



# **Convergence Programme Czech Republic**

**January 2010**

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# Introduction

This regular update of the Convergence Programme (the “CP”) is hereby submitted as a part of the European Union’s multilateral budgetary surveillance and fiscal policy coordination process. With respect to the date of submission, the macroeconomic scenario draws from the data known at January 15, 2010.

The global financial market crisis and subsequent recession were reflected in the Czech economy by a marked slowdown in economic growth in 2008 and a drop in GDP in 2009. GDP is expected to have decreased by 4.0% in real terms in 2009 and to slightly increase by 1.3% in 2010. In line with the anticipated abatement of the global crisis, economic growth should accelerate up to a level of 3.8% in 2012. General government finances during 2008 turned out slightly worse than expected: the government balance reached –2.1% of GDP. The worsening of the public finances continued to accelerate significantly due to the strong impact of automatic stabilisers and the government stimulus package to support the economy. For 2009, the preliminary estimate of the government balance is around –6.6% of GDP. The general government debt will rise to 35.2% of GDP this year with future prospect of growth. On the other hand, the Czech Republic has avoided the banking sector crisis.

This CP is submitted by the government which was given a mandate until the parliamentary elections in May 2010 after the coalition government had lost a no-confidence vote in spring 2009. Aware of the problems in public budgets, the risks of excessive indebtedness, and the expected gradual economic recovery, the Czech government has pushed through Parliament in the proposal for the 2010 budget measures to reduce the government sector deficit. In comparison with 2009, the consolidation package will contribute to year-on-year improvement of the structural balance by approximately 2% of GDP and make it possible to reduce the government deficit to about 5.3% of GDP.

An excessive deficit procedure was initiated with the Czech Republic on 2 December 2009. The Council of the EU has recommended that the Czech Republic by credible and sustainable means reduce the ratio of its general government deficit to GDP below the 3% reference limit by 2013. A report on the progress made in implementing the Council’s recommendations is the subject of Chapter 8.

Another consequence of the internal political situation is that the current government did not inherit approved consolidation strategy beyond the 2010 horizon. Despite the given political limitations, however, and in addition to enforcing an austerity budget for 2010, the government has prepared a consolidation strategy ensuring progress in correcting the excessive deficit within the timetable set by the Council. The aim is to create conditions for the succeeding government formed after the May elections to continue the initiated consolidation in following years with specification of its own consolidation strategy.

Even excluding political factors, macroeconomic and fiscal development is currently encumbered by substantial uncertainties. Although the macroeconomic scenario on the basis of which the CP is created is rather conservative compared to other institutions’ forecasts, the recovery profile of the Czech economy cannot, for the time being, be estimated with greater certainty.

The Programme was sent to the Czech Parliament for information. The relevant committees have discussed it and are regularly informed about its assessment by European bodies. Both

chambers of the Parliament of the Czech Republic have also been properly informed about the initiation of the excessive deficit procedure with the Czech Republic.

The CP is available in electronic format on the website of the Ministry of Finance:  
<http://www.mfcr.cz>.

# 1 Economic Policy

## 1.1 Fiscal Policy

Reducing general government deficits and improving the structural parameters of public finances will be the priorities of fiscal policy for the coming period. Preparation and enforcement of a medium-term fiscal strategy, however, is currently complicated by the announcement of elections. The main objective of fiscal policy is thus maintenance of the government deficit in 2010 at 5.3% of GDP and gradual consolidation in subsequent years such that the Czech Republic eliminates the excessive deficit by 2013.

Other objectives of the government in the fiscal area are:

- Limiting the negative impacts of economic development in 2009 on general government finances through the adoption of measures to reduce the deficit,
- Reducing the administrative burden and tax distortion by simplifying the tax system,
- Increasing the effectiveness of government expenditures.

The measures adopted by the Chamber of Deputies toward reducing the deficit in 2010 are focused, in particular, on the revenue side of public budgets, and especially in the area of indirect taxes. On the expenditure side, a compromise in the form of a temporary reduction of certain social benefits was adopted in the Chamber of Deputies. The government at the same time decided to cancel unfilled administrative positions in the general government and subsequently to freeze the volumes of funds for wages of civil servants as well as for 2010 pensions.

In accordance with the requirements of the excessive deficit procedure, the government also prepared and approved a consolidation strategy for the following years of the outlook. In contrast to the measures for 2010, greater emphasis is placed on the expenditure side of public budgets. This approved strategy guarantees reduction of the general government deficit to 4.2% of GDP in 2012.

The simplification of the tax system and the transparent and business-friendly tax administration are the main factors improving the quality of public finances and supporting economic growth. Despite the economic decline, funding for education, support for science and research, and financing of investments that support economic growth remain government priorities. This policy is reflected in expenditure cuts in individual chapters which were carried out selectively with regard for the government's priorities.

A precondition for successful fiscal consolidation shall be determination of achievable fiscal objectives by the new government. The main instrument will be thorough implementation of a fiscal targeting regime and upholding the newly approved medium-term expenditure frameworks.

No deadline for achieving the medium-term budgetary target for the general government structural balance has been established as, given the current state of public finances in the Czech Republic, its achievement would extend well beyond the CP horizon. The new government will be able to credibly establish a date for its achievement.

The macroeconomic forecast of the Ministry of Finance upon which this document is based is rather conservative in comparison with the predictions of other institutions (see Chap. 4.4). This provides a good basis for the achieving the estimated levels of tax revenues and achieving the planned financial results in 2010. Nevertheless, current forecasts do not, and cannot, take into account the consolidation of public finances of most EU countries, which in large measure will have occurred only from 2011. Thus, there is a risk that the EU's economic growth will be lower than currently expected. This would of course have a particularly negative impact on the small, open economy of the Czech Republic with corresponding consequences for the amounts of deficits (Chap. 4.3 is devoted to the impact of the growth rate of the external environment on the Czech Republic).

### 1.2 Monetary Policy

The CNB will continue to conduct monetary policy with the help of the inflation-targeting regime. After four years during which the inflation target was at a level of 3% (expressed as annual growth in the consumer price index), a new target of 2% takes effect from 2010. For the new target, as for the previous one, a tolerance band of  $\pm$  one percentage point will be set.

The reduction in the inflation target reflected, in particular, the longer-term perspective for inflation targeting in the Czech Republic due to postponing the euro adoption date beyond the originally envisaged 2010 horizon (see below) and the current low-inflationary environment of the Czech economy, exhibited in inflation expectations anchored at low levels. Lower inflation in the Czech Republic in line with the new target further increases the chances of meeting the Maastricht price stability criterion in the future. The CNB continues to view its inflation targets as medium-term in nature, and real inflation may temporarily deviate from them as a result of exogenous shocks. Changes to indirect taxes are one such shock. Monetary policy does not react to the first-round effects of such changes and concentrates only on their second-round effects.

The Czech Republic's Updated Strategy for Euro Area Accession, approved by the Czech government in August 2007, and did not set a new target date for accession to the Euro Area. This date will depend on the resolution of problematic areas as part of a fundamental public finance reform and strengthening the flexibility of the Czech economy. In this respect, entry into ERM II is still viewed as only a necessary condition for adopting the euro, and hence, the amount of time spent in ERM II should be kept at a minimum. The periodic document "Assessment of the Fulfilment of the Maastricht Convergence Criteria and the Degree of Economic Alignment of the Czech Republic with the Euro Area", jointly prepared by the Ministry of Finance of the Czech Republic and the CNB and approved by the government on 21 December 2009, states that it is very improbable under current conditions that the Czech Republic will be able to meet all Maastricht convergence criteria in the medium-term horizon. The major barrier for entry into the monetary union will be that the general government deficit is higher than 3%. Equally uncertain is the sustainability and necessary further increase in the achieved degree of alignment of the Czech economy with the euro area in coming years. Given this situation, it is therefore impossible to establish a new target date for accession to the euro area. This also implies that the Czech Republic will not strive for entry to the ERM II mechanism during 2010.

With the economic crisis subsiding and inflation expected to slowly rise during 2010, interest rates can be expected gradually to increase in this period.



### 1.3 Structural Policies

A detailed outline of priorities and measures adopted in the area of structural policies is presented in the Report on Fulfilment of the Czech Republic's National Reform Programme 2008–2010, which was approved by the Czech government on 26 October 2009. In this section, therefore, only a selection of the most important measures is presented.

#### Education, science, research and innovation

In January 2009, the Czech government discussed the “White Book of Tertiary Education”, which provides the basis for the current debate on the objectives and means of the planned reform of university education in the Czech Republic. In addition to the Strategy for Life-Time Learning approved by the Czech government in July 2007, an Implementation Plan for the Strategy for Life-Time Learning was approved in January 2009. The Strategy was supplemented by specific implementing measures through which its objectives will be fulfilled in the period 2009–2015. The Plan proposes a procedure, organisation, responsibility, timetable and financial backing for putting the Strategy into practice.

Future competitiveness must be based on the use of modern technologies in industry, a whole range of services and agriculture, on energy savings and on increasing economic rationality of the use of alternative energy sources. To meeting this goal, precisely targeted promotion of priority areas in fundamental research, experimental research and innovations that ensure competitive advantages to the key branches in the Czech Republic will contribute, together with promotion of international cooperation in science, research and tertiary education, a shift from input-oriented targets to performance-based targets at all levels of education and increasing pressure on the quality of outcomes and effectiveness of education at all levels and in research supported by the state.

Currently, the Reform of the Research, Development and Innovation System is being executed. Its objective is to simplify administration, achieve more effective use of public resources for this area, and increase the benefits of research, development and innovation for the Czech economy. In June 2009, the National Policy on Research, Development and Innovations of the Czech Republic was approved by the Czech government within the aforementioned reform for the years 2009–2015, defining the government's approach to creating an environment of innovation and its further direction. The Czech Republic will focus primarily on improving strategic management and the efficiency of the science, research and innovation system, improving cooperation between the public and private sectors, greater involvement in international cooperation, and ensuring quality human resources.

#### Business environment

One of the most important reforms adopted in the past period is the Act on Free Movement of Services. This legal regulation transposes into the Czech legal system the Directive on Services in the Internal Market of the EU which significantly liberalises the provision of services in the EU. The Act came into force in December 2009.

One of the priorities of the Czech government in terms of improving the business environment is to reduce the administrative burden on businesses. In 2008, the Czech government committed itself to reducing the administrative burden by 20% in the period of 2005–2010. In this connection, the Report on Implementation of Plan of Reducing the

Administrative Burden of Entrepreneurs till 2010 and Its Acceleration was approved in April 2009 and, in accordance with it, future activities will focus on ten norms presenting the greatest burden for companies.

In July 2009, the Act on eGovernment came into force. This act regulates electronic transactions of select public administration authorities and legal entities and establishes a secure data exchange system and authorised conversion of documents.

### **Energy industry and climate change**

At present, a proposal for an update of the State Energy Policy of the Czech Republic is being discussed. The update should ensure for the next 20 years and with an outlook up to 2050 that the Czech Republic has a safe, low-emission energy industry with permanently surplus balances. The proposal allows for greater use of nuclear and renewable sources of energy. Further discussion on this material will be linked with discussion of the proposal for the Climate Protection Policy with the aim of maximum accord between the two documents.

As part of efforts to support renewable energy sources, an amendment to the Act on Excise Duties has been approved that establishes support of first-generation high-percentage biofuels. The amendment took effect in October 2009.

### **Labour market**

Another priority of the government is a flexible labour market, particularly during the ongoing economic recession. The amendment to the Employment Act that came into force in January 2009 focuses on strengthening economic activity by making conditions for granting unemployment benefits more restrictive.

## 2 Macroeconomic Scenario

Although the Czech economy seems very likely to have come out of the recession, great uncertainties remain regarding the intensity of the economic recovery. The CP scenario was drawn up to be conservative and with an effort to balance the potential positive and negative divergence of economic development while drawing upon the current state of knowledge<sup>1</sup>.

### 2.1 The World Economy and Technical Assumptions<sup>2</sup>

The world economy is recovering from the global financial and economic crisis. Equity markets have been improving since spring 2009, while industrial output and export began to revive at around the same time. China and other Asian economies have returned to strong growth. Any remaining uncertainty is connected primarily with the unfinished consolidation of the financial sector and with how economies will respond to the termination of stimulus measures.

The crisis on financial markets was manifested in EU 27 economies by a slowdown in GDP growth during 2008 and its deep decline at the start of 2009. Already for 2010, the scenario plans for gradual recovery, which should be followed by an increase in dynamics in following years. An important element in this situation is the early and relatively strong recovery in Germany. The impacts of the prepared “exit strategies”, on the other hand, will be a significant risk factor.

Although the current USD price for oil is certainly well below its peaks from mid-2008, it will likely remain high. The expected increase above the level of USD 90/barrel in 2011 should be caused particularly by low flexibility of supply and growth in demand in certain Asian countries, which should be dampened, however, by weaker demand from advanced economies.

**Table 2.1: Exogenous assumptions of the scenario**

		Year 2008	Year 2009	Year 2010	Year 2011	Year 2012
<b>USD/EUR exchange rate</b>	<i>(annual average)</i>	1,46	1,39	1,44	1,43	1,43
<b>CZK/EUR exchange rate</b>	<i>(annual average)</i>	24,9	26,4	25,8	24,8	23,8
<b>Government bond yield to maturity 10Y</b>		4,6	4,7	3,8	4,0	4,0
<b>PRIBOR 3M</b>		4,0	2,2	1,7	2,4	2,8
<b>GDP EU27</b>	<i>(real growth in %)</i>	0,8	-4,0	1,1	2,0	2,2
<b>Oil prices</b>	<i>(Brent, USD/barrel)</i>	98	62	81	92	91

Source: Czech National Bank, Eurostat, IMF, Ministry of Finance calculations.

An assumption for moderate appreciation of the euro to around a 1.43 USD/EUR exchange rate was chosen. Following the correction in 2009, the CZK/EUR exchange rate should continue its previous appreciating trend and reach approximately 23.8 CZK/EUR in 2012.

<sup>1</sup> The CP was prepared on the basis of data available as of 11 January 2010. The development on world financial and commodities markets after that date is not taken into consideration.

<sup>2</sup> “Common assumptions on the external environment” were not used in preparing the CP. Therefore, the CP was supplemented by a sensitivity analysis for certain macroeconomic indicators based on the exogenous variables.

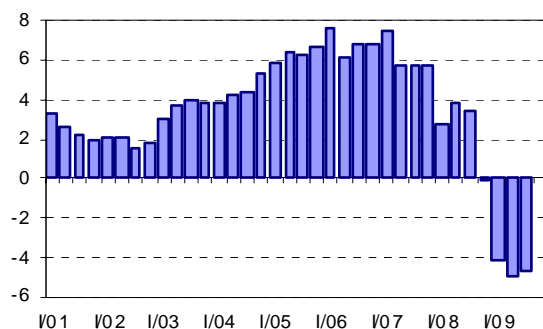
The assumptions on short-term interest rates were chosen to be consistent with meeting the CNB's inflation target.

## 2.2 Current Macroeconomic Development

During 2005 to 2007, the Czech economy went through a period of high GDP growth. After the gradual slowdown beginning at the start of 2008, the economy fell into a recession in Q4 2008 and Q1 2009. The quarter-on-quarter GDP growth rates for Q2 2009 (+0.2%) and Q3 2009 (+0.8%) suggest that the decline in GDP has already reached its bottom. The main source of economic growth in 2006 and 2007 was domestic demand driven equally by household expenditures on final consumption and by gross capital formation. Since 2008, gross capital formation has contributed negatively to growth, particularly due to a year-on-year drop in inventories. In the first three quarters of 2009, all components of demand, apart from final consumption, contributed negatively to year-on-year GDP growth.

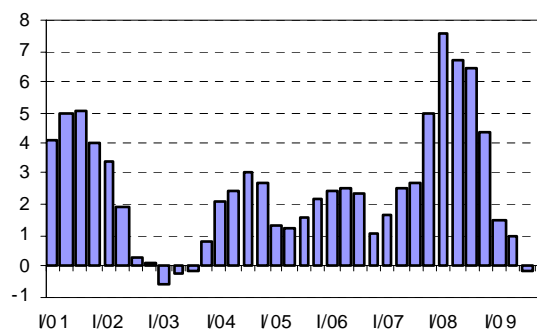
**Chart 2.1: Real GDP**

y-o-y growth in %



**Chart 2.2: Consumer prices (HICP)**

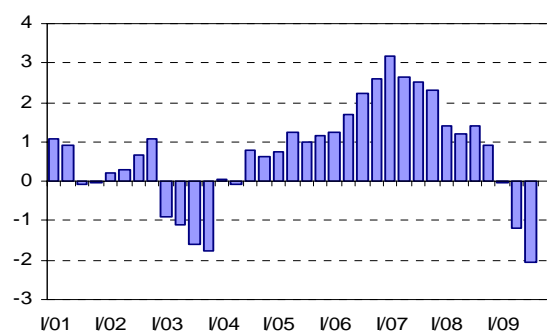
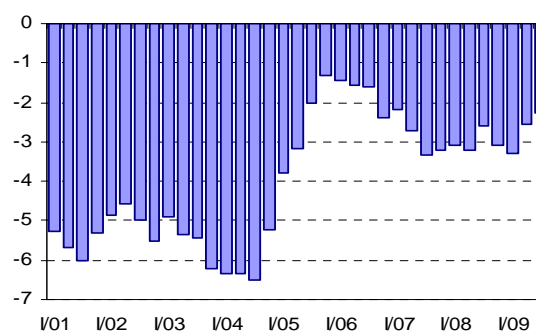
y-o-y growth in %



Source: Czech Statistical Office.

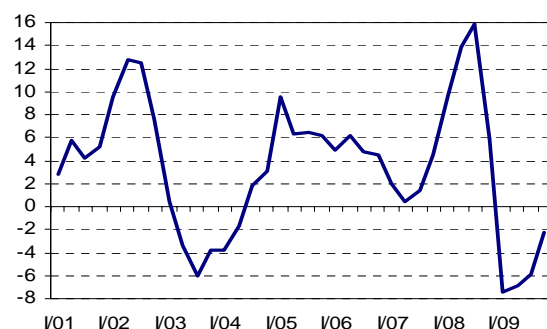
The low-inflationary environment that had been typical for the Czech economy was interrupted by an episode in 2008 when the average inflation rate reached 6.3% (on an HICP basis). The anchor of inflation expectations, however, appeared to be stable. This was supported by CNB's new inflation target of 2% with a  $\pm 1$  percentage point tolerance band. Once the overblown prices for energy and food on world markets subsided, inflation slowed sharply. The slowing growth or, as the case may be, decrease in household demand (based on seasonally adjusted data) in connection with the recession played its part as well. Year-on-year inflation in Q3 2009 even fell temporarily just below zero ( $-0.1\%$ ), rising to  $0.0\%$  in Q4. The annual average reached  $0.6\%$ .

With a delay of about four quarters behind the cyclical development of the Czech economy, employment (according to SNA) rose without interruption from H2 2004 until the end of 2008. In connection with the recession, the lag became shorter and employment fell by  $1.2\%$  year on year in Q2 2009 and by  $2.1\%$  in Q3 2009. Reciprocally, this effect was also evident in a rise in the unemployment rate. From Q1 2004, when the unemployment rate (according to the Labour Force Survey) reached  $8.7\%$ , its value gradually fell to  $4.2\%$  in Q2 2008. In Q3 2009, the unemployment rate increased to  $7.3\%$ .

**Chart 2.3: Employment (SNA basis)***y-o-y growth in %***Chart 2.4: Current account/GDP***in %*

Source: Czech Statistical Office, Czech National Bank.

The external economic imbalance, expressed by the current account balance as a proportion of GDP in 12-month rolling sums, has been within a sustainable range. In Q3 2009, the current account deficit as a proportion of GDP was 2.3% with a surplus balance of goods and services of 5.3% of GDP. The deficit income balance stems from the previous high investment activity, which, however, was not reflected in adequate domestic savings. The negative income balance still exceeds the positive balance of goods and services, which, in contrast, points to a solid performance of foreign trade.

**Chart 2.5: CZK/EUR exchange rate***y-o-y appreciation in %*

Source: Czech National Bank.

As measured by its actual performance and price level, the Czech economy in the long term will draw near the EU average. A result of this is the trend of long-term strengthening of the CZK/EUR exchange rate. This appreciation culminated in Q3 2008 when it reached 15.9% against the euro year on year. The subsequent correction in late 2008 and early 2009 helped the economy in terms of competitiveness of export prices. The exchange rate in Q3 and Q4 2009 (25.60 and 25.90 CZK/EUR, respectively) was already basically in correspondence with trend values.

## 2.3 The Medium-Term Scenario

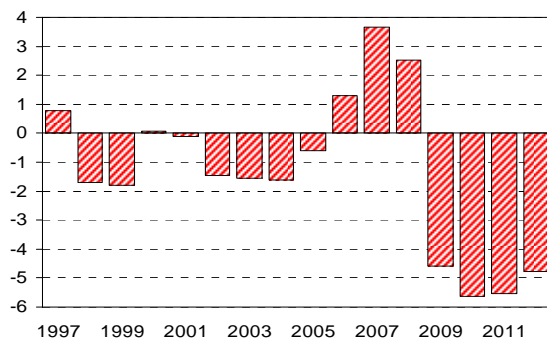
### Potential GDP and the position within the economic cycle

Under present circumstances, with the level of economic performance having changed abruptly, it is difficult to distinguish between the effect of the output gap and that of the

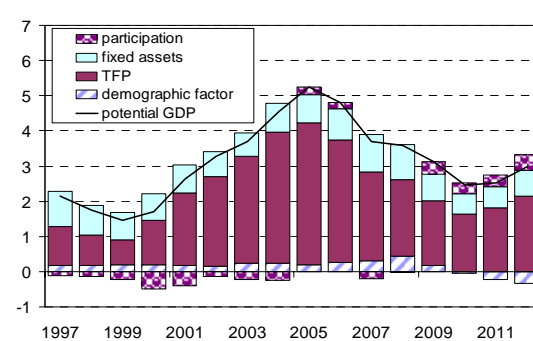
slowdown in potential GDP growth. The results of decompositions show great instability, and it is necessary to approach them with considerable caution. Nevertheless, it seems indisputable that the economic crisis plunged the economy into a deep negative output gap and at the same time led to a significant slowdown in potential GDP growth.

According to current calculations<sup>3</sup>, the output gap reached a level of around 4.6% in 2009. The high negative output gap in the economy is evident in the extremely low use of production capacities in industry, the significant rise in unemployment, the decrease in the number of job vacancies, and inflationary pressures.

**Chart 2.6: Output gap**  
in % of potential GDP



**Chart 2.7: Potential GDP growth**  
contribution to growth in percentage points



Source: Ministry of Finance calculations.

The most affected component of potential GDP is total factor productivity (TFP). Economic problems led to a slowdown in its trend growth below 2% in comparison with the average of 3.4% from 2004 to 2007. Impacts on growth in capital stock are less significant. In contrast, the growth in the labour supply, expressed as a ratio of the labour force to the number of residents aged 15–64, accelerated in 2009.

The slowdown in total trend productivity growth is directly reflected in the year-on-year potential GDP growth, which is now likely to move slightly below 3%. The future development of potential GDP will depend on the duration of the adverse economic situation. According to the CP scenario, we expect that the bottom of the economic slowdown should be reached in 2010.

The decisive factor will be the contribution of TPF. After slowing to 1.6 percentage points in 2010, TPF should exceed 2 percentage points in 2012. The contribution of growth in capital stock should be below 1 percentage point. The contribution of the participation rate should stay in positive values due to partial increased work motivation as a result of partial structural measures made. The influence of economic activity should outweigh adverse demographic factors. After slowing down to 2.5% in 2010, potential GDP growth could then reach 3.0% in 2012.

<sup>4</sup> Calculations of potential GDP and the output gap are currently made using the national methodology, based on the Cobb-Douglas production function. The methodology was described in the 2002 Pre-Accession Economic Programme. The main difference from the European Commission's method, important for interpreting the results, is the use of the "zero sum of output gaps over time" stipulation.

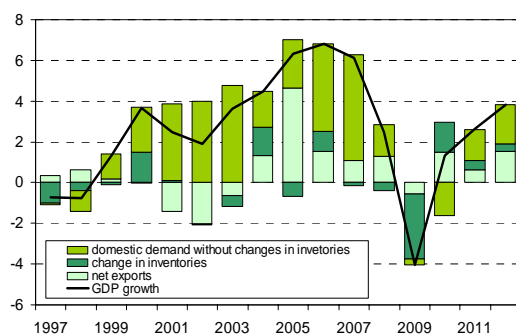
Within the outlook horizon, therefore, real GDP should still move well below its potential level. The deepest output gap of below  $-5.5\%$  should be reached in 2010. It should then gradually and slightly close in the following years. It is not expected to be fully closed within the CP horizon, however, and according to this scenario would still be below  $-4\%$  in 2012.

### GDP and the demand side

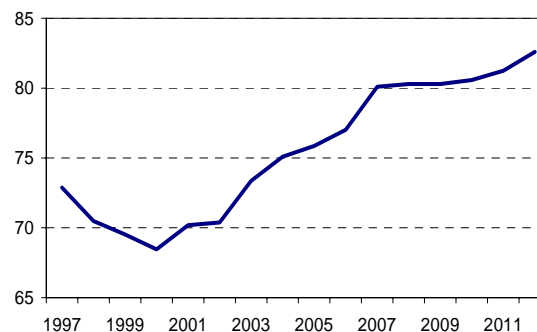
Once the economic crisis has passed, real GDP growth should gradually accelerate to  $3.8\%$  in 2012. Domestic demand's contribution (without the change in inventories) should reach its bottom of  $-1.6$  percentage points sometime in 2010 as a result of fiscal consolidation measures and reaching the deepest point of the drop in employment. All components of demand, except for government consumption, should contribute positively to GDP growth in the following years.

The relative level of GDP per capita compared with the EU27 average at purchasing power parity should be affected in the short term by the depth of the economic downturn and the rapidity of the onset of recovery. The Czech Republic's relative economic level should, after a period of stagnation, once again begin to increase and reach approximately  $82.6\%$  in 2012.

**Chart 2.8: Decomposition of GDP growth**  
contribution to growth in percentage points



**Chart 2.9: GDP per capita**  
calculated in purchasing power parity, EU27 = 100



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

Household consumption should decline some time in 2010, as it will strongly reflect measures taken to stabilise public budgets. Even in subsequent years, the increasing risk and debt burden of households should reduce the growth rate in final consumption spending. Nevertheless, it should fall behind that of GDP growth.

Government consumption<sup>4</sup> in future should for the most part decrease. Government institutions are expected to behave thriftily with respect to employment in the general government sector as well as in procuring goods and services. One-off outlays associated with the Czech Republic's EU presidency in 2009 also will fade away.

<sup>4</sup> More decisive reduction of government expenditures on final consumption with the goal of greater contribution to consolidation of public budgets was agreed only after finalisation of the regular macroeconomic forecast of the Czech Republic from January 2010. The CP macroeconomic scenario therefore was subsequently updated and differs slightly from the January forecast.

**Table 2.2: Economic growth**  
CZK billion, increase in %

	ESA code	Year 2008 level <sup>1)</sup>	Year 2008 rate of change	Year 2009 rate of change	Year 2010 rate of change	Year 2011 rate of change	Year 2012 rate of change
<b>1. Real GDP</b>	<b>B1*g</b>	3623	2,5	-4,0	1,3	2,6	3,8
<b>2. Nominal GDP</b>	<b>B1*g</b>	3689	4,3	-1,1	1,9	3,6	5,4
<b>Components of real GDP</b>							
<b>3. Private consumption expenditure</b>	<b>P.3</b>	1748	3,6	1,4	-0,8	2,0	2,5
<b>4. Government consumption expenditure</b>	<b>P.3</b>	725	1,0	4,0	-1,7	0,0	-0,4
<b>5. Gross fixed capital formation</b>	<b>P.51</b>	877	-1,5	-7,5	-3,7	2,5	3,6
<b>6. Changes in inventories and net acquisition of valuables<sup>2)</sup></b>	<b>P.52+P.53</b>	51	1,4	-1,8	-0,3	0,3	0,7
<b>7. Exports of goods and services</b>	<b>P.6</b>	3000	6,0	-11,9	4,4	6,4	6,5
<b>8. Imports of goods and services</b>	<b>P.7</b>	2779	4,7	-11,9	2,4	6,1	4,9
<b>Contribution to real GDP growth</b>							
<b>9. Final domestic demand</b>			1,5	-0,3	-1,6	1,5	2,0
<b>10. Change in inventories and net acquisition of valuables</b>	<b>P.52+P.53</b>		-0,4	-3,2	1,4	0,5	0,3
<b>11. External balance of goods and services</b>	<b>B.11</b>		1,3	-0,6	1,5	0,6	1,5

<sup>1)</sup> Levels 2008 are stated in prices from the previous year.

<sup>2)</sup> This item expresses change in inventories as a percent of GDP in current prices.

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

Following a significant slump in investment activities in 2009 and 2010, their dynamics should be gradually renewed. We expect a positive impact due to a higher drawdown of resources from the structural funds, the Cohesion Fund and infrastructure investment. Renewal of the inflow of foreign direct investment can be expected. We expect that new capacities will continue to be primarily export oriented.

The contribution of the trade balance for goods and services in constant prices to GDP growth was always positive between 2004 and 2008. We anticipate a negative contribution of –0.6 percentage point for 2009. After foreign demand is restored, a return of foreign trade's contribution to positive values can be expected. Export should once again begin to contribute significantly to economic growth.

## Prices

The long-term low-inflationary character of the Czech economy (with the exception of 2008) should be preserved in future years, as well. The positive influence of the inflation-targeting regime, which guides the inflation expectations of economic agents, and the high level of competition on the internal market have contributed to this development. Other anti-inflationary factors include the appreciation of the Czech koruna and non-inflationary growth of unit labour costs.

**Table 2.3: Prices of goods and services**

	Year 2008	Year 2009	Year 2010	Year 2011	Year 2012
<b>HICP</b>	6,3	0,6	1,8	1,5	1,8
<b>GDP deflator</b>	1,8	3,1	0,5	1,0	1,5
<b>Consumption of households deflator</b>	4,9	0,3	1,6	1,5	2,2

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

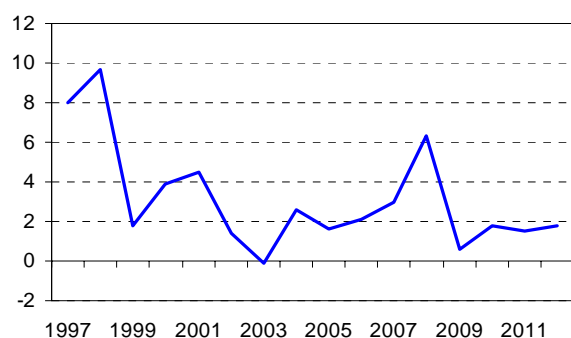
The significant slowing of inflation in 2009 was caused by the synergistic effects of the drop in cost pressures and the disappearance of demand impulses in an environment of a deeply



negative output gap. In coming years, we expect that inflation expectations will approach the CNB's new target (national CPI of 2% with a  $\pm 1$  percentage point tolerance band) effective from 2010. This creates conditions for meeting the inflation convergence criterion.

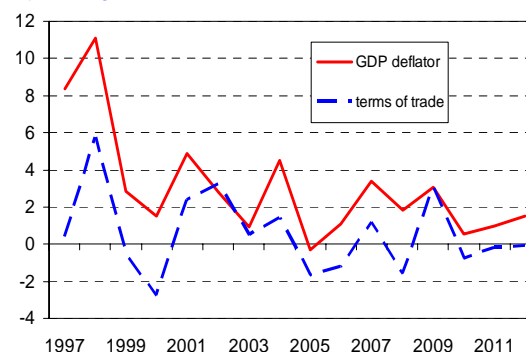
**Chart 2.10: HICP**

y-o-y growth in %



**Chart 2.11: GDP deflator and terms of trade**

y-o-y change in %



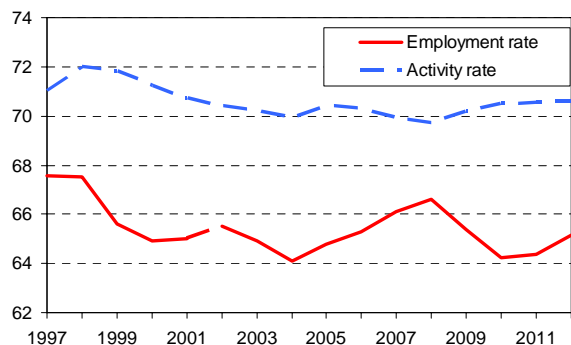
Source: Czech Statistical Office – price statistics and quarterly national accounts, Ministry of Finance calculations.

### The labour market and wages

Labour market indicators reacted promptly to the economic downturn at the turn of 2008 and 2009. Due to the high level of job vacancies and the declaration of social partners to prefer employment at the expense of shorter working hours, or even lower wages, the overall impact on employment was not so radical as compared with neighbouring countries. Future development will depend on a combination of gradual alleviation of the dramatic decrease on the demand side and restoration of economic growth generating jobs, as well as the resolution of existing structural problems on the supply side (professional and regional mobility, motivation for low-income groups to actively seek work, rigidity of labour contracts concluded for indefinite periods, and the like).

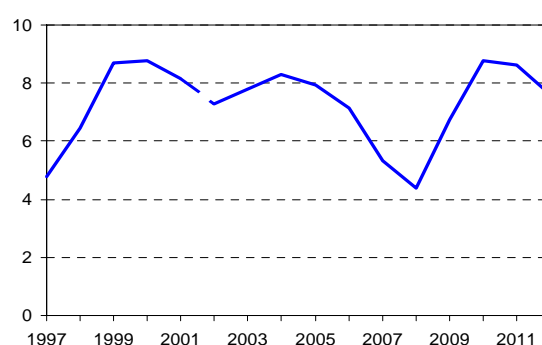
**Chart 2.12: Employment, participation rates**

in %



**Chart 2.13: Unemployment rate**

in %



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

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

At the beginning of the scenario period, we expect a decrease in employment by 1.8%, which should be replaced by stagnation in 2011 and then, in connection with economic recovery in 2012, slight growth of 0.7%.

Table 2.4: Employment and wages

	Year 2008	Year 2009	Year 2010	Year 2011	Year 2012
<b>Percentage change</b>					
<b>Employment (ESA 95)</b>	1,2	-1,3	-1,6	-0,4	0,6
<b>Compensation of employees</b>	7,7	-1,8	0,1	3,9	5,4
<b>Compensation per employee <sup>1)</sup></b>	6,3	0,3	2,5	4,1	4,8
<b>Unit labour costs <sup>2)</sup></b>	5,1	3,2	-0,5	1,0	1,6
<b>Unemployment rate (ILO)</b>	4,4	6,7	8,8	8,6	7,6
<b>Employment rate <sup>3)</sup></b>	66,6	65,4	64,2	64,4	65,1
<b>Activity rate <sup>4)</sup></b>	69,7	70,2	70,5	70,6	70,6

<sup>1)</sup> Compensation per employee (a Czech concept) according to the national accounts.

<sup>2)</sup> Ratio of nominal compensation per employee and labour productivity growth to real GDP.

<sup>3)</sup> Share of 15-to-64-year-old employment to population of the same age, according to the Labour Force Survey.

<sup>4)</sup> Share of 15-to-64-year-old labour force to population of the same age, according to the Labour Force Survey.

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

The unemployment rate seems to have reached 6.7% in 2009. This represents a year-on-year increase by over 2 percentage points. In 2010, it still can be expected to increase up to 8.8%, though for the following years of the scenario we expect a slow decline to a level of 7.6%.

After periods of strong growth in compensation of employees, it declined in 2009, with the main factors being slow growth in average wages, decline in employment, and a lower rate of social security contributions. The anticipated stagnation in 2010 will be related to the moderate development of wages in the private sector and the freezing of wages in the government sector. In 2011 and 2012, compensation could slightly accelerate once more by about 4.4% p.a. on average, i.e. roughly approximating nominal GDP growth.

On the other hand, the low growth rate of compensation per employee failed to offset the decline in labour productivity, and thus unit labour costs have risen by about 3.2% in 2009. The year 2010 is likely to be rather exceptional in that, among other things, unit labour costs will decline. The coming years will already be marked by around 1.3% growth.

## 2.4 Net Lending/Borrowing and Sectoral Balances<sup>5</sup>

The process of gradual improvement in the net lending balance should continue. After a deficit of –6.3% of GDP in 2003, the balance in 2009 should reach a value of around –0.2% of GDP, and it could achieve a surplus in 2010 for the first time in the history of the Czech Republic.

The increasing trend of surplus in the non-fuel component of the goods balance was halted in 2009 by the effect of limiting external demand. In future years, the surplus should again

<sup>5</sup> In accordance with the rules of the “Code of Conduct”, this chapter is prepared using the national accounts methodology. Based on the relationship between investments and savings, this allows the complete disaggregation of a surplus or deficit in foreign relations to the individual economic sectors. This differs from the analogous, customarily employed methodology of the balance of payments current account in its accrualisation, its categorisation of some items, and in the fact that it contains additional items (capital transfers).

steadily rise due to gradual alleviation of the consequences of the global economic crisis, better export performance and improvement in the competitiveness of domestic producers. The fuel component of the balance should reflect the development of koruna prices for mineral fuels. For the services balance, we expect a slightly increasing surplus as a share of GDP.

**Table 2.5: Net lending/borrowing**

	Year 2008	Year 2009	Year 2010	Year 2011	Year 2012
<b>% of GDP</b>					
<b>Balance of goods and services</b>	4,6	6,0	6,8	7,0	8,1
- mineral fuels (SITC 3)	-4,5	-3,0	-3,6	-3,9	-3,8
- other goods	6,8	7,5	9,1	9,5	9,7
- services	2,2	1,5	1,3	1,4	2,1
<b>Balance of primary income and transfers</b>	-8,0	-7,1	-6,8	-7,7	-8,4
- primary income	-7,1	-6,3	-6,3	-7,3	-8,1
- transfers	-0,9	-0,8	-0,6	-0,4	-0,3
<b>Capital transfers</b>	0,9	1,0	1,0	1,0	1,0
<b>Net lending/borrowing vis-a-vis ROW (B.9)</b>	-2,4	-0,2	1,0	0,2	0,6
<b>Net lending/borrowing of the private sector</b>	-0,3	6,4	6,3	5,0	4,8
<b>Net lending/borrowing of general government (EDP B.9)</b>	-2,1	-6,6	-5,3	-4,8	-4,2

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

The most significant negative component in net lending is—and will continue to be—the worsening balance of primary incomes, which reflects the flow of repatriated and reinvested profits from direct investment and compensation for foreign employees. The balance of current and capital transfers will be positively affected by the balance of financial flows from the EU (structural funds, the Cohesion Fund, and resources supporting agriculture and regional development).

## 3 General Government Deficit and Debt

### 3.1 Current Development of Public Finances

The trend of improvement in general government finances ended with 2007. The general government balance in 2008 reached  $-2.1\%$  of GDP, which represents a year-on-year worsening by 1.4 percentage points. This figure is 0.9 percentage points poorer in comparison with the assumptions from last year's CP update.

Worsening of general government finances in 2008 is primarily due to the economy's development in the second half of that year, and measures approved in 2007 aimed at sustaining public budgets were not sufficient to reverse the effects of this economic development. General government revenues increased by only 1.8% year-on-year mainly due to a very slight increase in tax revenues that represent a dominant share in total revenues.

The reform package approved in 2007 was reflected on the expenditure side essentially the same as on the revenue side. In particular, the growth rate of social transfers<sup>6</sup> decreased more significantly while, on the other hand, the growth in government investments accelerated. In 2008, therefore, a fairly favourable regrouping of expenditure priorities occurred. Unlike the revenue side, the economic crisis had yet no major impacts on the expenditure side of the government sector in the given year.

With the exception of excise taxes, revenue from all major taxes and social contributions declined in 2009. In addition to the dominant influence of the economic crisis, the adopted stimulus measures and reform measures from 2007 also contributed to this development. On the revenue side, more significant growth is expected in non-tax revenues, particularly due to the increase in general government investment grants received from abroad. These especially include EU payments for projects that it supports. This revenue is also reflected on the expenditure side and only affects the general government balance in the amount of Czech co-financing. The general government balance in this year is positively influenced also by savings of revenues from the sale of Assigned Amount Units of CO<sub>2</sub> in the amount of 0.3% of GDP.

General government expenditures in 2009 maintained their growth dynamics. Final consumption of the government actually recorded an acceleration in its growth rate in comparison with the previous period despite certain austerity measures from early 2009. The reason is a rise in social benefits in kind that constitute mainly general government expenditures on health care and stimulus measures consisting in an increase in state sector wages adopted in connection with the crisis. Another significant factor of total expenditure growth is interest paid.

In total, the adopted anti-crisis measures reach approximately 2% of GDP. They focused primarily on reducing the tax burden on businesses and individuals. On the expenditures side, to a lesser extent, they were directed to supporting investments into infrastructure and research, into export, which was affected severely by the crisis, and into purchasing power demand through a one-time increase of civil servants' salaries. As mentioned above, some

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<sup>6</sup> The adopted legislative measures contained in Act No. 261/2007 Coll., On Stabilisation of Public Budgets, were evident in 2008–2010 in the overall reduction of expenditures on social benefits by CZK 90 billion.

planned measures from 2007 were subsequently fully or at least partly used to counter the crisis. These included especially a reduction in the corporate income tax rate (accompanied by deferral of tax advances), a transformation of the planned reduction in personal income tax rates into a reduction of the social security rate paid by employees (which has a more uniform impact on taxpayers in contrast to the originally planned change and thereby increases the purchasing demand of low-income groups as well), and finally maintenance of the planned amount of investments into transport infrastructure (although plans for their limitation have already been prepared).

**Table 3.1: Anti crisis measures for 2009**

Measures	2009		
	Rev	Exp	Balance
<b>I. Tax measures</b>			
1 Changes in CIT	-16,0	0,0	-16,0
2 Changes in VAT	-2,5	0,0	-2,5
3 Changes in social security contributions	-36,4	0,0	-36,4
<b>Total I</b>	<b>-54,9</b>	<b>0,0</b>	<b>-54,9</b>
<b>II. Other measures</b>			
1 Salaries and social security expenditures	0,4	2,9	-2,5
2 R&D and infrastructure investments	0,0	9,3	-9,3
3 Support of SME's	0,0	4,5	-4,5
4 EU funds and state funds	0,0	5,1	-5,1
5 Reserve funds integration	0,0	-1,5	1,5
<b>Total II</b>	<b>0,4</b>	<b>20,2</b>	<b>-19,8</b>
<b>Total I+II</b>	<b>-54,5</b>	<b>20,2</b>	<b>-74,7</b>

Source: Outlook

After good results in previous years, the local government sub-sector and social security funds also fell into deficit.

The general government balance should be around  $-6.6\%$  of GDP for 2009, which is some 5.0 percentage points worse than figured in the assumption in last year's CP update. The deficit will probably deepen by 4.5 percentage points compared to 2008. Several factors contributed to this result. These include, in particular, the strong impacts of the economic crisis on fiscal positions, including the strong effects of automatic stabilisers and the anti-cyclical nature of Czech fiscal rules, which also increase the deficit in times of strong economic downturn, as well as the government stimulus package in support of the economy.

## 3.2 The Medium-Term Fiscal Outlook

The distinctive worsening in its fiscal position led the government to quickly reorient fiscal policy from stimulative, anti-crisis measures to the first consolidation steps prepared by the government in preparing the budget for 2010.

### The budget for 2010

The state budget for 2010 emerges from the approved expenditure framework, which should ensure achieving a general government budget balance of around  $-5.3\%$  of GDP. The approved expenditure framework for 2010 already reflects the government's efforts to bring

### 3 General Government Deficit and Debt

the excessive and, in the long term unsustainable general government deficits under control and is thus lower, if only for the given year marginally, as compared to the original expenditure framework. Furthermore, the government is planning to adopt such measures within its power, especially that of fixing expenditures under the budget chapters, to ensure the deficit is kept within the stated amount.

Aware of the problems in public budgets, the economic inefficiency of excessive indebtedness potentially leading to problems with funding the debt interest itself, and the expected gradual economic recovery, the Czech government has pushed through Parliament in connection with preparation of the 2010 budget proposal measures to reduce the general government deficit. The Czech Republic thus will be one of the first countries to begin consolidating its public finances. Compared to 2009, and in the context of an uncertain future development, the government deficit thus will significantly decrease by 1.3 percentage points.

The vast majority of economic measures is aimed at the revenue side of public budgets; and only a smaller part will lead to expenditure reductions. Moreover, the impact of the expenditure measures is designed only for 2010. This imbalance can create risks for the future as revenues are generally more volatile than expenditures.

Another factor that may affect the general government balance in coming years are revenues and expenditures associated with the sale of Assigned Amount Units of CO<sub>2</sub>. The government decided to use all of these additional funds for environmental projects. The general government balance for the period of implementing these revenues and expenditures thus will not be affected, but revenues and expenditures will not be in harmony over individual years and these individual balances will thus be affected.

Compared to the past, it is no longer necessary to consider the risk of increasing general government deficits due to an unexpected increase in expenditures as a result of integration of reserve funds. Resources from reserve funds that were not designated for pre-financing of projects co-financed from EU funds were used in early 2009 to finance the rapidly increasing deficit and not to finance new projects, as originally planned.

**Table 3.2: Government balance by sub-sector**

% of GDP	ESA code	Year	Year	Year	Year	Year
		2008	2009	2010	2011	2012
			(1)	(2)	(2)	(2)
<b>Net lending (+)/borrowing (-) (EDP B.9) by sub-sectors</b>						
<b>General government</b>	<b>S.13</b>	<b>-2,1</b>	<b>-6,6</b>	<b>-5,3</b>	<b>-4,8</b>	<b>-4,2</b>
<b>Central government</b>	<b>S.1311</b>	<b>-2,4</b>	<b>-5,8</b>	<b>-5,2</b>	<b>-4,8</b>	<b>-4,2</b>
<b>Local government</b>	<b>S.1313</b>	<b>0,1</b>	<b>-0,6</b>	<b>-0,1</b>	<b>-0,1</b>	<b>0,0</b>
<b>Social security funds</b>	<b>S.1314</b>	<b>0,3</b>	<b>-0,2</b>	<b>0,0</b>	<b>0,0</b>	<b>0,0</b>

(1) Notifications (October 2009)

(2) Outlook

Source: Czech Statistical Office (2008), Ministry of Finance.

### Outlook for 2011 and 2012

Aware of the commitments of the Czech Republic as an EU Member State, the government, despite its time-limited mandate, has proposed in this Convergence Programme the continuation of the consolidation strategy beyond 2010. In contrast to 2010, greater attention

will be placed on the expenditures side of public budgets. The largest measure in terms of volume is the reduction of expenditures under the budget chapters. Furthermore, reduction of mandatory expenditures is proposed. Both are measured against the no-policy-change scenario for 2011 and 2012.

On the revenues side, a permanent increase in ceilings for social security to six times the average wage, maintaining sickness insurance in its current form and the introduction of a 31% personal income tax rate on income exceeding social security ceilings are being considered.

These measures combined should ensure reduction of the general government deficit to 4.8% of GDP in 2011 and 4.2% of GDP in 2012.

### 3.3 The Structural Balance and the Fiscal Stance

According to current data, the Czech economy at the turn of 2008 and 2009 was in a recession phase. In 2009, GDP fell well below its potential level, and thus a positive output gap was overturned into negative values. Considering the slow economic recovery, we expect the negative output gap to deepen also in 2010 and to see gradual and only very slight improvement in 2011 and 2012.

As a result of the adverse macroeconomic conditions and the adoption of stimulus measures, the nominal deficit as a proportion of GDP for 2009 will increase. The structural balance in 2009 will reach a level of  $-5.5\%$  of GDP and between 2010 and 2012, as a result of adopted and proposed consolidation measures, will gradually improve to  $-2.6\%$  of GDP. In the item “One-off and other temporary measures”, one-off revenues from the sale of Assigned Amount Units of CO<sub>2</sub> and the related one-off expenditures are taken into account in 2009–2012.

The fiscal effort, defined as the year-on-year change in the structural balance, did not develop well in 2008 and 2009. In 2009, the negative impacts of stimulus measures adopted by the Czech Republic in response to and in accordance with the European Economic Recovery Plan were evident here. In 2010, the adopted consolidation measures will result in a positive turnover and thus in a positive and relatively high fiscal effort. Positive fiscal effort in 2011 and 2012 thus corresponds with the intention of the government to gradually further consolidate Czech public finances.

Table 3.3: Structural balance <sup>(a)</sup>

% of GDP	ESA code	Year 2008	Year 2009 (1)	Year 2010 (2)	Year 2011 (2)	Year 2012 (2)
<b>1. Real GDP growth (%)</b>		2,5	-4,0	1,3	2,6	3,8
<b>2. Net lending of general government</b>	<b>EDP B.9</b>	-2,1	-6,6	-5,3	-4,8	-4,2
<b>3. Interest expenditure</b>	<b>EDP D.41</b>	1,1	1,1	1,7	2,0	2,1
<b>4. One-off and other temporary measures</b>		-0,1	0,2	-0,1	-0,1	-0,3
<b>5. Potential GDP growth (%)</b>		3,6	3,1	2,5	2,5	3,0
<i>contributions:</i>						
- total factor productivity		2,2	1,8	1,6	1,8	2,2
- labour		0,4	0,5	0,3	0,1	0,1
- capital		1,0	0,8	0,6	0,6	0,7
<b>6. Output gap</b>		2,5	-4,6	-5,6	-5,5	-4,8
<b>7. Cyclical budgetary component</b>		0,7	-1,2	-1,6	-1,6	-1,3
<b>8. Cyclically-adjusted balance (2 – 7)</b>		-2,8	-5,3	-3,7	-3,3	-2,9
<b>9. Cyclically-adjusted primary balance (8 + 3)</b>		-1,7	-4,2	-1,9	-1,2	-0,8
<b>10. Structural balance (8 – 4)</b>		-2,7	-5,5	-3,6	-3,2	-2,6

(a) The data in rows 5 to 10 are based on the current estimates of the Ministry of Finance.

(1) Estimate.

(2) Outlook.

Source: Ministry of Finance.

### 3.4 Government Debt

The expected scenario for public finances development indicates that the general government debt will increase in the overall outlook horizon from 30% of GDP in 2008 to 42.0% of GDP in 2012. The main factor for the rapid growth in government debt is the amount of the central government deficits. However, the general government debt should increase more slowly than would correspond to a simple accumulation of deficits. These are also funded partially from the accumulated financial assets from 2009 onwards.

Table 3.4: Government debt by sub-sector

% of GDP	ESA code	Year 2008	Year 2009 (1)	Year 2010 (2)	Year 2011 (2)	Year 2012 (2)
<b>Gross debt by sub-sectors</b>						
<b>General government</b>	<b>S.13</b>	<b>30,0</b>	<b>35,2</b>	<b>38,6</b>	<b>40,8</b>	<b>42,0</b>
<b>Central government</b>	<b>S.1311</b>	<b>27,5</b>	<b>32,6</b>	<b>36,0</b>	<b>38,2</b>	<b>39,6</b>
<b>Local government</b>	<b>S.1313</b>	<b>2,5</b>	<b>2,6</b>	<b>2,7</b>	<b>2,6</b>	<b>2,5</b>
<b>Social security funds</b>	<b>S.1314</b>	<b>0,0</b>	<b>0,0</b>	<b>0,0</b>	<b>0,0</b>	<b>0,0</b>

(1) Notifications (October 2009).

(2) Outlook.

Sources: Czech Statistical Office (2008), Ministry of Finance.

This scenario does not take into account any new privatisation actions. In the case of executing some further privatisation projects and the use of privatisation revenues to finance government expenditures, then the proportion of government debt to GDP would grow more slowly compared to the outlook. The project of the state treasury, currently under preparation, will also contribute to non-debt financing of the central government deficit (see Chapter 7).



Table 3.5: Government debt and related indicators

% of GDP	Year	Year	Year	Year	Year
	2008	2009 (1)	2010 (2)	2011 (2)	2012 (2)
<b>Gross debt</b>	30,0	35,2	38,6	40,8	42,0
<b>Change in gross debt share</b>	1,0	5,2	3,4	2,3	1,2
<b>Contributions to change in gross debt</b>					
<b>Primary balance</b>	1,0	5,4	3,5	2,8	2,1
<b>Interest expenditure</b>	1,1	1,1	1,7	2,0	2,1
<b>Nominal GDP growth</b>	-1,2	0,3	-0,7	-1,3	-2,1
<b>Stock-flow adjustment</b>	0,1	-1,6	-1,2	-1,2	-0,9
- Difference between cash and accruals	-1,3	-0,5	-0,5	-0,3	-0,2
- Net accumulation of financial assets	1,3	-1,1	-0,7	-0,7	-0,6
of which: Privatisation proceeds <sup>(3)</sup>	0,6	0,0	0,0	0,0	0,0
- Valuation effects and other	0,1	0,0	0,0	0,0	0,0
<b>p.m. implicit interest rate on debt</b>	3,6	3,3	4,5	5,0	5,0

(1) Notifications (October 2009).

(2) Outlook.

(3) Privatisation alone has no impact on the amount of the debt. However, cash revenues from privatisation are one of the potential sources of non-debt financing for the deficit.

Source: Ministry of Finance.

### The debt strategy and stability of the risk structure of government debt

An important factor in the stability of public finances and the national financial system is a sustainable risk structure of state debt, which accounts for over 90% of the total general government debt. When designing the state's medium-term debt management and issuance strategy, great attention is devoted to refinancing and market risks. These present the most significant sources of uncertainty for government financing and their stabilisation appears to be particularly significant during a period of considerable volatility on international financial markets and investor uncertainty.

The long-term target of the strategy was to reduce the proportion of the short-term state debt (i.e. debt payable within one year) from the 69% in 2000 to below a threshold of 20%. This target value was achieved for the first time in 2006 and has been a key stabilising element in subsequent years in financing the central government's borrowing needs and in planning issuance activity on domestic and foreign markets. This criterion was maintained in 2009.

Table 3.6: Refinancing of the state debt

	Year	Year	Year	Year	Year	Year	Year
	2006	2007	2008	2009 (1)	2010 (2)	2011 (2)	2012 (2)
<b>Average maturity (years)</b>	6,2	6,4	6,6	6,4	6,0	6,3	6,3
<b>Debt due within 1 year (% of debt)</b>	17,1	18,7	17,7	14,3	15,0	15,0	15,0
<b>Financing reserve/debt due within 1 year (%)</b>	1,9	7,3	44,1	39,6	42,7	39,8	37,5

(1) Forecast

(2) Strategic plan

The stable refinancing structure is also confirmed by the average maturity of state debt. This indicator ranged from 6 to 7 years, and in 2009 its value also remained above the threshold of 6 years with no significant reduction. For 2010, the target range for the average maturity of state debt was set at 5.5–7 years.

As at the end of 2009, the structure of state debt in terms of interest paid on debt instruments has generated an exposure to a change in interest rates on a one-year horizon of about 30% of the state debt (debt with interest rate refixing up to 1 year). The interest-rate exposure expressed in this way has hovered around this value since 2004. In terms of the debt portfolio's stability, this constitutes a threshold that can be regarded as relatively safe and comparable also with the international practice of developed countries.

**Table 3.7: The state debt's interest**

%	Year	Year	Year	Year	Year	Year	Year
	2006	2007	2008	2009 (1)	2010 (2)	2011 (2)	2012 (2)
1. Fixed interest long-term debt due within 1 year	5,4	9,0	9,8	7,0	7,6	4,3	6,7
2. Variable interest long-term debt	4,3	4,1	7,3	13,1	13,0	14,0	11,6
3. Monetary instruments	11,5	9,2	7,9	7,2	6,3	6,3	6,3
4. Effect of derivative operations	4,2	3,7	3,4	3,0	3,1	5,4	5,4
5. Debt with interest fixation within 1 year (1+2+3+4)	25,4	26,0	28,4	30,3	30,0	30,0	30,0

(1) Forecast

(2) Strategic plan

In terms of the interest-rate structure, the proportion of variable interest rate long-term instruments grew in 2008 and 2009. This led to an increase in the overall interest rate exposure. At the same time, however, the share of money market instruments in financing long-term debt was reduced. The effect of derivative transactions on the interest rate exposure relates to operations hedging the currency risk in foreign issues.

It can be derived from the amount and structure of the state debt that a rise in interest rates by an average of one percentage point along the entire yield curve would lead to a rise in interest costs by approximately CZK 3.5 billion in the 2010 horizon.

### 3.5 The Budgetary Impact of Major Reforms

General government finances during the CP horizon are influenced by a set of measures aimed at stabilising public finances that were approved in 2007 and, for the most part, became effective as from 1 January 2008. Furthermore, they are influenced by the stimulus measures associated with the European Economic Recovery Plan, by the austerity measures approved during the second half of 2009, and finally by the measures proposed by the government for 2011 and 2012.

The impacts of the first two groups of measures were accounted for and enumerated already in previous CP updates and supplements to last year's CP update. Estimates of the impacts of these two groups of measures have not yet been revised. Certain items among the government revenues and expenditures are developing differently from the original assumptions. The differences, however, are not of such an extent that it would be possible, particularly in the current turbulent period, to determine with certainty whether this results from an inaccurate estimate of impacts or is a distinctly autonomous development owing to lower-than-expected economic growth, higher-than-expected inflation, and other factors.

The approved austerity measures were incorporated into the current CP scenario on the revenues side in increasing taxes and social contributions and on the expenditures side particularly in temporary freezing of pensions, cancellation of administrative positions in the general government and reduction of certain social benefits. The measures proposed by the government for 2011 and 2012 also were incorporated into the CP.

Table 3.5 summarises the incremental effects<sup>7</sup> of the fiscally important economic policy measures approved by Parliament that change the fiscal outlook compared to last year's CP update. The nature of certain measures, in particular their temporariness, the suspension of originally envisaged measures and the cancellation of other only temporary measures result in problems with their intuitive depiction. The interpretation of impacts presented in Table 3.5 and in Chapter 5 thus should be given increased attention.

For example, the increase in revenues from insurance premiums in 2010 consists of an increase in ceilings for contributions to social security and health insurance<sup>8</sup>, cancellation of the temporary credit on social security contributions paid by employers, and postponement of the reduction in the sickness insurance rate. With the exception of an increase in the ceiling for health insurance, the measures are only for 2010, and thus in the incremental depiction the measures effective only in 2010 must be recorded in the following year with the opposite sign<sup>9</sup>.

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<sup>7</sup> By contrast, the effects in Chapter 5 are enumerated in comparison with the no-policy-change scenario and are therefore cumulative.

<sup>8</sup> The ceiling for social security is increased only for 2010; the ceiling for health insurance is increased indefinitely.

<sup>9</sup> The temporary nature of the planned effectiveness of the credit on social security contribution, which was approved for 2009 and 2010, and the year-long postponement of the effectiveness of the reduction in the sickness insurance rate, however, imply that the no-policy-change scenario for 2011 already has taken into account lower revenues due to the reduction in the health insurance rate and higher revenues due to the expiration of the effectiveness of the credit on social security contributions. Therefore, Chapter 5 presents an increase in insurance revenues as compared to the no-policy-change scenario in the amount of additional revenues due to the higher ceiling for health insurance.

Table 3.8: Impact of the approved measures on deficits

Main structural reform measures	Categories affected	ESA code		Year 2010	Year 2011	Year 2012
Property taxes		D.29/D.59	CZK bn	2,8	0,1	0,1
			% of GDP	0,1	0,0	0,0
Income taxes	Tax on incomes	D.51	CZK bn	1,5	0,1	0,1
			% of GDP	0,0	0,0	0,0
Excise taxes	Tax on products	D.21	CZK bn	11,1	0,3	0,2
			% of GDP	0,3	0,0	0,0
VAT	Tax on products	D.21	CZK bn	17,8	0,3	0,4
			% of GDP	0,5	0,0	0,0
Income from insurance	Social contributions	D.61	CZK bn	32,6	-31,0	0,0
			% of GDP	0,9	-0,8	0,0
Maintaining the 50% refunding of wage compensation to employers		D.1, D.61, D.62	CZK bn	-2,2	2,2	0,0
			% of GDP	-0,1	0,1	0,0
Payment of sickness benefits	Social benefits other than natural	D.62	CZK bn	4,4	-4,4	0,0
			% of GDP	0,1	-0,1	0,0
Cancelled valorisation of pensions	Social benefits other than natural	D.62	CZK bn	6,9	-2,4	0,6
			% of GDP	0,2	-0,1	0,0
Volume reduction of public sector wages	Employee compensations	D.1	CZK bn	2,0	0,0	0,0
			% of GDP	0,1	0,0	0,0
Total impact on the government sector's balance		EDP B.9	CZK bn	76,9	-34,8	1,4
			% of GDP	2,1	-1,0	0,0

Source: Ministry of Finance.

Table 3.9: Impact of government measures proposed for 2011 – 2012

Main structural reform measures	Categories affected	ESA code		Year 2011	Year 2012
Ceilings on SSC – 6 times of AW	Social contributions	D.61	CZK bn	3,0	0,1
			% of GDP	0,1	0,0
Sickness insurance - maintaining of the current state, net impact		D.1, D.61, D.62	CZK bn	6,8	0,2
			% of GDP	0,2	0,0
PIT, rate of 31 per cent above the ceilings for the SSC	Tax on incomes	D.51	CZK bn	2,0	0,1
			% of GDP	0,1	0,0
Decrease in current expenditures			CZK bn	13,3	8,7
			% of GDP	0,3	0,2
Decrease in mandatory expenditures	Social benefits other than natural	D.62	CZK bn	5,1	14,5
			% of GDP	0,1	0,4
Total impact on the government sector's balance		EDP B.9	CZK bn	30,2	23,6
			% of GDP	0,8	0,6

Source: Ministry of Finance.

## 4 Comparison with the Previous Convergence Programme and Sensitivity Analysis

### 4.1 Comparison with the Macroeconomic Scenario of the Previous Convergence Programme

The differences between the macroeconomic scenarios of this year's programme and last year's programme ensue especially from the fact that the global financial and economic crisis hit the world and Czech economy to an extent such that at the time of compiling CP 2008 could not have been expected either by the Ministry of Finance of the Czech Republic or the European Commission.

**Table 4.1: Change in the external assumptions of the scenario**

	CP 2008			CP 2009			Difference		
	2008	2009	2010	2008	2009	2010	2008	2009	2010
<b>GDP growth in EU 27 (%)</b>	1,4	0,9	1,7	0,8	-4,0	1,1	-0,6	-4,9	-0,6
<b>Prices of oil (USD / barrel)</b>	113	120	115	98	62	81	-15	-58	-34
<b>Exchange rate USD / EUR</b>	1,49	1,39	1,35	1,46	1,39	1,44	-0,03	0,00	0,09

Source: Ministry of Finance.

CP 2008 assumed only a slight slowdown in the Czech economy's growth for 2009 and perceived the possibility of deeper economic problems only as a risk scenario, not as the most likely possibility. The deep recession and anticipated subsequent slow recovery are reflected in the differing current and future developments of key labour market indicators and the individual components of GDP. CP 2008 also could not have foreseen the introduction of economising budgetary measures.

**Table 4.2: Change in the indicators of the macroeconomic scenario**

	CP 2008			CP 2009			Difference (p.p.)		
	2008	2009	2010	2008	2009	2010	2008	2009	2010
<b>Growth in real terms (in %)</b>									
<b>GDP</b>	4,4	3,7	4,4	2,5	-4,0	1,3	-1,9	-7,7	-3,1
<b>Households consumption</b>	3,3	3,9	4,2	3,6	1,4	-0,8	0,3	-2,5	-5,0
<b>Government consumption</b>	1,1	0,5	0,0	1,0	4,0	-1,7	-0,1	3,5	-1,7
<b>Gross fixed capital formation</b>	5,1	4,5	6,2	-1,5	-7,5	-3,7	-6,6	-12,0	-9,9
<b>Contribution of domestic demand (pp)</b>	2,2	3,3	3,6	1,2	-3,5	-0,2	-1,0	-6,8	-3,8
<b>Contribution of foreign trade (pp)</b>	2,2	0,4	0,9	1,3	-0,6	1,5	-0,9	-1,0	0,6
<b>Potential product</b>	5,2	5,0	4,8	3,6	3,1	2,5	-1,6	-1,9	-2,3
<b>Output gap (%)</b>	1,2	-0,1	-0,5	2,5	-4,6	-5,6	1,3	-4,5	-5,1
<b>Growth (in %)</b>									
<b>HICP</b>	6,4	2,9	3,0	6,3	0,6	1,8	-0,1	-2,3	-1,2
<b>GDP deflator</b>	2,4	2,1	2,9	1,8	3,1	0,5	-0,6	1,0	-2,4
<b>Employment</b>	1,7	0,7	0,3	1,2	-1,3	-1,6	-0,5	-2,0	-1,9
<b>Unemployment rate (level in %)</b>	4,4	4,4	4,6	4,4	6,7	8,8	0,0	2,3	4,2
<b>Exchange rate CZK/EUR (level)</b>	24,9	24,7	24,2	24,9	26,5	25,8	0,0	1,8	1,6
<b>Balance of goods and services (in % of GDP)</b>	5,4	5,4	6,7	4,6	6,0	6,8	-0,8	0,6	0,1
<b>Net lending/borrowing (in % of GDP)</b>	-1,0	-0,5	0,4	-2,4	-0,2	1,0	-1,4	0,3	0,6

Source: Ministry of Finance.

## 4 Comparison with the Previous Convergence Programme and Sensitivity Analysis

The marked slowdown in household consumption growth in 2009 and its expected decline in 2010, the drop in employment and resulting decrease in the wage bill and the decrease or stagnation in compensation of employees, the increase in unemployment, and the economy's almost non-inflationary development can be regarded as the most significant divergences from a fiscal point of view. These negative divergences in growth rates in 2009 and 2010 will be evidenced in coming years by reduction in the level of tax bases.

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

The fiscal scenarios for last year's and this year's CP updates are compared in Table 4.3. In 2008, the general government balance as well as general government debt achieved less favourable values than expected. This was caused particularly by the economic development in the second half of the year. Due to the insufficient reduction in expenditure frameworks and/or increasing of tax revenues, significantly higher deficit and debt levels than predicted in last year's CP update can be expected in the coming years as well.

**Table 4.3: Comparison with the previous convergence programme**

% of GDP	ESA code	Year 2008	Year 2009 (1)	Year 2010 (2)	Year 2011 (2)	Year 2012 (2)
<b>Real GDP growth (%)</b>						
<b>Previous update</b>		4,4	3,7	4,4	5,2	.
<b>Current update</b>		2,5	-4,0	1,3	2,6	3,8
<b>Difference</b>		-2,0	-7,7	-3,1	-2,6	.
<b>General government net lending</b>						
<b>Previous update</b>	<b>EDP B.9</b>	-1,2	-1,6	-1,5	-1,2	.
<b>Current update</b>	<b>EDP B.9</b>	-2,1	-6,6	-5,3	-4,8	-4,2
<b>Difference</b>		-0,9	-5,0	-3,7	-3,6	.
<b>General government gross debt</b>						
<b>Previous update</b>		28,8	27,9	26,8	25,5	.
<b>Current update</b>		30,0	35,2	38,6	40,8	42,0
<b>Difference</b>		1,2	7,3	11,7	15,3	.

(1) Forecast, notifications (October 2009).

(2) Outlook.

Source: Ministry of Finance.

### 4.3 Sensitivity Analysis

At present, the Czech economy is passing through an unfavourable period in connection with the economic crisis. Considering the nature of the Czech Republic as a small and open economy, future development depends for the most part on the recovery of major trading partners' economies, especially the European economies. With regard to the risk of future development in the EU, we have analysed the dependence of the Czech economy on various economic growth scenarios for Europe.

The sensitivity analysis is made with two scenarios. The pessimistic scenario is based on the assumption of poorer development of economic growth in the EU, defined as 1 percentage

## 4 Comparison with the Previous Convergence Programme and Sensitivity Analysis

point lower growth in real GDP and taken into account with the start of 2010. The optimistic scenario symmetrically assumes 1 percentage point higher growth in real GDP.

### Simulation results

Positive effects on the Czech economy are seen within the optimistic scenario of higher growth in the EU due to higher exports, more than 80% of which are bound for EU countries. The higher foreign demand for exports is reflected in higher GDP growth and is projected into a lower unemployment rate. On the other hand, the impact on inflation is very moderate. This is due to offsetting effects in the form of real wages growth and lower import prices as a result of the Czech crown's appreciating exchange rate.

The impact on government finances can be observed in the more moderate deficit. The causes come both from the revenues side in the form of higher tax collection and from the expenditures side due to the slightly lower expenditures on unemployment benefits. The improved deficit is then reflected in the slower accumulation of government debt.

**Table 4.4: Basic macroeconomic indicators – baseline scenario**

		Year 2008	Year 2009	Year 2010	Year 2011	Year 2012
<b>Gross domestic product</b>						
<b>Gross domestic product</b>	volumes, y/y in %	2,5	-4,0	1,3	2,6	3,8
<b>Inflation</b>	y/y in %	6,3	1,0	2,0	1,8	2,0
<b>Unemployment rate</b>	in %	4,4	6,7	8,8	8,6	7,6
<b>Government deficit</b>	in % of GDP	-2,1	-6,6	-5,3	-4,8	-4,2
<b>Gross government debt</b>	in % of GDP	30,0	35,2	38,6	40,8	42,0
<b>Current account</b>	in % of GDP	-3,1	-1,0	0,5	-0,2	0,2

Source: Ministry of Finance.

NB: Consumer Price Index according to the national methodology (different from HICP methodology)

**Table 4.5: Basic macroeconomic indicators – optimistic scenario**

		Year 2008	Year 2009	Year 2010	Year 2011	Year 2012
<b>Gross domestic product</b>						
<b>Gross domestic product</b>	volumes, y/y in %	2,5	-4,0	2,4	4,0	4,8
<b>Inflation</b>	y/y in %	6,3	1,0	2,0	1,7	2,0
<b>Unemployment rate</b>	in %	4,4	6,7	8,5	8,3	7,5
<b>Government deficit</b>	in % of GDP	-2,1	-6,6	-4,9	-4,1	-3,6
<b>Gross government debt</b>	in % of GDP	30,0	35,2	38,5	40,6	41,6
<b>Current account</b>	in % of GDP	-3,1	-1,0	2,0	1,9	2,0

Source: Ministry of Finance.

NB: Consumer Price Index according to the national methodology (different from HICP methodology)



## 4 Comparison with the Previous Convergence Programme and Sensitivity Analysis

**Table 4.6: Basic macroeconomic indicators – pessimistic scenario**

		Year 2008	Year 2009	Year 2010	Year 2011	Year 2012
<b>Gross domestic product</b>						
<b>Gross domestic product</b>	volumes, y/y in %	2,5	-4,0	0,2	1,2	2,8
<b>Inflation</b>	y/y in %	6,3	1,0	2,0	1,8	2,0
<b>Unemployment rate</b>	in %	4,4	6,7	9,0	8,9	7,7
<b>Government deficit</b>	in % of GDP	-2,1	-6,6	-5,7	-5,5	-4,7
<b>Gross government debt</b>	in % of GDP	30,0	35,2	38,7	41,1	42,5
<b>Current account</b>	in % of GDP	-3,1	-1,0	-0,9	-2,3	-1,6

Source: Ministry of Finance.

NB: Consumer Price Index according to the national methodology (different from HICP methodology)

### 4.4 Verification of the Scenario by Means of Other Institutions' Forecasts

The CP's macroeconomic scenario also was verified by a comparison with the prognoses of leading relevant institutions. The survey of macroeconomic prognoses of the Czech economy (the so-called Colloquium) is regularly conducted by the Ministry of Finance of the Czech Republic twice a year. The last survey was conducted in November 2009 and its results are based on the forecasts of 15 domestic and 3 foreign institutions.

**Table 4.7: Verification of CP 2009 scenario by means of other institutions' forecasts**

	Average of forecasts			CP 2009			Difference (p.p.)		
	2010	2011	2012	2010	2011	2012	2010	2011	2012
<b>Growth in real terms (in %)</b>									
<b>GDP</b>	1,1	2,4	3,2	1,3	2,6	3,8	0,2	0,2	0,6
<b>Households consumption</b>	-0,1	1,5	2,6	-0,8	2,0	2,5	-0,7	0,5	-0,1
<b>Government consumption</b>	0,3	1,0	1,5	-1,7	0,0	-0,4	-2,0	-1,0	-1,9
<b>Gross fixed capital formation</b>	-1,0	2,3	3,9	-3,7	2,5	3,6	-2,7	0,2	-0,3
<b>Growth (in %)</b>									
<b>National CPI (aop)</b>	1,5	2,2	2,4	2,0	1,8	2,0	0,5	-0,4	-0,4
<b>GDP deflator</b>	1,3	1,9	1,8	0,5	1,0	1,5	-0,8	-0,9	-0,3
<b>Employment (LFS)</b>	-1,2	0,5	1,2	-1,8	0,0	0,7	-0,6	-0,5	-0,5
<b>Unemployment rate (LFS-level in %)</b>	8,4	8,0	6,9	8,8	8,6	7,6	0,4	0,6	0,7

Source: Ministry of Finance.

Generally, it can be said that the CP 2009 macroeconomic scenario does not deviate greatly from the average of other institutions' forecasts. Moreover, the existing divergences can be explained in part by the fact that the macroeconomic scenario is based on more recent data.

# 5 Quality of Public Finances – Revenues and Expenditures

## 5.1 General Government Revenues

Due to the unfavourable economic situation, a year-on-year decrease in total general government revenues by almost 6% to about CZK 1,422 billion, or 39.0% of GDP, is expected in 2009. The drop in revenues is primarily the result of tax and social insurance revenues that will decrease by more than 8% compared to 2008 and in relative terms will thus reach approximately 33.2% of GDP.

The revenue side in 2009 also reflects both the impact of the economic crisis on general government tax revenues as well as measures adopted by the government to mitigate the consequences of the crisis. With the exception of excise taxes, the revenues from all important taxes and social contributions are likely to decrease in 2009 (see Table 5.1).

This decrease will be most noticeable in corporate income tax revenues, which will be 21% lower in 2009 compared to the previous year. This fact is based mainly on the highly cyclical nature of the tax base, which, depending on the phase of the economic cycle, fluctuates to a much greater extent than, for example, employees' wages or consumption. Another revenue item for which we expect a significant decline is personal income tax, which should decrease by almost 18% compared to 2008.

Excise taxes increased by 3.6%. This rate of increase, however, also includes the effect of a legislative amendment adopted in 2007 as a result of which the excise tax on tobacco products has been raised since 2008. The lower comparison basis in 2008, from which the 2009 growth is calculated, is based on the effect of stockpiling. Abstracting away from this effect, an observable decline in excise taxes would probably occur as well.

A more substantial increase can be expected on the revenue side in non-tax revenues, mainly due to an increase in the general government investment grants received from other sectors or from abroad. In this case, they are primarily payments from the European Union for projects that it supports.

As a result of measures to strengthen the revenue side (see Box 5.1), the revenue situation of the general government will improve significantly in 2010 and tax revenues will increase by about 1.0 percentage points of GDP to 19.1% of GDP year-on-year (i.e. once again approach the relative level from 2008). In 2010, the improvement will affect all revenue items, most notably the item "taxes on production and imports" (year-on-year increase in revenues by 0.8 percentage points of GDP). In the following years of the outlook, the proportion of tax revenues to GDP will gradually decrease in connection with a decline in the total tax burden, though it will not reach the bottom of 2009 even in the last year of the outlook.

The total tax burden continues to show a decline over time. The year 2010 is an exception that will fully reflect measures on the revenues side adopted to stabilise public finances. Following the expected record drop in the tax burden in 2009 to the level of 33.2% of GDP, caused primarily by decrease in the amount of income tax revenues, it will increase by 1.3 percentage points to 34.5% of GDP in 2010. The trend of gradual reduction in the value of the burden

## 5 Quality of Public Finances – Revenues and Expenditures

established in the past will then continue down to the threshold of about 34.6% of GDP in 2012 (see Table 5.1).

**Table 5.1: General government revenues**

% of GDP	ESA code	Year 2008	Year 2009 (1)	Year 2010 (2)	Year 2011 (2)	Year 2012 (2)
<b>Components of revenues</b>						
<b>Total taxes</b>		<b>19,6</b>	<b>18,1</b>	<b>19,1</b>	<b>19,1</b>	<b>19,0</b>
Taxes on production and imports	D.2	11,0	11,1	11,9	11,6	11,3
Current taxes on income, wealth etc.	D.5	8,6	7,0	7,2	7,5	7,6
Capital taxes	D.91	0,0	0,0	0,0	0,0	0,0
<b>Social contributions</b>	<b>D.61</b>	<b>16,2</b>	<b>15,1</b>	<b>15,4</b>	<b>15,6</b>	<b>15,6</b>
<b>Property income</b>	<b>D.4</b>	<b>0,9</b>	<b>0,9</b>	<b>1,0</b>	<b>0,9</b>	<b>0,9</b>
<b>Other</b>		<b>4,2</b>	<b>4,9</b>	<b>5,1</b>	<b>5,1</b>	<b>5,1</b>
<b>Total revenue</b>	<b>TR</b>	<b>40,9</b>	<b>39,0</b>	<b>40,5</b>	<b>40,8</b>	<b>40,5</b>
<b>p.m.: Tax burden</b>		<b>35,8</b>	<b>33,2</b>	<b>34,5</b>	<b>34,7</b>	<b>34,6</b>

(1) Prediction.

(2) Outlook.

Sources: Czech Statistical Office (2008), Ministry of Finance.

### Box 5.1: Measures to strengthen the revenue side approved by Parliament in 2009

#### Personal income tax

In the area of income tax, the tax exemption on compensation (with the exception of that listed by law) to institutional officials was cancelled with a positive annual impact of CZK 0.1 billion and also lump-sum deductible expenses for independent professions and author's royalties were reduced. Here, the revenue increase is projected at CZK 1.5 billion in 2010, then at CZK 1.6 billion in 2011 and CZK 1.7 billion in 2012.

#### Property taxes

From 1 January 2010, the real property tax rate will double for most buildings and plots of land. The revenue from this change, all of which goes into the municipal budgets, is expected to be CZK 2.8 billion for 2010, approximately CZK 2.9 billion for 2011 and about CZK 3 billion in 2012.

#### VAT

From 1 January 2010, both VAT rates will increase by 1 percentage point, i.e. the basic rate will increase from 19% to 20% and the reduced rate will increase from 9% to 10%. The expected revenue from this measure is estimated on an accrual basis to be CZK 17.8 billion in 2010, CZK 18.1 billion in 2011 and CZK 18.5 billion in 2012.

#### Excise taxes

From 1 January 2010, the rates of the following taxes will be adjusted:

- The excise tax on fuels is increased by CZK 1 per litre, with an expected increase in collections of CZK 7.6 billion in 2010, CZK 7.7 billion in 2011 and CZK 7.9 billion in 2012.
- The excise tax on alcohol is increased from CZK 26,500 to CZK 28,500 per hectolitre of ethanol, except for the alcohol in fruit spirits from producer distillation for which the tax rate is increased from CZK 13,300 to CZK 14,300 per hectolitre of ethanol. This measure is expected to increase collection by CZK 0.5 billion in each year of the medium-term outlook of 2010–2012.
- The excise tax on beer is increased in the basic rate by CZK 8 from the current level of CZK 24 for each degree Plato per hectolitre to CZK 32. Reduced rates for small independent breweries are also increased by between CZK 4 (for breweries with production of up to 10,000

## 5 Quality of Public Finances – Revenues and Expenditures

hectolitres per year) and CZK 7.20 (for breweries with production ranging from 150,000 to 200,000 hectolitres). The revenue from this measure is estimated at CZK 1.2 billion in each year of the medium-term outlook of 2010–2012.

- The excise tax on tobacco products will also be increased. In the case of cigarettes, the fixed tax rate will be increased from CZK 1.03 per cigarette to CZK 1.07 per cigarette and the minimum amount of tax will be increased from CZK 1.92 per cigarette to CZK 2.01 per cigarette. The excise tax on tobacco will be increased from CZK 1,280/kg to CZK 1,340/kg. The revenue from this measure is estimated at CZK 1.8 billion in 2010 and CZK 2 billion in each of the subsequent two years.

### Social and health insurance

The reduction in the sickness insurance rate by 0.9 percentage points, initially planned to start from 2010, has been postponed by a year and will apply as from 1 January 2011. At the same time, the ceiling for the premium assessment base increases from 48 times the average monthly wage to 72 times the average monthly wage. In the case of social insurance, this measure is valid only for 2010, while in the case of health insurance the law does not set any time limitation. Furthermore, insurance credits have been cancelled. The impacts of such measures are anticipated based upon the accrual methodology as an increase in revenues by CZK 32.6 billion in 2010 and CZK 1.6 billion in 2011 and 2012 against the no-policy-change scenario.

The impacts of active tax policy measures are summarised in Table 5.2.

**Table 5.2: Impact of revenue measures approved in 2009**

CZK bn	Year 2010	Year 2011	Year 2012
Property taxes	2,8	2,9	3,0
Income taxes	1,5	1,6	1,7
Excise taxes	11,1	11,4	11,6
VAT	17,8	18,1	18,5
Social and health insurance	32,6	1,6	1,6
<b>Total impact on revenues</b>	<b>65,8</b>	<b>35,6</b>	<b>36,4</b>
<b>Total impact on revenues (% of GDP)</b>	<b>1,8</b>	<b>0,9</b>	<b>0,9</b>

Source: Ministry of Finance.

Beyond the framework of revenue measures approved for 2010, the government proposed additional measures improving the revenues side of public finances for 2011 and beyond. Specifically, these included a proposed increase in the ceiling for social security payments to six times the average monthly wage, maintaining the current form of sickness insurance and introduction of a second, personal income tax bracket with rate of 31% to be imposed on income exceeding the social security ceiling. A summary of the impacts of the proposed revenue measures in 2011 and 2012 is contained in Table 5.3 below.

**Table 5.3: Impact of revenue measures proposed for 2011 – 2012**

CZK bn	Year 2010	Year 2011
Ceilings on SSC – 6 times of AW	3,0	3,1
Sickness insurance - maintaining of the current state, net impact	6,8	7,0
PIT, rate of 31 per cent above the ceilings for the SSC	2,0	2,1
<b>Total impact on revenues</b>	<b>11,8</b>	<b>12,2</b>
<b>Total impact on revenues (% of GDP)</b>	<b>0,3</b>	<b>0,3</b>

Source: Ministry of Finance.

### 5.2 General Government Expenditures

In contrast to the revenue side, general government expenditures will maintain certain growth dynamics and, according to estimates, will increase by 4.8% in 2009. Mainly due to a decline in nominal GDP, general government expenditures will significantly increase as a percent of GDP to 45.5%, which represents a year-on-year jump of 2.5 percentage points.

Compared to 2008, the general government final consumption will increase as a proportion of GDP by 1.5 percentage points. Expenditures on individual consumption and particularly the relatively significant growth of social benefits in kind, especially on health care, are the main reason for its growth.

Given the greater increase in unemployment due to reduction in the number of jobs during the economic downturn, social transfers (mainly to the population) accelerate as well. They will rise by 6.8% compared to 2008. Nevertheless, in comparison with previous years, the increase is relatively modest even in this time of crisis. Another significant factor of the expenditure growth is the interest paid by the general government from its position as a debtor, estimated to increase by ca. 13% in 2009.

Relatively modest growth is expected for 2009 in government investments, which should increase by 1.6% compared to 2008. It is necessary to mention here the vital influence of European funds, without which government investments in 2009 would likely considerably decline. The significant increase in investment grants received (mainly from the EU) corresponds to this development.

The overall dynamics of the expenditures side in 2009 are slowed by sales of Assigned Amount Units of CO<sub>2</sub>, so far considered in a relatively conservative amount of approximately CZK 11 billion as a revenue of the State Environmental Fund. In 2009, only a small portion of these funds (approximately CZK 0.5 billion) is expected to be used, and thus the item significantly improves this year's general government balance.

Other expenditures developed essentially in line with trends stemming from past years.

In addition to the government austerity measures, a number of reductions in social expenditures (see Box 5.2) which will mitigate the growth dynamics of general government expenditures also will come into force in 2010. These include in particular a reduction in the volume of civil servants' wages and salaries (cancellation of administrative positions), freezing of pensions and the planned fixing of expenditures under individual budget chapters. The government is committed to regulate its current expenditures in 2010 so that the general government deficit does not exceed 5.3% of GDP.

## 5 Quality of Public Finances – Revenues and Expenditures

**Table 5.4: General government expenditures**

% of GDP	ESA code	Year 2008	Year 2009 (1)	Year 2010 (2)	Year 2011 (2)	Year 2012 (2)
<b>Components of expenditures</b>						
<b>Compensation of employees</b>	<b>D.1</b>	<b>7,6</b>	<b>7,9</b>	<b>7,7</b>	<b>7,4</b>	<b>7,0</b>
<b>Intermediate consumption</b>	<b>P.2</b>	<b>6,2</b>	<b>6,8</b>	<b>6,3</b>	<b>6,0</b>	<b>5,6</b>
<b>Social transfers</b>		<b>18,2</b>	<b>19,6</b>	<b>19,8</b>	<b>19,5</b>	<b>19,1</b>
Social transfers in kind supplied via market producers	D.631 1, D.63121, D.63131	5,4	5,8	5,8	5,8	5,7
Social transfers other than in kind	D.62	12,8	13,8	14,0	13,7	13,4
<b>Interest expenditure</b>	<b>EDP D.41</b>	<b>1,1</b>	<b>1,3</b>	<b>1,7</b>	<b>2,0</b>	<b>2,1</b>
<b>Subsidies</b>	<b>D.3</b>	<b>1,7</b>	<b>1,8</b>	<b>1,7</b>	<b>1,7</b>	<b>1,7</b>
<b>Gross fixed capital formation</b>	<b>P.51</b>	<b>5,0</b>	<b>5,1</b>	<b>5,4</b>	<b>5,6</b>	<b>5,7</b>
<b>Other</b>		<b>3,2</b>	<b>3,1</b>	<b>3,1</b>	<b>3,3</b>	<b>3,5</b>
<b>Total expenditures</b>	<b>TE</b>	<b>43,0</b>	<b>45,5</b>	<b>45,8</b>	<b>45,6</b>	<b>44,7</b>
<b>p.m.: Government consumption (nominal)</b>	<b>P.3</b>	<b>20,4</b>	<b>21,9</b>	<b>21,3</b>	<b>20,6</b>	<b>19,6</b>

(1) Prediction.

(2) Outlook.

Sources: Czech Statistical Office (2008), Ministry of Finance.

### Box 5.2: Changes in social expenditures approved by Parliament in 2009

#### Expenditures associated with social and health insurance

The assessment basis for the state payment to the public health insurance system has been newly revised with a fixed amount stipulated by law (from 1 January 2010 in the amount of CZK 5,355) with the possibility to adjust its amount by a government decree. Total savings are expected to reach CZK 4.5 billion in 2010 and CZK 7 billion in 2011. Although in this case the impact on the state budget is positive, the public health insurance balance will worsen by the same amount. The overall impact on public budgets, therefore, is zero.

Within the payment of wage compensation for sick leave, which in 2010 remains in its former arrangement, the 50% refund for employers is maintained. This will increase expenditures by CZK 2.2 billion in that year.

#### Payments of social benefits

In the area of social benefits, in particular an increase in benefits proposed in the Act on Promotion of Economic Growth and Social Stability was cancelled. These include unemployment benefits as well as the child benefit, which was to increase by CZK 50 according to the original proposal. We have not quantified the impacts of these changes as the given measures were cancelled practically before their implementation.

The benefit parameters for calculating payments from sickness insurance have changed. In the period from 1 January 2010 to 31 December 2010, in adjusting the daily assessment base for calculating the maternity benefit and compensatory contribution for pregnancy and maternity leave the first reduction threshold of 90% is calculated into the amount. The amount of the sickness and maternity benefits per calendar day in the period from 1 January 2010 to 31 December 2010 is 60% of the daily assessment base. During the period from 1 January 2010 to 31 December 2010, the support period for giving care is a maximum 6 calendar days, and no more than 13 calendar days if the person is a sole employee taking permanent care of at least one child under 16 years of age without having completed the compulsory education. The support period starts from the fourth day of the need for treatment or care. Moreover, the percentage rate for the daily sickness contribution during long-term inability to work was reduced (from the 31st to the 60th day of inability to work from 66% to 60% and from the 61st day of inability to work onward from 72% to 60%). The savings impact of these measures is approximately CZK 4.4 billion under the accrual methodology.

#### Wage policy

In the area of wages and salaries of state employees, administrative positions have been cancelled with a savings impact on expenditures in 2010 of CZK 3.8 billion. However, the reduction in premium and tax payments in the

## 5 Quality of Public Finances – Revenues and Expenditures

amount of about 1.8 billion must be deducted from this impact. This cancellation of administrative positions is of a permanent character.

### Freezing of pensions

In the Czech Republic, the increase in pensions is set so that the amount of the average retirement pension increase corresponds to at least 100% of the growth in prices as well as to at least one third of the rise in real wages, if the increase thus calculated is at least 2%. Since the latter condition was not met, however, the government decided not to carry out valorisation as at 1 January 2010. This regulation is to have a savings effect of about CZK 6.9 billion in 2010, approximately CZK 4.5 billion in 2011 and approximately CZK 5.1 billion in 2012.

**Table 5.5: Impact of changes in social acts**

CZK bn	Year		
	2010	2011	2012
Change in assessment base for public health insurance	0,0	0,0	0,0
Retaining reimbursement of 50 % wage compensations to employers	-2,2	0,0	0,0
Payment of health insurance	4,4	0,0	0,0
Cancelled valorization of pensions	6,9	4,5	5,1
Cancellation of function posts in public sector	2,0	2,0	2,0
<b>Total impact on balance</b>	<b>11,1</b>	<b>6,5</b>	<b>7,1</b>
<b>Total impact on balance (% GDP)</b>	<b>0,3</b>	<b>0,2</b>	<b>0,2</b>

Source: Ministry of Finance.

Similarly as in the case of the revenues side, the government proposed additional measures for 2011 and 2012 beyond the framework of expenditure savings measures approved for 2010. These include in particular reduction of current expenditures of the budget chapters and overall reduction of mandatory expenditures. In their overall impact, these measures represent an improvement in public revenues in 2011 and 2012 by 0.5 and 1.0 percentage point of GDP, respectively. Table 5.6 below provides a quantification of these impacts.

**Table 5.6: Impact of expenditure measures proposed for 2011 – 2012**

mld. Kč	Rok	
	2011	2012
Decrease in current expenditures	13,3	22,0
Decrease in mandatory expenditures	5,1	19,6
<b>Total impact on expenditures</b>	<b>18,4</b>	<b>41,6</b>
<b>Total impact on expenditures (% of GDP)</b>	<b>0,7</b>	<b>1,5</b>

Source: Ministry of Finance.

Table 5.7 and Chart 5.1 show a continuing year-on-year decrease in the proportion of total expenditure to GDP in the structure of general government expenditures by function (COFOG). The decline was reflected in all items of the COFOG classification with the exception of social protection, which recorded a slight year-on-year increase from 12.7% of GDP to 12.9% of GDP. In contrast, the greatest relative decline occurred in housing and community infrastructure during the period 2006–2007 (from 1.6% of GDP in 2006 to 1.1% of GDP in 2007).

## 5 Quality of Public Finances – Revenues and Expenditures

**Table 5.7: General government expenditures by function**

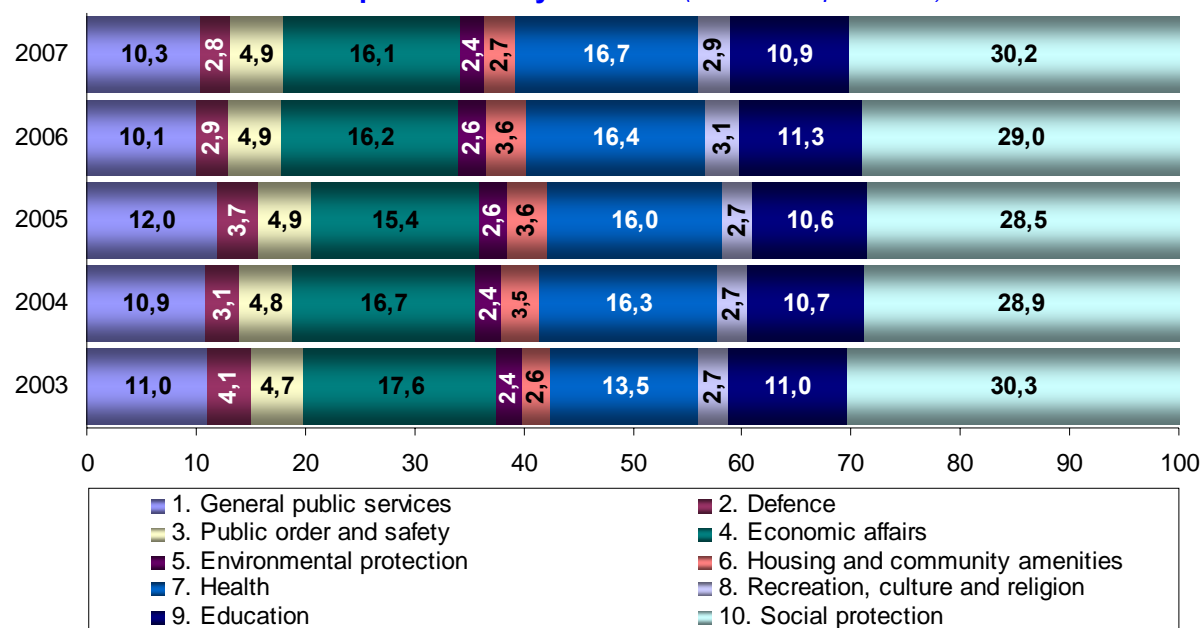
% of GDP	ESA code	Year 2003	Year 2004	Year 2005	Year 2006	Year 2007
1. General public services	1	5,2	4,9	5,4	4,4	4,4
2. Defence	2	1,9	1,4	1,6	1,3	1,2
3. Public order and safety	3	2,2	2,2	2,2	2,2	2,1
4. Economic affairs	4	8,3	7,5	6,9	7,1	6,9
5. Environmental protection	5	1,2	1,1	1,2	1,2	1,0
6. Housing and community amenities	6	1,2	1,6	1,6	1,6	1,1
7. Health	7	6,4	7,3	7,2	7,2	7,1
8. Recreation, culture and religion	8	1,3	1,2	1,2	1,3	1,3
9. Education	9	5,2	4,8	4,8	4,9	4,7
10. Social protection	10	14,4	13,0	12,8	12,7	12,9
<b>Total expenditure</b>	TE	47,3	45,1	45,0	43,8	42,6

*Note: Total expenditures do not correspond precisely to the current version of the yearly national accounts. This is due to the different periodicity for publishing the main aggregates of the annual national accounts (every half year in April and October) and the expenditures of general government institutions by function (once a year in December).*

*Source: Czech Statistical Office.*

In the following chart, expenditures for individual purposes are shown as their share of total general government expenditures.

**Chart 5.1: Government expenditures by function (% of total expenditures)**



*Source: Czech Statistical Office.*



# 6 Sustainability of Public Finances

## 6.1 The Government's Strategy

Long-term sustainability is one of the weak spots of public finances. The most serious risk is the expected demographic development, which will somewhat dramatically increase the proportion of persons of retirement age in the economically active population over the next several decades.

No new reform measures have been adopted in connection with the pension and health care systems that would lead to a change in the development of the sustainability of public finances.

## 6.2 The Fiscal Consequences of Ageing: A Long-Term Projection

Analysis of long-term public expenditure development based upon an assumption of unchanging policies emerges from the common assumptions discussed by the Economic Policy Committee's Working Group on the Ageing Population (AWG). Thus, assumptions on demographics (EUROPOP2008) and the macroeconomic framework that are over the long term consistent for EU countries were used in the analysis.<sup>10</sup>

**Table 6.1: Macroeconomic projection assumptions**

% of GDP	Year 2007	Year 2015	Year 2020	Year 2030	Year 2040	Year 2050	Year 2060
Labour productivity growth	4,1	3,0	2,9	1,8	1,7	1,7	1,7
Real GDP growth	5,2	3,0	2,5	1,4	0,9	0,7	1,1
Participation rate males (aged 15–64)	78,3	80,7	81,0	78,8	78,5	79,0	78,9
Participation rates females (aged 15–64)	61,6	66,1	66,7	66,0	66,0	67,8	68,1
Total participation rate (aged 15–64)	70,0	73,5	73,9	72,5	72,3	73,5	73,5
Unemployment rate	5,4	4,5	4,5	4,5	4,5	4,5	4,5
Population aged 65+ over total population	14,6	17,9	20,2	22,9	26,3	30,9	33,4

Sources: Ministry of Finance, AWG.

The results of long-term projections are fully consistent with the analyses processed by AWG and published in spring 2009 in the latest report<sup>11</sup> on long-term projections.

Table 6.2 summarises the long-term development of expenditures related to changes in the population structure. In total, these will increase by 5.7 percentage points of GDP by 2060. The largest portion of this growth is traditionally comprised of pension expenditures, which will increase from the current level of around 7% of GDP to 11% of GDP. The increase in expenditures on health care by 2.2 percentage points since the initial year of projections is worthy of note.

<sup>10</sup> The projection assumptions and their analysis emerge from AWG's long-term assumptions and do not reflect the current medium-term macroeconomic and fiscal outlook of the Czech Republic.

<sup>11</sup> "The 2009 Ageing Report: economic and budgetary projections for the EU-27 Member States (2008–2060)".

Table 6.2: Long-term sustainability of public finances

% of GDP	Year 2007	Year 2010	Year 2020	Year 2030	Year 2040	Year 2050	Year 2060
<b>Total expenditure</b>	43,1	41,9	41,4	43,7	47,6	53,5	59,8
<i>of which: Age-related expenditure</i>	18,8	18,0	18,2	19,1	20,7	23,1	24,5
<b>Pension expenditure</b>	7,8	7,1	6,9	7,1	8,4	10,2	11,0
<b>Social security pensions</b>	7,8	7,1	6,9	7,1	8,4	10,2	11,0
<b>Old-age and early pensions</b>	7,1	6,5	6,3	6,6	7,9	9,7	10,5
<b>Other pensions</b>	0,7	0,5	0,5	0,6	0,5	0,5	0,6
<b>Occupational pensions</b>	0,0	0,0	0,0	0,0	0,0	0,0	0,0
<b>Health care</b>	6,2	6,4	6,9	7,4	7,8	8,1	8,4
<b>Long-term care</b>	0,2	0,2	0,3	0,4	0,5	0,5	0,7
<b>Education expenditure</b>	3,5	3,0	3,0	3,1	2,9	3,0	3,2
<b>Other age-related expenditures</b>	1,0	1,0	1,0	1,0	1,0	1,1	1,1
<i>of which: Interest expenditure</i>	1,1	1,0	1,8	3,2	5,5	9,0	13,9
<b>Total revenue</b>	42,0	41,0	40,1	40,0	40,0	39,9	39,9
<i>of which: Property income</i>	0,8	0,7	0,6	0,5	0,5	0,5	0,4
<i>of which: From pension contributions (or social contributions if appropriate)</i>	8,6	8,6	8,6	8,6	8,6	8,6	8,6
<b>Pension reserve fund assets <sup>(a)</sup></b>	0,4	3,4	17,1	32,6	45,0	42,3	24,2
<i>of which: Consolidated public pension fund assets (assets other than government liabilities)</i>	0,0	0,0	0,0	0,0	0,0	0,0	0,0

Sources: Ministry of Finance, AWG.

The sustainability analysis identifies the scope of fiscal consolidation necessary to secure the stability of public finances in the horizon to 2060. So-called sustainability indicators are calculated. These indicators show how extensive implemented measures would need to be in order to decrease expenditures or increase revenues as proportions of GDP. At present, the S1 indicator<sup>12</sup> stands at 5.3 and S2<sup>13</sup> at 7.4.

The sustainability analysis showed some improvement that may be attributed to pension system reform measures implemented in the past, particularly to the increase in the age limit. The current fiscal position that has resulted in a more rapid accumulation of debt through relatively high deficits is a negative factor of the long-term development. This has resulted in a relatively dramatic increase in interest costs.

<sup>12</sup> S1 permanent fiscal consolidation expresses as a percentage of GDP the necessity to permanently increase taxes (from the given year) or reduce expenditures in order to achieve a government debt of 60% of GDP at the end of the projection period.

<sup>13</sup> S2 permanent fiscal consolidation expresses the level of fiscal effort necessary to achieve the equality of discounted revenues and expenditures for an indefinite period of time.

# 7 Changes to the Institutional Framework for Fiscal Policy

## 7.1 Forthcoming Changes in the Tax System

In late 2008, the Czech government approved the Project to Establish a Single Collection Point for Public Budgets Revenues, or the so-called JIM project. Subsequently, the Czech government decided to prepare a conceptual proposal for harmonising taxes and insurance premiums.

The JIM project envisages the establishment of a single collection point for taxes, customs and public insurance premiums. The project should be implemented in several time phases, with the first step being to establish a separate tax administration as a system of bodies led by a general directorate subordinate to the Ministry of Finance that would gradually take over other collection functions. The target status should be reached as early as 2014.

The aim of the forthcoming conceptual proposal of harmonising taxes and insurance premiums in particular is to reduce administrative costs, both direct costs for the managers of these payments and indirect costs for the payers, as well as to simplify the existing system and make it more understandable for all the aforementioned entities. Harmonisation will unify the approach to defining the payer and the assessment base of personal income tax and social and health insurances, their operative period, payment date, penalty procedures and conducted controls. Also considered is to eliminate the varying interpretative approaches associated with the current fragmentation of this issue in the competence areas of finance, labour, social protection and health care and others that manage collection of social security payments. This project is closely linked with the JIM project mentioned above and will be carried out in parallel with it.

## 7.2 The State Treasury

The primary objective of the integrated information system of the state treasury that has been launched is to establish an efficient and transparent instrument for managing public finances that enables gradual reduction of the general government deficit and ensures long-term sustainable development of its finances. The activities of the state treasury consist in directed planning; record keeping; collecting state revenues and executing payments; investment, non-investment and financial accounting of its assets; momentarily accounting for any movements that occur when dealing with state assets and liabilities; implementing automated financial and management controls for dealing with state budget funds; and reporting on state finances.

Establishment of the state treasury should proceed as a combination of elements of centralised control and decentralised performance of rights and responsibilities. Such system will be established that will provide accurate information on the overall development of state finances at the central level while maintaining the performance and responsibility for operations with public funds at the appropriate level of the government. All of this will proceed in a fully automated way and in real time. Unified accounting, a budgetary information system providing information for budgetary management, and the financial management in real time that this system makes possible will contribute to reducing the costs of debt service and the

## 7 Changes to the Institutional Framework for Fiscal Policy

administrative burden of accounting units. In addition to these direct savings, the forthcoming state treasury system will lead to a greater efficiency of public expenditures.

The Czech state treasury system can be characterised by the following set of key activities:

- financial and budgetary planning (programming of public expenditures),
- implementation of the budget,
- central system of state accounting information,
- management of liquidity and debt,
- financial and management control (ex-ante and ex-post),
- central processing of statistical reports and financial analyses,
- payment system and implementation of a single state account.

The project of creating an integrated information system for the state treasury is divided into four functional phases. In the first phase, the central system of state accounting information is put into operation and the economic information system is activated. Trial operation of these functions takes place at the Office of the Government—the organisational unit of the state. Operation of the first phase of the project will be initiated at the start of 2010. The focus of the second phase of the project will be on preparing and drawing up the budget, and it will be launched in April 2010. In early 2011, the third phase of the project, devoted to implementation of the budget, will begin. The fourth phase will follow one year later and consist in linking the state treasury system with the operation of the payment system.

## 8 Implementation of the Excessive Deficit Procedure

Based on the expected exceeding of the reference value for the government deficit in 2009, an Excessive Deficit Procedure (EDP) was initiated with the Czech Republic on 2 December 2009. The Council of the EU has recommended that the Czech Republic should bring the general government deficit below the 3% limit in a credible and sustainable manner by 2013. At the same time, the Council called upon Czech authorities to report on progress made in implementing the EDP recommendations in separate chapters of the Convergence Programme updates that they will be preparing in the period between 2010 and 2013.

The Council Recommendation of 2 December urged Czech authorities especially i) in 2010 to implement the budget reducing measures to limit the deficit as planned in the State Budget Act for 2010; ii) for the period 2010–2013 to ensure fiscal effort (in terms of improvement in the structural balance) at an average annual rate of 1% of GDP; and iii) to specify the measures that are necessary to achieve the correction of the excessive deficit by 2013, cyclical conditions permitting and accelerate the reduction of the deficit if economic and budgetary conditions turn out better than currently expected. The Czech Republic should, among other things, enforce rigorously the medium-term budgetary framework and improve monitoring of the budget execution throughout the year to avoid expenditures overruns to the budget and multiannual plans.

The Czech authorities aim to correct the excessive deficit by 2013. Within the Convergence Programme's horizon, the government is planning the following consolidation strategy:

### Year 2010

The worsening budgetary and financial situation prompted the government in the summer of 2009 to quickly prepare an austerity package in order to prevent further worsening of the fiscal situation in 2010. This package was already incorporated into the Draft state budget for 2010 and was approved by the Chamber of Deputies of the Parliament in October 2009, prior to the actual discussion on the Draft State Budget for 2010. The most important measures are the increases in VAT, excise taxes and property taxes as well as the abolition of certain anti-crisis measures already adopted, such as higher unemployment benefits, higher child benefits, temporary reduction in social benefits and in the public sector salaries, and freezing of pensions. According to the forecast of the Ministry of Finance from January 2010, the consolidation package will contribute to year-on-year improvement in the structural balance by approximately 2% of GDP and will enable reduction of the government deficit in 2010 to about 5.3% of GDP.

In the case of more favourable economic and budgetary conditions than are currently expected, the government is committed to faster deficit reduction.

### Years 2011–2012

In the time leading up to the regular elections in May 2010, the government is concentrating on two tasks. These are rigorous implementation of the state budget in 2010 and preparation of a proposal for a set of economic policy measures (“Recovery from the Crisis – Government Policy in the Short- and Medium-term Horizon”; hereinafter referred to as “Recovery from the Crisis”). Its target is to identify growth-oriented structural measures and simultaneously will support the sustainability of fiscal consolidation. At the start of February, the Council of

## 8Error! Reference source not found. Implementation of the Excessive Deficit Procedure

Economic and Social Agreement (Tripartite Council) approved the Proposal of Short-term Measures for Exit from the Crisis and Resolution of their Consequences.

The recovery strategy identifies consolidation of public budgets as a priority of the government in the short-term and medium-term horizon so that the deficit in public finances is gradually reduced. It continues the turnabout from the expansive fiscal policy of 2009 to a restrictive budgetary policy already being implemented during 2010. The main priority of sustainable fiscal consolidation will be the support of such structural reforms that ensure the sustainable stabilisation and subsequent reduction of the government's relative indebtedness.

Thus the current government, in cooperation with the social partners, establishes conditions for continuity of policies including continuation of the initiated consolidation. Completion of the fiscal consolidation path will be the task of the next government, including to decide to what extent it will use the proposals and recommendations from the prepared recovery strategy.

The new government will be able to build on the outputs of the expert advisory group of the Minister of Finance and the Minister of Labour and Social Affairs, which was established in January 2010 with the aim of preparing for the next government alternative proposals for pension reform. These outputs will be continuously published and will be finalised by the end of May 2010.

**Table 8.1: Plan of fiscal consolidation**

		2008	2009	2010	2011	2012
			Estimate	Outlook	Outlook	Outlook
Autonomous outlook	(bn CZK)	-77,4	-239,6	-195,8	-215,7	-222,6
	(% HDP)	-2,1	-6,6	-5,3	-5,6	-5,5
Cumulative consolidation	(p.p. HDP)				0,8	1,3
	(bn CZK)				30,2	53,8
Target for general governme	(bn CZK)				-185,5	-168,8
	(% HDP)				-4,8	-4,2
Structural balance	(% HDP)		-5,5	-3,6	-3,2	-2,6
Fiscal effort	(p.p. HDP)			1,9	0,4	0,6

Source: Ministry of Finance.

With a view to the autonomous fiscal development beyond 2010 and the currently expected economic development in 2011–2012, the aimed consolidation target of an average fiscal effort of 1 percentage point over this period in line with the EDP recommendations will be ensured under following assumptions:

- (i) increase in tax revenues due to proposed changes in the tax system for 2011 and thereafter of ca CZK 12 billion,
- (ii) adherence to the intention of sustainably decreasing current and mandatory expenditures cumulatively by ca CZK 40 billion (see Chapter 5).

Achieving these fiscal objectives will require adjustment on the expenditures sides of the budget especially. Structural measures will be closely scrutinized regarding not only the consolidation effects but also their social costs. It will be the responsibility of the next government to formulate its priorities and policies and to establish a consolidation strategy for the coming periods.

There is a risk of further external shocks and in particular the slower than expected speed of the recovery in EU countries and the pace of their fiscal consolidation. The Czech authorities

## **8Error! Reference source not found. Implementation of the Excessive Deficit Procedure**

are fully aware of the risk for Czech economy, as a small and very open one, while having high fiscal stabilizers. Based on recent predictions, whether of the Ministry of Finance, the European Commission, or other international institutions, the risk of further global economic decline cannot be excluded. The Council's recommendations for the Czech Republic and the planned fiscal effort in 2010 provide a sufficient margin for manoeuvring and flexible adjustment of the fiscal consolidation path in following years according to actual economic developments.

## 9 Annexes

### 9.1 Table Annex

Sources: Czech Statistical Office, Czech National Bank, Ministry of Finance.

**Table 9.1: Economic growth**  
(from quarterly accounts, CZK billion, increase in %)

	ESA code	Year 2008 level <sup>1)</sup>	Year 2008 rate of change	Year 2009 rate of change	Year 2010 rate of change	Year 2011 rate of change	Year 2012 rate of change
<b>1. Real GDP</b>	<b>B1*g</b>	3623	2,5	-4,0	1,3	2,6	3,8
<b>2. Nominal GDP</b>	<b>B1*g</b>	3689	4,3	-1,1	1,9	3,6	5,4
<b>Components of real GDP</b>							
<b>3. Private consumption expenditure</b>	<b>P.3</b>	1748	3,6	1,4	-0,8	2,0	2,5
<b>4. Government consumption expenditure</b>	<b>P.3</b>	725	1,0	4,0	-1,7	0,0	-0,4
<b>5. Gross fixed capital formation</b>	<b>P.51</b>	877	-1,5	-7,5	-3,7	2,5	3,6
<b>6. Changes in inventories and net acquisition of valuables</b> (% of GDP) <sup>2)</sup>	<b>P.52+P.53</b>	51	1,4	-1,8	-0,3	0,3	0,7
<b>7. Exports of goods and services</b>	<b>P.6</b>	3000	6,0	-11,9	4,4	6,4	6,5
<b>8. Imports of goods and services</b>	<b>P.7</b>	2779	4,7	-11,9	2,4	6,1	4,9
<b>Contribution to real GDP growth</b>							
<b>9. Final domestic demand</b>			1,5	-0,3	-1,6	1,5	2,0
<b>10. Change in inventories and net acquisition of valuables</b>	<b>P.52+P.53</b>		-0,4	-3,2	1,4	0,5	0,3
<b>11. External balance of goods and services</b>	<b>B.11</b>		1,3	-0,6	1,5	0,6	1,5

<sup>1)</sup> Real level in 2007 prices.

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

**Table 9.2: Price development**  
(in %)

	Year 2008 level <sup>1)</sup>	Year 2008 rate of change	Year 2009 rate of change	Year 2010 rate of change	Year 2011 rate of change	Year 2012 rate of change
<b>1. GDP deflator</b>	120,8	1,8	3,1	0,5	1,0	1,5
<b>2. Private consumption deflator</b>	119,5	4,9	0,3	1,6	1,5	2,2
<b>3. HICP</b>	111,7	6,3	0,6	1,8	1,5	1,8
<b>4. Public consumption deflator</b>	135,2	3,9	1,9	0,7	0,3	1,1
<b>5. Investment deflator</b>	104,7	0,7	1,8	0,7	0,7	0,7
<b>6. Export price deflator (goods and services)</b>	88,6	-5,2	0,4	-0,3	-1,3	1,0
<b>7. Import price deflator (goods and services)</b>	85,1	-3,7	-2,6	0,5	-1,1	1,1

<sup>1)</sup> 2000 = 100; for the HICP, 2005 = 100.



Table 9.3: Labour market development

	ESA code	Year 2008 level	Year 2008 rate of change	Year 2009 rate of change	Year 2010 rate of change	Year 2011 rate of change	Year 2012 rate of change
1. Employment (thous. persons) <sup>1)</sup>		5288	1,2	-1,3	-1,6	-0,4	0,6
2. Employment (bill. hours worked) <sup>2)</sup>		10,30	1,4	-4,1	-2,4	-0,4	0,8
3. Unemployment rate (%) <sup>3)</sup>		4,4	4,4	6,7	8,8	8,6	7,6
4. Labour productivity (thous. CZK/person) <sup>4)</sup>		685	1,2	-2,8	3,0	3,0	3,2
5. Labour productivity (CZK/hour) <sup>5)</sup>		352	1,0	0,1	3,9	3,0	3,0
6. Compensation of employees (bill. CZK)	D.1	1634	7,7	-1,8	0,1	3,9	5,4
7. Compensation per employee (thous. CZK/person)		377	6,3	0,3	2,5	4,1	4,8

<sup>1)</sup> Employed population, domestic concept in national accounts definition.

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

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

<sup>4)</sup> Real GDP per employed person (in 2007 prices).

<sup>5)</sup> Real GDP per hour worked (in 2007 prices).

Table 9.4: Analysis of the change in the net financial position  
(from national accounts)

% of GDP	ESA code	Year 2008	Year 2009	Year 2010	Year 2011	Year 2012
<b>1. Net lending/borrowing vis-a-vis the rest of the world</b>	B.9	-2,4	-0,2	1,0	0,2	0,6
<i>of which</i>						
- Balance on goods and services		4,6	6,0	6,8	7,0	8,1
- Balance of primary incomes and transfers		-8,0	-7,1	-6,8	-7,7	-8,4
- Capital account		0,9	1,0	1,0	1,0	1,0
<b>2. Net lending/borrowing of the private sector</b>	B.9	-0,3	6,4	6,3	5,0	4,8
<b>3. Net lending/borrowing of general government</b>	EDP B.9	-2,1	-6,6	-5,3	-4,8	-4,2
<b>4. Statistical discrepancy</b>		0,0	0,0	0,0	0,0	0,0

Table 9.5: General government budget

	ESA code	Year	Year	Year	Year	Year	Year
		2008	2008	2009	2010	2011	2012
		CZK bn	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (+)/borrowing (-) (EDP B.9) by sub-sectors							
1. General government	S.13	-77,4	-2,1	-6,6	-5,3	-4,8	-4,2
2. Central government	S.1311	-87,5	-2,4	-5,8	-5,2	-4,8	-4,2
3. State government	S.1312	-	-	-	-	-	-
4. Local government	S.1313	0,1	0,0	-0,6	-0,1	-0,1	0,0
5. Social security funds	S.1314	10,0	0,3	-0,2	0,0	0,0	0,0
General government (S.13)							
6. Total revenue	TR	1 507,8	40,9	39,0	40,5	40,8	40,5
7. Total expenditure <sup>(3)</sup>	TE <sup>(3)</sup>	1 585,2	43,0	45,5	45,8	45,6	44,7
8. Net lending (+)/borrowing (-)	EDP B.9	-77,4	-2,1	-6,6	-5,3	-4,8	-4,2
9. Interest expenditure <sup>(3)</sup>	EDP D.41	41,4	1,1	1,3	1,7	2,0	2,1
10. Primary balance		-35,9	-1,0	-5,3	-3,5	-2,8	-2,0
11. One-off and other temporary measures		-3,1	-0,1	0,2	-0,1	-0,1	-0,3
Components of revenues							
12. Total taxes		722,7	19,6	18,1	19,1	19,1	19,0
12a. Taxes on production and imports	D.2	405,6	11,0	11,1	11,9	11,6	11,3
12b. Current taxes on income, wealth etc.	D.5	316,7	8,6	7,0	7,2	7,5	7,6
12c. Capital taxes	D.91	0,4	0,0	0,0	0,0	0,0	0,0
13. Social contributions	D.61	599,2	16,2	15,1	15,4	15,6	15,6
14. Property income	D.4	31,4	0,9	0,9	1,0	0,9	0,9
15. Other		154,5	4,2	4,9	5,1	5,1	5,1
16. Total revenue	TR	1 507,8	40,9	39,0	40,5	40,8	40,5
p.m.: Tax burden		1 321,9	35,8	33,2	34,5	34,7	34,6
Components of expenditures							
17. Compensation of employees	D.1	280,0	7,6	7,9	7,7	7,4	7,0
18. Intermediate consumption	P.2	229,1	6,2	6,8	6,3	6,0	5,6
19. Social payments		669,8	18,2	19,6	19,8	19,5	19,1
19a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	198,6	5,4	5,8	5,8	5,8	5,7
19b. Social transfers other than in kind	D.62	471,2	12,8	13,8	14,0	13,7	13,4
20. Interest expenditure <sup>(3)</sup>	EDP D.41	41,4	1,1	1,3	1,7	2,0	2,1
21. Subsidies	D.3	63,7	1,7	1,8	1,7	1,7	1,7
22. Gross fixed capital formation	P.51	183,1	5,0	5,1	5,4	5,6	5,7
23. Other		118,0	3,2	3,1	3,1	3,3	3,5
24. Total expenditures <sup>(3)</sup>	TE <sup>(3)</sup>	1 585,2	43,0	45,5	45,8	45,6	44,7
p.m.: Government consumption (nominal)	P.3	753,2	20,4	21,9	21,3	20,6	19,6

(1) Estimate.

(2) Outlook.

(3) Expenditures are adjusted for interest on swap transactions so that TR-TE = EDP B.9.

Table 9.6: General government debt

% of GDP	Year	Year	Year	Year	Year
	2008	2009 (1)	2010 (2)	2011 (2)	2012 (2)
<b>1. Gross debt</b>	30,0	35,2	38,6	40,8	42,0
<b>2. Change in gross debt ratio</b>	1,0	5,2	3,4	2,3	1,2
<b>Contributions to change in gross debt</b>					
<b>3. Primary balance</b>	1,0	5,4	3,5	2,8	2,1
<b>4. Interest expenditure</b>	1,1	1,1	1,7	2,0	2,1
<b>5. Nominal GDP growth</b>	-1,2	0,3	-0,7	-1,3	-2,1
<b>6. Stock-flow adjustment</b>	0,1	-1,6	-1,2	-1,2	-0,9
- Difference between cash and accruals	-1,3	-0,5	-0,5	-0,3	-0,2
- Net accumulation of financial assets	1,3	-1,1	-0,7	-0,7	-0,6
of which: Privatisation proceeds	0,6	0,0	0,0	0,0	0,0
- Revaluation effects and other	0,1	0,0	0,0	0,0	0,0
<b>p.m. implicit interest rate on debt</b>	3,6	3,3	4,5	5,0	5,0
<b>7. Liquid financial assets</b>	-	-	-	-	-
<b>8. Net financial debt</b>	-	-	-	-	-

(1) Estimate.

(2) Outlook.

Table 9.7: Cyclical development

% of GDP	ESA code	Year	Year	Year	Year	Year
		2008	2009 (1)	2010 (2)	2011 (2)	2012 (2)
<b>1. Real GDP growth (%)</b>		2,5	-4,0	1,3	2,6	3,8
<b>2. Net lending of general government</b>	<b>EDP B.9</b>	-2,1	-6,6	-5,3	-4,8	-4,2
<b>3. Interest expenditure</b>	<b>EDP D.41</b>	1,1	1,1	1,7	2,0	2,1
<b>4. One-off and other temporary measures</b>		-0,1	0,2	-0,1	-0,1	-0,3
<b>5. Potential GDP growth (%)</b>		3,6	3,1	2,5	2,5	3,0
<i>contributions:</i>						
- total factor productivity		2,2	1,8	1,6	1,8	2,2
- labour		0,4	0,5	0,3	0,1	0,1
- capital		1,0	0,8	0,6	0,6	0,7
<b>6. Output gap</b>		2,5	-4,6	-5,6	-5,5	-4,8
<b>7. Cyclical budgetary component</b>		0,7	-1,2	-1,6	-1,6	-1,3
<b>8. Cyclically-adjusted balance (2 – 7)</b>		-2,8	-5,3	-3,7	-3,3	-2,9
<b>9. Cyclically-adjusted primary balance (8 + 3)</b>		-1,7	-4,2	-1,9	-1,2	-0,8
<b>10. Structural balance (8 – 4)</b>		-2,7	-5,5	-3,6	-3,2	-2,6

(1) Estimate.

(2) Outlook.

Table 9.8: Divergence from the previous update

% of GDP	ESA code	Year 2008	Year 2009 (1)	Year 2010 (2)	Year 2011 (2)	Year 2012 (2)
<b>Real GDP growth (%)</b>						
Previous update		4,4	3,7	4,4	5,2	.
Current update		2,5	-4,0	1,3	2,6	3,8
Difference		-2,0	-7,7	-3,1	-2,6	.
<b>General government net lending (% of GDP)</b>						
Previous update	<b>EDP B.9</b>	-1,2	-1,6	-1,5	-1,2	.
Current update	<b>EDP B.9</b>	-2,1	-6,6	-5,3	-4,8	-4,2
Difference		-0,9	-5,0	-3,7	-3,6	.
<b>General government gross debt (% of GDP)</b>						
Previous update		28,8	27,9	26,8	25,5	.
Current update		30,0	35,2	38,6	40,8	42,0
Difference		1,2	7,3	11,7	15,3	.

(1) Estimate.

(2) Trend values or period averages.

Table 9.9: Long-term sustainability of public finances

% of GDP	Year 2007	Year 2010	Year 2020	Year 2030	Year 2040	Year 2050	Year 2060
<b>Total expenditure</b>	43,1	41,9	41,4	43,7	47,6	53,5	59,8
<i>of which: Age-related expenditure</i>	18,8	18,0	18,2	19,1	20,7	23,1	24,5
<b>Pension expenditure</b>	7,8	7,1	6,9	7,1	8,4	10,2	11,0
<b>Social security pensions</b>	7,8	7,1	6,9	7,1	8,4	10,2	11,0
<b>Old-age and early pensions</b>	7,1	6,5	6,3	6,6	7,9	9,7	10,5
<b>Other pensions</b>	0,7	0,5	0,5	0,6	0,5	0,5	0,6
<b>Occupational pensions</b>	0,0	0,0	0,0	0,0	0,0	0,0	0,0
<b>Health care</b>	6,2	6,4	6,9	7,4	7,8	8,1	8,4
<b>Long-term care</b>	0,2	0,2	0,3	0,4	0,5	0,5	0,7
<b>Education expenditure</b>	3,5	3,0	3,0	3,1	2,9	3,0	3,2
<b>Other age-related expenditures</b>	1,0	1,0	1,0	1,0	1,0	1,1	1,1
<b>Interest expenditure</b>	1,1	1,0	1,8	3,2	5,5	9,0	13,9
<b>Total revenue</b>	42,0	41,0	40,1	40,0	40,0	39,9	39,9
<i>of which: Property income</i>	0,8	0,7	0,6	0,5	0,5	0,5	0,4
<i>of which: From pension contributions (or social contributions if appropriate)</i>	8,6	8,6	8,6	8,6	8,6	8,6	8,6
<b>Pension reserve fund assets</b>	0,4	3,4	17,1	32,6	45,0	42,3	24,2
<i>of which: Consolidated public pension fund assets (assets other than government liabilities)</i>	0,0	0,0	0,0	0,0	0,0	0,0	0,0
<b>Labour productivity growth</b>	4,1	3,0	2,9	1,8	1,7	1,7	1,7
<b>Real GDP growth</b>	5,2	3,0	2,5	1,4	0,9	0,7	1,1
<b>Participation rate males (aged 15–64)</b>	78,3	80,7	81,0	78,8	78,5	79,0	78,9
<b>Participation rates females (aged 15–64)</b>	61,6	66,1	66,7	66,0	66,0	67,8	68,1
<b>Total participation rates (aged 15–64)</b>	70,0	73,5	73,9	72,5	72,3	73,5	73,5
<b>Unemployment rate</b>	5,4	4,5	4,5	4,5	4,5	4,5	4,5
<b>Population aged 65+ over total population</b>	14,6	17,9	20,2	22,9	26,3	30,9	33,4

Table 9.10: Basic assumptions

	Year 2008	Year 2009	Year 2010	Year 2011	Year 2012
<b>Short-term interest rate (CZ) (annual average)</b>	4,0	2,2	1,7	2,4	2,8
<b>Long-term interest rate (CZ) (annual average)</b>	4,6	4,7	3,8	4,0	4,0
<b>Nominal effective exchange rate (2005 = 100)</b>	120	116	119	124	129
<b>Exchange rate CZK/EUR (annual average)</b>	24,9	26,4	25,8	24,8	23,8
<b>World excluding EU, GDP growth</b>	3,0	-1,0	3,5	4,0	4,5
<b>EU27 GDP growth</b>	0,8	-4,0	1,1	2,0	2,2
<b>Growth of relevant foreign markets</b>	1,7	-12,5	0,5	4,0	7,0
<b>World import volumes, excluding EU</b>	3,8	-9,7	5,5	6,5	7,3
<b>Oil prices (Brent, USD/barrel)</b>	98	62	81	92	91