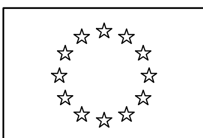

EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

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CZECH REPUBLIC: MACRO FISCAL ASSESSMENT

AN ANALYSIS OF THE NOVEMBER 2007 UPDATE

OF THE CONVERGENCE PROGRAMME

The Stability and Growth Pact requires each EU Member State to present an annual update of its medium-term fiscal programme, called "stability programme" for countries that have adopted the euro as their currency and "convergence programme" for those that have not. The most recent update of the Czech Republic's convergence programme was submitted on 30 November 2007. The attached technical analysis of the programme, prepared by the staff of, and under the responsibility of, the Directorate-General for Economic and Financial Affairs (DG ECFIN) of the European Commission, was finalised on 25 February 2008. Comments should be sent to Neil Kay (neil.kay@ec.europa.eu) or Malgorzata Galar (malgorzata.galar@ec.europa.eu). The main aim of the analysis is to assess the realism of the budgetary strategy presented in the programme as well as its compliance with the requirements of the Stability and Growth Pact. However, the analysis also looks at the overall macro-economic performance of the country and highlights relevant policy challenges.

The analysis takes into account (i) the Commission services' autumn 2007 forecast, (ii) the code of conduct ("Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005) and (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances. Technical issues are explained in an accompanying "methodological paper" prepared by DG ECFIN.

Based on this technical analysis, the European Commission adopted a recommendation for a Council opinion on the programme on 11 February 2008. The ECOFIN Council adopted its opinion on the programme on 4 March 2008.

* * *

All these documents, as well as the provisions of the Stability and Growth Pact, can be found on the following website:

http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm

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SUMMARY AND CONCLUSIONS

As part of the preventive arm of the Stability and Growth Pact, each Member State that does not use the single currency, such as the Czech Republic, has to submit a convergence programme and annual updates thereof. The most recent programme, covering the period 2007-2010, was submitted on 30 November 2007. Under the corrective arm of the Pact, the Czech Republic was placed in excessive deficit by the Council in 5 July 2004. The deadline for correcting the excessive deficit is 2008.

The Czech Republic is experiencing a period of high growth which is expected to moderate in the medium term. The recent sharp fall in unemployment can be mainly accounted for by cyclical factors. Structural rigidities still appear to remain in the labour market, indicated by a high level of vacancies, evidence of skills-mismatches, and regional disparities in unemployment, which will need to be addressed by future employment policy. The stabilisation programme adopted in 2007 appears to be a step in the right direction while further measures will be necessary to continue fiscal consolidation. Notably, risks remain with respect to long-term sustainability of public finances, given the ageing population and current state of pension and health care systems. A well devised pension reform could also have a positive impact on potential growth. While taking into consideration the good track record of the Czech Republic, inflationary pressures are set to increase due to rises in indirect taxation and rising international commodity prices.

The convergence programme estimates GDP growth to be about 6% in 2007 and moderate to about 5% over the rest of the programme period. Assessed against currently available information[1], this scenario appears to be based on plausible assumptions. The Commission services' autumn 2007 forecast expects private consumption growth to remain strong on the back of high wage increases in the private sector and rising employment, while moderating from the high level in 2007 linked to the government's planned fiscal consolidation. The convergence programme sees a strong role for investment and inventories. Both the convergence programme and the Commission services' autumn forecast predict a steep rise in inflation in 2008 due to increases in indirect taxation and rising commodity prices.

For 2007, the Commission services' autumn forecast and the convergence programme estimate a general government deficit of 3.4% of GDP, which is 0.6 percentage points below the target set in the previous update. However, recent information on budgetary implementation indicates that the 2007 outturn could be significantly better than envisaged in the current programme: the most recent information suggests that the general deficit in 2007 could be about 2% of GDP. The lower estimated fiscal outcome is mainly due to the base effect of a higher revenue-to-GDP ratio in 2006 than anticipated in the previous convergence programme, as well as some expenditure restraint in 2007 and dynamic revenue growth thanks to stronger nominal GDP growth than anticipated. A lower 2007 deficit compared to the 2006 budgetary outcome is in line with the invitation

[1] The assessment takes notably into account the Commission services' autumn forecast and the Commission assessment of the July 2007 national reform programme.

in the Council opinion of 10 July 2007 on the previous update of the convergence programme[2] to limit the budgetary deterioration in 2007

The main goal of the budgetary strategy in the programme is to correct the excessive deficit in 2008 and thereafter to continue consolidation towards the achievement of the medium-term objective (MTO), which is a structural deficit of 1% of GDP, in 2012. The general government deficit is projected to decrease from 3.4% of GDP in 2007 to 2.9% of GDP in 2008, 2.6% of GDP in 2009 and 2.3% of GDP in 2010. The primary deficit follows a similar path, narrowing from 2.3% of GDP in 2007 to 1.1% of GDP in 2010. The consolidation will be mainly expenditure-driven. In particular, the expected fall in the revenue-to-GDP ratio (partly attributable to the introduction of a flat tax in 2008) will be more than offset by a cut in the expenditure-to-GDP ratio. The latter is relatively broad-based but affects social and welfare benefits most significantly; public investment is the only spending category that is planned to increase as a share of GDP. Building on the better-than-expected outturns in 2006 and 2007, the targets for public finances have been improved compared to those in the previous convergence programme. The most recent estimate of a lower general deficit in 2007 implies that these targets should be comfortably within reach.

The outcome for 2008 could be better than expected while the balance of risks is neutral with respect to budgetary outcomes from 2009 onwards. On one hand, the Czech Republic has a history of achieving lower-than-planned deficits and the latest estimate for 2007 is significantly better than foreseen in the programme, which may have a favourable base effect from 2008. While there are a large amount of tax changes occurring, which makes forecasting difficult, the programme's tax estimates appear cautious. On the other hand, the targeted consolidation requires significant expenditure restraint, including public sector wage restraint and cut backs in the number of public employees, while expenditure ceilings have been breached in previous years. After 2008, further consolidation measures remain to be spelled out.

In view of this risk assessment, namely in the light of the better-than-expected outturn in 2007, the budgetary stance in the programme seems consistent with a durable correction of the excessive deficit by 2008, as recommended by the Council. This is conditional on continuing expenditure restraint and a close monitoring of the fiscal impact of the tax reforms in the stabilisation programme. However, sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations would not be achieved within the programme period. In the years following the correction of the excessive deficit, the pace of adjustment towards the MTO implied by the programme should be strengthened and backed up with measures to be in line with the Stability and Growth Pact. In particular, while the Czech Republic has experienced a period of strong growth, the programme target for 2010 implies that a significant adjustment will have to be made in 2011-2012 to achieve the MTO by 2012.

The Czech Republic appears to be at high risk with regard to the sustainability of public finances. The initial budgetary position in the programme is not sufficiently high to stabilize the debt ratio over the long-term. The long-term budgetary impact of ageing is well above the EU average, influenced notably by a substantial increase in pension expenditure as a share of GDP as well as a significant increase in health care expenditure. Implementation of structural reform measures notably in the field of

[2] OJ C 204, 1.9.2007, p.1.

pensions and health care aimed at containing the significant increase in age-related expenditures would contribute to reducing risks to the sustainability of public finances. While some initial steps have been made to reform the health care system, reform of the pension system still lacks implementation against a definite timetable.

The Czech Republic's national reform programme identifies as key challenges/priorities: the long-term sustainability of public finances in the context of an ageing population, fulfilling the commitments for public R&D expenditure and further increasing its effectiveness, improving security and flexibility in the labour market, improving the efficiency and equity in education and training and increasing participation in life-long learning. The Commission's assessment is that the Czech Republic has made some progress in implementing its National Reform Programme over the period 2005-2007. The budgetary strategy in the programme is partly consistent with the country-specific broad economic policy guidelines, including in the integrated guidelines, in the area of budgetary policies issued in the context of the Lisbon strategy given the limited actions on pension and health care reform. Structural measures have been introduced with the aim of increasing the flexibility of the labour market. A review of the tertiary education system has been launched and a strategy adopted on life-long learning. To improve the accountability and transparency of public finances, the use of the government's reserve funds has been limited and more clearly defined in accounting terms. A proposal will be introduced to simplify and integrate tax collection with the intention of bringing the changes into effect in 2010. The Czech consolidation Agency has been dissolved.

The overall conclusion is that the programme is consistent with a correction of the excessive deficit in 2008, conditional on continuing expenditure restraint and close monitoring of the impact of the fiscal impact of the tax measures in the stabilisation package. Owing to the positive macroeconomic outlook and a likely better 2007 budgetary outturn than expected in the programme, there could be ample opportunity to bring the 2008 deficit below the 3% of GDP reference value by a larger margin, and to achieve stronger-than-targeted fiscal consolidation afterwards. The main risks are in the reliance on reductions to public sector employment and relate to the fact that further consolidation measures remain to be spelled out after 2008. The Czech Republic remains at high risk with respect to the sustainability of public finances, while first steps have been made on health care reform.

In view of the above assessment and also in the light of the recommendation under Article 104(7) of 10 October 2007, and given the need to achieve sustainable convergence, the Czech Republic is invited to:

i) exploit the likely better-than-expected 2007 budgetary outcome to bring the 2008 deficit below the 3% of GDP reference value by a larger margin by continuing to exercise expenditure restraint;

(ii) exploit the high rate of growth in the economy by further strengthening the pace of adjustment so as to build a safety margin against breaching the reference value as soon as possible, and speed up the achievement of the MTO;

(iii) in view of the projected increase in age-related expenditures, improve the long-term sustainability of public finances through the necessary pension and health care reforms.

Comparison of key macroeconomic and budgetary projections

		2006	2007	2008	2009	2010
Real GDP (% change)	**CP Nov 2007**	**6.4**	**5.9**	**5.0**	**5.1**	**5.3**
	COM Nov 2007	6.4	5.8	5.0	4.9	n.a.
	CP March 2007	*6.0*	*4.9*	*4.8*	*4.8*	*n.a.*
HICP inflation (%)	**CP Nov 2007**	**2.1**	**2.4**	**3.9**	**2.3**	**2.1**
	COM Nov 2007	2.1	3.0	3.8	3.2	n.a.
	CP March 2007	*2.4*	*2.6*	*2.5*	*2.5*	*n.a.*
Output gap[1] (% of potential GDP)	**CP Nov 2007**	**0.9**	**1.8**	**1.4**	**0.7**	**0.5**
	COM Nov 2007[2]	1.1	2.1	2.1	1.4	n.a.
	CP March 2007	*0.9*	*1.1*	*1.0*	*1.0*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**CP Nov 2007**	**-2.7**	**-2.4**	**-1.6**	**-0.4**	**1.5**
	COM Nov 2007	-2.7	-2.5	-2.1	-1.9	n.a.
	CP March 2007	*-2.8*	*-1.4*	*0.2*	*1.1*	*n.a.*
General government balance (% of GDP)	**CP Nov 2007**	**-2.9**	**-3.4**	**-2.9**	**-2.6**	**-2.3**
	COM Nov 2007	-2.9	-3.4	-2.8	-2.7	n.a.
	CP March 2007	*-3.5*	*-4.0*	*-3.5*	*-3.2*	*n.a.*
Primary balance (% of GDP)	**CP Nov 2007**	**-1.8**	**-2.3**	**-1.7**	**-1.3**	**-1.1**
	COM Nov 2007	-1.8	-2.3	-1.8	-1.7	n.a.
	CP March 2007	*-2.4*	*-2.6*	*-2.0*	*-1.6*	*n.a.*
Cyclically-adjusted balance[1] (% of GDP)	**CP Nov 2007**	**-3.3**	**-4.1**	**-3.4**	**-2.8**	**-2.5**
	COM Nov 2007	-3.3	-4.1	-3.6	-3.2	n.a.
	CP March 2007	*-3.9*	*-4.4*	*-3.9*	*-3.5*	*n.a.*
Structural balance[3] (% of GDP)	**CP Nov 2007**	**-3.1**	**-4.1**	**-3.4**	**-2.8**	**-2.5**
	COM Nov 2007	-3.3	-4.1	-3.6	-3.2	n.a.
	CP March 2007	*-3.9*	*-4.4*	*-3.9*	*-3.5*	*n.a.*
Government gross debt (% of GDP)	**CP Nov 2007**	**30.1**	**30.4**	**30.3**	**30.2**	**30.0**
	COM Nov 2007	30.1	30.2	30.3	30.5	n.a.
	CP March 2007	*30.6*	*30.5*	*31.3*	*32.2*	*n.a.*

Notes:

[1]Output gaps and cyclically-adjusted balances according to the programmes as recalculated by Commission services on the basis of the information in the programmes.

[2]Based on estimated potential growth of 4.5%, 4.7%, 5.0% and 5.6% respectively in the period 2006-2009.

[3]Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures in the convergence programme of November 2007 are -0.2% of GDP in year 2006; deficit-increasing. There are no one-offs in the Commission services' autumn forecast.

Source :
Convergence programme (CP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations

1. INTRODUCTION

The November 2007 update of the Convergence Programme was submitted on 30 November 2007. It covers the period 2007 to 2010. The programme was approved by the Czech government on 28 November 2007 on the basis of the 2008 budget.

This assessment is further structured as follows. Section 2 discusses key challenges for public finances in the Czech Republic, with a particular focus on the long-term sustainability of public finances. Section 3 assesses the plausibility of the macroeconomic scenario underpinning the public finance projections of the convergence programme against the background of the Commission services' economic forecasts. Section 4 analyses budgetary implementation in the year 2007 and the medium-term budgetary strategy outlined in the new programme. Taking into account risks attached to the budgetary targets, it also assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact. Section 5 reviews recent debt developments and medium-term prospects, as well as the long-term sustainability of public finances. Section 6 discusses the quality of public finances and structural reforms, while Section 7 analyses the consistency of the budgetary strategy outlined in the programme with the National Reform Programme and its implementation reports and with the broad economic policy guidelines. The annexes provide a detailed assessment of compliance with the code of conduct, including an overview of the summary tables from the programme (Annex 1) and selected key indicators of past economic performance (Annex 2).

2. KEY CHALLENGES FOR PUBLIC FINANCES WITH A PARTICULAR FOCUS ON AGEING, CATCHING-UP AND FISCAL SUSTAINABILITY IN THE CZECH REPUBLIC – THE CASE FOR PENSION REFORM.

2.1. Introduction

The Commission's assessment of the 2006 national reform programme of the Czech Republic contained a recommendation on long-term sustainability. With a view to improving the long-term sustainability of public finances, the Czech Republic was recommended to "take steps to implement reforms of the pension and healthcare systems, in particular on the basis of the 2005 all-party pensions report, and fix a timetable for their implementation". The Council Opinion on the March 2007 Convergence Programme also noted that the Czech Republic appears to be at high risk with regard to the sustainability of public finances.

Economic convergence in the Czech Republic will be accompanied by a rapidly ageing population. The demographic shift will place a greater strain on public finances and could potentially slow down growth in the economy. The impact of these changes will be felt most directly on age-related public services, such as the pension and health-care systems.

Figure 1: Main economic channels of ageing

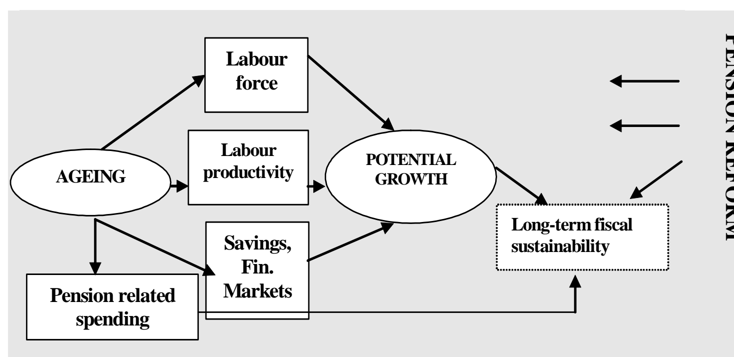


Figure 1 illustrates the main economic channels through which ageing affects potential growth, fiscal balances, and long-term fiscal sustainability.

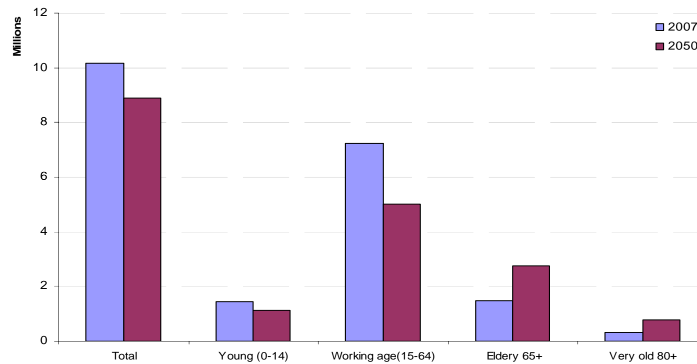
The following sections examine the economic challenges faced by the Czech Republic. Particular focus is given to the pension system, including an assessment of the recent proposals put forward by the main political parties. The potential impact of ageing on growth is analysed by examining the potential effect on labour supply, productivity and savings.

2.2. Demographic developments: the ageing process in the long term perspective

The Czech population is undergoing a demographic shift due to a low fertility rate and increasing life expectancy. According to Commission services' projections[3], the Czech population will have shrunk from 10.17 millions to 8.89 millions by 2050. While the working age population (15-64) will decline by more than 2 millions, the elderly population (65+) will almost double. This includes a marked rise in the very old (85+) where more than a twofold increase is expected. Figure 2 shows the anticipated demographic trends over the next 4 decades.

[3] European Commission (2006) “The impact of ageing on public expenditure: projections for the EU-25 member states on pensions, healthcare, long-term care, education and unemployment transfers (2004-2050)”, Special Report No 1/2006.

Figure 2: Ageing population in the Czech Republic (2007-2050)



Source: Commission services

The impact can be highlighted by comparing the proportion of the elderly population (65+) as a percentage of the working age population (aged 15-64). According to Commission services' projections, the elderly dependency ratio (EDR) will increase from 20% in 2007 to 55% in 2050, i.e. almost triple between 2007 and 2050 (on average, for EU-27 the EDR is projected to increase 2.1 times, for EU-10 2.5 times).

2.3. The impact of ageing on public finances

Population ageing and the associated increase in the dependency ratio will place direct pressure on fiscal balances with rising costs for pension, health care and other social services. It is expected that these effects will already start to be felt in the short-term as the baby-boom generation reaches retirement.

The latest projection of the increase in age-related spending in the Czech Republic is 7.2 p.p. of GDP between 2004 and 2050 (See Section 5 of this convergence programme assessment). This increase is significantly higher than the EU average, 3.4 (p.p.) of GDP, and a reflection of the rapid ageing of the Czech population as well as the structure of the current pension and health care systems. As indicated by Table 12 in Section 5, the largest proportion of the expected increase in age-related spending up to 2050 will be due to rises in gross pension expenditures, estimated to account for 5.6 p.p. of GDP. The projection of the increase in spending in health care and long-term care is also relatively high at 2.4 p.p. of GDP between 2004 and 2050, the second highest increase in the EU-25. Health care in the Czech Republic has not undergone significant economic reform and still has features which contribute to relatively high costs including a high capacity of beds, specialists and services, and the service level expected by the average Czech citizen is also high. Some nominal charging for basic services was introduced in 2007, but the system remains largely unreformed.

On the basis of the current budgetary position and the projected budgetary changes over the long-term, the Czech Republic is assessed (in Section 5 of this assessment) to have a sustainability gap (required permanent budgetary adjustment of the primary balance) of 3.8% of GDP for containing debt within the Maastricht level of 60% of GDP by 2050, and 6.8% of GDP for fulfilling the inter-temporal budget constraint over an infinite horizon (for the exact definition of these sustainability gaps and the underlying assumptions, see Section 5). These estimates illustrate the size of the required fiscal effort which is of a scale to warrant structural reforms directly in the areas which cause

age-related expenditure, i.e. pensions and health care, in order to ensure the sustainability of public finances.

2.4. Current pension system in the Czech Republic

The Czech pension system is made up of two elements. The first element is a mandatory state-run pay-as-you-go (PAYG) system. The second element is a fully-funded (FF) voluntary private system, known as the "third pillar".

2.4.1. Pay-as-you-go system

The PAYG system is financed by a pension contribution levied on employees' gross wages as well as a proportion of the income of the self-employed. The PAYG scheme covers all sectors of the economy with the exception of the armed forces. The contribution rate is currently 28% of gross income[4] which is paid by salaried workers and the self-employed. The contribution for the self-employed is calculated on a base of half the difference between income and expenditures, which cannot fall below a minimum level of half the average gross monthly wage in the national economy. Pension insurance contributions are the sole source of income. In principle, the pension system only receives a contribution from general public finances if it falls into deficit.

The PAYG system covers old-age pensions, disability pensions and survivors' pensions. A person qualifies for an old-age pension after having contributed to the pension system for a minimum of 25 years and after having reached the statutory retirement age. The retirement age is gradually being increased to 63 years for men and between 59-63 years for women, depending on their number of children, by 2013. Pension entitlements are earnings-related but redistributive in the sense that entitlements are calculated regressively against pay.

Compared with other Visegrad countries, the pension system has a weaker link between pensions and earnings and is more redistributive. The benefit rate for an average earner under the current PAYG pension system is just under 50%[5]. This is below the average for OECD countries and the other three Visegrad countries. For those earning half of average earnings, the benefit rate increases to above the average for OECD countries.

Pension increases are partly discretionary, but mainly reflect changes in the cost and standard of living since total pension entitlement must be increased by at least inflation plus one-third of average real-earnings growth.

2.4.2. Voluntary fully-funded private system

A fully-funded (FF) private system based on voluntary individual contracts, 'the third pillar', was created in 1994 in order to supplement the state pension scheme. The system covers old-age pension, disability pension and survivors' pensions similar to the PAYG system and, in addition, includes life-insurance.

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[4] This is made up of a contribution from employees (6.5%) and a contribution from employers (21.5%). These are among the highest pension contributions in the EU.

[5] OECD (2006) Economic Survey of the Czech Republic.

The government provides a number of incentives for participation in the FF system including tax exemption on employers' contributions for an employee up to 5% of the employee's assessment base. Membership of the supplementary pension scheme has expanded strongly since its inception. The scheme now includes more than half of those in the PAYG system but the total assets still remain low at around 4% of GDP. These reflect the average contribution which is only around 2.5% of individual gross earnings.

2.4.3. Past reforms to the Czech pension system

Since the beginning of transition in 1990, there have been a number of steps taken towards improving the long-term sustainability of the pension system, mainly parametric changes to the mandatory first pillar as well as the introduction of the voluntary fully-funded third pillar. These changes are summarised in the following table.

Table 1: Main reforms to the Czech pension system

Date	Modification
1990-1992	The abolition of special pension entitlements for specific groups of workers.
1993	The creation of an earmarked contribution rate for financing part of social policy, including pensions, and the creation of an explicit pension benefit formula.
1994	The introduction of a voluntary FF pillar
1996	The introduction of a new law on pension insurance containing several parametric changes aimed at reducing the fiscal burden and strengthening inter-generational equity, e.g. a gradual increase in the statutory retirement age by 2007 to 62 for men and 57-61 for women, depending on the number of children, and a reduction in the contribution rate from 27.2% to 26%.
1997	The indexation rule was tightened and the non-contributory periods in the benefit formula were reduced.
2001	Early retirement provisions were tightened.
2004	Significant cuts were made to the non-contributory periods for higher education The possibility of early retirement with only a temporary benefit reduction was eliminated and there was an increase in the contribution base for self-employed to 50% of net income. The introduction of a further and gradual increase of the retirement age to 63 for men and 59 to 63 for women by 2013. An increase in the pension contribution from 26% to 28% (the overall social security contribution rate was unchanged because the contribution to the employment policy was lowered by 2% at the same time).
2005	An all-party report on pension reform was produced under the auspices of an independent executive committee (see Section 5).
Source: European Commission, 2005	

2.5. Proposed reform of the pension system

While these changes have improved the financial stability of the PAYG pillar, it is widely acknowledged that further reforms to the system are necessary given the pronounced demographic shift in the Czech Republic. The PAYG pillar is expected to start generating deficits from around 2025 which will increase sharply then stabilise from 2050 at round 4-5% of GDP per year[6].

This section presents the proposals put forward for pension system reform, ranging from parametric adjustments to the PAYG pillar to systemic reforms introducing a funded pillar, developed by the main political parties in the Czech Republic under the co-ordination of a special working group. The financial basis of the proposals is drawn primarily from the final report of the Executive Team of the Czech Government published in 2005[7]. The macroeconomic assumptions in the final report are broadly comparable with those in the European Commission's AWG report[8] while there are differences in certain parameters, for example, projections of GDP growth.

2.5.1. Notional accounts (Czech Social Democratic Party)

Under the proposal of the CSSD party, the main PAYG pillar would remain but based on a new system of notional accounts holding each individual's pension contributions. The statutory retirement age would be gradually increased to 65 for men and women. A minimum guaranteed pension would be introduced to protect those on low earnings.

Under the proposal, revenues of the PAYG pillar would increase from 8.5% in 2005. Expenditures would increase from 8.4% of GDP in 2005 to 10.2% of GDP in 2050. This would improve the accumulated balance in 2050 from -42.7% of GDP (under the present pension system) to -5.6% of GDP, hence a reduction of 37.1% of GDP. The overall benefit rate (the ratio of the average pension in a given time period compared with the gross average income in the same time period) would decline from 42.1% to 36.8% in 2050.

2.5.2. Carve-out defined contribution (Christian-Democratic Union - Czech People's Party)

Under the proposal of the KDU-CSL party, the PAYG system would be adjusted parametrically to improve its sustainability. A partial opt-out would be allowed whereby 8 percent of an individual's pension contribution can be transferred to a separate account. The statutory retirement age would be increased to 65 for men and women without children. For women with children, the retirement age would be reduced according to their number of children.

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[6] Czech Ministry of Labour and Social Affairs (2006) "Actuarial Report on Social Insurance 2006".

[7] Executive Team of the Czech Government (2005) "Final report on pension system reform".

[8] European Commission (2006) "The impact of ageing on public expenditure: projections for the EU-25 member states on pensions, healthcare, long-term care, education and unemployment transfers (2004-2050)", Special Report No 1/2006.

Under the proposal, and taking into account the anticipated impact of the fully-funded pillar, overall revenues would decrease from 8.5% of GDP in 2005 to 8.2% of GDP in 2050. Expenditures would increase from 8.4% of GDP in 2005 to 9.3% of GDP in 2050. This would improve the accumulated balance by 2050 to 25.6% of GDP, representing an improvement over the present system of 68.3% of GDP. The overall benefit ratio would decline from 42.1% to 30.5%. However, the revenue of the pension system would be strengthened by proceeds from indirect taxation, namely a proposed increase in the lower rate of VAT from 5% to 8%.

2.5.3. Parametric reform (Communist Party of Bohemia and Moravia)

Under the KSCM proposal, the PAYG system is maintained in its current form while the retirement age would be increased to 65 for men and women from 2030, as well as other parametric measures to improve sustainability.

Under the proposal, revenues would increase from 8.5% of GDP to 10.7% of GDP in 2050. Expenditures would increase from 8.4% of GDP to 11.5% of GDP in 2050. This would improve the accumulated balance to 34% of GDP in 2050, representing an improvement over the present system of 76.7% of GDP. The overall benefit ratio would marginally decline from 42.1% to 40.1%. However, the revenue of the system would be strengthened by proceeds from an increase in direct taxes on labour and additional transfers from other areas of the state budget, including excise duties.

2.5.4. Flat-rate (Civic Democratic Party)

Under the ODS proposal, the PAYG would provide a flat-rate pension of 20% of the average wage. This would significantly increase the motivation to subscribe to a supplementary pension plan but may also increase the burden on other parts of the social security system. The retirement age would be increased to 65 for men and women and there would be no provisions for early or late retirement.

Under the proposal, revenues would decrease from 8.5% of GDP to 6% of GDP in 2050. Expenditures would also decrease from 8.4% of GDP to 6.2% of GDP in 2050. This would improve the accumulated balance in 2050 to -20.7% of GDP, representing an improvement over the present system of 22% of GDP. The benefit rate would decline markedly from 42.1% to 20.7%.

2.5.5. Add-on defined contribution (Freedom Union - Democratic Union)

Under the US-DEU proposal, the PAYG pillar would be combined with an optional funded pillar based on individual accounts. If an individual opts for the funded pillar, the overall contribution rate is increased by 6 p.p. and 9 p.p. of an individual's overall pension contribution rate would be transferable to the voluntary funded pillar. The statutory retirement age would eventually be increased to 67 for men and women.

Under the proposal, revenues of the PAYG pillar would increase from 8.5% of GDP to 9.3% of GDP in 2050. Expenditures would also decrease slightly from 8.4% of GDP to 8.3% of GDP in 2050. The accumulated balance would decrease in 2050 to -5.2% of GDP, representing an improvement over the present system of 37.5% of GDP. The benefit rate would decline from 42.1% to 30.3%.

Table 2: Key features of the pension reform proposals

System	Contributions	Retirement age	Benefits	Indexation
Current system	28%	63 men; 59-63 women by 2013	Basic pension plus DB	Prices + at least 1/3 of real average earnings growth (RAEG)
Notional accounts (2.5.1)	29,6% (1.6% from unemployment fund)	65 for all	Notional accounts	Prices + at least half of RAEG
Carve-out DC (2.5.2)	28% + 2% extra from transition generation choosing DC; 8% of earnings to DC	65 for all except of women with children	Change in DB formula; returns based on 8% of earnings	Prices
Parametric reform (2.5.3)	29,6% (as in notional accounts) 3% increase from 2040 and further 0.9% from 2060	65 for all, increase starting in 2030	Basic pension + DB	Prices + at least 1/3 of RAEG
Flat-rate (2.5.4)	20%	Increase up 65 and beyond (finally reaching 71)	20% of gross average earnings	Average earnings
Add-on DC (2.5.5)	28% + 6% for those choosing DC; 9% of earnings to DC	67 for all	Change in DB benefits; returns based on 9% of earnings;	Average earnings for DC; current system for DB
Source: OECD (2006) Economic Surveys Czech Republic				

2.5.6. Overall assessment of the pension reform proposals

All proposals include parametric reforms to the PAYG-system and some also encompass the introduction of a systemic reform element in the form of a fully funded pillar. The latter diversifies risks by substituting market risks for the "political risk" of unfavourable changes in the PAYG parameters. A fully funded pillar should lead to higher rates of return, set better work incentives, foster financial market development and may increase savings. However, while it improves fiscal sustainability in the medium and long run, its introduction is associated with transition costs as it diverts part of pension contributions away from the PAYG-pillar, while leaving obligations initially unchanged. Private funded pension pillars may also have relatively high administrative costs. To the extent that parametric reforms of the PAYG-system are implemented, it is essential to emulate as much as possible the positive incentive effects of systemic reforms (for instance by establishing a close link between contributions and benefits).

All the proposals involve an increase to the statutory retirement age, albeit being phased in at different rates. In comparison with the current system, all the proposals improve sustainability over the current pension system. A comparison of the impact of each proposal on the sustainability gap is given in Table 3 below. This comparison is based on the pension expenditures of each reform proposal[9]. Based on these calculations, the flat-

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[9] The impact on expenditure up to 2050 has been assessed in order to be compatible with the analytical framework used in the sustainability assessment (see Section 5 of this assessment).

rate proposal would have the highest impact on reducing the sustainability gap, while it would not be sufficient to close the sustainability gap entirely (based on either indicator).

Table 3: Impact of pension reform proposals on sustainbility[10]

Pension expenditure (% of GDP)							Impact on sustainability	
	2005	2010	2020	2030	2040	2050	S1	S2
Current system	8.4	8	8.2	9.1	11	12.4	-	-
Notional accounts	8.4	8.2	8.6	8.9	9.8	10.2	-0.4	-1.2
Carve-out DC	8.4	7.6	7.2	7.2	8.4	9.3	-1.7	-2.3
Parametric reform	8.4	8	8.3	9.3	10.4	11.5	-0.1	-0.5
Flat-rate	8.4	7.5	6.8	6.2	5.9	6.2	-3.0	-4.4
Add-on DC	8.4	8.7	9	8.7	8.5	8.3	-0.7	-2.2
Source: Commission services								

In terms of incentives to stay in work, the OECD has ranked the proposals on the basis of the change in pension wealth (the net present value of the flow of pension payments), or 'implicit tax'[11]. By this measure, the proposals provide incentives to stay in the labour market up to statutory retirement age in the following order: Add-on DC, Flat-rate, Parametric reform, DC carve-out, and Notional accounts.

Apart from fiscal sustainability and incentive compatibility, the adequacy of future pensions is another crucial criterion when designing reforms; if suitable replacements rates and an adequate minimum old-age income are not guaranteed, an additional fiscal burden may arise through the need for more expenditure on social assistance and other social transfers. This could, in particular, be the case with the flat-rate proposal which has a benefit ratio of 20%.

As far as timing is concerned, a number of factors point to the benefit of carrying out structural reforms in the pension system sooner rather than later. The current PAYG pension system is still broadly in balance but it is anticipated by the Czech authorities that, even with pension increases kept to the legal minimum, it will go into deficit within the next 15 to 20 years. The Czech economy is currently enjoying record growth levels which are expected to moderate in the medium-term as the economy matures. Although the level of public debt is well below the EU average, it is projected to rise steadily, incurring increasing service costs and limiting the scope for structural reform. Hence, pension reforms are easier to implement now rather than later. This also holds in the case of the introduction of a mandatory funded pension pillar, where the transition cost, which arises from the diversion of contributions away from the PAYG-pillar while claims on

[10] According to the way the Commission and the Council assess sustainability, future increases/decreases in tax rates are not considered as sustainability-enhancing/reducing factors. This explains, for example, why the reform proposal 'parametric optimization' has little impact on sustainability while it has a strong impact on the accumulated balance, according to the calculations in the report of the Czech authorities. Indeed, with respect to this reform proposal, the improvement comes almost exclusively from a future increase in tax rates.

[11] Hemmings, P., Whitehouse, E. (2006) "Assessing the 2005 Czech proposals for pension reform", OECD, Economics department working papers, No. 496.

this pillar decrease in the longer run, may be easier to bear now, i.e. in times of high growth. In any case, the further reforms are delayed and the smaller the implemented reforms are, the more ambitious will the short- and medium-term structural fiscal adjustments in other areas need to be in order to create a sufficiently favourable position for absorbing the future cost of ageing.

2.6. Ageing and its impact on potential growth

The pronounced demographic shift that is taking place in the Czech Republic has a number of implications for the catching-up process and potential growth (see Figure 1) via labour supply, productivity and domestic saving, thus hampering long-term fiscal sustainability also from this side. As already indicated in the previous section, in addition to its direct positive fiscal implications, a well-designed pension reform could partly counteract these negative implications through its incentive effects.

2.6.1. Labour force and productivity

Demographic projections presented at the beginning of this section, together with OECD-projections of total employment rates (increase from 64.8% in 2003 to 72.1% in 2025, then decrease to 69.7% in 2050) allow distinguishing between three periods with differing influences of ageing on the workforce in the Czech Republic. The first period is 2004-2007 when the working-age population and the employment rates are growing simultaneously. In particular, there is a projected increase in the participation of women and older workers. In the next period 2008-2013, still rising employment rates will offset the beginning decline in the working-age population, as the baby-boom generation enters retirement. In the third period, starting from 2014, the ageing effect will dominate, as the employment rate for women and older workers will reach a steady state[12]. Thus, ageing will have a strong negative impact on labour supply in the Czech economy already in the medium term.

The future relationship between ageing and labour productivity is difficult to predict. The traditional view is that it follows an inverted U shape with productivity rising as workers enter prime age and then declining as they approach retirement. However, empirical evidence for the pattern is mixed and tends to be dependent on the nature and complexity of work and the education level of workers. In this respect, the still on-going rapid technological and organisational change and the sectoral shifts in the post-transitional catching-up economy of the Czech Republic are causing job requirements to change and how these changes will affect the relative productivity of different age groups is uncertain[13].

The currently high Czech labour productivity growth of around 5% helps to reduce the productivity gap compared with the EU average (currently about 68% of the EU average). In the last decade productivity growth arose mainly from within-sector improvements, while reallocation of labour to more productive sectors has had small negative effects on labour productivity[14]. The consistent rise in productivity in parallel

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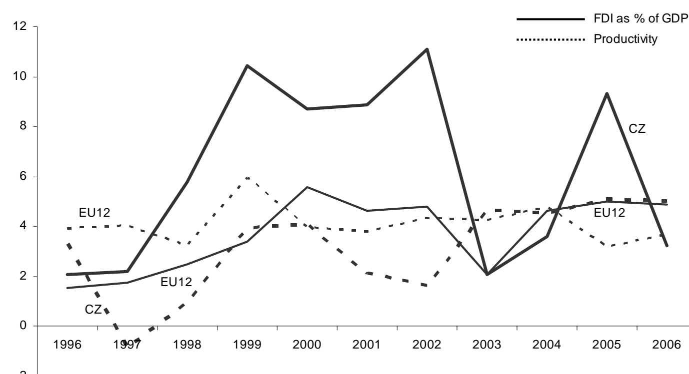
[12] European Commission (2005) “The economic impact of ageing populations in the EU25 Member States”, DG ECFIN, Economic Papers No 236.

[13] World Bank (2007) “From Red to Gray. The Third Transition of Ageing Populations in Eastern Europe and the Former Soviet Union”.

[14] IMF (2006) “Growth in the Central and European Countries of the European Union”, Occasional Paper no. 252.

with substantial FDI flows in the last decade (see Figure 3) underlines the importance of FDI in the catching-up process. Future FDI flows are expected to moderate but the Czech Republic remains an attractive location to foreign investors in the years to come. Moreover, new investments are envisaged to flow into more high-technology sectors fostering knowledge transfer and promoting greater efficiency.

Figure 3: FDI inflows and labour productivity growth in the Czech Republic



Source: Commission services

European Commission[15] projections indicate average productivity growth for the Czech Republic at 3.3% for the period 2004-10, at 3% between 2011-2030 and further below 2% by 2050).

2.6.2. *Savings and financial markets*

Based on increased age-related public spending and the life-cycle hypothesis of household consumption, a common view is that countries that experience demographic ageing can expect reduced levels of both public and private saving. While the link between ageing and public saving is clear, the influence on private saving is more ambivalent. While based on the life-cycle hypothesis, households change their mix of consumption and savings over their expected life-span so that the elderly population (as well as younger people) save less than the working-age population, this may be subject to modifications in catching-up economies: for instance, taking into account the rising life-expectancy in the Czech Republic, there is a plausible view that household savings could still rise until the middle of next decade, because individuals are anticipating longer life spans. However, thereafter, one projection is a gradual decrease in savings to zero around 2030 and a further decrease to around -4% of GDP by 2050[16].

Another potentially offsetting effect on an age-related decrease in the savings rate is further financial sector development: the Czech Republic already belongs to the best performers in the Visegrad region regarding deepening of financial markets (sum of financial system deposits and stock and bond market capitalisation of 140% of GDP in

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[15] The report "The economic impact of ageing populations in the EU25 Member States", (European Economy,Economic Paper, No 236) draws upon the macroeconomic assumptions developed by the Ageing Working Group attached to the Economic Policy Committee and the DG for Economic and Financial Affairs for the purpose of making age-related expenditure projections.

[16] IMF (2005) Czech Republic: Selected Issues, Country Report no. 05/257.

2006[17]) and the conditions for further deepening are broadly in place (regulatory framework, integration with EU and globally, economic performance, etc). Nevertheless, IMF model simulations seem to suggest a significant impact of ageing on investment and capital stock formation in the Czech Republic in the long run[18] .

The potentially negative relationship between ageing and financial market development could be partly off-set by systemic reforms of the current pension system as discussed in the previous section. In particular a fully-funded 2nd pillar could have facilitating and fostering implications for deepening of the financial market in the Czech Republic.

2.6.3. Implications for potential growth

Figure 4: Projected GDP growth and its determinants in the Czech Republic (2004-2050)

Source: Commission services

According to Commission services' projections[19], in the Czech Republic an average annual GDP growth rate of 2% is projected for the entire reference period (2005-2050), with productivity being the main source of growth (2.6% growth of GDP per person employed, out of which 1.4 pp will come from total factor productivity and 1.2 pp from capital deepening), while the impact of labour input (decline of 0.7%) will be negative. The decreasing growth rates over the long run will also impact debt dynamics and therefore long term fiscal sustainability. Hence, a properly designed incentive-compatible pension reform would improve fiscal sustainability not only directly but also indirectly via incentive and growth effects. It could thereby dovetail with a host of other structural reforms, in particular in the labour market (e.g. reduction of skill mismatches, educational reforms, active labour market policies, housing market reforms).

2.7. Conclusion

The Czech Republic will feel the impact of a rapidly ageing population on public finances and growth. By far the largest impact will be felt on the current pension system

[17] World Bank (2007) "From Red to Gray. The Third Transition of Ageing Populations in Eastern Europe and the Former Soviet Union".

[18] IMF (2005) Czech Republic: Selected Issues, Country Report no. 05/257.

[19] European Commission (2005a) "The economic impact of ageing populations in the EU25 Member States", DG ECFIN, Economic Papers No 236.

which is unsustainable and in need of reform. The proposals put forward by the main political parties are a step in the right direction, while reform design and implementation should be optimized under both fiscal sustainability and growth-compatible incentive aspects.

3. MACROECONOMIC OUTLOOK

This section assesses the plausibility of the macroeconomic scenario (economic activity, labour market, costs and prices) underpinning the public finance projections of the programme. It also examines whether good or bad economic times in the sense of the Stability and Growth Pact prevail.

3.1. Economic activity

The programme foresees a decline in real growth from 5.9% in 2007 to 5% in 2008 and a slight increase to 5.3% by 2010, which is above the estimate of the average potential growth of 5.1% in the Commission services' autumn forecast for the period 2007-2009. For the entire period 2007-2010 the average GDP growth projection (5.3%) is above the average growth performance of the past ten years (3%). Growth will be mainly driven by domestic demand, in particular investment. The output gap calculated according to the common methodology based on the programme's data indicates that the Czech economy will remain in positive territory, but the output gap is narrowing in 2008-2010.

The external assumptions underpinning the macroeconomic scenario in the programme diverge slightly from the Commission services' autumn 2007 forecast. The programme assumes lower oil prices and a slightly higher GDP growth for Germany and the EU-27 in 2008 and 2009.

Table 4: Comparison of macroeconomic developments and forecasts

	2007		2008		2009		2010
	COM	CP	COM	CP	COM	CP	CP
Real GDP (% change)	5.8	5.9	5.0	5.0	4.9	5.1	5.3
Private consumption (% change)	6.1	6.5	4.9	4.2	5.3	4.6	4.2
Gross fixed capital formation (% change)	6.5	6.0	6.5	9.0	6.6	7.8	7.2
Exports of goods and services (% change)	14.9	13.2	12.9	11.9	10.8	12.9	13.5
Imports of goods and services (% change)	14.1	13.9	12.8	12.7	11.1	12.4	12.4
Contributions to real GDP growth:							
- Final domestic demand	4.7	4.5	4.2	4.2	4.4	4.1	3.7
- Change in inventories	0.0	1.5	0.2	0.9	0.3	0.0	0.0
- Net exports	1.0	-0.1	0.6	-0.1	0.2	1.0	1.5
Output gap[1]	2.1	1.8	2.1	1.4	1.4	0.7	0.5
Employment (% change)	1.6	1.5	1.5	1.1	1.6	0.5	0.2
Unemployment rate (%)	5.9	5.5	5.4	4.8	5.0	4.5	4.5
Labour productivity (% change)	4.2	4.4	3.4	3.8	3.3	4.6	5.1
HICP inflation (%)	3.0	2.4	3.8	3.9	3.2	2.3	2.1
GDP deflator (% change)	2.1	3.5	2.9	3.1	2.6	2.3	2.2
Comp. of employees (per head, % change)	6.5	7.7	6.6	6.5	6.8	6.9	7.0
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-2.5	-2.4	-2.1	-1.6	-1.9	-0.4	1.5

Note:

[1]In percent of potential GDP, with potential GDP growth according to the programme as recalculated by Commission services.

Source :

Commission services' autumn 2007 economic forecasts (COM); Convergence programme (CP)

The GDP growth deceleration envisaged in the programme from 5.9% in 2007 to 5.0% in 2008 against the background of the fiscal consolidation package is in line with the Commission services' autumn 2007 forecast (5.8% and 5.0% for the respective years).

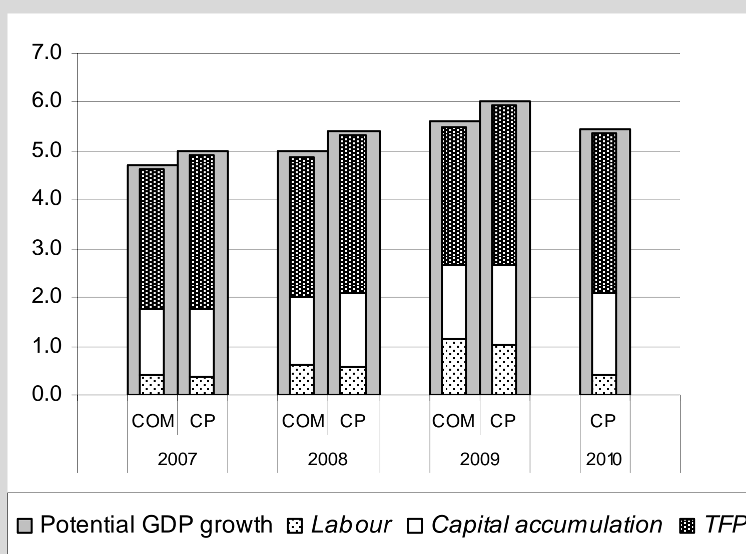
The programme foresees a slight upturn thereafter to 5.3% in 2010 while the Commission services' autumn 2007 forecast expects growth to slow down to 4.9% in 2009 on a more subdued contribution from net exports as compared to the Czech convergence programme. Both projections foresee private consumption to grow more slowly, due to the fiscal consolidation including cuts in social benefits and increase of the lower VAT rate. Private consumption is according to the programme expected to grow on average by 5.1% in 2007-2009, which is below the average growth of 5.4% envisaged in the Commission services' autumn forecast. The difference can be explained by the stronger employment growth envisaged in the Commission services' autumn forecast. Both, the Commission services' autumn forecast and the programme's projections foresee gross fixed capital formation to provide a strong impetus to the economy in 2008 and in 2009. However, the programme foresees gross fixed capital formation to grow more strongly (by 9.0% and 7.8% in 2008 and 2009 respectively) than projected by the Commission services' autumn forecast (6.9% and 6.6% in 2008 and 2009 respectively). In the programme, a stronger absorption of the EU funds and major investments projects are taken on board, while the Commission services' autumn forecast remains more prudent in this respect.

Overall, the programme's macroeconomic assumptions are plausible.

Box 1: Potential growth and its determinants

Potential growth as recalculated by the Commission services using the commonly agreed methodology based on the information in the programme is estimated to increase gradually from 5% in 2007 to 6.1% in 2009 and to decline to 5.5% by 2010. The average potential growth over the programming period is above the average growth in the past ten years. This development might in particular result from strong FDI inflows contributing to higher TFP growth.

Potential growth and its determinants



Positive output gaps for 2008 and 2009 as recalculated by the Commission services on the basis of the data provided in the programme using the commonly agreed method are by 0.6 and by 0.7 p.p. lower than the output gaps indicated in the Commission service's autumn forecast.

3.2. Labour market and cost and price developments

According to the programme, employment growth is expected to slow down from 1.5% in 2007 to 0.2% in 2010 while the unemployment rate is to decrease from 5.5% in 2007 to 4.5% in 2010. Further improvements in the labour market are expected to be more difficult due to remaining limited regional mobility and skill-mismatches. Despite slightly higher employment growth in the Commission services' autumn forecast, the level of unemployment predicted for 2008 and 2009 will be comparatively higher due to a higher starting base in 2007 and the presumption of a higher activity rate. The tightening labour market conditions presented in the programme reflect the positive output gaps.

The programme envisages HICP inflation to accelerate from 2.4% in 2007 to 3.9% in 2008 and to decelerate to 2.3% in 2009 and to 2.1% in 2010. The temporary increase in 2008 is associated with the increase in indirect taxation, in particular of the reduced VAT rate, and with an increase in regulated prices. The Commission services' autumn forecast foresees HICP to accelerate to 3.8% in 2008 and to moderate to 3.2% in 2009. While the inflation projections for 2008 are broadly in line, the difference of 0.9 percentage point for 2009 may be partly attributable to different external assumptions (stronger appreciation of CZK against EUR and more favourable oil prices). However, the most recent available data indicates that the balance of risks to the inflation projections in 2008 is on the upside (see section 3.3)

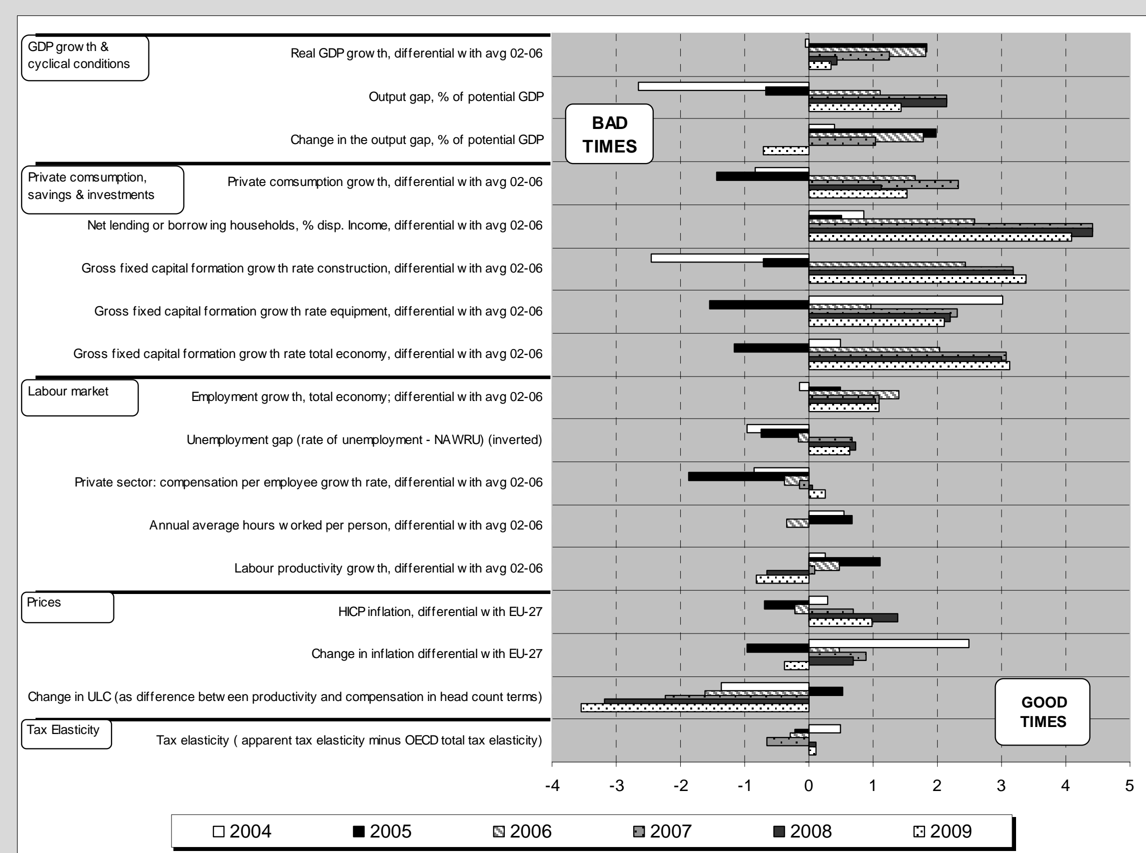
Compensation of employees is according to the programme expected to grow on average by 7% in 2007-2009. Thus, the programme's projection for growth of compensation of employees is above the Commission services' autumn 2007 forecast of 6.6%. While according to the programme, real compensation of employees will be about in line with labour productivity over 2007-2010, the Commission services' autumn forecast project a more subdued development of productivity implying that wages may turn out relatively high from this perspective. Furthermore, the positive unemployment gap indicates possible additional pressures on wages in the programme period.

Box 2: Good or bad economic times?

According to the code of conduct, the assessment of whether the economy is experiencing good or bad economic times starts from the output gap, but draws on an overall economic assessment, which should also take into account tax elasticities. The figure below presents a set of macroeconomic indicators drawn from the Commission services' autumn 2007 forecast. Overall, the economy seems to be in good economic times taking into account tax elasticities in the period 2007-2009.

Positive output gaps for 2007-2009 re-calculated by the Commission services on the basis of the programme's data are supported by most of the indicators remaining on the side of good economic times. Private consumption is anticipated to remain strong, raising the Commission services' estimate of tax elasticity above OECD estimates. Investment is expected to exceed the 2002-2006 averages. Labour market developments and in particular employment growth and the positive unemployment gap contribute to the positive developments in the economy. However growing ULC may hamper somehow the competitiveness of the Czech economy on international markets.

Good versus bad times



3.3. Macroeconomic challenges

The major macroeconomic challenges for the Czech Republic include: the correction of the excessive general government deficit (discussed in section 4), the high risk with regard to the sustainability of public finances (sections 1 and 5), as well as the recent acceleration of inflation. The first two challenges are extensively analysed elsewhere in this assessment, therefore in this section only inflation is briefly discussed.

In recent years, the Czech Republic has been regarded as a "low inflation" country, also benefiting from a strong currency. In 2001-2006 average inflation in the Czech Republic was 2.0% compared to 2.2% in the euro area. This feature helped to keep interest rates low which stimulated investment and growth of the economy, and influenced positively the external competitive position. It has been mirrored in the relatively low current account deficit compared to other countries in the region.

However HICP inflation accelerated to 5.5% (y-o-y) in December 2007, bringing the average inflation rate to 2.8% in 2007 compared to 2.1% in 2006. The upsurge in inflation has to a substantial extent been influenced by food and regulated price increases. Additional pressures are expected from the hikes in indirect taxation as of January 2008 (when the "September 2007 stabilisation package" comes into force) and also from the acceleration of international commodity prices. These upward inflationary trends has to be seen against a positive, albeit declining, output gap and emerging labour market shortages which put pressure on wages. In order to ensure price stability in such a context, it is important to contain second-round effects of the inflation acceleration by keeping wage growth aligned to productivity developments.

4. GENERAL GOVERNMENT BALANCE

This section consists of four parts. The first part discusses budgetary implementation in the year 2007 and the second presents the medium-term budgetary strategy in the new update. The third analyses the risks attached to the budgetary targets in the programme. The final part assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact.

4.1. Budgetary implementation in 2007

Table 5 compares the 2007 revenue and expenditure targets (as a percentage of GDP) from the previous update of the convergence programme with the results of the Commission services' autumn 2007 forecast. The difference between the revenue and expenditure targets for 2007 and the projected outcome is decomposed into a base effect, a GDP growth effect on the denominator and a revenue / expenditure growth effect[20]:

- The base effect captures the part of the difference that is due to the actual outcome for 2006 being different from what was projected in the previous update in the programme (either because the actual revenue / expenditure level in 2006 was different from the estimated outturn in the previous programme or because GDP turned out to be different from the scenario in the previous update of the programme). The base effect therefore also captures the effect revisions to the of GDP series.
- The GDP growth effect on the denominator captures the part of the difference that is related to current GDP growth projections for 2007 turning out higher or lower than anticipated in the previous update of the programme (therefore reducing / increasing the denominator of the revenue and expenditure ratio).
- The revenue / expenditure growth effect captures the part of the difference related to the revenue / expenditure growth rate in 2007 turning out to be higher or lower than targeted in the previous update of the programme. This would typically be due to GDP developments different from those expected in the previous update of the programme, or as a result of apparent tax elasticities different from the ex ante elasticities (or both).

[20] A fourth, residual component is usually small, except if there are very large differences between the autumn forecast and the target (the full mathematical decomposition is in the methodological paper mentioned above).

Table 5: Budgetary implementation in 2007

	2006		2007	
	Planned CP March 2007	Outcome CP Nov 2007	Planned CP March 2007	Outcome CP Nov 2007
Revenue (% of GDP)	39.9	40.7	39.9	39.8
Expenditure (% of GDP)	43.4	43.6	43.9	43.3
Government balance (% of GDP)	-3.5	-2.9	-4.0	-3.4
Nominal GDP growth (%)			7.6	9.6
Nominal revenue growth (%)			7.6	7.3
Nominal expenditure growth (%)			8.8	8.7
Revenue surprise compared to target (% of GDP)			**-0.1**	
Of which [1] : 1. Base effect			0.8	
2. GDP growth effect on the denominator			-0.7	
3. Revenue growth effect			-0.1	
Of which: due to a marginal elasticity of total revenue w.r.t. GDP larger than1 [2]			*-0.8*	
Expenditure surprise compared to target (% of GDP)			**-0.6**	
Of which [1] : 1. Base effect			0.2	
2. GDP growth effect on the denominator			-0.7	
3. Expenditure growth effect			-0.1	
Government balance surprise compared to target (% of GDP)			**0.6**	
Of which: 1. Base effect			0.6	
2. GDP growth effect on the denominator			0.0	
3. Revenue / expenditure growth effect			-0.1	

Notes:

[1]A positive base effect points to a higher-than-anticipated outcome of the revenue / expenditure ratio in 2006. A positive GDP growth effect (on the denominator) indicates lower-than-anticipated economic growth in 2007. A positive revenue / expenditure growth effect points to higher-than-anticipated revenue / expenditure growth in 2007. The three components may not add up to the total because of a residual component, which is generally small.

[2] Equal to (2)+(3). A positive sign means that the marginal elasticity of revenue with respect to GDP exceeds one.

Source :
Commission services

The Commission services' autumn forecast and the convergence programme estimate a general government deficit of 3.4% of GDP in 2007, which is 0.6 p.p. below the target set in the previous update. The lower estimated fiscal outcome is mainly due to the base effect of a better revenue to expenditure ratio in 2006 than anticipated in the previous convergence programme, as well as some expenditure restraint, sufficient to offset less dynamic revenue growth in 2007 than anticipated in the previous update (in spite of higher-than-anticipated nominal GDP growth).

Recent information on budgetary execution indicates that the outturn for 2007 could be substantially better than expected in the current convergence programme (estimated at 1.9% of GDP compared to 3.4% of GDP in the current programme). The reduction of 1.5% of GDP is estimated to have come mainly from better-than-expected revenues (0.8% of GDP) as well as lower-than-planned expenditure of about 0.6% of GDP. However, these preliminary estimates may be revised in future.

In its opinion of 10 July 2007 on the previous update of the convergence programme, the Council invited the Czech Republic to: "limit the budgetary deterioration in 2007 and ensure the correction of the excessive deficit in a credible and sustainable manner by 2008 at the latest."

The latest estimate of the budgetary deficit for 2007 from the Czech authorities is significantly better than anticipated. While this estimate has to be confirmed, it suggests that the Czech Republic has exercised some expenditure restraint in 2007 and, therefore,

responded to the invitation in the Council opinion on the previous update of the convergence programme.

4.2. The programme's medium-term budgetary strategy

This section describes the medium-term budgetary strategy outlined in the programme, and how it compares with the one in the previous update, as well as the composition of the budgetary adjustment, including the broad measures envisaged.

4.2.1. The main goal of the programme's budgetary strategy

The main goal of the budgetary strategy is to correct the excessive deficit in 2008 (the deadline of the current EDP) and, further, to continue consolidation towards the achievement of the MTO in 2012 (a structural deficit of -1% of GDP). The general government deficit is, according to the programme, projected to decrease from 3.4% of GDP in 2007 to 2.9% of GDP in 2008, 2.6% of GDP in 2009 and 2.3% of GDP in 2010. Compared with the previous convergence programme, the path of fiscal consolidation has been markedly improved. For 2007, 2008, and 2009, the targets have been reduced by 0.6 p.p. in each year compared with those in the programme of March 2007. To achieve a nominal deficit below the 3% of GDP threshold in 2008 would require a structural adjustment of around ¾% of GDP, based on the convergence programme, but structural balances need to be interpreted with caution as there is considerable uncertainty about the precise size of the output gap.[21] The adjustment in structural and nominal terms is front loaded towards the beginning of the programme period.

The target date for achieving the MTO has been brought forward by one year compared with the previous convergence programme. However, the target date for achievement of the MTO is only a return to the target date in the November 2005 convergence programme, while growth is stronger and the predicted general deficit for 2007 (3.4% of GDP) is only slightly higher than that foreseen in the November 2005 convergence programme (3.3% of GDP). The programme bases the achievement of the medium-term objective by 2012 on the implementation of further public finance reforms which will be put to parliament in 2008. However, there is a lack of information on specific measures. The structural adjustment to achieve the MTO is partially shifted to after the programme.

[21] As discussed in Section 3, there are significant differences between the output gap estimates according to the Commission services' forecast, the Commission services' recalculations based on the programme information, and the programme's output gaps as presented in the programme itself.

Box 3: The excessive deficit procedure (EDP) for the Czech Republic

On 5th July 2004 the Council adopted a decision stating that the Czech Republic had an excessive deficit in accordance with Article 104(6). At the same time, the Council addressed a recommendation under Article 104(7) specifying that the excessive deficit had to be corrected by 2008.

In particular, the Czech Republic was recommended to put an end to the excessive deficit as rapidly as possible by taking action in a medium-term framework in order to achieve their objective of bringing the deficit below 3% of GDP by 2008 in a credible and sustainable manner and in accordance with the path for deficit reduction specified in the Council opinion of 5 July 2004 on the convergence programme submitted in May 2004. The Czech Republic was recommended to implement with vigour the measures envisaged in the May 2004 convergence programme, in particular a cut in the wage bill of central government and a reduction in spending of individual ministries, and to take effective action by 5 November 2004 regarding the measures envisaged to achieve the 2005 deficit target.

On 22 December 2004, the Commission concluded that the Czech government had taken effective action regarding the measures envisaged to achieve the 2005 deficit target, by the deadline of 5 November, in response to the Council recommendation, and that no further steps were necessary under the excessive deficit procedure.

On 10 March 2007, the Council adopted a decision 104(8), stating that the action being taken by the Czech Republic did not appear to be effective enough to correct the excessive deficit by the deadline of 2008. Further, the Council issued a 104(7) recommendation on 10 October 2007 inviting the Czech Republic to:

i) further contain the budgetary deterioration in 2007 and put an end to the excessive deficit situation as rapidly as possible and by 2008 at the latest, of which the Council established the deadline of 9 April 2008 for the Czech authorities to take effective action to this end.

ii) The Czech authorities should bring the general government deficit below the 3 % of GDP reference value in a credible and sustainable manner. To this end, on the basis of current projections they should ensure an improvement in the structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) of at least ¾% of GDP in 2008 compared to 2007.

iii) In addition, the Council invites the Czech Republic to ensure that budgetary consolidation towards its medium-term objective (MTO) for the budgetary position of a structural deficit of 1 % of GDP is sustained after the excessive deficit has been corrected and to achieve the MTO by the original deadline of 2012 at the latest.

Table 6: Evolution of budgetary targets in successive programmes

		2006	2007	2008	2009	2010
General government balance (% of GDP)	**CP Nov 2007**	**-2.9**	**-3.4**	**-2.9**	**-2.6**	**-2.3**
	CP March 2007	*-3.5*	*-4.0*	*-3.5*	*-3.2*	*n.a.*
	COM Nov 2007	-2.9	-3.4	-2.8	-2.7	n.a.
General government expenditure (% of GDP)	**CP Nov 2007**	**43.6**	**43.3**	**42.4**	**40.7**	**39.4**
	CP March 2007	*43.4*	*43.9*	*43.9*	*43.4*	*n.a.*
	COM Nov 2007	43.6	43.0	43.0	42.9	n.a.
General government revenue (% of GDP)	**CP Nov 2007**	**40.7**	**39.8**	**39.5**	**38.1**	**37.1**
	CP March 2007	*39.9*	*39.9*	*40.4*	*40.3*	*n.a.*
	COM Nov 2007	40.7	39.6	40.2	40.2	n.a.
Structural balance[1] (% of GDP)	**CP Nov 2007**	**-3.1**	**-4.1**	**-3.4**	**-2.8**	**-2.5**
	CP March 2007	*-3.9*	*-4.4*	*-3.9*	*-3.5*	*n.a.*
	COM Nov 2007	-3.3	-4.1	-3.6	-3.2	n.a.
Real GDP (% change)	**CP Nov 2007**	**6.4**	**5.9**	**5.0**	**5.1**	**5.3**
	CP March 2007	*6.0*	*4.9*	*4.8*	*4.8*	*n.a.*
	COM Nov 2007	6.4	5.8	5.0	4.9	n.a.

Note:

[1]Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are -0.2% of GDP in Year 2006; deficit-increasing.

Source :

Convergence programmes (CP); Commission services' autumn 2007 economic forecasts (COM)

Compared with the previous programme, there is a marked improvement in the adjustments of both nominal and structural balances while GDP growth projections have only been increased slightly from 2008.

Table 7: Composition of the budgetary adjustment

(% of GDP)	2006	2007	2008	2009	2010	Change: 2010-2007
Revenue	**40.7**	**39.8**	**39.5**	**38.1**	**37.1**	**-2.7**
of which:						
- Taxes on production and imports	10.9	10.9	11.5	11.1	10.8	**-0.1**
- Current taxes on income, wealth, etc.	8.8	8.8	8.2	7.7	7.5	**-1.3**
- Social contributions	16.2	16.2	15.9	15.4	15.0	**-1.2**
- Other (residual)	4.8	3.9	3.8	3.8	3.8	**-0.1**
Expenditure	**43.6**	**43.3**	**42.4**	**40.7**	**39.4**	**-3.9**
of which:						
- Primary expenditure	42.5	42.1	41.1	39.4	38.2	**-3.9**
of which:						
Compensation of employees	7.8	7.6	7.3	7.0	6.7	**-0.9**
Intermediate consumption	6.6	5.8	5.5	5.1	4.8	**-1.0**
Social payments	17.9	18.2	17.4	16.8	16.3	**-1.9**
Subsidies	1.9	2.0	2.2	1.9	1.8	**-0.2**
Gross fixed capital formation	5.0	5.1	5.3	5.4	5.6	**0.5**
Other (residual)	3.3	3.4	3.6	3.3	3.1	**-0.4**
- Interest expenditure	1.1	1.2	1.3	1.2	1.2	**0.0**
General government balance (GGB)	**-2.9**	**-3.4**	**-2.9**	**-2.6**	**-2.3**	**1.1**
Primary balance	**-1.8**	**-2.3**	**-1.7**	**-1.3**	**-1.1**	**1.2**
One-off and other temporary measures	-0.2	0.0	0.0	0.0	0.0	**0.0**
GGB excl. one-offs	**-2.7**	**-3.4**	**-2.9**	**-2.6**	**-2.3**	**1.1**
Output gap[1]	0.9	1.8	1.4	0.7	0.5	**-1.3**
Cyclically-adjusted balance[1]	-3.3	-4.1	-3.4	-2.8	-2.5	**1.6**
Structural balance[2]	**-3.1**	**-4.1**	**-3.4**	**-2.8**	**-2.5**	**1.6**
Change in structural balance		*-1.0*	*0.7*	*0.6*	*0.4*	
Structural primary balance[2]	-2.0	-2.9	-2.2	-1.6	-1.3	**1.6**
Change in structural primary balance		*-1.0*	*0.7*	*0.6*	*0.3*	

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance as recalculated by Commission services on the basis of the information in the programme.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source :

Convergence programme; Commission services' calculations

4.2.2. The composition of the budgetary adjustment

According to the convergence programme, the consolidation will be mainly expenditure driven while both revenue and expenditure ratios to GDP will fall. Expenditure will be reduced mainly due to cuts to social and welfare benefits, as well as a decrease in the compensation of public sector employees. Reductions in direct taxation will outweigh increases in indirect taxes to produce an overall decrease in the tax revenue ratio.

On the expenditure side, reductions in social insurance and casualty insurance have been approved and will be introduced through the programme period from 2008. Legislation to reduce health insurance is still pending approval while nominal service charges will be effective from January 2008. Welfare benefits will be reduced by a wide-range of measures including cuts to child and social care benefits, parental contributions and maternity benefits. The automatic indexation of social care benefits has also been

abolished. A reduction in the level of compensation of public sector employees will be achieved by a combination of wage restraint and cut backs in the number of employees in public administration. Public investment is expected to rise partly due to an increase in EU transfers.

On the revenue side, a flat-tax on personal income will be introduced from 2008: 15% in 2008, reduced to 12.5% in 2009 (dependant on a new Income Tax Act to be introduced in the first half of 2008). The rate of corporate income tax will be gradually reduced from 24 % in 2008 to 19 % in 2010. VAT will be increased from 5 to 9% from 2008. The new flat-tax will, however, be calculated according to an extended base, the "super-gross wage" (the gross wage plus premiums paid by employers) which will increase the tax base by over half. In addition, excise duties will be raised including increases on cigarettes and tobacco and the introduction of environmental taxes on electricity, natural gas and solid fuels. Social contributions are projected to decline due to the introduction of a maximum assessment base, and adjustments to the sickness insurance system from 2009. The introduction of health care service charges (approximately 1 EUR) is estimated to generate revenue equivalent to about 0.1% of GDP, with a similar saving from lower demand on health services.

Box 4: The budget for 2008

The budget was presented to the Czech parliament on 17 October 2007 and approved by parliament on 5 December 2007. The budget targets a general government deficit of 2.9% of GDP in 2008. The budget includes a range of revenue and expenditure measures including cuts to social and welfare benefits, reductions to direct personal and corporate taxation, changes to excise taxes, and a decrease in direct taxation.

Main measures in the budget for 2008

Revenue measures*	Expenditure measures**
o 15% flat rate of personal tax (-0.6% of GDP)	o Adjustments to social and health insurance (-0.3% of GDP)
o Reduction of corporate tax (-0.3% of GDP)	o Changes to government welfare benefits (-0.25% of GDP)
o Increases to excise taxes (0.3% of GDP)	
o Increase in lower VAT band (0.8% of GDP)	

* Estimated impact on general government revenues.
** Estimated impact on general government expenditure.

Sources: Commission services and convergence programme

4.3. Risk assessment

This section discusses the plausibility of the programme's budgetary projections by analysing various risk factors. For the period until 2009, Table 8 compares the detailed revenue and expenditure projections in the Commission services' autumn 2007 forecast, which are derived under a no-policy change scenario, with those in the updated programme.

The macroeconomic scenario is plausible and is similar to the Commission services' forecast. There is firm growth in the economy throughout the programme period and the output gap, though declining, remains in positive territory. Hence, the country is enjoying economic 'good times'.

The programme's tax projections are cautious compared with those of the OECD and the Commission services' autumn 2007 forecast. This may be partly attributable to the

reductions in direct taxation in 2008 and 2009 but the large amount of changes occurring to the tax system during the programme period makes the exact impact on the balance of tax revenue uncertain. As the envisaged consolidation does not rely on one-off or temporary measures, there are no risks stemming from these elements.

Recent information indicates that the deficit for 2007 may be significantly better than estimated in the programme. This may have a positive base effect on expenditure in 2008.

Table 8: Comparison of budgetary developments and projections

(% of GDP)	2006	2007		2008		2009		2010
	COM	COM	CP	COM	CP	COM[1]	CP	CP
Revenue	**40.7**	**39.6**	**39.8**	**40.2**	**39.5**	**40.2**	**38.1**	**37.1**
of which:								
- Taxes on production and imports	10.9	10.9	10.9	10.9	11.5	10.9	11.1	10.8
- Current taxes on income, wealth, etc.	8.8	8.6	8.8	8.8	8.2	8.9	7.7	7.5
- Social contributions	16.2	14.7	16.2	14.8	15.9	14.9	15.4	15.0
- Other (residual)	4.8	5.4	3.9	5.8	3.8	5.5	3.8	3.8
Expenditure	**43.6**	**43.0**	**43.3**	**43.0**	**42.4**	**42.9**	**40.7**	**39.4**
of which:								
- Primary expenditure	42.5	41.9	42.1	42.0	41.1	41.9	39.4	38.2
of which:								
Compensation of employees	7.8	7.7	7.6	7.6	7.3	7.5	7.0	6.7
Intermediate consumption	6.6	5.7	5.8	5.7	5.5	5.4	5.1	4.8
Social payments	17.9	18.1	18.2	17.8	17.4	17.3	16.8	16.3
Subsidies	1.9	1.9	2.0	1.7	2.2	1.7	1.9	1.8
Gross fixed capital formation	5.0	5.2	5.1	5.6	5.3	6.3	5.4	5.6
Other (residual)	3.3	3.3	3.4	3.6	3.6	3.7	3.3	3.1
- Interest expenditure	1.1	1.0	1.2	1.0	1.3	1.0	1.2	1.2
General government balance (GGB)	**-2.9**	**-3.4**	**-3.4**	**-2.8**	**-2.9**	**-2.7**	**-2.6**	**-2.3**
Primary balance	**-1.8**	**-2.3**	**-2.3**	**-1.8**	**-1.7**	**-1.7**	**-1.3**	**-1.1**
One-off and other temporary measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	**-2.9**	**-3.4**	**-3.4**	**-2.8**	**-2.9**	**-2.7**	**-2.6**	**-2.3**
Output gap[2]	1.1	2.1	1.8	2.1	1.4	1.4	0.7	0.5
Cyclically-adjusted balance[2]	-3.3	-4.1	-4.1	-3.6	-3.4	-3.2	-2.8	-2.5
Structural balance[3]	**-3.3**	**-4.1**	**-4.1**	**-3.6**	**-3.4**	**-3.2**	**-2.8**	**-2.5**
Change in structural balance		*-0.8*	*-1.0*	*0.6*	*0.7*	*0.4*	*0.6*	*0.4*
Structural primary balance[3]	-2.2	-3.1	-2.9	-2.6	-2.2	-2.2	-1.6	-1.3
Change in structural primary balance		*-0.9*	*-1.0*	*0.5*	*0.7*	*0.3*	*0.6*	*0.3*

Notes:

[1]On a no-policy-change basis.

[2]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission services on the basis of the information in the programme.

[3]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source :

Convergence programme (CP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations

The Czech Republic has a record of achieving better-than-planned deficits but this has been established against a background of stronger-than-anticipated macroeconomic performance. While the mainly expenditure-driven consolidation is underpinned by medium-term expenditure ceilings. In the past these medium-term ceilings have been breached in subsequent annual budget setting, but this did not in general prevent meeting

deficit targets thanks to strong revenue growth. The previously approved ceiling for 2005 was breached by 0.7 bn CZK, for 2006 the ceiling was breached by 24.4 bn CZK (about ¾% of GDP), and for 2007 the ceiling was breached by 56.8 bn CZK (about 1¾% of GDP).

The main downside risks to meeting the consolidation targets stem from a lack of information on the measures envisaged by the government after 2008. The continuing possibility to spend carried-over budgetary allocations represents a risk for fiscal consolidation, while usage of these allocations has been restricted. In addition, the targeted consolidation depends on cut backs to the number of employees in public administration and public sector wage restraint.

In summary, it is estimated that the balance of risks is that the outcome in 2008 could be better than expected and neutral from 2009.

Table 9: Assessment of tax projections

	2008			**2009**			**2010**
	CP	**COM**	**OECD**[3]	**CP**	**COM**[1]	**OECD**[3]	**CP**
Change in tax-to-GDP ratio (total taxes)	-0.3	0.3	0.0	-1.5	0.2	0.0	-1.1
Difference (CP – COM)	-0.5		/	-1.7		/	/
of which [2] *:*							
- discretionary and elasticity component	*-0.1*		*/*	*-1.4*		*/*	*/*
- composition component	*-0.3*		*/*	*-0.4*		*/*	*/*
Difference (COM - OECD)	/	0.3		/	0.3		/
of which [2] *:*							
- discretionary and elasticity component	*/*	*-0.1*		*/*	*-0.2*		*/*
- composition component	*/*	*0.5*		*/*	*0.7*		*/*
p.m.: Elasticity to GDP	0.9	1.1	1.0	0.5	1.1	1.0	0.6

Notes:

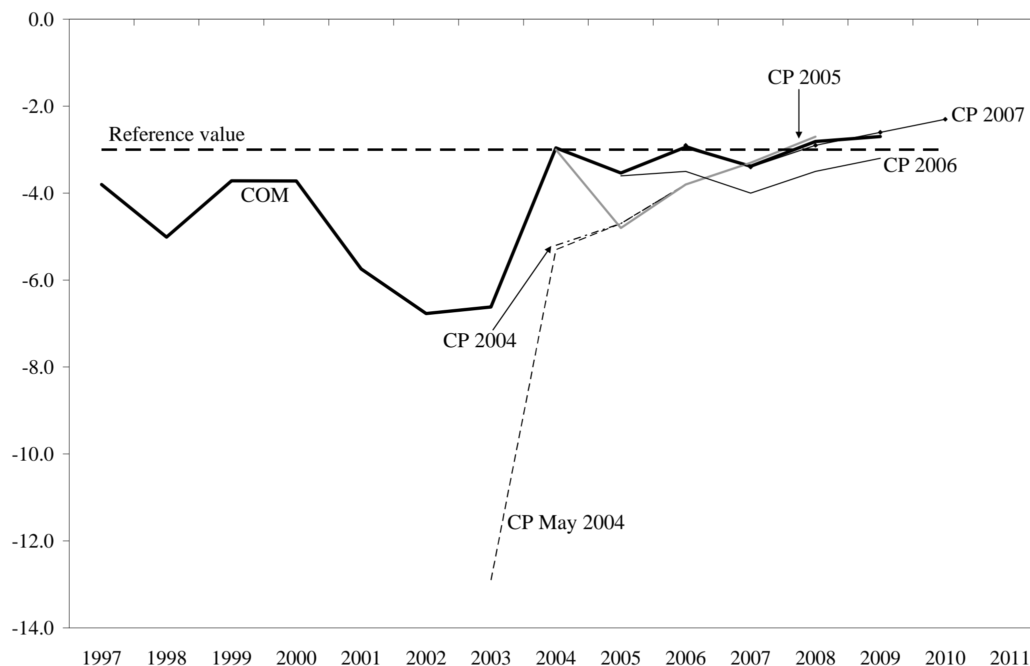
[1]On a no-policy change basis.

[2]The composition component captures the effect of differences in the composition of aggregate demand (more tax rich or more tax poor components). The discretionary and elasticity component captures the effect of discretionary fiscal policy measures as well as variations of the yield of the tax system that may result from factors such as time lags and variations of taxable income that do not necessarily move in line with GDP, e.g. capital gains. The two components may not add up to the total difference because of a residual component, which is generally small.

[3]OECD ex-ante elasticity relative to GDP.

Source :
Commission services' autumn 2007 economic forecasts (COM); Convergence programme (CP); Commission services' calculations; OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434).

Figure 5: Government balance projections in successive programmes (% of GDP)



Source: Commission services' autumn 2007 forecast (COM) and successive convergence programmes

4.4. Assessment of the fiscal stance and budgetary strategy

The table below offers a summary assessment of the country's position relative to the budgetary requirements laid down in the Stability and Growth Pact. In order to highlight the role of the preceding analysis of the risks that are attached to the budgetary targets presented in the programme, this assessment is done in two stages: first, a preliminary assessment on the basis of the targets taken at face value and, second, the final assessment also taking into account risks.

Table 10: Overview of compliance with the Stability and Growth Pact

	Based on programme[3] (with the targets taken at face value)	**Assessment** (taking into account risks to the targets)
a. Consistency with correction of excessive deficit by 2008 deadline	yes	yes, conditional on continuing expenditure restraint
b. Safety margin against breaching 3% of GDP deficit limit[1]	not within the programme period.	not within the programme period
c. Achievement of the MTO	not within the programme period	not within the programme period
d. Adjustment towards MTO in line with the Pact[2]? (after the correction of the excessive deficit)	Should be strengthened, especially in 2010.	Should be strengthened and backed-up by measures

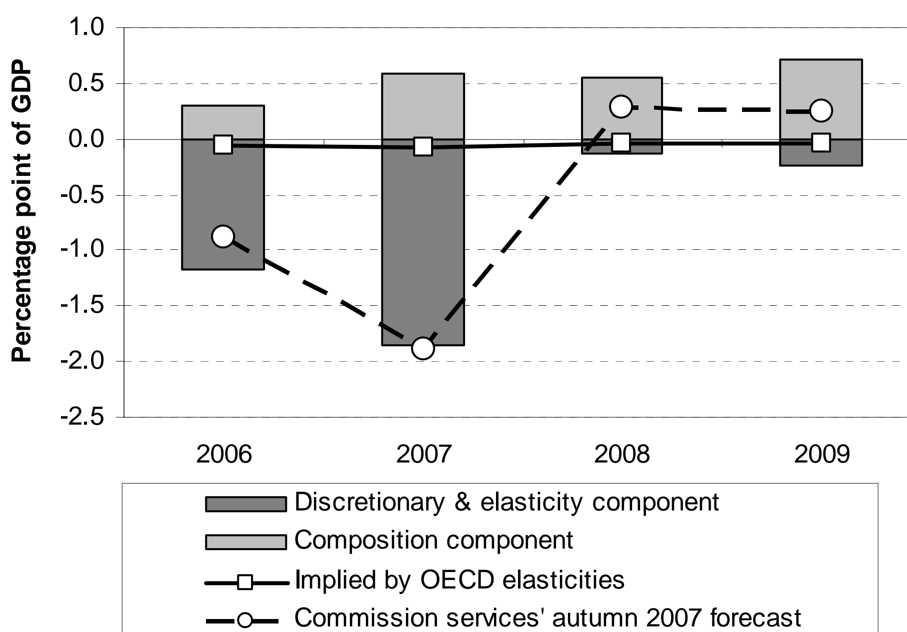
Notes:
[1]The risk of breaching the 3% of GDP deficit threshold with normal cyclical fluctuations, i.e. the existence of a safety margin, is assessed by comparing the cyclically-adjusted balance with the minimum benchmark (estimated as a deficit of around 1½% of GDP for the Czech Republic). These benchmarks represent estimates and as such need to be interpreted with caution.
[2]The Stability and Growth Pact requires Member States to make progress towards their MTO (for countries

in the euro area or in ERM II, this has been quantified as an annual improvement in the structural balance of at least 0.5% of GDP as a benchmark). In addition, the structural adjustment should be higher in good times, whereas it may be more limited in bad times.
[3]Targets in structural terms as recalculated by Commission services on the basis of the information in the programme.

Source:
Commission services

According to the Commission services' an average annual structural effort of 0.6% of GDP would be required from 2008 (structural balance of -4.1% of GDP in 2007) to reach the MTO by the target date of 2012. While within the period of the convergence programme the effort has been front loaded, overall most of the structural effort is shifted to after the programme. Speeding up the planned structural effort toward the achievement of the MTO is likely to require further public finance measures in addition to those already approved by parliament. The consolidation strategy relies on continuing public expenditure restraint, in particular with respect to public sector wages and overall numbers of public employees.

**Figure 6: Changes in the tax-to-GDP ratio:
actual/projected changes vs. changes implied by OECD elasticity**



Note:
The dashed line displays the change in the tax ratio in the Commission services' 2007 autumn forecast (for 2009, on a no-policy-change basis). The solid line shows the change in the tax ratio implied by the ex-ante OECD elasticity with respect to GDP. The difference between the two is explained by the bars. The composition component captures the effect of differences in the composition of aggregate demand (more tax rich or more tax poor components). The discretionary and elasticity component captures the effect of discretionary fiscal policy measures as well as variations of the yield of the tax system that may result from factors such as time lags and variations of taxable income that do not necessarily move in line with GDP, e.g. capital gains. The two components may not add up to the total difference because of a residual component, which is generally small.

Source:
Commission services

5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY

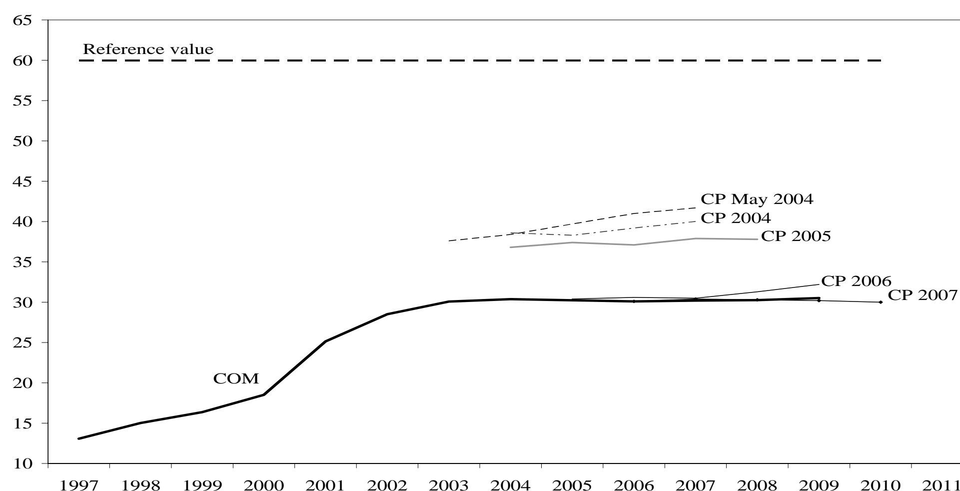
This section is in two parts. A first part describes recent debt developments and medium-term prospects, including risks to the outlook presented in the programme. A second part takes a longer-term perspective with the aim of assessing the long-term sustainability of public finances.

5.1. Recent debt developments and medium-term prospects

5.1.1. Debt projections in the programme

The programme estimates the 2007 debt ratio at 30.4% of GDP which is in line with the Commission services' autumn 2007 forecast of 30.2% of GDP. According to the programme, the debt ratio is expected to slightly decrease over the programme period to 30% in 2010, benefiting from strong GDP growth and consolidation of the primary balance.

Figure 7: Debt projections in successive programmes (% of GDP)



Source: Commission services' autumn 2007 forecast (COM) and successive convergence programmes

Table 11: Debt dynamics

(% of GDP)	average 2002-05	2006	2007		2008		2009		2010
			COM	CP	COM	CP	COM	CP	CP
Gross debt ratio[1]	**29.8**	**30.1**	**30.2**	**30.4**	**30.3**	**30.3**	**30.5**	**30.2**	**30.0**
Change in the ratio	1.3	-0.1	0.1	0.2	0.1	0.0	0.2	-0.1	-0.2
Contributions[2]:									
Primary balance	**3.8**	**1.8**	**2.3**	**2.3**	**1.8**	**1.7**	**1.7**	**1.3**	**1.1**
"Snow-ball" effect	**-0.5**	**-1.1**	**-1.1**	**-1.4**	**-1.2**	**-1.0**	**-1.1**	**-0.9**	**-0.9**
Of which:									
Interest expenditure	1.2	1.1	1.0	1.2	1.0	1.3	1.0	1.2	1.2
Growth effect	-1.1	-1.8	-1.6	-1.6	-1.4	-1.4	-1.4	-1.4	-1.5
Inflation effect	-0.5	-0.5	-0.6	-1.0	-0.8	-0.9	-0.7	-0.7	-0.6
Stock-flow adjustment	**-2.0**	**-0.8**	**-1.1**	**-0.6**	**-0.5**	**-0.6**	**-0.3**	**-0.6**	**-0.3**
Of which:									
Cash/accruals diff.	-0.9	0.0		0.0		-0.3		-0.2	0.0
Acc. financial assets	-1.4	-0.8		-0.7		-0.4		-0.3	-0.3
Privatisation	*-2.4*	*0.0*		*0.9*		*0.0*		*0.0*	*0.0*
Val. effect & residual	0.2	0.0		0.0		0.0		0.0	0.0

Notes:

[1]End of period.

[2]The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$$

where t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth (in the table, the latter is decomposed into the growth effect, capturing real GDP growth, and the inflation effect, measured by the GDP deflator). The term in parentheses represents the "snow-ball" effect. The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source:
Convergence programme (CP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations

5.1.2. Assessment

The programme's debt projections are broadly in line with the Commission services' autumn 2007 forecast. Continuing strong growth in the economy will slow down the level of debt accumulation. The convergence programme predicts that government debt will stabilise by 2009.

5.2. Long-term debt projections and the sustainability of public finances

The long-term sustainability of pubic finances is also addressed in Section 2 with regard to the impact of ageing on the public finances and potential growth.

5.2.1. Sustainability indicators and long-term debt projections

Table 12 shows the evolution of government spending on pensions, healthcare, long-term care for the elderly, education and unemployment benefits according to the EPC's projections and property income received by general government according to an agreed methodology. Non age-related primary expenditure and primary revenue is assumed to remain constant as a share of GDP.

Table 12: Long-term age-related expenditure: main projections

(% of GDP)	2004	2010	2020	2030	2040	2050	Change up to 50
Total age-related spending	19.3	18.8	19.2	21.0	24.1	26.4	7.2
- Pensions	8.5	8.2	8.4	9.6	12.2	14.0	5.6
- Healthcare	6.4	6.8	7.4	7.8	8.1	8.4	2.0
- Long-term care	0.3	0.3	0.4	0.5	0.6	0.7	0.4
- Education	3.8	3.3	2.8	3.0	3.0	3.1	-0.7
- Unemployment benefits	0.2	0.2	0.2	0.2	0.2	0.2	0.0
Property income received	0.7	0.7	0.6	0.5	0.5	0.4	-0.3

Source: Economic Policy Committee and Commission services.

The projected increase in age-related spending in the Czech Republic is considerably above the average of the EU, rising by 7.2p.p. of GDP between 2004 and 2050. The bulk of this increase is due to the expected high increase in expenditure on pensions, projected to rise in the Czech Republic by 5.6p.p. of GDP. The increase in health-care expenditure is projected to be 2.0p.p. of GDP, which is also above the EU average. For long-term care, the projected increase of 0.4p.p. of GDP up to 2050 is below the average in the EU.

Table 13: Sustainability indicators and the required primary balance

	2007 scenario			Programme scenario		
	S1	**S2**	**RPB**	**S1**	**S2**	**RPB**
Value	5.6	8.5	5.7	3.8	6.8	5.6
of which:						
Initial budgetary position (IBP)	3.5	3.7	-	1.8	2.0	-
Debt requirement in 2050 (DR)	-0.5	-	-	-0.5	-	-
Long-term change in the primary balance (LTC)	2.6	4.8	-	2.6	4.8	-

Source: Commission services.

Based on the long-term budgetary projections, sustainability indicators can be calculated. Table 13 shows the sustainability indicators for the two scenarios; the 2007 scenario assumes that the structural primary balance in 2007 is unchanged for the rest of the programme period and the programme scenario assumes that the programme's budgetary plans are fully attained.

In the “2007 scenario”, the sustainability gap (S2) which satisfies the intertemporal budget constraint would be 8.5p.p. of GDP.[22] This is slightly higher than in last year's assessment, essentially due to the deterioration in the structural primary balance in 2007 compared to 2006.

The initial budgetary position is not sufficiently high to stabilize the debt ratio over the long-term and entails a risk of unsustainable public finances before considering the long-term budgetary impact of ageing. According to both sustainability gaps, the long-term budgetary impact of ageing is above the EU average.

The programme targets a structural consolidation of 1.6p.p. of GDP between 2007 and 2010. This would lower the risks to long-term sustainability, by reducing the S2 sustainability gap to 6.8% of GDP, and would partially address the budgetary challenges posed by demographic developments. However, the structural deficit at the end of the programme period, according to the convergence programme (-2.5p.p.), would still not be sufficient to stabilize the debt ratio over the long term. Therefore, it would still pose a

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[22] The sustainability gap (S1) that assures reaching the debt ratio of 60% of GDP by 2050 would be 5.6% of GDP.

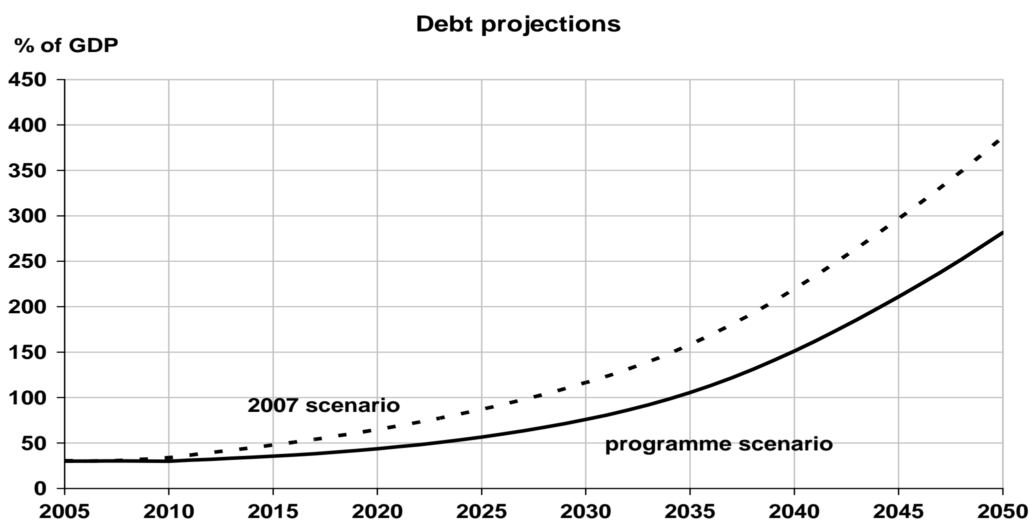
risk to the sustainability of public finances even before considering the long-term budgetary impact of ageing.

The required primary balance (RPB) is around 5.7% of GDP and is significantly higher than the structural primary balance over the programme period, which remains negative.

The sustainability gap indicators would increase by up to ¾% of GDP if the planned budgetary adjustment was to be postponed by 5 years, highlighting the budgetary savings that can be made if action is taken sooner rather than later.

Another way to look at the prospects for the long-term sustainability of public finances is to project the debt/GDP ratio over the long-term using the same assumptions as for the calculations of the sustainability indicators. The long-term projections for government debt under the two scenarios are shown in Figure 8. The gross debt ratio is currently below the 60% of GDP reference value, estimated in the programme at close to 30.4% of GDP in 2007. According to the “2007 scenario”, the debt ratio is projected to increase significantly over the programme period, reaching 60% of GDP by 2020 and more than 350% of GDP in 2050. In the “programme scenario”, thanks to the stronger position in 2010, debt would increase somewhat less markedly but would still reach 60% of GDP by the mid-20s and would be close to 300% of GDP in 2050.[23]

Figure 8: Long-term projections for the government debt ratio



Source: Commission services

5.2.2. Additional factors

To reach an overall assessment of the sustainability of public finances, other factors have to be taken into account which also serve to highlight the source of the main risks to sustainability.

[23] It should be recalled, however, that being a mechanical, partial-equilibrium analysis, the long-term debt projections are bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels should not be seen as a forecast similar to the Commission services’ short-term forecasts, but as an indication of the risks faced by Member States.

First, the long-term budgetary projections presented in the updated programme, which update the projections of the Ageing report, differ slightly from the EPC common projections. The age-related expenditure ratio is projected to rise more (by around 1p.p. of GDP in 2050) in the update compared with the common projections in the Ageing Report. Therefore, the sustainability gaps reported above, which were calculated on the basis of the EPC common projections, may slightly underestimate the cost of ageing.

Second, the programme mentions the preparation of a three-phase pension reform with the first phase being a parametric reform that would, inter alia, increase the retirement age gradually to 65 years old. The expected savings from the envisaged measures would amount to 1p.p. of GDP over the long-term, according to the programme. There is however no timing of implementation provided in the programme.

5.2.3. Assessment

The long-term budgetary impact of ageing in the Czech Republic is well above the EU average, influenced notably by a considerable increase in pension expenditure as a share of GDP. Consolidating the public finances further than currently planned and implementing structural reform measures, notably in the field of pensions as planned by the authorities, would contribute to reducing risks to the sustainability of public finances.

Overall, the Czech Republic appears to be at high risk with regard to the sustainability of public finances.

6. STRUCTURAL REFORM, THE QUALITY OF PUBLIC FINANCES AND INSTITUTIONAL FEATURES

As discussed in Section 2, the Czech Republic will feel the impact of a rapidly ageing population on public finances and growth. By the far the largest burden will be felt on the current pension system which is unsustainable and in need of reform. The proposals put forward by the main political parties are a step in the right direction, while reform design and implementation should be optimized under both fiscal sustainability and growth-compatible incentive aspects. Some effort has been made to address the risks to long-term sustainability in that a pension committee was established in June 2007, made-up of the leaders of all parliamentary parties, with the intention of agreeing on reforms to the pension system, in order to make it less sensitive to ageing. However, the implementation of reform measures is still lacking. A similar committee was established at the same time to develop proposals for reform of the health care system. Some service changes were introduced into the health care system in 2007. These are designed to limit health care expenditures and should therefore improve sustainability. However, implementation is still lacking.

In order to improve the flexibility of the labour market, measures were introduced as part of the stabilisation package to increase the motivation to seek employment and reduce social dependency in low income groups. The changes have included the introduction of flat-rate direct taxation as well as ceilings for the assessment base of social and health insurance. In addition, a review of the tertiary education system has been launched, “the White Book of Tertiary Education” as the basis of a reform. In July 2007, a strategy was adopted on life-long learning and measures were taken in August 2007 to acknowledge educational attainment gained outside the formal education system.

Government reserve funds were introduced in 2004 in order to increase the efficiency of the use of public resources. Currently, reserve funds currently amount to 2.6% of GDP. The practice of reserve funds will be continued while the method of accounting will be altered in order to avoid artificially inflating revenues and expenditures creating a distorted picture of the budget balance in terms of national methodology. The intention of the measures envisaged in the convergence programme is for expenditures realised from the reserve funds to be counted as expenditures in the year of disbursement.

The Czech Consolidation Agency (CKA), which was created to support restructuring during the process of economic transformation, will be dissolved by the end of 2007. The portfolio of the CKA will divided between strategic assets and residual assets, which will be taken over by the Ministry of Finance, and non-performing assets which will be sold to the private sector via a subsidiary of the CKA.

A draft proposal will be introduced to simply the system of tax administration for citizens. The aim is to integrate the collection of taxes, customs, and contributions to social and health insurance. The changes will mean that tax payers only need to deal with one government body. It is intended that the changes will come into effect on 1 January 2010.

7. CONSISTENCY WITH THE NATIONAL REFORM PROGRAMME AND WITH THE BROAD ECONOMIC POLICY GUIDELINES

The latest update of the convergence programme is in line with the 2007 National Reform Programme. The convergence programme includes a number actions taken with the objective of improving the long-term sustainability of public finances; increasing the amount and quality of education and research, and increasing the motivation to take up employment. The convergence programme does not contain a qualitative assessment of the overall impact of the National Reform Programme with the medium-term fiscal strategy. As a result, the two programmes seem to be integrated to some extent.

Box 5: The Commission assessment of the October 2007 implementation report of the national reform programme

On 11 December 2007, the Commission adopted its Strategic Report on the renewed Lisbon strategy for growth and jobs, which includes an assessment of the October 2007 implementation report of the Czech Republic's national reform programme[24] and is summarised as follows.

The Czech Republic's national reform programme identifies as key challenges/priorities: the long-term sustainability of public finances in the context of an ageing population, fulfilling the commitments for public R&D expenditure and further increasing its effectiveness, improving security and flexibility in the labour market, improving the efficiency and equity in education and training and increasing participation in life-long learning.

The Commission's assessment is that the Czech Republic has made some progress in implementing its National Reform Programme over the period 2005-2007.

Against the background of strengths and weaknesses identified, the Commission recommends that the Czech Republic is recommended to take action in the areas of: pension and health care system reform; research by increasing expenditure and building human capacity; employment and education in order to introduce a flexicurity approach.

In addition the Commission recommended that the Czech Republic should focus on the following areas: improving the protection of intellectual property rights, speeding up progress in the ICT area (including by implementing and monitoring the development of a fully enabling legal environment for e-government), improving access to finance for innovative companies (in particular through further developing the venture capital market), increasing the coverage of entrepreneurship education, better integrating disadvantaged groups into the labour market, reducing regional disparities, reconciling work and family life, tackling the gender pay gap and implementing the active ageing strategy.

The table below provides an overview of whether the strategy and policy measures in the convergence programme are consistent with the broad economic policy guidelines in the area of public finances issued in the context of the Lisbon strategy for growth and jobs, in particular the integrated guidelines for the period 2005-2008, adopted by the Council in July 2005.

[24] Communication from the Commission to the European Council, "Strategic report on the renewed Lisbon strategy for growth and jobs: launching the new cycle (2008-2010)", 11.12.2007, COM(2007)803.

Table 14: Consistency with the broad economic policy guidelines (integrated guidelines)

Broad economic policy guidelines (integrated guidelines)	Yes	Steps in right direction	No	Not applicable
1. To secure economic stability				
– Member States should respect their medium-term budgetary objectives. As long as this objective has not yet been achieved, they should take all the necessary corrective measures to achieve it[1].		X		
– Member States should avoid pro-cyclical fiscal policies[2].				X
– Member States in excessive deficit should take effective action in order to ensure a prompt correction of excessive deficits[3].	X			
– Member States posting current account deficits that risk being unsustainable should work towards (…), where appropriate, contributing to their correction via fiscal policies.				X
2. To safeguard economic and fiscal sustainability In view of the projected costs of ageing populations,				
– Member States should undertake a satisfactory pace of government debt reduction to strengthen public finances.				X
– Member States should reform and re-enforce pension, social insurance and health care systems to ensure that they are financially viable, socially adequate and accessible (…)		X		
3. To promote a growth- and employment-orientated and efficient allocation of resources				
Member States should, without prejudice to guidelines on economic stability and sustainability, re-direct the composition of public expenditure towards growth-enhancing categories in line with the Lisbon strategy, adapt tax structures to strengthen growth potential, ensure that mechanisms are in place to assess the relationship between public spending and the achievement of policy objectives and ensure the overall coherence of reform packages.		X		

Notes:
[1]As further specified in the Stability and Growth Pact and the code of conduct, i.e. with an annual 0.5% of GDP minimum adjustment in structural terms for euro area and ERM II Member States.
[2]As further specified in the Stability and Growth Pact and the code of conduct, i.e. Member States that have already achieved the medium-term objective should avoid pro-cyclical fiscal policies in "good times".
[3]As further specified in the country-specific Council recommendations and decisions under the excessive deficit procedure.

Source:
Commission services

Annex 1: Compliance with the code of conduct

This annex provides an assessment of whether the programme respects the requirements of Section II of the code of conduct (guidelines on the format and content), notably as far as (i) the model structure (Annex 1 of the code of conduct); (ii) the formal data provisions (Annex 2 of the code of conduct); and (iii) other information requirements is concerned.

(i) Model structure

The update adheres to the code of conduct with respect to its table of contents.

(ii) Data requirements

With respect to optional data, the following were not provided: COFOG data for 2010 and liquid financial assets and net financial debt with respect to government debt.

The tables on the following pages show the data presented in the November 2007 update of convergence programme, following the structure of the tables in Annex 2 of the code of conduct. Compulsory data are in bold, missing data are indicated with grey-shading.

(iii) Other information requirements

The table below provides a summary assessment of the adherence to the other information requirements in the code of conduct.

The SCP…	Yes	No	Comments
a. Involvement of parliament			
… mentions status vis-à-vis national parliament.	X		
… indicates whether Council opinion on previous programme has been presented to national parliament.		X	
b. Economic outlook			
… (for euro area and ERM II Member States) uses "common external assumptions" on main extra-EU variables.			not applicable
… explains significant divergences with Commission services' forecasts[1].		X	
… bears out possible upside/downside risks to economic outlook.	X		
… analyses outlook for sectoral balances and, especially for countries with high external deficit, external balance.	X		
c. Monetary/exchange rate policy			
… (CP only) presents medium-term monetary policy objectives and their relationship to price and exchange rate stability.	X		
d. Budgetary strategy			
… presents budgetary targets for general government balance in relation to MTO and projected path for debt ratio.	X		
… (in case new government has taken office) shows continuity with respect to budgetary targets endorsed by Council.			not applicable
… (when applicable) explains reasons for deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify situation (+ provides information on them).	X		
… backs budgetary targets by indication of broad measures necessary to achieve them and analyses their quantitative effects on balance.	X		(less information after 2008)
… specifies state of implementation of measures.	X		
e. "Major structural reforms"			
… (if MTO not yet reached or temporary deviation is planned from MTO) includes comprehensive information on economic and budgetary effects of possible 'major structural reforms' over time.			not applicable (no dispensation from MTO requested)
… includes quantitative cost-benefit analysis of short-term costs and long-term benefits of reforms.			not applicable
f. Sensitivity analysis			

The SCP…	Yes	No	Comments
… includes comprehensive sensitivity analyses and/or develops alternative scenarios showing impact on balance and debt of: a) changes in main economic assumptions b) different interest rate assumptions c) (for CP only) different exchange rate assumptions d) if common external assumptions are not used, changes in assumptions for main extra-EU variables.	X		
… (in case of "major structural reforms") analyses how changes in assumptions would affect budget and potential growth.			not applicable
g. Broad economic policy guidelines			
… provides information on consistency with broad economic policy guidelines of budgetary objectives and measures to achieve them.		X	
h. Quality of public finances			
… describes measures to improve quality of public finances, both revenue and expenditure sides.	X		
i. Long-term sustainability			
… outlines strategies to ensure sustainability.	X		
… includes common budgetary projections by the AWG and all necessary additional information (esp. new relevant information).	X		
j. Other information (optional)			
… includes information on implementation of existing national budgetary rules and on other institutional features of public finances.	X		

Notes: SCP = stability/convergence programme; CP = convergence programme
[1]To the extent possible, bearing in mind the typically short time period between the publication of the Commission services' autumn forecast and the submission of the programme.

Source:
Commission services

Table 1a. Macroeconomic prospects

	ESA Code	2006 Level	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change
1. Real GDP	B1*g	*3185.6*	6.4	5.9	5.0	5.1	5.3
2. Nominal GDP	B1*g	*3220.3*	7.5	9.6	8.3	7.6	7.6
Components of real GDP							
3. Private consumption expenditure	P.3	*1530.0*	4.4	6.5	4.2	4.6	4.2
4. Government consumption expenditure	P.3	*668.7*	1.1	-0.6	-0.4	-0.3	-0.5
5. Gross fixed capital formation	P.51	*802.8*	7.6	6.0	9.0	7.8	7.2
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	*60.7*	1.9	3.0	3.7	3.8	3.6
7. Exports of goods and services	P.6	*2497.1*	15.9	13.2	11.9	12.9	13.5
8. Imports of goods and services	P.7	*2373.7*	15.2	13.9	12.7	12.4	12.4
Contributions to real GDP growth							
9. Final domestic demand		-	4.3	4.5	4.2	4.1	3.7
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	1.1	1.5	0.9	0.0	0.0
11. External balance of goods and services	B.11	-	1.0	-0.1	-0.1	1.0	1.5

Table 1b. Price developments

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

[1] Optional for stability programmes.

Table 1c. Labour market developments

	ESA Code	2006 Level	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change
1. Employment, persons[1]		*5071.0*	1.7	1.5	1.1	0.5	0.2
2. Employment, hours worked[2]		*9948.6*	1.4	1.5	1.1	0.5	0.2
3. Unemployment rate (%)[3]		*7.1*	7.1	5.5	4.8	4.5	4.5
4. Labour productivity, persons[4]		*628.2*	4.7	4.4	3.8	4.6	5.1
5. Labour productivity, hours worked[5]		*320.2*	4.9	4.4	3.8	4.6	5.1
6. Compensation of employees	D.1	*1382.9*	7.8	9.2	7.3	7.1	7.0
7. Compensation per employee		*331.6*	5.7	7.7	6.5	6.9	7.0

[1]Occupied population, domestic concept national accounts definition.

[2]National accounts definition.

[3]Harmonised definition, Eurostat; levels.

[4]Real GDP per person employed.

[5]Real GDP per hour worked.

Table 1d. Sectoral balances

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

Table 2. General government budgetary prospects

	ESA Code	2006	2006	2007	2008	2009	2010
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	*-95.0*	-2.9	-3.4	-2.9	-2.6	-2.3
2. Central government	S.1311	*-92.1*	-2.8	-3.5	-2.9	-2.5	-2.2
3. State government	S.1312	*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.
4. Local government	S.1313	*-14.7*	-0.5	-0.2	-0.1	-0.1	-0.1
5. Social security funds	S.1314	*11.8*	0.4	0.3	0.0	0.0	0.0
General government (S13)							
6. Total revenue	TR	*1314.7*	40.7	39.8	39.5	38.1	37.1
7. Total expenditure	TE[1]	*1409.7*	43.6	43.3	42.4	40.7	39.4
8. Net lending/borrowing	EDP B.9	*-95.0*	-2.9	-3.4	-2.9	-2.6	-2.3
9. Interest expenditure	EDP D.41	*35.9*	1.1	1.2	1.3	1.2	1.2
10. Primary balance[2]		*-59.0*	-1.8	-2.3	-1.7	-1.3	-1.1
11. One-off and other temporary measures[3]		*-6.4*	-0.2	0.0	0.0	0.0	0.0
Selected components of revenue							
12. Total taxes (12=12a+12b+12c)		*637.2*	19.7	19.7	19.7	18.9	18.3
12a. Taxes on production and imports	D.2	*351.4*	10.9	10.9	11.5	11.1	10.8
12b. Current taxes on income, wealth, etc	D.5	*284.8*	8.8	8.8	8.2	7.7	7.5
12c. Capital taxes	D.91	*0.9*	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	*524.8*	16.2	16.2	15.9	15.4	15.0
14. Property income	D.4	*25.6*	0.8	0.6	0.5	0.5	0.4
15. Other [4]		*127.2*	3.9	3.3	3.3	3.3	3.4
16=6. Total revenue	TR	*1314.7*	40.7	39.8	39.5	38.1	37.1
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[5]			36.0	35.9	35.7	34.3	33.3
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	*465.4*	14.4	13.4	12.8	12.1	11.5
17a. Compensation of employees	D.1	*251.0*	7.8	7.6	7.3	7.0	6.7
17b. Intermediate consumption	P.2	*214.4*	6.6	5.8	5.5	5.1	4.8
18. Social payments (18=18a+18b)		*578.6*	17.9	18.2	17.4	16.8	16.3
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	*171.2*	5.3	5.2	5.1	5.0	4.8
18b. Social transfers other than in kind	D.62	*407.4*	12.6	13.0	12.3	11.8	11.5
19=9. Interest expenditure	EDP D.41	*n.a.*	1.1	1.2	1.3	1.2	1.2
20. Subsidies	D.3	*62.0*	1.9	2.0	2.2	1.9	1.8
21. Gross fixed capital formation	P.51	*161.5*	5.0	5.1	5.3	5.4	5.6
22. Other[6]		*106.2*	3.3	3.4	3.6	3.3	3.1
23=7. Total expenditure	TE[1]	*1409.7*	43.6	43.3	42.4	40.7	39.4
p.m.: Government consumption (nominal)	P.3	*685.4*	21.2	20.0	19.1	18.2	17.4

[1]Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

[2]The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41, item 9).

[3]A plus sign means deficit-reducing one-off measures.

[4] P.11+P.12+P.131+D.39+D.7+D.9 (other than D.91).

[5]Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

[6] D.29+D4 (other than D.41)+ D.5+D.7+D.9+P.52+P.53+K.2+D.8.

Table 3. General government expenditure by function

% of GDP	COFOG Code	2005	2010
1. General public services	1	5.5	n.a.
2. Defence	2	1.8	n.a.
3. Public order and safety	3	2.2	n.a.
4. Economic affairs	4	6.9	n.a.
5. Environmental protection	5	1.2	n.a.
6. Housing and community amenities	6	1.4	n.a.
7. Health	7	6.1	n.a.
8. Recreation, culture and religion	8	1.2	n.a.
9. Education	9	4.8	n.a.
10. Social protection	10	12.8	n.a.
11. Total expenditure (=item 7=23 in Table 2)	TE[1]	43.8	n.a.

[1]Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

Table 4. General government debt developments

% of GDP	ESA Code	2006	2007	2008	2009	2010
1. Gross debt[1]		30.1	30.4	30.3	30.2	30.0
2. Change in gross debt ratio		-0.1	0.2	0.0	-0.1	-0.2
Contributions to changes in gross debt						
3. Primary balance[2]		1.8	2.3	1.7	1.3	1.1
4. Interest expenditure[3]	EDP D.41	1.1	1.2	1.3	1.2	1.2
5. Stock-flow adjustment		-0.8	-0.7	-0.6	-0.6	-0.3
of which:						
- Differences between cash and accruals[4]		0.0	0.0	-0.3	-0.2	0.0
- Net accumulation of financial assets[5]		-0.8	-0.7	-0.4	-0.3	-0.3
of which:						
- privatisation proceeds		0.1	0.9	0.0	0.0	0.0
- Valuation effects and other[6]		0.0	0.0	0.0	0.0	0.0
p.m.: Implicit interest rate on debt[7]		3.6	3.9	4.2	4.1	4.0
Other relevant variables						
6. Liquid financial assets[8]		n.a.	n.a.	n.a.	n.a.	n.a.
7. Net financial debt (7=1-6)		n.a.	n.a.	n.a.	n.a.	n.a.

[1]As defined in Regulation 3605/93 (not an ESA concept).

[2]Cf. item 10 in Table 2.

[3]Cf. item 9 in Table 2.

[4]The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

[5]Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.

[6]Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.

[7]Proxied by interest expenditure divided by the debt level of the previous year.

[8]AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

Table 5. Cyclical developments

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

[1]A plus sign means deficit-reducing one-off measures.

Table 6. Divergence from previous update

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

Table 7. Long-term sustainability of public finances

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

Table 8. Basic assumptions

	2006	2007	2008	2009	2010
Short-term interest rate[1] (annual average)	2.3	3.0	3.6	3.3	3.4
Long-term interest rate (annual average)	3.8	4.4	5.1	4.5	4.6
USD/€exchange rate (annual average) (euro area and ERM II countries)	n.a.	n.a.	n.a.	n.a.	n.a.
Nominal effective exchange rate	104.8	106.0	108.0	111.0	115.0
(for countries not in euro area or ERM II) exchange rate vis-à-vis the €(annual average)	n.a.	n.a.	n.a.	n.a.	n.a.
World excluding EU, GDP growth	5.2	5.0	4.9	4.8	5.0
EU GDP growth	3.0	2.7	2.5	2.5	2.5
Growth of relevant foreign markets	9.0	7.8	7.6	7.7	8.0
World import volumes, excluding EU	9.0	7.8	7.5	7.5	7.8
Oil prices (Brent, USD/barrel)	65.4	67.8	72.5	66.8	65.0

[1]If necessary, purely technical assumptions.

Annex 2: Key indicators of past economic performance

This annex displays key indicators that summarise the past economic performance of the Czech Republic. To put the country's performance into perspective, right-hand side of the table displays the same set of indicators for the recently acceded Member States (EU12).

Table: Key economic indicators

	Czech Republic						Recently acceded Member States					
	Averages			2005	2006	2007	Averages			2005	2006	2007
	'96 - '05	'96 - '00	'01 - '05				'96 - '05	'96 - '00	'01 - '05			
Economic activity												
Real GDP (% change)	2.6	1.5	3.8	6.4	6.4	5.8	3.8	3.6	4.1	4.8	6.3	6.0
Contributions to real GDP growth:												
Domestic demand	*2.7*	*2.0*	*3.3*	*1.6*	*5.5*	*4.7*	*4.4*	*4.6*	*4.1*	*4.1*	*7.3*	*7.8*
Net exports	*-0.1*	*-0.5*	*0.4*	*4.8*	*0.9*	*1.0*	*-0.5*	*-1.0*	*-0.1*	*0.8*	*-0.9*	*-1.8*
Real GDP per capita (PPS; EU27 = 100)	70	70	71	76	78	80	47	45	49	52	54	56
Real GDP per capita (% change)	2.7	1.6	3.8	6.1	6.0	5.6	4.1	3.8	4.4	4.9	6.4	6.1
Prices, costs and labour market												
HICP inflation (%)	4.3	6.5	2.0	1.6	2.1	3.0	7.8	12.9	5.7	3.8	3.4	4.0
Labour productivity (% change)	2.9	2.3	3.6	5.2	4.5	4.2	4.2	4.3	4.1	3.3	3.6	3.5
Real unit labour costs (% change)	0.5	0.3	0.7	-0.3	-0.1	0.1	-1.3	-1.4	-1.3	-0.6	-1.5	0.4
Employment (% change)	-0.3	-0.8	0.2	1.0	1.9	1.6	-0.3	-0.6	0.0	1.4	2.6	2.4
Unemployment rate (% of labour force)	7.5	7.2	7.9	7.9	7.1	5.9	11.3	9.7	12.9	11.9	9.9	7.8
Competitiveness and external position												
Real effective exchange rate (% change)	5.4	4.6	6.3	4.6	6.0	2.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Export performance (% change)[1]	2.8	0.0	5.6	4.4	3.6	6.8	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-4.6	-4.4	-4.9	-2.9	-2.7	-2.5	-4.5	-4.8	-4.3	-4.3	-5.0	-6.1
Public finances												
General government balance (% of GDP)	-4.5	-3.9	-5.1	-3.5	-2.9	-3.4	-4.2	-3.8	-4.4	-3.5	-3.3	-2.7
General government gross debt (% of GDP)	22.0	15.1	28.9	30.2	30.1	30.2	37.7	35.4	39.0	39.6	38.8	37.9
Structural balance (% of GDP)[2]	n.a.	n.a.	-3.0	-2.2	-3.3	-4.1	n.a.	n.a.	-3.8	-3.3	-3.6	-3.0
Financial indicators												
Short-term real interest rate (%)[3]	2.2	3.8	0.5	2.2	0.6	1.0	3.9	6.3	2.9	1.4	1.0	0.5
Long-term real interest rate (%)[3]	2.6	5.4	2.1	3.7	2.1	2.2	n.a.	n.a.	n.a.	n.a.	1.6	1.1

Notes:

[1]Market performance of exports of goods and services on export-weighted imports of goods and services of 35 industrial markets.

[2]Cyclically-adjusted balance net of one-off and other temporary measures; available since 2003.

[3]Using GDP deflator.

Source :
Commission services