programme. The main distinction from the European Commission's method, important for interpreting the results, is the use of the clause "zero sum of output gaps over time".

## GDP and the demand side

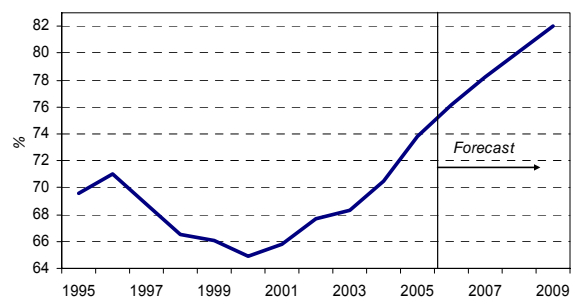
Real GDP growth will be in a range of 4.8% in the period up to 2009. Domestic demand should contribute to growth of around four percentage points. The contribution from the foreign trade balance should remain positive.

The growth trajectory of potential GDP implies that the process of economic convergence with the neighbouring advanced EU countries will continue. The Czech Republic's economic level (GDP per capita in purchasing power parity) in comparison with the EU-25 will increase by about eight percentage points against 2005 to ca 82% in 2009.

**Chart 3.7: Decomposition of GDP growth**



**Chart 3.8: GDP in parity per capita (EU-25 = 100)**



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

Household consumption growth (including non-profit organisations) has fallen behind the growth rate for economic performance. Low interest rates support the propensity of households to invest in private housing, which in turn draws on a part of their disposable income. Growth in the stock of mortgages increases the debt burden of households and reduces the growth rate of expenditures on final consumption. During the upcoming years, household consumption expenditures should accelerate, though remaining below the rate of GDP growth.

Government consumption should be flat or even slightly decrease in the future. Government institutions are expected to behave economically from the standpoint of employment in the government sector as well as in purchasing goods and services.

**Table 3.2: Economic growth (CZK billion, increase in %)**

	ESA code	Year 2005 level <sup>1)</sup>	Year 2005 y-o-y	Year 2006 y-o-y	Year 2007 y-o-y	Year 2008 y-o-y	Year 2009 y-o-y
<b>1. Real GDP</b>	<b>B1*g</b>	2950	6,1	6,0	4,9	4,8	4,8
<b>2. Nominal GDP</b>	<b>B1*g</b>	2978	7,1	7,5	7,6	7,8	7,9
<b>Components of real GDP</b>							
<b>3. Private consumption expenditure</b>	<b>P3</b>	1442	2,3	3,9	4,2	4,1	4,1
<b>4. Government consumption expenditure</b>	<b>P3</b>	628	0,7	-1,0	0,5	-0,3	-0,3
<b>5. Gross fixed capital formation</b>	<b>P51</b>	756	3,6	6,5	7,8	7,9	8,0
<b>6. Changes in inventories and net acquisition of valuable a % of GDP <sup>2)</sup></b>	<b>P52+P53</b>	30	1,0	2,4	2,5	2,4	2,3
<b>7. Exports of goods and services</b>	<b>P6</b>	2184	10,6	12,7	10,6	10,3	10,4
<b>8. Imports of goods and services</b>	<b>P7</b>	2089	4,9	11,4	10,2	9,6	9,7
<b>Contribution to GDP growth</b>							
<b>9. Final domestic demand</b>			2,3	3,3	4,2	4,0	4,0
<b>10. Change in inventories and net acquisition of valuable</b>	<b>P52+P53</b>		-0,2	1,6	0,3	0,1	0,0
<b>11. External balance of goods and services</b>	<b>B11</b>		4,0	1,1	0,5	0,7	0,9

Note: 2005 levels are given in last year's prices.

The share of the change in inventories to GDP is in current prices.

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

Following a certain slowdown in investment activities in 2005, the dynamics should be renewed and exceed the rate of GDP growth primarily due to the continued inflow of foreign direct investment, which reflects the Czech economy's high attractiveness for foreign investors. The new capacity is expected to be primarily export oriented. In addition, an increase in the investment activity of domestic companies can be expected thanks to adopted measures and an anticipated high drawdown of resources from the structural funds in support of small and medium-size enterprises.

In 2007 and especially in 2008, the contributions from structural funds and the Cohesion Fund should significantly increase as a part of the new Financial Perspective 2007–2013. Together with co-financing from public budgets, they will be mainly channelled into infrastructure investments.

The contribution of the trade balance for goods and services in constant prices to GDP growth has attained positive figures since 2004. A positive contribution in a range of 0.5 to 1.0 percentage point is anticipated to persist up to 2009. The actual extent will depend on meeting the assumptions for the external environment, the launch of new technological complexes and on domestic demand developments.

## Prices

The Czech economy has been characterised by low inflation since the end of the 1990s. The inflation targeting regime has had a positive influence and has helped to guide the inflation expectations of economic agents.

**Table 3.3: Prices of goods and services**

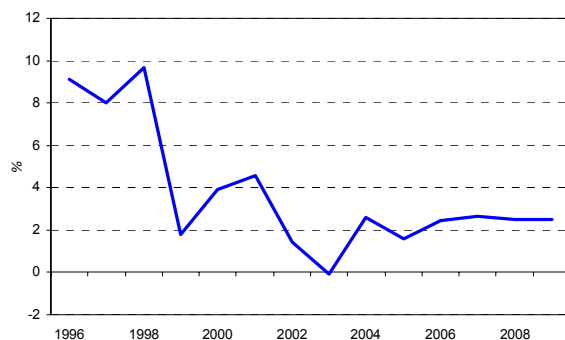
	Year 2005	Year 2006	Year 2007	Year 2008	Year 2009
<b>Percentage changes</b>					
<b>HICP</b>	1,6	2,4	2,6	2,5	2,5
<b>GDP deflator</b>	0,9	1,4	2,6	2,9	2,9
<b>Consumption of households deflator</b>	1,8	2,7	2,9	2,9	2,8

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

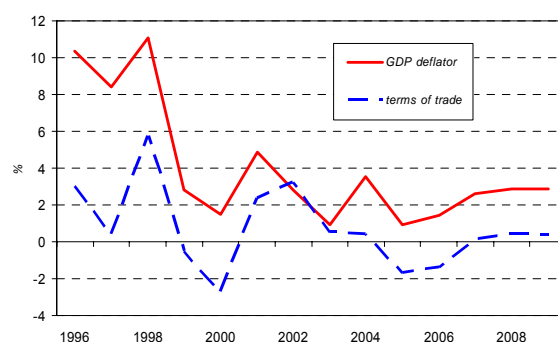
The scenario is based on the assumptions of the decline in USD oil prices, additional CZK appreciation and continuous non-inflation growth of total unit labour costs. Stable development or a slight increase is expected for food prices. The market fluctuation of other prices should remain moderate.

In the area of administrative measures, a rise in excise taxes on tobacco products during the first half of 2007 will have the strongest effect. Additional measures will relate to housing – rises in the prices of electricity, regulated rent, natural gas, heat, water and sewage. Nevertheless, the scenario does not account for the inflationary effects of the contemplated environmental tax reform, seeing as though the timetable and content of the reform measures are not yet known.

**Chart 3.9: HICP**  
y-o-y growth in %



**Chart 3.10: GDP inflator and terms of trade**  
y-o-y growth in %



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

On the whole, we expect the CNB's inflation target (national CPI of 3%) to be reached between 2007 and 2009. This creates conditions for meeting the inflation convergence criteria close to the reference rate as long as the prices in certain EU member states do not deviate sharply in a downward direction from the European Central Bank's definition of price stability.

When terms of trade start to improve again, growth of the implicit GDP deflator should stabilise around 3%.

### The labour market and wages

The positive development of labour market indicators is the result of the favourable position of the economy in the economic cycle. Structural problems are still present and are reflected

in the strong regional disparity and in long-term unemployment that has not declined. The reasons behind this development are low professional and regional mobility, the lack of motivation of low-income groups to seek work actively, the rigidity of labour contracts concluded for indefinite periods, and the still underdeveloped mortgage market.

**Table 3.4: Employment and wages**

	Year 2005	Year 2006	Year 2007	Year 2008	Year 2009
<b>Percentage changes</b>					
Employment (LFS)	0,7	1,6	1,0	0,5	0,2
Compensation of employees	6,6	7,8	7,8	7,6	7,3
Real compensation per 1 employee <sup>1)</sup>	2,7	3,6	4,2	4,6	4,8
Unit labour costs <sup>2)</sup>	0,5	1,7	2,8	2,7	2,4
<b>Per cent</b>					
Unemployment rate ILO	7,9	7,2	6,7	6,5	6,5
Employment rate <sup>3)</sup>	64,8	65,6	66,1	66,4	66,6
Activity rate <sup>4)</sup>	70,4	70,7	70,8	70,9	71,1

<sup>1)</sup> Wage bill per one employee (according to the Labour Force Survey) deflated by the HICP

<sup>2)</sup> Nominal compensation of employees per unit of real GDP

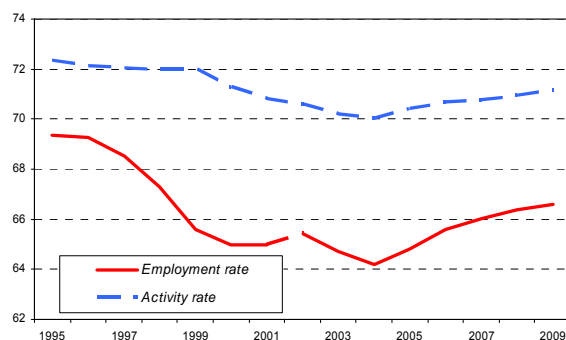
<sup>3)</sup> Share of total employment in the population 15 to 64 years old (according to the Labour Force Survey)

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

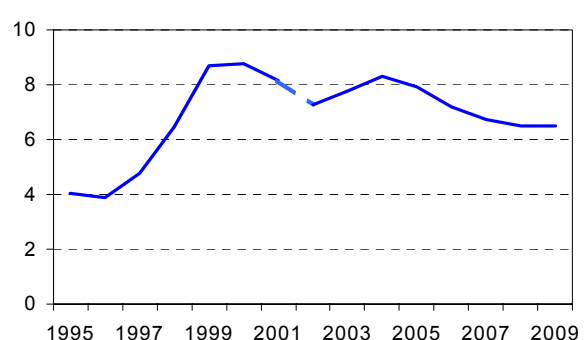
Source: Czech Statistical Office – employment statistics and quarterly national accounts, calculations of the Ministry of Finance

The demand side of the labour market will still be affected in particular by high economic growth during the scenario period. An active employment policy focused on problematic regions will also have a positive impact. The labour market's lack of flexibility, however, will continue to be a challenge for structural policies.

**Chart 3.11: Employment, participation rates in %**



**Chart 3.12: Unemployment rate in %**



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

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

We anticipate an additional rise in employment in the future, due mainly to the integration of foreigners and persons outside the labour force. The unemployment rate in 2008 should drop

to 6.5%. Without adopting relevant measures, this value can be considered to be the structural limit.

Wages have been developing in line with labour productivity and hence do not interfere with Czech macroeconomic stability. The growth rate for nominal compensation of employees should slowly decline in the monitored period from 7.8% in 2006 to 7.3% in 2009. There should also be a slight acceleration in the growth of real compensation of employees from 3.6% in 2006 to 4.8% in 2009.

In 2007, we expect the growth rate of total unit labour costs to increase against 2006 from 1.7% to 2.8%. It will then gradually decline to 2.4% in 2009, in line with the GDP deflator. This should not generate wage inflation pressures or jeopardise the financial situation of the corporate sector.

#### 3.4 Foreign Relations and Sectoral Balances<sup>6</sup>

The negative balance of net lending reached 6.2% of GDP in 2004. In 2005, this was reduced to 3.3% of GDP thanks in particular to an improved merchandised balance.

The trade balance has registered a surplus since April 2005, despite high and ever-increasing mineral fuel prices. Increasing export performance shows an improvement in the competitiveness of domestic products. New capacities with a large export potential have had a substantial impact, mainly in the automobile industry, information and communication technology and the substitution of imported intermediate products with domestic products.

For the balance of goods and services, the surplus in the balance's non-fuel component should be around 6% of GDP. A stable low-inflation environment and wage developments corresponding to the equilibrium appreciation of the real exchange rate will be pivotal for the competitive capabilities of Czech export. The declining CZK prices for mineral fuels should have a positive impact. We anticipate for the balance of services a stable surplus in the share of GDP with continued improvements in the balance for transport and tourism and a decline in "other services".

The most significant negative component in net lending is and will continue to be the worsening balance of primary incomes, which reflects, in particular, the increasing flow of foreign investors' repatriated and reinvested profits. Starting from 2007, the balance of current and capital transfers will be positively affected by financial flows from the EU as a part of the contributions from the structural funds, the Cohesion Fund and for supporting agriculture and regional development

As a result, we expect the net lending deficit to gradually decline, so that in 2008, the Czech Republic could register a surplus for the first time in history.

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<sup>6</sup> In accordance with the rules of the "Code of Conduct", this section is prepared using the methodology of national accounts. On the basis of the relationship between investments and savings, this allows a surplus or deficit in net lending to the rest of the world to be decomposed into individual economic sectors. This differs from the analogical, ordinarily employed methodology of the balance of payment's current account in the categorisation of some transactions and in the fact that it contains additional items (capital transfers, acquisition of non-produced, non-financial assets).



Table 3.5: Net lending/borrowing

	Year 2005	Year 2006	Year 2007	Year 2008	Year 2009
<b>% of GDP</b>					
<b>Balance of goods and services</b>	1,9	1,8	2,2	3,1	4,0
- mineral fuels (SITC 3)	-3,7	-4,6	-4,0	-3,3	-2,9
- other goods	5,0	6,1	5,8	6,0	6,5
- services	0,7	0,3	0,4	0,4	0,5
<b>Balance of primary income and transfers</b>	-4,6	-4,8	-4,2	-4,1	-4,1
- primary income	-4,4	-4,8	-5,0	-5,2	-5,3
- transfers	-0,2	0,0	0,8	1,1	1,2
<b>Capital transfers</b>	-0,5	0,4	0,7	1,3	1,3
<b>Net acquisition of non-produced assets</b>	-0,1	-0,1	-0,1	-0,1	-0,1
<b>Net lending/borrowing vis-a-vis ROW (B.9)</b>	-3,3	-2,8	-1,4	0,2	1,1
<b>Net lending/borrowing of the private sector</b>	0,3	0,7	2,6	3,7	4,1
- households	-0,6	-0,7	-0,8	-0,6	-0,4
- financial and non-financial institutions	1,0	1,4	3,4	4,3	4,5
<b>Net lending/borrowing of general government</b>	-3,6	-3,5	-4,0	-3,5	-3,0

<sup>1)</sup> e.g. payments for licences, patents and trademarks

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

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

### 3.5 The Growth Implications of Structural Reforms

The CP itself contains the assessed effects of the approved reform measures in accordance with the National Reform Programme.

Other structural reforms in the Czech Republic are currently in the deliberation and discussion phase, so the actual structure of these reforms will depend solely on political decisions that have not yet transpired. Therefore, it is not possible to quantify the macroeconomic impact or include it in the CP.

## 4 General Government Finances – Deficit and Debt

### 4.1 The Medium-Term Budgetary Outlook

The Czech Republic's strategy in the area of budgetary policy is mainly driven by its efforts to eliminate the excessive general government deficit.

The systematic endeavour to reduce the government deficit was commenced by the adoption of the Conception of Public Finance Reform in 2003. A collection of measures on the revenue and expenditure sides of public budgets, along with favourable economic development, helped to successfully meet the reform objectives in 2004 and 2005. It is anticipated that the fiscal target will also be reached in 2006.

Development in the upcoming period is encumbered by the political cycle prior to the parliamentary elections in 2006 and the post-election political stalemate. Owing to these factors, reform efforts before the elections were weakened, and immediately following the parliamentary elections, there was no opportunity to implement substantial measures.

The latest development shows that the Czech Republic will not be capable of reaching the fiscal targets for 2007/2008 defined in last year's CP. The original goal of eliminating the excessive deficit in 2008 in a sustainable manner will apparently be postponed by at least one year. The CP is based fully on the approved act on the state budget for 2007 and its medium-term outlook for 2008/2009, which assumes a temporary increase in the government deficit in 2007 to 4.0% of GDP and then the continued reduction of the deficit to 3.5% in 2008 and to 3.2% in 2009. The planned measures, which should help speed up fiscal consolidation and which are contained in the new government's programme declaration (see Section 9), are not reflected in the submitted quantitative scenario.

The planned reduction in the government deficit will require strengthening of the role of the fiscal targeting regime and renewal of the credibility of the binding expenditure frameworks and of public finances' medium-term focus that the new government has explicitly committed itself to in its declaration.

The expected increase in the government deficit in 2007 means a temporary interruption in the consolidation strategy and will cause a delay in reaching the medium-term budgetary objective established for the Czech Republic as a part of the fiscal rules of the Stability and Growth Pact. The medium-term objective for the general government balance is -1.0% of GDP.

Starting in 2008, the medium-term outlook will be based on the obligation to continue reducing the government deficit and on the approved medium-term expenditure frameworks. The submitted strategy was approved by the government and the Chamber of Deputies of the Czech Parliament during negotiations on the 2007 state budget. Assuming that the same rate of deficit reduction is maintained at least at the level of minimum fiscal effort, the Czech Republic could reach its medium-term budgetary target of -1.0% of GDP in 2013.

**Table 4.1: General government medium-term outlook – deficit by sub-sector**

% of GDP	ESA code	Year 2005	Year 2006 (1)	Year 2007 (2)	Year 2008 (2)	Year 2009 (2)
<b>Net lending/borrowing (EDP B.9) by sub-sectors</b>						
<b>General government</b>	<b>S.13</b>	<b>-3,6</b>	<b>-3,5</b>	<b>-4,0</b>	<b>-3,5</b>	<b>-3,2</b>
<b>Central government</b>	<b>S.1311</b>	<b>-3,6</b>	<b>-3,7</b>	<b>-3,8</b>	<b>-3,3</b>	<b>-3,0</b>
<b>Local government</b>	<b>S.1313</b>	<b>-0,1</b>	<b>0,0</b>	<b>-0,2</b>	<b>-0,2</b>	<b>-0,2</b>
<b>Social security funds</b>	<b>S.1314</b>	<b>0,1</b>	<b>0,1</b>	<b>0,0</b>	<b>0,0</b>	<b>0,0</b>

(1) Notifications (October 2006)

(2) Outlook

Source: Czech Statistical Office, Ministry of Finance

Budgetary policy settings must increasingly account for the long-term challenges of public finances. The Czech Republic is one of the countries with the least favourable long-term fiscal outlook. The demands for a medium-term public finance position will, therefore, be significantly influenced by the reform structure for the pension and healthcare systems.

## 4.2 General Government Balance from 2005 to 2007

### 2005

The previous CP worked with an expected general government deficit in 2005 of 4.8% of GDP. According to preliminary figures, this deficit registered a substantially lower level of 3.6 %.

Higher-than-expected tax collections were reflected on the revenue side. This was the result of substantial changes in the structure of taxes made in 2004, which complicated the estimate of tax revenues. It was also partially the result of slightly faster growth for the nominal tax bases in comparison with the assumptions.

For the second year in a row, the possibility of transferring unused resources to the reserve funds has had a positive impact on the expenditure side of the balance. For the first time in 2004, the budgetary rules allowed an unlimited amount of funds to be carried over into future years. The state organisational units transferred CZK 24.7 billion in 2004. This situation was repeated in 2005, and the transfer of funds improved the balance by CZK 24.9 billion (0.8% of GDP). The resources in the reserve funds could be used in future years to increase expenditures and, therefore, add a considerable amount of uncertainty to the general government's expected performance.

Expenditures in 2005 were influenced by two substantial one-off transactions that have had an adverse effect on the general government deficit. These were the lease of Gripen aircraft for CZK 9.6 billion (0.3% of GDP) and forgiving Syria's unrecoverable debt amounting to CZK 18.7 billion (0.6% of GDP).

### 2006

The fiscal target for the general government deficit in 2006 was set at 3.8% of GDP in the last CP. Current development indicates that the general government deficit could be slightly lower. In the autumn notifications, the Ministry of Finance estimated a deficit of CZK 110.6 billion (3.5% of GDP).

General government revenues roughly correspond to last year's assumptions. Favourable economic development and the continuing rise in corporate profitability are reflected in an increase of approximately CZK 10 billion in corporate income tax collection (0.3% of GDP). On the other hand, excise taxes have registered lower performance, whose prediction is complicated by producers' overstock due to the current increase in the tax rates for tobacco products. Personal income tax revenues are more adversely affected by the introduction of joint taxation for spouses with children than originally expected.

The increase in social transfers and strengthening of general government investment activities contribute the most to expenditure growth. However, government consumption has risen at a relatively lower pace and is essentially flat in real term. In 2006, it was decided to stabilise the volume of resources in the reserve funds (see Section 8.1). The possibility of carrying over funds to future periods should not, therefore, have any impact on the general government deficit in 2006. The accuracy of the deficit estimate is, nevertheless, highly dependent on meeting this assumption.

### 2007

In 2007, the Czech Republic will not be capable of fulfilling the general government's deficit target of 3.3% of GDP set in the last CP. Without implementing additional austerity measures, the deficit will be in a range of 4.0% of GDP.

Preparations for the 2007 state budget had begun during the period prior to the parliamentary elections. The reform efforts from 2003 to 2005 were weakened by the effect of the position in the political cycle and a number of acts were passed that increase general government expenditures for upcoming years. The complicated post-election political situation stemming from the equal division of power between the left and right political parties prevented the adoption of appropriate budget cuts along with the already approved measures. This has also caused the set expenditure frameworks to be overshot by CZK 56.6 billion in 2007 (1.6% of GDP) and CZK 56.8 billion in 2008 (1.5% of GDP).

The main cause of the worsening outlook is rooted in the expenditures for the social sphere. The package of legislation approved at the end of 2005 and during 2006 will result in an increase in social transfers in 2007 of around CZK 36.2 billion (1.1% of GDP). This will cause further acceleration of annual social expenditure growth from 7.3% in 2006 to 9.7% in 2007.

The item with the second highest contribution to expenditure dynamics continues to be gross fixed capital formation, in which resources from EU funds have begun to play a larger role. With respect to the anticipated increase in interest rates, a rise of about one third in the costs for debt service can also be expected (from 1.1% to 1.4% of GDP). The expenditures for collective consumption will continue to increase at a slower rate of around 5% in nominal terms.

## 4 General Government Finances – Deficit and Debt

General government revenues in 2007 will continue to draw on the structural changes implemented since the start of the public budget reform. A change in the tax structure and improved tax collection have increased the absolute level of tax revenues, which is not only accounted for through favourable cyclical development. Dynamic economic growth has only partially contributed to increasing the revenue forecast. In view of slow price growth and a high foreign trade contribution, the acceleration of the nominal tax bases was slower than the acceleration of real economic growth. From the standpoint of general government revenues, the shift in growth dynamics from net export to domestic demand has a positive impact.<sup>7</sup>

**Table 4.2: General government deficit by sub-sector**

% of GDP	ESA code	Year	Year	Year	Year	Year	Year
		2002	2003	2004	2005	2006	2007
				(1)	(1)	(1)	(2)
<b>Net lending/borrowing (EDP B.9) by sub-sectors</b>							
<b>General government</b>	<b>S.13</b>	<b>-6,8</b>	<b>-6,6</b>	<b>-2,9</b>	<b>-3,6</b>	<b>-3,5</b>	<b>-4,0</b>
<b>Central government</b>	<b>S.1311</b>	<b>-6,1</b>	<b>-6,0</b>	<b>-2,8</b>	<b>-3,6</b>	<b>-3,7</b>	<b>-3,8</b>
<b>Local government</b>	<b>S.1313</b>	<b>-0,5</b>	<b>-0,5</b>	<b>-0,1</b>	<b>-0,1</b>	<b>0,0</b>	<b>-0,2</b>
<b>Social security funds</b>	<b>S.1314</b>	<b>-0,2</b>	<b>-0,1</b>	<b>0,0</b>	<b>0,1</b>	<b>0,1</b>	<b>0,0</b>

(1) Notifications (October 2006)

(2) Outlook

Source: Czech Statistical Office, Ministry of Finance

The overall development of the government deficit is affected considerably by the performance of central government institutions. The local government institutions operate with a constantly low deficit. In respect of their expenditure independence, the government is limited in the ways it can affect their performance. In principle, social security funds (health insurance companies) have recorded steady performance that is, nonetheless, achieved at the cost of transfers from the state budget and the purchase of unrecoverable receivables from health insurance companies by central government institutions. The social security funds sub-sector to some extent operates at the expense of the central government.

### 4.3 The Cyclically Adjusted Budget Balance and Fiscal Stance

During the timeframe of the CP, the Czech economy will be close to its potential. In 2006, a positive output gap was created that will gradually close from 2007 to 2009. Actual GDP will approach its potential, especially due to a reduction in the real GDP growth rate. Anticipated potential GDP growth should be driven mainly by total factor productivity.

With the anticipated closing of the positive output gap between 2006 and 2009, the cyclical component of the general government deficit will also be reduced. In 2008, a year-on-year decline of 0.6 of a percentage point can be expected in the absolute value of the cyclically adjusted balance, i.e. at a rate that does not interfere with the government's economic policies, and at the same time, that meets the requirements for developing a minimum level of fiscal effort as stipulated in the Stability and Growth Pact. To comply with the requirement of

<sup>7</sup>It is very difficult to clearly assess the impact of factors behind the increased tax collection. Between 2003 and 2005, there was also a change in the statutory tax rates, a change in the tax assignment, shifts in the tax structure, and the macroeconomic tax bases were repeatedly revised as a part of the major revisions of the Czech national accounts.

## 4 General Government Finances – Deficit and Debt

minimum fiscal effort in 2009, additional measures must be adopted for reducing the deficit against the approved outlook by a minimum of 0.1 to 0.2 of a percentage point of GDP.

**Table 4.3: Cyclically adjusted balance<sup>(a)</sup>**

% of GDP	ESA code	Year 2005	Year 2006 (1)	Year 2007 (2)	Year 2008 (2)	Year 2009 (2)
<b>1. Real GDP growth (%)</b>		6,1	6,0	4,9	4,8	4,8
<b>2. Net lending of general government</b>	<b>EDP B.9</b>	-3,6	-3,5	-4,0	-3,5	-3,0
<b>3. Interest expenditure (incl. FISIM)</b>	<b>EDP D.41</b>	1,2	1,2	1,4	1,5	1,5
<b>4. Potential GDP growth (%)</b>		4,8	5,0	5,1	5,1	5,2
<i>contributions:</i>						
- labour		0,4	0,5	0,3	0,2	0,1
- capital		0,8	0,9	1,0	1,1	1,2
- total factor productivity		3,6	3,6	3,8	3,8	4,0
<b>5. Output gap</b>		-0,1	0,9	0,7	0,4	0,1
<b>6. Cyclical budgetary component</b>		0,0	0,3	0,2	0,1	0,0
<b>7. Cyclically-adjusted balance (2 – 6)</b>		-3,6	-3,8	-4,2	-3,6	-3,0
<b>8. Cyclically-adjusted primary balance (7 – 3)</b>		-2,5	-2,6	-2,8	-2,2	-1,4

(a) The data in rows 4 to 8 are based on the current estimates of the Ministry of Finance.

(1) Estimate

(2) Outlook

Source: Ministry of Finance

### 4.4 Government Debt

The ratio of general government debt to GDP reached 30.4% in 2005. This rate has been substantially revised in a downward direction since the last year's CP as a result of the decision on a change in the classification of a non-standard guarantee<sup>8</sup>. Only a gradual increase in the debt-to-GDP ratio can be expected up to 2009. Despite the existence of an excessive deficit, the government debt should only rise to 32.2% of GDP by 2009. On condition that the consolidation strategy for this year's CP is met and the estimated level of potential growth is sustained, the deficit should then drop below the level ensuring stabilisation of the share of government debt in GDP<sup>9</sup>.

The debt projection assumes a negative net accumulation of financial assets of around 4.7% of GDP from privatisation activities between 2005 and 2007. These revenues will be used to finance the deficit up to 2008. The second significant one-off factor affecting the government debt is that the Czech Consolidation Agency (CKA) will wind up its activities at the end of 2007. CKA anticipates the sale of the remaining assets and settlement of liabilities, which will gradually reduce its share in the general government debt from 1.5% of GDP in 2005 to 0.2% of GDP. The imputed state guarantees will eventually be settled from the state budget. The provision of new risk guarantees is not anticipated.

<sup>8</sup> As a part of the notifications in April 2006, there was a decision made to exclude the maximum amount of the non-standard guarantee (CZK 160 billion, i.e. 6.2% of GDP) from the general government deficit and the debt for 2003. Thus, the Czech Statistical Office responded to Eurostat's statement from January 2006 that this guarantee should be excluded from the government deficit for 2003 and from the government debt for 2003 to 2005 (and as a conditioned obligation, from the balance sheets of government institutions as well).

<sup>9</sup> With a nominal GDP growth rate between 7% and 8% per annum and a debt level of ca 32% of GDP, a deficit of ca 2.2% to 2.5% of GDP will stabilise the share of the debt in GDP.

## 4 General Government Finances – Deficit and Debt

Dynamic nominal GDP growth of 7.5% to 8.0% will help prevent any rise in the debt-to-GDP ratio. In view of the expected increase in interest rates, the contribution of interest payments to the change in debt will rise starting from 2007.

**Table 4.4: Government debt – share by sub-sector**

% of GDP	ESA code	Year	Year	Year	Year	Year
		2005	2006 (1)	2007 (2)	2008 (2)	2009 (2)
<b>Contributions to gross debt by sub-sectors</b>						
<b>General government</b>	<b>S.13</b>	<b>30,4</b>	<b>30,6</b>	<b>30,5</b>	<b>31,3</b>	<b>32,2</b>
<b>Central government</b>	<b>S.1311</b>	<b>27,8</b>	<b>27,8</b>	<b>27,8</b>	<b>28,6</b>	<b>29,6</b>
<i>of which: CKA</i>		<i>1,5</i>	<i>0,6</i>	<i>0,2</i>	<i>-</i>	<i>-</i>
<i>state guarantees</i>		<i>2,6</i>	<i>1,7</i>	<i>1,2</i>	<i>1,0</i>	<i>0,9</i>
<b>Local government</b>	<b>S.1313</b>	<b>2,6</b>	<b>2,8</b>	<b>2,7</b>	<b>2,7</b>	<b>2,7</b>
<b>Social security funds</b>	<b>S.1314</b>	<b>0,0</b>	<b>0,0</b>	<b>0,0</b>	<b>0,0</b>	<b>0,0</b>

(1) Notifications (October 2006)

(2) Outlook

Source: Czech Statistical Office, Ministry of Finance

The outcome of the given factors in 2007 will be no change or a slight decline of around 0.1 of a percentage point in the share of debt in GDP. In 2008 and 2009, a rise in this share determined by the general government deficit and nominal GDP growth can be expected, with the diminishing impact of one-off factors in the form of the sale of financial assets. The projection, therefore, does not consider additional privatisation projects beyond 2007.

**Table 4.5: Government debt and related indicators**

% of GDP	Year	Year	Year	Year	Year
	2005	2006 (1)	2007 (2)	2008 (2)	2009 (2)
<b>Gross debt</b>	30,4	30,6	30,5	31,3	32,0
<b>Change in gross debt</b>	-0,3	0,2	-0,1	0,8	0,7
<b>Contributions to change in gross debt</b>					
<b>Primary balance</b>	2,5	2,4	2,6	2,0	1,4
<b>Interest expenditure (incl. FISIM)</b>	1,2	1,2	1,4	1,5	1,5
<b>Nominal GDP growth</b>	-2,0	-2,2	-2,2	-2,2	-2,3
<b>Stock-flow adjustment</b>	-2,0	-1,1	-1,9	-0,5	0,0
- Difference between cash and accruals	-1,6	0,4	0,0	0,0	0,0
- Net accumulation of financial assets	-0,4	-1,5	-1,9	-0,5	0,0
<i>of which: Privatisation proceeds</i>	-3,6	-0,1	-1,0	0,0	0,0
- Valuation effects and other	0,0	0,0	0,0	0,0	0,0
<b>p.m. implicit interest rate on debt</b>	4,0	4,1	4,9	5,2	5,3

(1) Notifications (October 2006)

(2) Outlook

Source: Ministry of Finance

# 5 Comparison with the Previous Convergence Programme and Sensitivity Analysis

## 5.1 Comparison with the Previous Macroeconomic Scenario

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

- New observations of the macroeconomic phenomena were included.
- The timetables for the quarterly and yearly accounts were revised, relating in particular to the manner of expressing the financial intermediation services indirectly measured (FISIM).
- The figures for the annual national accounts for 2004 and the figures for the quarterly national accounts for Q1 and Q2 2005 were updated.
- The exogenous assumptions of the programme were slightly changed, especially for 2006.
- The estimate for the potential GDP growth rate was increased.

The differences between the expected development of the external environment in both programmes relate primarily to 2006. The assumptions of economic growth in the EU-25 and in Germany were increased. A change occurred in the price of oil where the anticipated USD price, according to the current forecast, is USD 7 higher than in the last CP. The differences in the USD/EUR exchange rate are relatively small in comparison. The assumptions for 2007 and 2008 are roughly in line with the previous CP.

**Table 5.1: Assumptions of the scenario**

	CP 2005			CP 2006			Difference		
	2005	2006	2007	2005	2006	2007	2005	2006	2007
<b>GDP growth (%)</b>									
<b>USA</b>	3,5	3,3	2,6	3,5	3,4	2,6	0,0	0,1	0,0
<b>EU-25</b>	1,5	2,0	2,3	1,7	2,7	2,2	0,2	0,7	-0,1
<b>Germany</b>	1,0	1,4	1,1	0,9	2,2	1,4	-0,1	0,8	0,3
<b>Prices of oil</b>									
<b>(USD / barrel)</b>	55,5	60,5	57,8	54,4	67,5	59,8	-1,1	7,0	2,0
<b>Exchange rate</b>									
<b>USD / EUR</b>	1,26	1,24	1,24	1,24	1,25	1,26	-0,02	0,01	0,02

Source: Ministry of Finance

Real GDP growth recorded for 2005 and the forecast for 2006 are substantially higher than in the previous programme. This was related to an adjustment in data for the first half of 2005 (up by 0.9 of a percentage point) and considerably higher investment activity in 2006. The consistency and composition of use caused an increase of 0.8 of a percentage point in the assumption for the potential GDP growth rate.

However, the more favourable macroeconomic situation has only a limited effect on general government finances. The rise in the nominal GDP growth rate is less than the real growth rate due to the influence of slower GDP deflator growth. From the standpoint of use, the change in the scenario has been concentrated in areas having only a small effect on tax



## 5 Comparison with the Previous Programme and Sensitivity Analysis

revenues (gross fixed capital formation, inventory changes), while the growth rate of consumption only moderately increases.

**Table 5.2: Change in the indicators of the macroeconomic scenario**

	CP 2005			CP 2006			Difference (p.p.)		
	2005	2006	2007	2005	2006	2007	2005	2006	2007
<b>Growth in real terms (in %)</b>									
<b>GDP</b>	4,8	4,4	4,2	6,1	6,0	4,9	1,3	1,6	0,7
<b>Households consumption</b>	2,3	3,5	3,6	2,3	3,9	4,2	0,0	0,4	0,6
<b>Government consumption</b>	-0,6	-0,2	-0,5	0,7	-1,0	0,5	1,3	-0,8	1,0
<b>Gross fixed capital formation</b>	2,8	3,4	4,8	3,6	6,5	7,8	0,8	3,1	3,0
<b>Contribution of domestic demand (pp)</b>	0,8	3,2	3,2	2,1	4,9	4,4	1,3	1,7	1,2
<b>Contribution of foreign trade (pp)</b>	4,0	1,2	1,0	4,0	1,1	0,5	0,0	-0,1	-0,5
<b>Potential product</b>	4,3	4,3	4,3	5,0	5,1	5,1	0,7	0,8	0,8
<b>Output gap (%)</b>	0,1	0,1	0,0	-0,1	0,9	0,7	-0,2	0,8	0,7
<b>Growth (in %)</b>									
<b>HICP</b>	1,5	2,2	2,0	1,6	2,4	2,6	0,1	0,2	0,6
<b>GDP deflator</b>	0,9	2,2	2,8	0,9	1,4	2,6	0,0	-0,8	-0,2
<b>Employment</b>	0,9	0,8	0,5	0,7	1,6	1,0	-0,2	0,8	0,5
<b>Unemployment rate (level in %)</b>	7,9	7,4	7,1	7,9	7,2	6,7	0,0	-0,2	-0,4
<b>Exchange rate CZK/EUR (level)</b>	29,8	29,2	28,7	29,8	28,4	28,0	0,0	-0,8	-0,7
<b>Balance of goods and services (in % of GDP)</b>	2,1	2,8	4,1	1,9	1,8	2,2	-0,2	-1,0	-1,9
<b>Net lending/borrowing (in % of GDP)</b>	-2,6	-2,2	-0,6	-3,3	-2,8	-1,4	-0,7	-0,6	-0,8

Source: Ministry of Finance

Higher energy and food prices and to a limited degree also a change in the view on the economy's cyclical position will result in slightly higher inflation, which, according to our estimates, should remain within the range of the CNB's inflation target. Improved current and future economic performance is also reflected in the basic labour market indicators – higher employment growth and a decline in unemployment. Higher prices of imported fuels and higher investment activity have an effect on reducing the expected results for foreign relations.

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

From 2004 to 2006, the Czech Republic has succeeded in meeting the defined fiscal targets. Acceleration of economic growth and the favourable effects of tax changes have helped in reaching these targets. The fiscal outlook for the period 2007 to 2009 has worsened vis-à-vis the previous CP. Additional expenditures approved towards the end of 2005 and the beginning of 2006 have not yet been supplemented with appropriate austerity measures, and so the level of the general government deficit for 2007 and 2008 has shifted approximately 0.7 to 0.8 of a percentage point above the level expected a year ago.

Comparison of the assumptions on the government debt is complicated by the extensive revision carried out in April 2006. The level of debt was reduced at the beginning of 2003<sup>10</sup> by the amount of the non-standard guarantee, i.e. 6.2% of GDP in 2003. The rise in the government debt will be slightly faster than was assumed in last year's CP as a result of the higher expected deficits. However, in addition to the deficit, the debt will also be affected by

<sup>10</sup> See note 10, page 22.

## 5 Comparison with the Previous Programme and Sensitivity Analysis

revenues from the sale of financial assets, which will be used, as in the past, to finance a part of the deficit.

**Table 5.3: Comparison with the previous Convergence Programme**

% of GDP	ESA code	Year 2005	Year 2006 (1)	Year 2007 (2)	Year 2008 (2)	Year 2009 (2)
<b>GDP growth</b>						
Previous update		4,8	4,4	4,2	4,3	.
Latest update		6,1	6,0	4,9	4,8	4,8
Difference		1,3	1,6	0,7	0,5	.
<b>Actual budget balance</b>						
Previous update	<b>EDP B.9</b>	-4,8	-3,8	-3,3	-2,7	.
Latest update	<b>EDP B.9</b>	-3,6	-3,5	-4,0	-3,5	-3,0
Difference		1,2	0,3	-0,7	-0,8	.
<b>Gross debt levels <sup>(a)</sup></b>						
Previous update		37,4	37,1	37,9	37,8	.
Latest update		30,4	30,6	30,5	31,3	32,0
Difference		x	x	x	x	.

(a) Due to the extensive statistical revision of the gross debt, the figures in the current CP and the previous CP are not comparable.

(1) Estimate

(2) Outlook

Source: Ministry of Finance

### 5.3 Sensitivity Analysis

The Czech economy is small and open, and to a large degree, dependent on raw materials. In this respect, the prices of mineral resources can be seen as a substantial risk factor for Czech economic development<sup>11</sup>. Therefore, the sensitivity analysis presented in this section is based primarily on various scenarios of oil price development and related variables. The adverse development of raw material prices, however, does not only have a negative effect on the Czech economy, but it will most likely affect economic development throughout the European Union as well<sup>12</sup>. We have, therefore, decided to supplement the sensitivity analysis with two secondary effects, i.e. the effect of foreign demand and foreign inflation<sup>13</sup>.

We have decided to test the sensitivity of the Czech economy in relation to various developments of the above factors with the help of two scenarios. The optimistic scenario combines positive external supply and demand shocks. It is based on the assumption of a gradual decline in the price of oil, slightly higher foreign demand dynamics, and on the

<sup>11</sup> For a quantitative analysis of the effects of the above factors on Czech economic development, the Ministry of Finance employs a medium-term, quarterly calibrated model. The model is generated by approximately 20 stochastic equations and 50 identities. This model is a standard Keynesian model supplemented with a neoclassical supply side.

<sup>12</sup> In our case, we have focused exclusively on the probable impact of oil price fluctuations on the economy of the European Union, our largest trade partner. The simulation results of the MULTIMOD model, set up and managed by the International Monetary Fund, were used to estimate the sensitivity of the European economy.

<sup>13</sup> In view of the very uncertain development of mineral resource prices, we have decided to specify the symmetric simulation scenarios. We would like to add that the results of the asymmetric scenarios were presented in previous CPs.

## 5 Comparison with the Previous Programme and Sensitivity Analysis

contrary, a lower growth rate for foreign industrial prices. On the other hand, the pessimistic scenario is derived from the assumptions of a higher oil price, lower foreign demand dynamics and acceleration of foreign inflation.

**Table 5.4: Scenario of exogenous variables**

		Year 2005	Year 2006	Year 2007	Year 2008	Year 2009
<b>UK Brent</b>						
<b>Optimistic</b>	USD/barrel		62,5	49,8	45,0	42,0
<b>Baseline</b>	USD/barrel	54,4	67,5	59,8	55,0	52,0
<b>Pessimistic</b>	USD/barrel		72,5	69,8	65,0	62,0
<b>GDP EU 15</b>						
<b>Optimistic</b>	y/y in %		2,8	2,5	2,6	2,5
<b>Baseline</b>	y/y in %	1,5	2,6	2,1	2,3	2,4
<b>Pessimistic</b>	y/y in %		2,4	1,8	2,1	2,3
<b>PPI EU 15</b>						
<b>Optimistic</b>	y/y in %		3,2	2,9	3,4	3,7
<b>Baseline</b>	y/y in %	3,0	3,9	3,9	3,9	3,9
<b>Pessimistic</b>	y/y in %		4,6	4,9	4,4	4,1

Source: Ministry of Finance

### Optimistic scenario

The settings of the above scenarios are characterised by the primary nominal and secondary real impact on the Czech economy. Thanks to the assumed slow decline in the price of oil to around USD 40 per barrel, we can expect in 2009 a very substantial improvement in the external imbalance measured by the balance of payments current account. A lower price for oil has a very positive income effect. Thanks to the relatively high and, in particular, unchanged energy demands of the Czech economy, firms reduce their production costs, which is reflected positively in lower price dynamics as well as wider profit margins.

Higher foreign demand growth will then have a positive impact on acceleration of the export growth rate and in turn on industrial activity. However, thanks to the slowly declining import intensity of the supply side of the Czech economy, the higher export dynamics will also lead to high import dynamics. So the overall positive effect will be partially reduced. The higher dynamics for economic activity should be associated with higher demand for labour as well as higher labour productivity. Thanks to lower raw material prices and lower foreign price dynamics, relatively positive price and wage development can be expected. Inflation and economic activity (or the output gap) will show contradictory development, however, lower interest rates than in the baseline scenario can be expected with the current settings of the central bank's reaction function<sup>14</sup>.

<sup>14</sup> We assume that the CNB is more sensitive to inflation developments than to output gap developments. This fact is incorporated into the central bank's reaction function, and therefore, it is more significantly affected by deviations in inflation than in the output gap.

## 5 Comparison with the Previous Programme and Sensitivity Analysis

**Table 5.5: Macroeconomic effects of the optimistic scenario**

		Year 2005	Year 2006	Year 2007	Year 2008	Year 2009
<b>Gross domestic product</b>						
Private consumption	volumes, y/y in %	2,3	3,9	4,3	4,2	4,3
Gross fixed capital formation	volumes, y/y in %	3,6	6,5	7,9	8,1	8,3
Government expenditures	volumes, y/y in %	0,7	-1,0	0,4	-0,4	-0,3
Export of goods and services	volumes, y/y in %	10,6	12,8	11,0	11,0	10,9
Import of goods and services	volumes, y/y in %	4,9	11,5	10,5	10,2	10,1
Gross domestic product	volumes, y/y in %	6,1	6,1	5,1	5,2	5,4
<b>Labour market</b>						
Total employment	y/y in %	1,2	1,6	1,0	0,6	0,3
Unemployment rate	in %	7,9	7,2	6,7	6,4	6,3
Wages and salaries	y/y in %	6,6	7,7	7,7	7,4	7,2
<b>Prices</b>						
Consumer price index	y/y in %	1,9	2,8	2,8	2,5	2,6
Gross domestic product deflator	y/y in %	0,9	1,6	3,0	2,7	2,6
<b>Public finances</b>						
Deficit	in % of GDP	-3,6	-3,4	-3,9	-3,3	-2,7
Debt	in % of GDP	30,4	30,5	30,2	30,5	30,9
<b>Other indicators</b>						
PRIBOR 3M	in %	2,0	2,3	2,7	2,7	2,8
Current account	in % of GDP	-2,1	-3,2	-1,6	-0,7	0,2

Source: Ministry of Finance

Thanks to the expected moderate deceleration of inflation and an increase in GDP dynamics, there will only be unsubstantial changes in the nominal volume of wages and salaries. Hence, the revenue increase for income taxes in our scenario is actually negligible. In addition, with respect to the composition of economic growth, even the revenues from consumption (VAT and excise tax) have not really increased. The expenditure side of the budget assumes nominal rigidity of the expenditure frameworks, and for the given simulations, it has actually not changed<sup>15</sup>. The decline on the expenditure side of the budget is associated with a decline in debt service, which is affected by a lower level of nominal interest rates and lower expenditures for unemployment benefits. The optimistic scenario would lead to a certain level of improvement in general government finances.

### Pessimistic scenario

In view of energy demands and raw material dependency, an immediate impact on the external imbalance would be observed should the pessimistic oil price scenario occur. This fact would cause production costs to rise and in turn affect the price block.

<sup>15</sup> In reality, positive price development could also be connected to savings on the expenditure side of the budget (e.g. lower indexation of pensions, social benefits, etc.). However, this factor is not accounted for in our simulations, which could cause the deficit or debt to be overestimated in the specific scenario.

## 5 Comparison with the Previous Programme and Sensitivity Analysis

**Table 5.6: Macroeconomic effects of the pessimistic scenario**

		Year 2005	Year 2006	Year 2007	Year 2008	Year 2009
<b>Gross domestic product</b>						
<b>Private consumption</b>	volumes, y/y in %	2,3	3,9	4,2	4,0	3,9
<b>Gross fixed capital formation</b>	volumes, y/y in %	3,6	6,5	7,7	7,7	7,7
<b>Government expenditures</b>	volumes, y/y in %	0,7	-1,0	0,6	-0,2	-0,3
<b>Export of goods and services</b>	volumes, y/y in %	10,6	12,6	10,2	9,5	9,9
<b>Import of goods and services</b>	volumes, y/y in %	4,9	11,4	10,0	9,0	9,3
<b>Gross domestic product</b>	volumes, y/y in %	6,1	6,0	4,7	4,4	4,3
<b>Labour market</b>						
<b>Total employment</b>	y/y in %	1,2	1,6	0,9	0,4	0,1
<b>Unemployment rate</b>	in %	7,9	7,2	6,8	6,6	6,6
<b>Wages and salaries</b>	y/y in %	6,6	7,7	7,9	7,8	7,4
<b>Prices</b>						
<b>Consumer price index</b>	y/y in %	1,9	2,9	3,2	3,2	3,2
<b>Gross domestic product deflator</b>	y/y in %	0,9	1,2	2,2	3,0	3,1
<b>Public finances</b>						
<b>Deficit</b>	in % of GDP	-3,6	-3,6	-4,2	-3,7	-3,3
<b>Debt</b>	in % of GDP	30,4	30,7	30,8	32,1	33,1
<b>Other indicators</b>						
<b>PRIBOR 3M</b>	in %	2,0	2,3	3,0	3,2	3,3
<b>Current account</b>	in % of GDP	-2,1	-3,7	-3,2	-2,7	-2,2

Source: Ministry of Finance

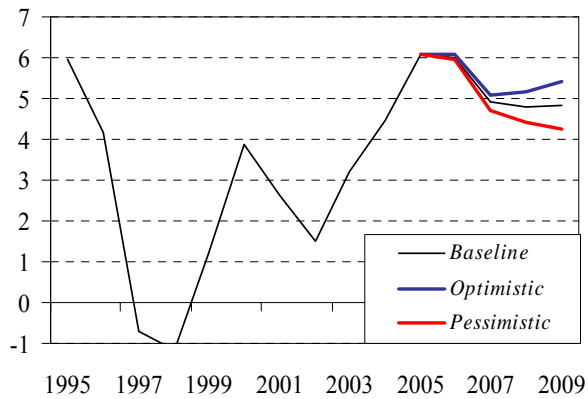
A secondary effect of high oil prices would be lower foreign demand dynamics, and on the contrary, faster foreign price growth. Lower foreign demand would be reflected in lower export performance and in turn lower GDP dynamics. Higher foreign price growth would put additional pressure on import price growth and production cost growth. In addition, higher price dynamics would prompt the acceleration of wage demands, which would cause production costs to increase again with an effect on prices. Efforts to cope with inflation pressures are expected to exceed interest in economic growth, and the central bank would then resort to higher interest rates. Together with lower corporate profitability it will depress investment activity, which will cause both actual economic performance and potential GDP to deteriorate further. Lower economic activity will be connected with lower demand for labour resulting in a slight increase in the unemployment rate.

Higher inflation acceleration than deceleration of real variables (employment, GDP) causes certain tax revenues to increase, even in the pessimistic scenario. However, a higher inflation rate is associated with higher nominal interest rates and thus higher debt service costs. An increase in the drawdown of unemployment benefits would also occur<sup>16</sup>. With the pessimistic scenario, deterioration of public finance performance could be expected.

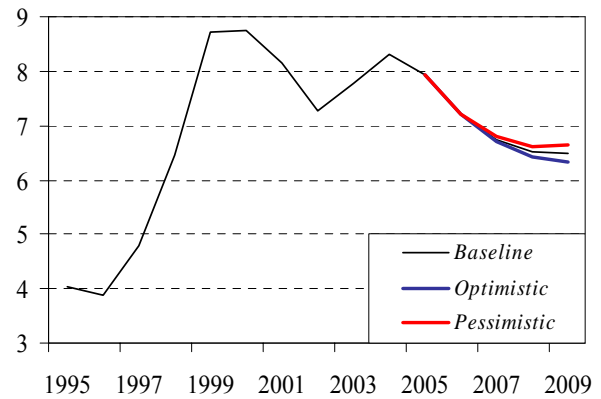
<sup>16</sup> In addition, it should be pointed out that a higher inflation rate in our scenario is not related to additional indexation of old-age pensions or other social benefits. This simplification could cause the resulting rise in the deficit or public debt to be underestimated in the pessimistic scenario.

## 5 Comparison with the Previous Programme and Sensitivity Analysis

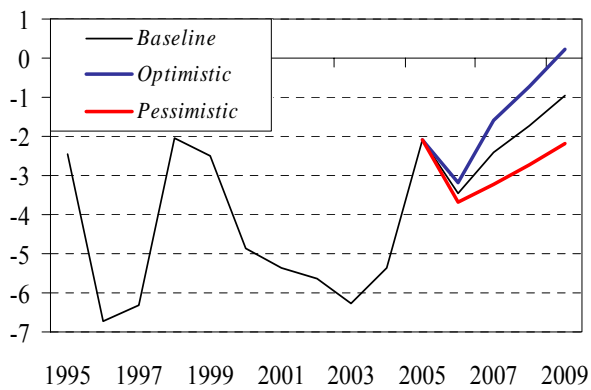
**Chart 5.1: GDP (y-o-y, in %)**



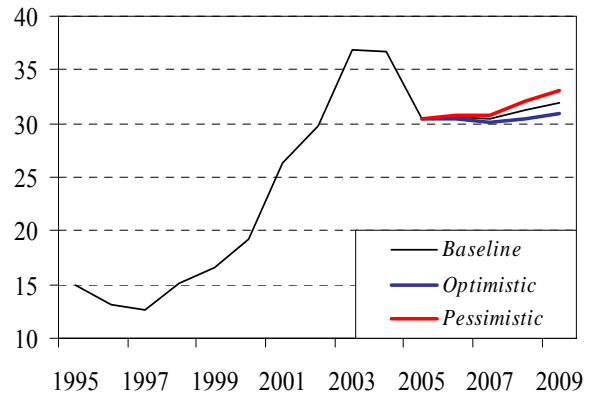
**Chart 5.2: Unemployment rate (in %)**



**Chart 5.3: Current account (in % GDP)**



**Chart 5.4: Government debt (in % GDP)**



Source: Ministry of Finance

## 6 Quality of Public Finances – Revenues and Expenditures

### 6.1 The Government's Strategy

In 2003, the Czech government launched a public finance reform focusing on fiscal consolidation and elimination of the public budgets' deficit tendency, increasing the flexibility of fiscal policy and strengthening the long-term sustainability of public finances.

The reform measures, together with favourable economic development and partial expenditure savings, contributed to the positive results of general government finances, a reduction in the deficit's share in GDP from 6.8% in 2002 to 3.5% in 2006 and to preventing any rise in the public debt's share.

Despite strong GDP growth and meeting the fiscal target set in the CP for 2005, the general government's outlook has deteriorated in year-on-year terms. In particular, this deterioration is at the expense of accelerated expenditure growth of primarily a mandatory nature in the social sphere. In spite of the gradually declining costs associated with transformation and the anticipated continuation of robust GDP growth of around 4.8%, the fiscal target from the last CP for 2007 to 2008 may in all probability not be met.

Nevertheless, the government will once again achieve a decline in the deficit's share in GDP for the 2008 and 2009 outlook, which is a part of the 2007 state budget. The key priority still focuses on the gradual reduction of the general government deficit to under 3% of GDP, ending the current excessive deficit procedure and in turn reaching the medium-term budget objective of a deficit of 1% of GDP. For renewing the process of fiscal consolidation, it will be necessary, in addition to continued GDP growth, to implement austerity measures on the expenditure side, among others, in view of the fact that the tax quota will have a tendency to decline autonomously on the revenue side after the tax measures from 2004 to 2006 have died out.

The main points of the medium-term fiscal strategy are contained in the Economic Growth Strategy and the National Reform Programme from 2005. This involves upholding the principles of fiscal targeting and strengthening the medium-term expenditure frameworks, restructuring the expenditure side of public budgets, continuing to restructure the tax burden, preventing the onset of indirect indebtedness in the form of extra-budgetary fiscal risks and prioritisation of strategic decisions for stabilising the pension system and the healthcare financing system.

### 6.2 Public Expenditures

As a part of the public finance reform, the government has focused on the goal of restructuring the expenditure side of public finances in order to widen the manoeuvring space for fiscal policy performance, increase the expenditures for programmes with positive growth effects (infrastructure, education, research, development and innovation) and to ensure sufficient resources for co-financing projects with EU funds.

## 6 Quality of Public Finances – Revenues and Expenditures

Succeeding in these priorities is a condition for reducing the share of mandatory expenditures in public budget expenditures and in turn increasing the effectiveness of allocated resources. One of the main instruments for improving the quality of public expenditures will be the introduction of programme budgeting (see Section 8.1).

**Table 6.1: General government expenditures**

% of GDP	ESA code	Year 2005	Year 2006 (1)	Year 2007 (2)	Year 2008 (2)	Year 2009 (2)
<b>Components of expenditures</b>						
<b>Collective consumption</b>	<b>P.32</b>	11,2	10,9	10,6	10,3	10,1
<b>Total social transfers</b>	<b>D.62+D.63</b>	22,7	22,6	23,0	23,0	22,5
<b>Social transfers in kind</b>	<b>D.63</b>	11,2	11,0	10,9	10,9	10,7
<b>Social transfers other than in kind</b>	<b>D.62</b>	11,5	11,6	12,1	12,1	11,8
<b>Interest expenditure</b>	<b>EDP D.41</b>	1,2	1,2	1,4	1,5	1,5
<b>Subsidies</b>	<b>D.3</b>	1,9	1,9	1,9	1,8	1,7
<b>Gross fixed capital formation</b>	<b>P.51</b>	5,0	5,1	5,2	5,6	5,7
<b>Other</b>		2,2	1,8	1,8	1,7	1,7
<b>Total expenditures</b>	<b>TE</b>	44,0	43,4	43,9	43,9	43,2
<b>p.m.: Compensation of employees</b>	<b>D.1</b>	8,0	7,7	7,6	7,4	7,2

(1) Estimate

(2) Outlook

Source: Ministry of Finance (2005 calculation of the Ministry of Finance from Czech Statistical Office sources)

At the end of 2005 and the beginning of 2006, a number of new acts were adopted in the area of social mandatory expenditures, which make up the largest part of the state budget. These measures relate to previously taken steps, such as suspending the valorisation of sickness benefits, permitting a combination of proceeds and collection of parental contributions or the entitlement to social benefits conditioned by the duty to accept eight hours of public service work per month. However, the budget is burdened by additional mandatory expenditures. The adverse fiscal effects related to these legislative changes slow down the restructuring of the expenditure side. The expected negative impact of these measures on the general government deficit exceeds the expected 1% of GDP in the individual years. An overview of these measures and the calculation of their assumed impact are presented in Box 6.1 and Table 6.2.

The measures which would more substantially reduce the share of mandatory expenditures in GDP have not yet been fully implemented. To create more space for additional expenditure priorities, it will, therefore, be necessary to increase social mandatory expenditures in upcoming years at a lower rate than nominal GDP growth.

The 2007 state budget expects to contribute an overall amount of CZK 25.1 billion to expenditures for supporting research and development as a priority area of the National Reform Programme. So the share of these expenditures in nominal GDP for 2007 will reach 0.7% and will register an annual increase in absolute terms of CZK 6.9 billion or 37.9%.



### Box 6.1: Changes in social security

#### **Sickness insurance expenditures**

The new Act on Sickness Insurance set forth the obligation of employers to pay wage compensation to employees for the first 14 days of work disability due to sickness. This act comes into effect on 1 January 2008. The valid version proposes for 2008 a 50% refund of the employers' financial obligation from the state budget. In addition, there should be a gradual reduction in the rate for employers' sickness insurance contribution from the current 3.3% in 2007 to 2.3% in 2008 and to a target rate of 1.4% in 2009. The old system will still be valid in 2007. In 2008, expenditures will decline by CZK 2.9 billion and by CZK 8.4 billion in 2009. However, due to a decline in contribution revenues, the overall impact on the state budget will be negative during the indicated years (CZK 7.6 billion in 2008 and CZK 12.1 billion in 2009).

#### **Government welfare benefits**

Changes to government welfare benefits include increasing the parental contribution, the maternity benefit, the housing contribution and foster parent remuneration and introducing new benefits relating to school supplies for children entering the first class of elementary school. The impact of this increase amounts to CZK 19.5 billion for 2007, of which CZK 15.2 billion relates to the increase in the parental contribution. In 2008, an increase in expenditures of CZK 23.4 billion is expected and CZK 26.2 billion in 2009.

#### **Introducing poverty relief assistance and cancellation of certain social care benefits**

A new system for poverty relief benefits will be introduced, which replaces the cancelled social need benefits. Social care benefits, which target disabled persons, will remain in tact. This legislative change should have a slightly positive impact on the budget in 2007 (reduction of expenditures by CZK 0.1 billion). However, it will be negative in future years (increase in expenditures of CZK 1.7 billion in 2008 and CZK 3.4 billion in 2009).

#### **Act on Social Services**

Upon adoption of the Act on Social Services, effective 1 January 2007, the structure and nature of state budget expenditures for activities financed or supported through this act will substantially change. A care allowance will be introduced, replacing the increase in pension for dependent individuals, and gradually over a three-year period, also the care allowance for next of kin as well as most of the funding for the costs of social service providers. The net impact of this act on the state budget's mandatory expenditures is estimated to be CZK 6.3 billion in 2007, CZK 5.4 billion in 2008 and CZK 4.4 billion in 2009.

#### **State's payment into the public health insurance system for non-income-earning individuals**

The assessment base is 25% of the average monthly wage defined as the product of the general assessment base and the coefficient for the purpose of pension insurance, which is set every year by way of a government decree. The state's payment per person and month in 2007 is CZK 680. An increase of CZK 9.7 billion in payments is expected in 2007, CZK 10.6 billion in 2008 and CZK 11 billion in 2009.

#### **Amendment to the Act on Pension Insurance**

Under the amendment to the Act on Pension Insurance, provisions on widows' pensions and miners' pensions were incorporated into the pension insurance system (effective 1 July 2006). The overall impact of this amendment is estimated to be CZK 0.6 billion in 2007 and CZK 0.5 billion in the following years.

**Table 6.2: Impact of the approved social legislation**

CZK billion	Year 2007	Year 2008	Year 2009
<b>Impact on revenues</b>			
Amendment to the Act on Social Security Contributions	0,0	-11,9	-22,7
New Act on Casualty Social Insurance (contributions)	0,0	5,9	5,2
<b>Total impact on social revenues</b>	<b>0,0</b>	<b>-6,0</b>	<b>-17,5</b>
<b>Impact on mandatory expenditures</b>			
New Act on Sickness Insurance	0,0	-2,6	-7,3
Government welfare benefits	19,5	23,4	26,2
Poverty relief benefits	12,0	13,7	15,6
Cancellation of certain social need benefits	-12,1	-12,0	-12,2
New Act on Social Services	8,8	9,3	9,7
Cancellation of the benefits for the "increase in pension for dependent individuals" and the care allowance for next of kin	-2,5	-3,9	-5,3
New Act on Casualty Social Insurance	0,0	4,0	4,2
Change in the assessment base for the state's payment into the public health insurance system	9,7	10,6	11,0
Amendment to the Act on Pension Insurance	0,6	0,5	0,5
Increase in the special benefits for security forces	0,2	0,3	0,3
<b>Total impact on social expenditures</b>	<b>36,2</b>	<b>43,3</b>	<b>42,7</b>
<b>Impact on the balance</b>			
Total impact on the balance	-36,2	-49,3	-60,2
<b>Total impact on the balance (in % of GDP)</b>	<b>-1,1</b>	<b>-1,3</b>	<b>-1,5</b>

Source: Ministry of Finance

### 6.3 Public Revenues

Total general government revenues vis-à-vis GDP will be in the range of 40% of GDP during the monitored period. The slow decline in the tax quota is due to the fact that total tax revenues register lower-than-unit-elasticity vis-à-vis GDP and due to measures geared in particular to reducing the high taxation of labour. On the other hand, an increase in indirect taxation will cause a rise in the share of general government revenues in GDP. Another significant factor will be the strengthening inflow of resources from EU funds for financing projects, particularly investment in infrastructure.

Approximately one fifth of tax revenues register low elasticity and, therefore, the relative share in the growing level of GDP is decreasing autonomously shrinking. This decline is only partially offset by tax revenues with growth higher than GDP (e.g. via progressive taxation of revenues), which as a result causes an autonomous decline in the overall compound tax quota.

The tax burden in terms of the compound tax quota will be in a range of 36.5% of GDP in 2005. The compound tax quota declined in 2006 by 0.5 of a percentage point to 35.5% and a further decline is expected in later years, up to 34.1% in 2009 (see Table 6.3).

Table 6.3: General government revenues

% of GDP	ESA code	Year 2005	Year 2006 (1)	Year 2007 (2)	Year 2008 (2)	Year 2009 (2)
<b>Components of revenues</b>						
<b>Total taxes</b>		20,9	20,4	20,0	19,9	19,4
<b>Taxes on production and imports</b>	<b>D.2</b>	11,6	11,3	11,2	10,9	10,5
<b>Current taxes on income, wealth etc.</b>	<b>D.5</b>	9,3	9,0	8,8	9,0	8,9
<b>Capital taxes</b>	<b>D.91</b>	0,0	0,0	0,0	0,0	0,0
<b>Social contributions</b>	<b>D.61</b>	15,1	15,1	15,1	14,8	14,7
<b>Property income</b>	<b>D.4</b>	0,7	0,8	0,8	0,7	0,7
<b>Other</b>		3,7	3,7	4,1	4,9	5,5
<b>Total revenue</b>	<b>TR</b>	40,4	39,9	39,9	40,4	40,3
<b>p.m.: Tax burden</b>		36,0	35,5	35,1	34,7	34,1

(1) Estimate

(2) Outlook

Source: Ministry of Finance (2005 calculation of the Ministry of Finance from Czech Statistical Office sources)

The tax measures as a part of the ongoing fiscal restructuring are geared to promoting economic growth and employment. The trajectory for the shift of the tax burden from direct taxes to indirect taxes described in the last CP also continued during 2006. The goal is to reduce the distortion effect of direct taxes on economic activity.

The effective taxation of the incomes of legal entities was reduced mainly due to a gradual decline in the marginal rate of corporate income tax from 28% in 2004 to 24% in 2006. This trend also supported the possibility of reducing the tax base for investment in research and development introduced in 2005.

The taxation of labour was reduced in particular by changes in personal income tax. The joint taxation of spouses with children and tax bonuses for unsupported children were introduced. From 1 January 2006, there was another decline in the effective taxation of personal incomes. This involved reducing the two lowest marginal rate categories from 15% to 12% and from 20% to 19%, valorising the first tax bracket and replacing the standard tax allowances with tax credits. These changes also motivate low-income groups to work and increase the flexibility of the labour market.

The sickness insurance reform, effective from 1 January 2007, should also contribute to the decline in labour taxation. This reform includes a reduction in the rate of sickness insurance contributions paid by employers. In view of the strong negative impact on the state budget deficit, however, this change should be postponed in 2007 as a part of the draft state budget. Reductions in this rate will take place during 2008 and 2009 (see Box 6.1 and Table 6.2).

The prepared environmental tax reform, which should come into effect in 2008, will bring additional changes geared to the restructuring of the tax burden. The reform concept assumes fiscal neutrality. The specific parameters of the prepared changes, however, have not yet been set, and the impact of the reform is, therefore, not included in the projections for general government revenues.

In the area of excise taxes, the draft state budget for 2007 counts on an increase in the excise tax rates for tobacco products with respect to meeting the timeframe agreed for complying

with the minimum rates valid in the EU by 2007. Additional increases will occur in 2008 in accordance with the Accession Agreement.

### Box 6.2: Changes in taxation

#### **Reduction in corporate income tax**

The corporate income tax rate for 2005 was reduced to 26% (from 28% in 2004). The tax rate was cut again in 2006 to 24%. Assuming a 5% increase in the tax base, the impact of the tax rate cut on general government revenues is estimated to be a decline of CZK 17.6 billion in 2007, CZK 16.8 billion in 2008 and CZK 15.8 billion in 2009.

#### **Cut in personal income tax rates**

Important revenue related changes to the tax system coming into effect during the past two years include the cut in the tax rates for low- and medium-income groups, extending the tax bracket for the low-income group, replacing the tax allowances with tax credits and the joint taxation of spouses. These tax changes were targeted measures for increasing the disposable income of low- and medium-income earners and also increasing the level of the Czech tax system's vertical equity. In contrast to cutting tax rates, extending the tax bracket and introducing the joint taxation of spouses, the introduction of bonuses for unsupported children and replacing the tax allowances with tax credits had no substantial effect from the standpoint of the impact on the general government or increasing disposable income. The overall impact between 2007 and 2009 will be reflected on a concrete level as a reduction in general government revenues of CZK 23.7 billion in 2007, CZK 23.4 billion in 2008 and CZK 23 billion in 2009.

#### **Introducing tax allowances for research and development**

The newly introduced tax allowances permitted expenditures for research and development amounting to CZK 4.9 billion, according to preliminary and incomplete figures. From the standpoint of the net accrual approach used in the ESA 95 methodology, the estimated impact of this tax allowance on general government revenues from 2007 to 2009, taking into account a corporate income tax rate of 26% for 2005 and 24% for 2007 to 2009 and a 10% increase for the entries, is as follows: CZK 1.4 billion in 2007, CZK 1.6 billion in 2008 and CZK 1.7 billion in 2009.

#### **Environmental tax reform**

Estimates of the impact of introducing environmental taxes have not yet been included in the quantitative scenario because no final decision has yet been made on the rates and extent of the exemptions or on tax allowances as key parameters for calculating the revenue and setting compensation.

#### **Increasing excise taxes for tobacco products**

The Czech Republic is obliged to comply with the minimum required EU rates by 2008. In 2007, a rise in the rates should increase tax collection by CZK 10.4 billion against 2006. In 2008, an additional phase of rate increases should follow so that the Czech Republic can meet the EU requirements. The excise tax rates on tobacco products for 2008 have not yet been set, and therefore, the impact on the budget cannot be determined. It can be said, however, that this change will no longer be very significant. The financial impact of increasing excise taxes for tobacco products on general government revenues is estimated to be CZK 10.4 billion per annum during the period 2007–2009.

Completion of the Czech National Development Plan 2007–2013 in February 2006 was decisive for the drawdown of financial resources from the structural funds and the Cohesion Fund in the new programme period 2007–2013. This became the basis for drafting the Czech National Strategic Reference Framework for the period 2007–2013 as a master document for all operational programmes needed for drawing down resources from the structural funds and the Cohesion Fund. The strategic framework combines the priorities identified in the National Development Plan with the EU's objectives in the area of economic and social cohesion policy during the period 2007–2013. The resources of the structural funds and the Cohesion

## 6 Quality of Public Finances – Revenues and Expenditures

Fund are being gradually integrated into the national budgetary process. This was partially implemented up to 1 January 2006, and full integration should take place by 1 January 2007.

An overview of the main changes in the area of taxation and an assessment of their expected impact are given in Box 6.2 and Table 6.4.

**Table 6.4: The impact of tax changes on general government revenues<sup>(a)</sup>**

% of GDP	Year	Year	Year
	2007	2008	2009
<b>Taxes, total</b>	<b>-0,9</b>	<b>-0,8</b>	<b>-0,8</b>
<i>of which: VAT</i>	<i>0,0</i>	<i>0,0</i>	<i>0,0</i>
<i>Excises</i>	<i>0,3</i>	<i>0,3</i>	<i>0,3</i>
<i>CIT</i>	<i>-0,5</i>	<i>-0,5</i>	<i>-0,4</i>
<i>PIT</i>	<i>-0,7</i>	<i>-0,6</i>	<i>-0,6</i>

(a) The impact of approved changes as compared with the state of the tax system at the end of 2004

Source: Ministry of Finance

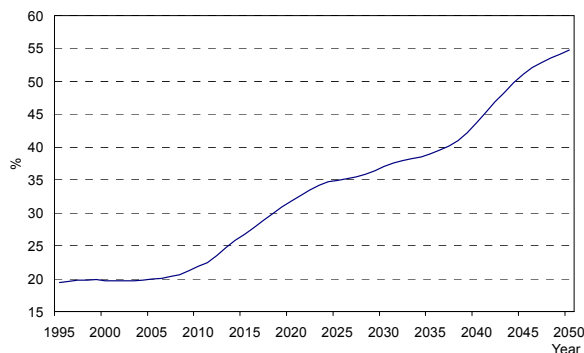
# 7 Sustainability of Public Finances

## 7.1 Introduction

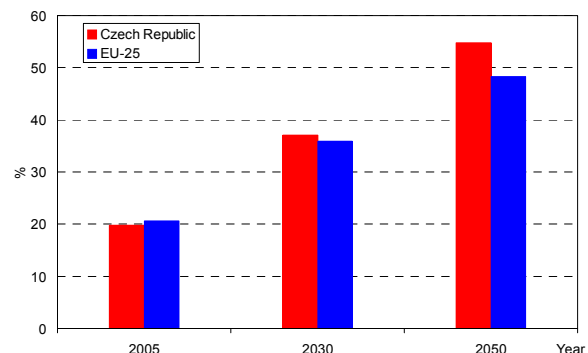
Population development in the Czech Republic will be influenced by a strong demographic shock in the form of a growing share of older persons in the total population. An ageing population will not only have an effect on the structure and volume of public expenditures, but it will also affect the labour market and the future development of the standard of living.

The best notion of the extent of demographic changes can be derived from the development of the dependency rate over the next 45 years. Eurostat's population projection (EUROPOP 2004) was used as a source database.<sup>17</sup>

**Chart 7.1: Dependency rate<sup>(a)</sup>**



**Chart 7.2: Dependency rate in the CR and the EU**



(a) The dependency rate is defined as the ratio of the population 65 years of age and older to the population 15 to 64 years old in the medium demographic scenario.

Source: Eurostat

Within the context of current European demographics, the Czech population is relatively young. However, very dynamic changes in its structure are expected in the upcoming decades. In fact, the Czech population will be among the oldest in Europe within the next 50 years (Chart 7.2).

The reason behind these changes is the rapidly increasing life expectancy accompanied by a low aggregate fertility rate. The Eurostat projection assumes that life expectancy at birth will increase between 2005 and 2050 by 7.1 years for men (from 72.6 to 79.7 years) and by 5.1 years for women (from 79.0 to 84.1 years). The aggregate fertility rate will remain far below the level that ensures simple reproduction (an increase from 1.28 to 1.5). Even significant growth in net immigration (from 4,300 to 20,000 annually) will not prevent an overall decline in the population (from 10.2 to 8.8 million people).

The demographic dependency rate will increase from a current rate of ca 20% to ca 55%, i.e. almost triple. In the absence of reform, the dependency rate would be a very good indicator of

<sup>17</sup> This demographic projection was produced by Eurostat in cooperation with the national statistical offices and is the basis for calculating the long-term projections. Use of this projection permits comparison with the demographic developments in other EU countries.

future deficit tendencies because it measures the ratio of the number of people in their productive age to those in their post-productive age. To confront such a strong demographic shock, the Czech government is preparing for the problems associated with an ageing population.

### 7.2 The Government's Strategy

Preparations for the long-term challenges of an ageing population continue to be a priority for economic policy. The main instruments for ensuring the long-term sustainability of public finances are the continuation of fiscal reform, the planned modifications to the pension and healthcare systems and increasing the total employment rate. There was, however, no substantial shift in the issues of pension and healthcare reform against the situation described in last year's CP.

Preparations for the pension system reform were launched in 2004 with the creation of an independent expert team, which carefully analysed the current state of the system and assessed the fiscal impact of the reform scenarios proposed by the main political parties. The expert team prepared detailed materials for making decisions on the pension reform. Nevertheless, the subsequent political negotiations were interrupted by the elections in June 2006. Despite the difficult post-election political situation, negotiations on the basic parametric changes have continued across the political spectrum.

The issue of the overall reform concept for healthcare also remains open. The draft reform stabilising the healthcare system is prepared, however, in view of the complicated political situation, further discussions are very uncertain at this time.

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

The Czech Republic supports the EU's efforts to maximise the comparability of the long-term fiscal projection results, and this is why it works as much as possible with the common assumptions and methodology discussed by the EPC's Working Group on the Ageing Population (AWG).

The projections were formed using the following assumptions:

- The population will develop in line with the Eurostat projection (EUROPOP 2004).
- The development of macroeconomic variables up to 2009 is based on national projections. After 2009, the input assumptions have been taken from the baseline scenario prepared by the AWG (see Table 7.1 for the main assumptions).
- The pension system projection relies on the national model apparatus. It assumes the validity of the current legislative framework, pension indexation at the level of the mandatory minimum and indexation of the pension system parameters that ensures a stable replacement rate for newly granted pensions.

- The expenditure projection for healthcare and long-term care is based on the assumption of health improvements in the population that fully reflect the increase in life expectancy and the assumption of neutral price development.
- The expenditure projection for education precisely follows the methodology proposed by the AWG. It calculates the expenses per student from the ratio of students to teachers, development of the average wage in the education sector and the share of other expenditures per student.
- In addition to the above expenditure entries, the development of family allowances with children and unemployment benefits was also explicitly modelled in order to be consistent with the demographic and macroeconomic scenario.

**Table 7.1: Macroeconomic projection assumptions**

% of GDP	Year 2005	Year 2010	Year 2020	Year 2030	Year 2040	Year 2050
Labour productivity growth	4,8	3,4	3,0	2,7	1,9	1,7
Real GDP growth	6,1	3,6	2,5	1,9	0,4	0,8
Participation rate males (aged 20–64)	83,5	84,6	87,4	87,1	84,4	85,6
Participation rates females (aged 20–64)	68,2	70,6	76,4	76,1	72,9	74,0
Total participation rates (aged 20–64)	75,8	77,6	81,9	81,6	78,7	79,8
Unemployment rate	7,9	7,3	6,5	6,5	6,5	6,5
Population aged 65+ over total population	14,2	15,5	20,8	23,6	26,8	31,0

Source: Czech Statistical Office (2005), AWG

The share of age-related expenditures in GDP will increase by about 8 percentage points of GDP from 2005 to 2050. The main driving factors are expenditures for old-age pensions and healthcare and long-term care. The adverse developments in the pension system and healthcare system will only be reduced to a limited extent by the development of expenditures for education and family allowances.

**Table 7.2: Long-term sustainability of public finances**

% of GDP	Year 2005	Year 2010	Year 2020	Year 2030	Year 2040	Year 2050
<b>Total expenditure</b>	44,0	42,5	43,3	46,2	52,0	59,2
<i>of which: Age-related expenditure</i>	19,9	18,5	18,9	20,9	24,5	27,7
<b>Pension Expenditure</b>	8,4	7,7	8,3	9,5	12,1	14,2
<b>Social security pensions</b>	8,4	7,7	8,3	9,5	12,1	14,2
<b>Old-age and early pensions</b>	7,6	7,0	7,5	8,7	11,4	13,5
<b>Other pensions</b>	0,8	0,7	0,7	0,8	0,7	0,7
<b>Occupational pensions</b>						
<b>Health care</b>	6,5	6,4	6,7	7,3	8,1	8,9
<b>Long-term care</b>	0,3	0,3	0,3	0,4	0,5	0,6
<b>Education expenditure</b>	3,6	3,1	2,7	2,8	2,9	3,0
<b>Other age-related expenditures</b>	1,2	1,0	1,0	0,9	1,0	1,1
<b>Interest expenditure</b>	1,2	0,9	1,3	2,2	4,3	8,4
<b>Total revenue</b>	40,4	40,3	40,3	40,3	40,3	40,3
<i>of which: Property income</i>	0,7	0,7	0,7	0,7	0,7	0,7
<i>of which: Pension contributions</i>	8,7	8,7	8,7	8,7	8,7	8,7
<b>Pension reserve fund assets</b>	0,5	4,9	12,9	12,4	0,0	0,0
<i>of which: Consolidated public pension fund assets</i>	0,0	0,0	0,0	0,0	0,0	0,0

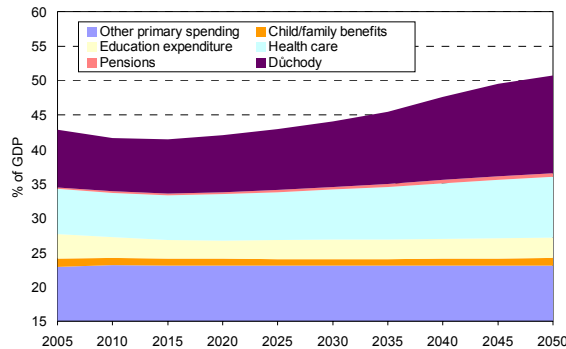


(a) The cumulative positive balance on the pension account (assets of pension security funds) will be depleted between 2030 and 2040.

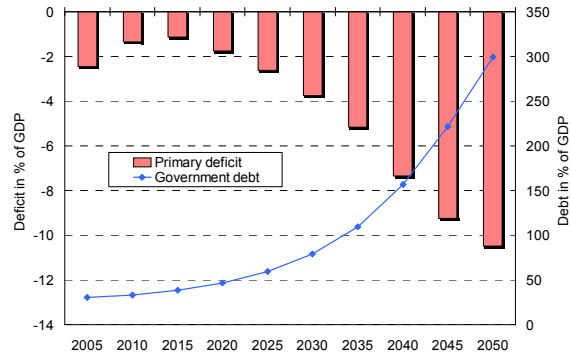
Source: Ministry of Finance

A substantial rise in age-related expenditures will cause the primary deficit to worsen, interest expenditures to increase from the current 1.2% of GDP to 8.4% of GDP and rapid accumulation of government debt. Under these assumptions, Czech public finances would not be compatible with the fiscal criteria defined in the Stability and Growth Pact.

**Chart 7.3: Projection of expenditures**



**Chart 7.4: Primary deficit and debt**



Source: Ministry of Finance

The results of the projections correspond, in principle, to those published by the European Commission for the Czech Republic in reports assessing the effects of an ageing population on the public budgets and the long-term sustainability of public finances<sup>18</sup>. Certain differences may stem from taking 2005 as the base year and from using the national medium-term macroeconomic outlook for 2006 to 2009. However, differences in the long-term projection period are minimal and do not have a substantial effect on the conclusions relating to the sustainability of public finances in the Czech Republic.

When interpreting the results of the projections, it should be remembered that the projections are created on the assumption of existing policies and do not account for any future reform measures.

The aim of this approach is to calculate the level of fiscal correction needed to ensure the long-term sustainability of public finances. In order for the Czech Republic to meet the requirements of the fiscal discipline set in the Stability and Growth Pact between 2009 and 2050, it would be necessary to implement measures that would reduce the share of expenditures or increase the share of taxes in GDP by more than four percentage points in 2009 (i.e. the S1 indicator). This means that the overall general government balance should register a surplus in 2009 of 1% of GDP. In order to ensure the long-term solvency of the general government, a fiscal correction of, in fact, 7.9% of GDP would be needed in 2009 (i.e. the S2 indicator).

<sup>18</sup> European Economy Special Report n° 1/2006 from March 2006 and Special Report n° 4/2006 from October 2006

**Table 7.3: Scope of needed fiscal consolidation**

% of GDP	Year	Year	Year
	2009	2010	2011
<b>1. Revenues</b>	40,3	40,3	40,3
<b>2. Primary expenditures</b>	41,7	41,6	41,5
<b>3. Primary balance (1-2)</b>	-1,4	-1,3	-1,3
<b>4. Sustainability gap S1 <sup>(1)</sup></b>	3,9	4,0	4,1
<b>5. Required primary balance (3+4)</b>	2,5	2,7	2,9
<b>6. Required total balance</b>	1,0	1,8	1,9
<b>Sustainability gap S2 <sup>(2)</sup></b>	7,9	8,1	8,2

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

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

Source: Ministry of Finance

# 8 The Institutional Framework for Fiscal Policy

The concept of the 2003 public finance reform laid the foundation for increasing the quality of the institutional framework of public finances. The individual steps of this reform are now taking place<sup>19</sup>. In addition, the new measures geared to the recently identified challenges for overall public finance management have been approved.

The principal objectives of the reform were identified as follows:

**Table 8.1: Objectives and measures of the 2003 Public Budget Reform**

Objectives	Measures
1. Improving fiscal discipline and the medium-term outlook	- Fiscal targeting - Medium-term expenditure frameworks
2. Strengthening the effectiveness of public expenditures	- Reserve funds - Programme budgeting
3. Increasing the transparency of public finances	- Integration of extra-budgetary institutions - Fiscal targeting

## 8.1 Implementation of the Public Finance Reform

### Medium-term expenditure frameworks

Fiscal targeting and the binding medium-term nominal expenditure frameworks have become a standard part of the budgetary process promoting the medium-term focus of budget policy. As a result, the budgetary process has become a consistent two-phase process. The decision-making on the aggregate level has been separated from the decision-making on individual budgetary line items or programmes. Meeting the aggregate frameworks should contribute to the anti-cyclical effects of fiscal policy and should increase the manoeuvring space for expenditure restructuring needed for the promotion of sustainable economic growth.

On a practical level, the adopted principles have so far only been partially upheld and the assessment of their effectiveness has been mixed. Introducing these principles along with favourable economic development and certain expenditure savings has contributed to the positive results of general government finances. However, problems do exist. Considering that the significant scope of additional general government revenues exceeded the estimates on which the expenditure framework settings were based, only a part of these additional revenues were used to reduce the deficit. The remainder was used to finance the additional expenditures, which caused the expenditure frameworks to be exceeded. However, sticking to the expenditure frameworks with substantially higher-than-expected tax revenues would have had a significantly more restrictive impact than was originally intended.

A challenge for intensifying the effects of the medium-term expenditure frameworks remains the strengthening of their accountability and the possible introduction of sanction procedures setting the steps in the event that the expenditure limits for the state budget headings are not met.

<sup>19</sup> Described in detail in 2004 programmes

### Integration of the state extra-budgetary institutions

The National Property Fund was terminated on 1 January 2006, and its activities and assets were transferred to the Ministry of Finance. Preparations have also continued with the termination of the Czech Consolidation Agency, which manages and trades non-performing assets associated in particular with transformation of the banking sector. The agency will be terminated on 31 December 2007, and the Ministry of Finance will become its successor. The Land Fund, which is entrusted with the privatisation of agricultural land, should be terminated on 31 December 2009.

### Reserve funds

A relatively large amount of unspent funds has been transferred to the reserve funds since their creation, and the volume of future carryovers is very difficult to estimate. In addition, reserve funds allow organisational units to increase expenditures above the approved budgetary allocation, which complicates meeting the fiscal targets. In fact, this limits the government's capacity to pursue a stabilising fiscal policy and worsens the pre-conditions for fiscal targeting.

In this respect, the government began regulating the volume of carryovers in 2006 with the goal of stabilising the volume to the level existing at year-end 2005. In 2007, resources from the reserve funds may only be used with prior government approval<sup>20</sup> and with respect to the set fiscal targets and fiscal policy stance.

Experience with fiscal targeting and introducing unlimited carryovers of unspent funds to reserves has revealed the deficiencies in the budgetary process. A change in the methods of budgeting the line items and programmes, among others, should help eliminate these deficiencies.

### Programme budgeting

Although the budgetary process is generally based on a top-down approach, method of incremental budgeting still exists at lower levels relating to past "historical bases". This, however, has a number of drawbacks, especially the potential risk of maintaining bad decisions from the past and not being able to make *ex-post* assessments of the effectiveness of public expenditures.

The main instrument for eliminating these deficiencies should be programme budgeting. In order to successfully implement such an instrument, a common methodology for specifying the requirements in the form of programme documents must be introduced (objectives, criteria for assessing effectiveness, monitoring indicators, etc.).

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<sup>20</sup> The restrictions for 2006 and 2007 do not relate to the funds earmarked for financing flood damages, supplementary financing for European projects and funds earmarked for financing Common Agricultural Policy.

### 8.2 New Challenges

#### Increasing the absorption of European funds

The main fiscal challenge is to increase absorption and to ensure sufficient space in public budgets for co-financing substantially larger volumes of funds that the Czech Republic will have at its disposal as a part of the EU financial perspectives 2007–2013. This will also require institutional changes.

On 1 January 2007, the transfers from the structural funds and the Cohesion Fund will be completely integrated into the national budgetary process which will simplify and speed up the system for the financial flow of EU funds to end users.

# 9 Programme Declaration of the New Government

## 9.1 The Medium-Term Objectives of Budgetary Policy

The government's objectives in its programme declaration are: (a) to reverse the unfavourable development of public finances, especially in the area of mandatory expenditures, (b) to reduce the general government deficit, (c) to halt government debt growth, (d) to reduce unemployment and the tax burden, and (e) to reduce the level of corruption and regulation. Fiscal consolidation and a change in the structure of expenditures, especially in the mandatory area, will also improve the quality of public finances.

These strategic objectives, however, will not be incorporated into the legislative steps until this year and next year, thus the government's objectives presented here are without quantification.

The programme declaration contains fiscal objectives expressed in the national methodology, which is cash based. The government plans to gradually reduce the general government deficit to 3.0% of GDP in 2008, to 2.6% of GDP in 2009 and to 2.3% of GDP in 2010. Since some of the planned measures on the revenue side will have a different impact in cash and accrual terms, the deficit may be approximately 0.2 of a percentage point higher in subsequent years according to ESA 95 methodology.

The government has explicitly adopted the principles of fiscal targeting and medium-term expenditure frameworks. It has committed itself to submit the medium-term fiscal outlook, which respects these principles and the Czech Republic's international obligations vis-à-vis the EU.

In this respect, it responds to the deficiencies identified in the last National Reform Programme (2006) and as a part of the preparations for the 2007 state budget and its medium-term outlook (see Sections 4 and 8). With respect to the maximum deficit level, the maximum nominal amount of expenditures will be set on the basis of macroeconomic assumptions and the related budgetary revenue forecasts. The obligation to meet the medium-term expenditure framework will be supported by the following principle: in the event of higher-than-expected revenues, expenditures will be the indicator not to be exceeded; if revenues are lower, then the deficit will be the indicator not to be exceeded.

Fiscal consolidation will rely to a substantial degree on the consolidation of the expenditure side of public finances through halting the growth of expenditures, especially social expenditures. The main instruments should be a moratorium on adopting acts that increase mandatory expenditures and a reduction in the share of mandatory expenditures in the state budget for 2010 to under 50% (from the 54.7% budgeted for 2007).

Expenditure-based consolidation leads to a reduction in the deficit and a gradual decline in the composite tax quota, which should fall to under 34% of GDP by 2009 according to the national methodology (against 37% in 2007).

As for the long-term financial sustainability of public finances, the government's main priority is to initiate reforms of the pension and healthcare systems.

### 9.2 Measures on the Expenditure Side

The main instrument for public budget consolidation and for reaching the set budgetary objectives is to slow the growth of mandatory expenditures, especially social expenditures. In its programme declaration, the government undertakes to regulate the development of mandatory social expenditures, which make up about 80% of total mandatory expenditures in the 2007 state budget. The goal is to keep the public finance deficits from exceeding the set targets and to keep total mandatory expenditures in 2010 below 50% of the state budget.

In particular, the government intends to implement the following austerity measures:

- A moratorium on adopting acts that increase mandatory expenditures;
- Removing the automatic valorisation schemes, with the exception of pensions;
- Reducing the number of civil service employees by at least 3% p.a. by 2010;
- Changing the conditions for providing social contributions and reducing the amount and reassessing the provision of additional benefits with the goal of increasing transparency and directness;
- Changing the system of sickness insurance by introducing a three-day exclusion period<sup>21</sup>, reducing the percentage rate for wage compensation and sickness benefits, and introducing a reduction in the daily assessment base;
- Introducing flexible parental and maternity leaves with payments that gradually decrease over time and with an age limit of three years old for the children;
- Assessing the connection between the disbursement of funds from the social system and the obligation of requalification, community work, and participation in further education projects;
- Eliminating the lack of motivation to earn caused by the incremental limits for receiving social benefits so that the marginal net rate of taxation is as linear as possible;
- Postponing the approved system of social casualty insurance for one year and creating a new system without encumbering the state budget.

### 9.3 Measures on the Revenue Side

A change in the trends of mandatory expenditures, together with a change in the quality of the expenditure structure, helps to gradually reduce the tax burden and to shift its structure towards indirect taxation. The following key measures will be taken:

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<sup>21</sup> During which sickness benefits are suspended.

### Income tax

- A flat income tax rate for private individuals and legal entities from 17% to 19% together with allowances for families with children and low-income groups;
- To perform an audit of exceptions and deductible items for the income taxes of private individuals and legal entities with the goal of verifying the need of these in the future, to significantly reduce the number of exceptions and deductible items;
- To simplify the system of accounting depreciation, especially for small organisations;
- To promote investment in science, research and environmentally friendly technology;

### Value added tax

- The standard VAT rate will be from 17% to 19%;
- In addition to reducing the standard VAT rate, the reduced rate will be changed so that it is also acceptable for socially weak groups;
- The reduced VAT rate will be calculated separately and certain environmental fuels and technology, among others, will be included;

### Additional tax measures

- Cancellation of taxes on dividends, capital earnings, inheritance, gifts (with the exception of persons who are not relatives), real estate transfer tax, and real estate tax on agricultural land;
- Cancellation of the minimum tax for self-employed;
- Possibility of one-year tax holidays for self-employed.

### Environmental tax reform

In accordance with EU requirements and the Czech Republic's commitment, an environmental tax reform will be implemented. A new energy tax (tax on electricity, coal and natural gas) will be introduced starting from January 2008. During the first phase, tax rates will be set at the level of the minimum tax rates under European legislation. In the second phase, gradual increases in the rates may be considered.

### Social insurance

The government plans to adopt the following measure in the area of social insurance:

- To reduce the social contribution rate in line with environmental tax revenue;
- To reduce the assessment base for the social security and health insurance contributions for self-employed to 35%;
- To introduce a maximum assessment base (ceiling) for contributions;
- With respect to the new act on sickness insurance (see Section 6.2), to allow firms with up to 50 employees to opt for a partial refund of earnings for wage compensation from the state budget without reducing the social security contributions.



### Tax administration

The government would like to significantly reduce the administrative burden of business by simplifying and streamlining the administration of taxes and social security contributions. Thus, the number of offices for tax and contribution collection will be reduced, the project of central registration offices will be completed, and a duty to provide binding interpretations of tax regulations will be introduced. In addition, the government would like to prevent tax evasion, strengthen motivation for paying taxes, and increase tax revenues. The government intends to submit a proposal for cancelling the obligation to introduce registration desks. It will also introduce a system of “super-gross” wages as current gross wages plus deductions for health and social security contributions paid by employers.

### Other revenues

Another objective of the government is to complete the privatisation process. The government plans to privatise Czech Airlines, the Prague Airport and the Czech Post Office and to review the partial privatisation of Czech Railways. The value of the shares of ČEZ should be incorporated into the pension reform. The incorporation of revenues from privatisation into state expenditures should be completed with the 2009 budget at the latest.

The system of electronic motorway tolls in the Czech Republic for vehicles over 12 tonnes was put into operation on 1 January 2007. The next step will be to combine it with microwave and satellite technology for collecting tolls on all motorways and certain first class state roads for vehicles over 3.5 tonnes. The government will have discussions with the regions with the goal of expanding the toll system for second class or possibly even third class roads. Toll rates will differ according to vehicle emission parameters to the maximum extent permitted by EU legislation.

With respect to the priorities identified in the last CP (see Section 8.2), the government plans to simplify the system of allocating European funds and to create a clear and unified system for informing the public. It will prepare a system of co-financing the structural fund programmes and the Cohesion Fund from national public sources that will ensure maximum possible access to the programmes for all relevant agents of regional development.

## 9.4 Long-Term Sustainability of Public Finances

In addition to the medium-term consolidation of public finances, the main priorities of the new government are pension and healthcare reforms. Changes in the pension system and healthcare system will be based on maintaining the principles of solidarity, increasing individual responsibility and supporting families with children.

### Pension reform

In the first stage of the pension reform, parametric changes to the pay-as-you-go system will be made, including the ongoing process of raising the retirement age to 65 years old, extending the minimum insurance period to 35 years, introducing a maximum assessment base (ceiling) for contributions, introducing a flexible age band for retirement, and additional changes with respect to the preliminary agreement between the political parties from the beginning of 2006.

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The second stage of the pension reform will involve the separation of client and shareholder assets in the system of voluntary pension schemes, including the option of providing various targeted pension plans, including guaranteed plans. Moreover, there will be an increase in motivation for higher contributions to voluntary supplementary pension insurance, higher employer participation, support in drawing on life-time pensions from supplementary insurance, creation of a reserve pension fund, and creation of independent state budget headings for financing pension insurance. With respect to the environmental tax reform, its integration with pension financing will be resolved and the contribution rate will be reduced in proportion to the environmental tax revenue. Minimum incomes for pensioners will be guaranteed at the minimum sustenance level.

The third stage of the pension reform could involve the creation of an additional voluntary savings scheme for the pension system based on the opt-out principle.

### Healthcare reform

The government considers economic stabilisation, modernisation and additional development of the healthcare system, based especially on public health insurance, to be one of its primary programme priorities.

In this respect, it will initiate a discussion on the transformation of the healthcare system and the creation of an expert committee under the direction of an independent coordinator (similar to the expert team for the pension reform). However, until this time, it will adopt needed institutional and legislative changes on the basis of the following principles:

- Maintaining solidarity in healthcare financing;
- Strengthening the status of patients in the healthcare system on the basis of solidarity between healthy persons and patients;
- Strengthening fair competition among healthcare institutions and the status of physicians, the equal status of healthcare facilities regardless of ownership and legal form and replacing the act on non-profit hospitals in the EU environment with a standard act on non-profit organisations;
- Transforming health insurance companies into joint-stock companies with increased transparency;
- Revising the scope of health insurance with clear definitions of healthcare requirements and the possibility of choosing alternative health insurance with the option of paying extra for higher standard care or arranging supplementary insurance for this care;
- Introducing the transparent and effective payment of medication and medical supplies;
- The healthcare system as one of the priorities in the operational programmes for drawing on the EU structural funds.

The government plans to implement these measures during its elected period up to 2010. The measures will be specified in more detail in the draft state budget for 2008 and in the next CP update.

# 10 Annexes

## 10.1 Table Annex

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

**Table 10.1: Economic growth (from quarterly accounts, CZK billion, increase in %)**

	ESA code	Year	Year	Year	Year	Year	
		2005 level <sup>1)</sup>	2005 rate of change	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change
1. Real GDP	B1*g	2950	6,1	6,0	4,9	4,8	4,8
2. Nominal GDP	B1*g	2978	7,1	7,5	7,6	7,8	7,9
<b>Components of real GDP</b>							
3. Private consumption expenditure	P3	1442	2,3	3,9	4,2	4,1	4,1
4. Government consumption expenditure	P3	628	0,7	-1,0	0,5	-0,3	-0,3
5. Gross fixed capital formation	P51	756	3,6	6,5	7,8	7,9	8,0
6. Changes in inventories and net acquisition of valuable a % of GDP <sup>2)</sup>	P52+P53	30	1,0	2,4	2,5	2,4	2,3
7. Exports of goods and services	P6	2184	10,6	12,7	10,6	10,3	10,4
8. Imports of goods and services	P7	2089	4,9	11,4	10,2	9,6	9,7
<b>Contribution to GDP growth</b>							
9. Final domestic demand			2,3	3,3	4,2	4,0	4,0
10. Change in inventories and net acquisition of valuable	P52+P53		-0,2	1,6	0,3	0,1	0,0
11. External balance of goods and services	B11		4,0	1,1	0,5	0,7	0,9

<sup>1)</sup> Real level in 2004 prices

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

**Table 10.2: Price development (%)**

Price developments ( in % )

	Year	Year	Year	Year	Year	Year
	2005 level <sup>1)</sup>	2005 rate of change	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change
1. GDP deflator	113,8	0,9	1,4	2,6	2,9	2,9
2. Private consumption deflator	109,9	1,8	2,7	2,9	2,9	2,8
3. HICP	110,4	1,6	2,4	2,6	2,5	2,5
4. Public consumption deflator	124,7	5,7	4,5	4,3	4,7	4,7
5. Investment deflator	101,5	0,4	1,0	0,5	0,5	0,7
6. Export price deflator (goods and services)	94,5	-2,2	-1,7	0,0	1,8	1,7
7. Import price deflator (goods and services)	90,1	-0,5	-0,3	-0,2	1,4	1,3

<sup>1)</sup> 2000 = 100%

**Table 10.3: Labour market development**

	ESA code	Year	Year	Year	Year	Year	
		2005 level	2005 rate of change	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change
1. Employment, 1000 persons <sup>1)</sup>		4966	0,7	1,6	1,0	0,5	0,2
2. Employment, mill. hours worked <sup>2)</sup>		9572	0,9	1,6	1,0	0,5	0,2
3. Unemployment rate (%) <sup>3)</sup>		7,9	7,9	7,2	6,7	6,5	6,5
4. Labour productivity, persons (1000CZK/person) <sup>4)</sup>		600	5,3	4,3	3,9	4,3	4,6
5. Labour productivity, hours worked <sup>5)</sup> (CZK/hour)		311	5,1	4,3	3,9	4,3	4,6
6. Compensation of employes	D.1	1282	6,6	7,8	7,8	7,6	7,3

<sup>1)</sup> Employed population, domestic meaning of the definition of national accounts

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

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

<sup>4)</sup> Real GDP per employed person

<sup>5)</sup> Real GDP per hour worked

Table 10.4: Analysis of the change in the net financial position

% of GDP	ESA code	Year 2005	Year 2006	Year 2007	Year 2008	Year 2009
<b>1. Net lending/borrowing vis-a-vis the rest of the world</b>	B.9	-3,3	-2,8	-1,4	0,2	1,1
- Balance on goods and services		1,9	1,8	2,2	3,1	4,0
- Balance of primary incomes and transfers		-4,6	-4,8	-4,2	-4,1	-4,1
- Capital account		-0,5	0,4	0,7	1,3	1,3
<b>2. Net lending/borrowing of the private sector</b>	B.9	0,3	0,7	2,6	3,7	4,1
- Corporate sector		1,0	1,4	3,4	4,3	4,5
- Households		-0,6	-0,7	-0,8	-0,6	-0,4
<b>3. Net lending/borrowing of general government</b>	B.9	-3,6	-3,5	-4,0	-3,5	-3,0
<b>4. Statistical Discrepancy</b>		0,0	0,0	0,0	0,0	0,0

Table 10.5: General government budget

	ESA code	Year 2005	Year 2005	Year 2006 (1)	Year 2007 (2)	Year 2008 (2)	Year 2009 (2)
		CZK bill		% of GDP			
<b>Net lending/borrowing (EDP B.9) by sub-sectors</b>							
1. General government	S.13	-107,6	-3,6	-3,5	-4,0	-3,5	-3,2
2. Central government	S.1311	-107,0	-3,6	-3,7	-3,8	-3,3	-3,0
3. State government	S.1312	-	-	-	-	-	-
4. Local government	S.1313	-2,3	-0,1	0,0	-0,2	-0,2	-0,2
5. Social security funds	S.1314	1,9	0,1	0,1	0,0	0,0	0,0
<b>General government (S13)</b>							
6. Total revenue	ESA	1 200,4	40,4	39,9	39,9	40,4	40,3
7. Total expenditure	ESA	1 308,1	44,0	43,4	43,9	43,9	43,4
8. Net lending/borrowing	EDP B.9	-107,6	-3,6	-3,5	-4,0	-3,5	-3,2
9. Interest expenditure (incl. FISIM)	EDP D.41	34,6	1,2	1,2	1,4	1,5	1,5
p.m.: FISIM		0,0	0,0	0,0	0,0	0,0	0,0
10. Primary balance		-94,3	-3,2	-3,1	-3,4	-2,8	-2,3
<b>Components of revenues</b>							
11. Total taxes		620,1	20,9	20,4	20,0	19,9	19,4
11a. Taxes on production and imports	D.2	344,1	11,6	11,3	11,2	10,9	10,5
11b. Current taxes on income, wealth etc.	D.5	275,3	9,3	9,0	8,8	9,0	8,9
11c. Capital taxes	D.91	0,7	0,0	0,0	0,0	0,0	0,0
12. Social contributions	D.61	448,4	15,1	15,1	15,1	14,8	14,7
13. Property income	D.4	21,2	0,7	0,8	0,8	0,7	0,7
14. Other		110,7	3,7	3,7	4,1	4,9	5,5
15. Total revenue	TR	1 200,4	40,4	39,9	39,9	40,4	40,3
p.m.: Tax burden		1 068,5	36,0	35,5	35,1	34,7	34,1
<b>Components of expenditures</b>							
16. Collective consumption	P.32	331,9	11,2	10,9	10,6	10,3	10,1
17. Total social transfers	D.62+D.63	673,9	22,7	22,6	23,0	23,0	22,7
17a. Social transfers in kind	D.63	331,2	11,2	11,0	10,9	10,9	10,7
17b. Social transfers other than in kind	D.62	342,7	11,5	11,6	12,1	12,1	12,0
18. Interest expenditure	EDP D.41	34,6	1,2	1,2	1,4	1,5	1,5
19. Subsidies	D.3	55,3	1,9	1,9	1,9	1,8	1,7
20. Gross fixed capital formation	P.51	147,9	5,0	5,1	5,2	5,6	5,7
21. Other		64,4	2,2	1,8	1,8	1,7	1,7
22. Total expenditures	TE	1 308,1	44,0	43,4	43,9	43,9	43,4
p.m.: Compensation of employees	D.1	236,6	8,0	7,7	7,6	7,4	7,2

(1) Notifications (October 2006), Ministry of Finance estimates

(2) Outlook

Table 10.6: General government debt

% of GDP	Year	Year	Year	Year	Year
	2005	2006 (1)	2007 (2)	2008 (2)	2009 (2)
<b>1. Gross debt</b>	30,4	30,6	30,5	31,3	32,0
<b>2. Change in gross debt</b>	-0,3	0,2	-0,1	0,8	0,7
<b>3. Primary balance</b>	2,5	2,4	2,6	2,0	1,4
<b>4. Interest expenditure (incl. FISIM)</b>	1,2	1,2	1,4	1,5	1,5
<b>5. Nominal GDP growth</b>	-2,0	-2,2	-2,2	-2,2	-2,3
<b>6. Stock-flow adjustment</b>	-2,0	-1,1	-1,9	-0,5	0,0
- Difference between cash and accruals	-1,6	0,4	0,0	0,0	0,0
- Net accumulation of financial assets	-0,4	-1,5	-1,9	-0,5	0,0
of which: Privatisation proceeds	-3,6	-0,1	-1,0	0,0	0,0
- Valuation effects and other	0,0	0,0	0,0	0,0	0,0
<b>p.m. implicit interest rate on debt</b>	4,0	4,1	4,9	5,2	5,3
<b>Other relevant variables</b>					
<b>7. Liquid financial assets</b>	-	-	-	-	-
<b>8. Net financial debt</b>	-	-	-	-	-

(1) Notifications (October 2006)

(2) Outlook

Table 10.7: Cyclical development<sup>(a)</sup>

% of GDP	ESA code	Year	Year	Year	Year	Year
		2005	2006 (1)	2007 (2)	2008 (2)	2009 (2)
<b>1. Real GDP growth (%)</b>		6,1	6,0	4,9	4,8	4,8
<b>2. Net lending of general government</b>	<b>EDP B.9</b>	-3,6	-3,5	-4,0	-3,5	-3,0
<b>3. Interest expenditure (incl. FISIM)</b>	<b>EDP D.41</b>	1,2	1,2	1,4	1,5	1,5
<b>4. Potential GDP growth (%)</b>		4,8	5,0	5,1	5,1	5,2
<i>contributions:</i>						
- labour		0,4	0,5	0,3	0,2	0,1
- capital		0,8	0,9	1,0	1,1	1,2
- total factor productivity		3,6	3,6	3,8	3,8	4,0
<b>5. Output gap</b>		-0,1	0,9	0,7	0,4	0,1
<b>6. Cyclical budgetary component</b>		0,0	0,3	0,2	0,1	0,0
<b>7. Cyclically-adjusted balance (2 – 6)</b>		-3,6	-3,8	-4,2	-3,6	-3,0
<b>8. Cyclically-adjusted primary balance (7 – 3)</b>		-2,5	-2,6	-2,8	-2,2	-1,4

(a) The figures in rows 4 to 8 are based on current estimates of the Ministry of Finance.

(1) Estimate

(2) Outlook

Table 10.8: Divergence from the previous update

% of GDP	ESA code	Year 2005	Year 2006 (1)	Year 2007 (2)	Year 2008 (2)	Year 2009 (2)
<b>GDP growth</b>						
Previous update		4,8	4,4	4,2	4,3	.
Latest update		6,1	6,0	4,9	4,8	4,8
Difference		1,3	1,6	0,7	0,5	.
<b>Actual budget balance</b>						
Previous update	EDP B.9	-4,8	-3,8	-3,3	-2,7	.
Latest update	EDP B.9	-3,6	-3,5	-4,0	-3,5	-3,0
Difference		1,2	0,3	-0,7	-0,8	.
<b>Gross debt levels <sup>(a)</sup></b>						
Previous update		37,4	37,1	37,9	37,8	.
Latest update		30,4	30,6	30,5	31,3	32,0
Difference		x	x	x	x	.

(a) In view of the extensive statistical revision of the gross debt, the figures in the current and previous CP are not comparable.

(1) Estimate

(2) Outlook

Table 10.9: Long-term sustainability of public finances

% of GDP	Year 2005	Year 2010	Year 2020	Year 2030	Year 2040	Year 2050
<b>Total expenditure</b>	44,0	42,5	43,3	46,2	52,0	59,2
<i>of which: Age-related expenditure</i>	19,9	18,5	18,9	20,9	24,5	27,7
<b>Pension Expenditure</b>	8,4	7,7	8,3	9,5	12,1	14,2
<b>Social security pensions</b>	8,4	7,7	8,3	9,5	12,1	14,2
<b>Old-age and early pensions</b>	7,6	7,0	7,5	8,7	11,4	13,5
<b>Other pensions</b>	0,8	0,7	0,7	0,8	0,7	0,7
<b>Occupational pensions</b>	0,0	0,0	0,0	0,0	0,0	0,0
<b>Health care</b>	6,5	6,4	6,7	7,3	8,1	8,9
<b>Long-term care</b>	0,3	0,3	0,3	0,4	0,5	0,6
<b>Education expenditure</b>	3,6	3,1	2,7	2,8	2,9	3,0
<b>Other age-related expenditures</b>	1,2	1,0	1,0	0,9	1,0	1,1
<b>Interest expenditure</b>	1,2	0,9	1,3	2,2	4,3	8,4
<b>Total revenue</b>	40,4	40,3	40,3	40,3	40,3	40,3
<i>of which: Property income</i>	0,7	0,7	0,7	0,7	0,7	0,7
<i>of which: Pension contributions</i>	8,7	8,7	8,7	8,7	8,7	8,7
<b>Pension reserve fund assets</b>	0,5	4,9	12,9	12,4	0,0	0,0
<i>of which: Consolidated public pension fund assets</i>	0,0	0,0	0,0	0,0	0,0	0,0
<b>Labour productivity growth</b>	4,8	3,4	3,0	2,7	1,9	1,7
<b>Real GDP growth</b>	6,1	3,6	2,5	1,9	0,4	0,8
<b>Participation rate males (aged 20–64)</b>	83,5	84,6	87,4	87,1	84,4	85,6
<b>Participation rates females (aged 20–64)</b>	68,2	70,6	76,4	76,1	72,9	74,0
<b>Total participation rates (aged 20–64)</b>	75,8	77,6	81,9	81,6	78,7	79,8
<b>Unemployment rate</b>	7,9	7,3	6,5	6,5	6,5	6,5
<b>Population aged 65+ over total population</b>	14,2	15,5	20,8	23,6	26,8	31,0

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

Table 10.10: Basic assumptions

	Year	Year	Year	Year	Year
	2005	2006	2007	2008	2009
<b>Short-term interest rate (CZ) (annual average)</b>	2,0	2,3	-	-	
<b>Long-term interest rate (CZ) (annual average)</b>	3,5	3,9	4,5	4,3	4,2
<b>USD/EUR exchange rate (annual average)</b>	1,24	1,25	1,26	1,26	1,26
<b>Nominal effective exchange rate (2000 = 100)</b>	123,5	129,3	131,5	133,4	135,3
<b>Exchange rate CZK/EUR (annual average)</b>	29,8	28,4	28,0	27,5	27,1
<b>World GDP growth, excluding EU</b>	5,3	5,7	5,2	5,2	5,0
<b>EU-25 GDP growth</b>	1,7	2,7	2,2	2,3	2,4
<b>Growth of relevant foreign markets</b>	8,2	10,9	7,9	8,0	8,0
<b>Growth of world import volumes, excluding EU</b>	8,5	9,0	8,2	7,8	7,7
<b>Oil prices (Brent, USD/barrel)</b>	54,4	67,5	59,8	55,0	52,0