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Assessment of the 2015 Convergence Programme for

CZECH REPUBLIC

(Note prepared by DG ECFIN staff)

CONTENTS

1. INTRODUCTION

This document assesses the Czech Republic's April 2015 Convergence Programme (hereafter called Convergence Programme), which was submitted to the Commission on 30 April and covers the period 2014-2018. It was approved by the government and presented to the national parliament for a debate without a vote.

The Czech Republic is currently subject to the preventive arm of the Stability and Growth Pact and should preserve a sound fiscal position which ensures compliance with the medium term objective.

This document complements the Country Report published on 26 February 2015 and updates it with the information included in the Convergence programme. Section 2 presents the macroeconomic outlook underlying the Convergence Programme and provides an assessment based on the Commission 2015 spring forecast. The following section presents the recent and planned budgetary developments, according to the Stability Programme. In particular, it includes an overview on the medium term budgetary plans, an assessment of the measures underpinning the Stability Programme and a risk analysis of the budgetary plans based on Commission forecast. Section 4 assesses compliance with the rules of the Stability and Growth Pact, including on the basis of the Commission forecast. Section 5 provides an overview on long term sustainability risks and Section 6 on recent developments and plans regarding the fiscal framework and the quality of public finances. Section 7 summarises the main conclusions.

2. MACROECONOMIC OUTLOOK

The programme's macroeconomic scenario projects an acceleration of real GDP growth in 2015 followed by a slight deceleration over the remainder of the forecast horizon. The programme scenario does not include the impact of any structural reforms. Following growth of 2.0 % in 2014, real GDP is projected to increase by 2.7 % in 2015 , before slowing to 2.5 % in 2016 and 2.3 % in 2017.[1] In 2015, growth is expected to be stimulated by a positive supply shock resulting from low oil prices and by expansive fiscal policy, partly related to an intensified effort to maximise the drawdown of EU funds from the 2007-2013 programming period. As neither of these factors is expected to persist in 2016, the programme forecasts a small deceleration in growth for that year.

According to the output gaps as recalculated by the Commission based on the information in the programme, following the commonly agreed methodology, the output gap is expected to remain negative in 2015 and 2016 and to become positive in 2017.[2] The Commission 2015 spring forecast implies closing of the output gap already in 2016.

Compared to the Commission 2015 spring forecast, the programme projections foresee a slightly higher rate of real GDP growth in 2015 and a lower rate in 2016. There are several

[1] The macroeconomic scenario presented in the programme is broadly consistent with monetary and exchange rate assumptions. The programme anticipates no change in the exchange rate of the CZK vis-à-vis the EUR in 2015 or 2016, consistent with the commitment of the Czech National Bank to maintain an exchange rate floor against the EUR until at least the second half 2016. External assumptions underpinning the programme scenario are somewhat more conservative than those of the Commission 2015 spring forecast with regard to EU28 GDP growth (1.6 % and 1.9 % in 2015 and 2016, respectively, against 1.8 % and 2.1 % in the Commission forecast).

[2] In contrast, the output gap as presented in the programme turns positive already in 2015 implying that estimates of potential growth are lower according to the methodology used by the Czech authorities.

factors contributing to these differences. Firstly, the programme forecasts stronger growth of household consumption expenditure in 2015 than the Commission forecast, which is driven mainly by higher projected real disposable income. Secondly, the Commission 2015 spring forecast projects a lower contribution of gross fixed capital formation to real GDP growth in 2016 than the projection contained in the programme. Public investment is projected to fall sharply in 2016 according to the programme, implying very high growth in private-sector investment which may not materialise. Finally, the Commission forecast projects a positive contribution of net exports in 2016 while the programme forecasts the contribution to remain slightly negative despite similar assumptions on the world and the EU economic outlook.

Overall, the programme's assumptions for real GDP growth are plausible in both 2015 and 2016, despite the fact that there are differences in composition as compared to the Commission forecast. The programme's assumption for the contribution of household consumption expenditure to real GDP growth is favourable in 2015. In 2016, the assumption for the contribution of gross fixed capital formation to real GDP growth is favourable while the assumption of the contribution of net exports is cautious.

Table 1: Comparison of macroeconomic developments and forecasts

	2014		2015		2016		2017	2018
	COM	CP	COM	CP	COM	CP	CP	CP
Real GDP (% change)	2.0	2.0	2.5	2.7	2.6	2.5	2.3	2.3
Private consumption (% change)	1.7	1.7	2.1	2.8	2.3	2.3	2.2	2.1
Gross fixed capital formation (% change)	4.5	4.5	5.0	5.3	2.5	4.2	3.2	3.2
Exports of goods and services (% change)	8.8	8.8	6.6	5.7	7.0	6.0	6.1	6.1
Imports of goods and services (% change)	9.5	9.5	7.5	6.6	7.2	6.6	6.6	6.6
Contributions to real GDP growth:								
- Final domestic demand	2.4	2.4	2.7	3.0	2.1	2.5	2.2	2.1
- Change in inventories	-0.3	-0.3	0.0	0.0	0.1	0.0	0.0	0.0
- Net exports	-0.1	-0.1	-0.2	-0.3	0.4	0.0	0.1	0.1
Output gap[1]	-1.9	-2.0	-0.9	-0.9	0.2	-0.2	0.0	0.3
Employment (% change)	0.4	0.4	0.4	0.7	0.3	0.2	0.1	0.1
Unemployment rate (%)	6.1	6.1	5.6	5.7	5.5	5.5	5.4	5.3
Labour productivity (% change)	1.6	1.6	2.1	2.0	2.3	2.3	2.2	2.2
HICP inflation (%)	0.4	0.4	0.2	0.2	1.4	1.4	1.8	1.9
GDP deflator (% change)	2.4	2.4	1.8	1.9	1.6	1.4	1.4	1.5
Comp. of employees (per head, %	3.0	3.0	3.1	3.2	3.2	3.9	4.2	4.0
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	1.0	1.0	2.3	2.1	2.0	1.0	0.9	0.8

Note:

[1]In percent of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source :

Commission 2015 spring forecast (COM); Convergence Programme (CP).

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. Deficit developments in 2014

The headline general government deficit reached 2% of GDP in 2014, which is a slightly worse outcome compared to the 1.8% of GDP deficit target envisaged in the 2014 Convergence Programme. There are, however, differences between the projected and actual outcomes at the level of the overall revenue and expenditure ratios and individual revenue and expenditure categories. A detailed analysis of these differences is complicated by the fact that they are partly due to changes in statistical recording (in particular the change from the ESA 95 accounting system to ESA 2010, which took place in September 2014). Nevertheless, several factors can be highlighted.

On the revenue side, income from indirect taxes, in particular from excise duties on tobacco, was lower than expected. Excise duties on tobacco have been increasing gradually for several years resulting in a significant pre-stocking effect every year. In 2014, the government limited the possibility of pre-stocking of tobacco products to 2 months (pre-stocking was unlimited in prior years) causing a significant change in behaviour of tobacco distributors and, therefore, a fall in revenue from excise duties on tobacco (by almost 50% compared to 2013). This development was only partly anticipated in the 2014 Convergence Programme. On the other hand, higher-than-expected revenue was received in current taxes on income and wealth and in social contributions, which partly reflects better-than-projected macroeconomic and labour market conditions. On the expenditure side, government consumption increased more than expected due to a higher public sector wage bill and higher healthcare expenditure. Growth of public wages accelerated towards the end of the year, due to an increase in public sector wages by 3.5% in the central administration that was brought forward from January 2015 to November 2014. Furthermore, public investment increased significantly (by more than 17% compared to 2013) on the back of both increased absorption of EU funds and a rebound in investment financed from domestic sources. On the other hand, significant savings were achieved in social benefits.

The budgetary outcome in 2014 was also influenced by one-off measures. The 2014 Convergence Programme included a one-off revenue from the sale of mobile licences (0.2% of GDP) but could not include a one-off payment from the Deposit Insurance Fund (0.3% of GDP) on the expenditure side, since the decision to reclassify the Fund into the government sector was only taken in early 2015. The structural balance reached -1% of GDP in 2014, i.e. it was at the medium-term objective.

3.2. Target for 2015 and medium-term strategy

Target for 2015

The 2015 Convergence Programme targets a general government deficit of 1.9% of GDP in 2015. This is a lower target compared to the 2.3% of GDP foreseen in the 2014 programme[3]. It is apparent that the main difference stems from the revenue side and is partly related to a better macroeconomic outlook for 2015, compared to the 2014 Convergence Programme.

The revenue-to-GDP ratio is expected to increase by 0.2 pp to 40.3% in 2015 according to the programme, reflecting a projected surge in revenue from EU funds (which affects both

[3] Assessment of the difference between the two targets is partly distorted by changes in the statistical recording of some revenue and expenditure items in ESA 2010.

revenues and expenditures) as well as a significant increase in income from excise duties on tobacco products, as revenues normalise after the large fall in 2014. The main factor driving expenditure growth in 2015 is the projected surge in public investment by almost 30%, partly because of a significant increase in EU co-funded investment projects and partly because of expenditure on military equipment (0.2% of GDP). Overall, measures underpinning the 2015 deficit target are sufficiently specified.

The Commission 2015 spring forecast projects a slightly higher deficit of 2% of GDP in 2015, which is mainly due to higher expected government consumption. In fact, both the public sector wage bill and social transfers in kind are forecast to grow slightly more than envisaged by the programme.

The recalculated structural deficit[4] is expected to deteriorate by 0.3 pp to 1.3% of GDP, mainly reflecting the expansionary measures included in the 2015 budget. The Commission 2015 spring forecast projects a deterioration by 0.6 pp to 1.6% of GDP, which is higher than in the programme. The programme envisages an expenditure-increasing one-off measure amounting to 0.2% of GDP in 2015 while the Commission spring forecast does not include any one-off measures in 2015. The one-off measure included by the Czech authorities is related to the above-mentioned military expenditure (long-term lease of fighter jets, the value of which accrues almost entirely in 2015). This measure is not considered a one-off according to the Commission methodology.

The medium-term strategy

The objective of the programme is to bring the headline government deficit down from 1.9% of GDP in 2015 to 0.6% of GDP by the end of the programme horizon (2018), which according to the authorities' calculations[5] would ensure that the MTO is achieved by 2018. According to the recalculated structural balance, the MTO would be reached already in 2016. The programme mentions explicitly the MTO, which is set at a structural deficit of 1% of GDP and reflects the objectives of the Pact. The MTO has not changed compared to the previous programme.

The programme expects the headline government deficit to drop by 0.7 pp to 1.2% of GDP in 2016 and further to 0.8% in 2017 and to 0.6% of GDP in 2018. The programme targets for 2016 and 2017 are significantly lower compared to last year's programme, reflecting a lower baseline from 2015, better macroeconomic scenario (only in 2016) and new discretionary measures (see the Table with the main budgetary measures below). The planned fiscal adjustment is slightly front-loaded and concentrated mainly in 2016 and 2017. The recalculated structural balance is expected to improve gradually from -1.1% of GDP in 2016 to -0.8% of GDP in 2017 and further to -0.7 of GDP in 2018.

The budgetary targets are underpinned by measures which are to a large extent sufficiently specified, in particular on the revenue side. The revenue-to-GDP ratio is projected to decline by more than 1 pp between 2015 and 2016 which is however mainly due to the expected fall in current and capital transfers from the EU. A similar development can be observed on the expenditure side, where the drop in the expenditure-to-GDP ratio by almost 2 pps in 2016 is largely due to a fall in public investment reflecting an expected slowdown in the implementation of EU co-financed investment projects as well as lower military expenditure

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[4] Commission calculations on the basis of the information in the programme according to the commonly agreed methodology.

[5] The authorities' calculations do not follow the commonly agreed methodology.

compared to 2015. The expenditure-to-GDP ratio is projected to continue falling gradually over the programme horizon but no specific measures underpinning this trend are mentioned in the programme.

The Commission 2015 spring forecast expects the general government deficit to decrease by 0.3 pp to 1.5% of GDP in 2016 while the structural deficit is projected to remain unchanged at 1.6% of GDP. The main difference with respect to the programme scenario is due to the fact that the Commission forecast does not include the fiscal impact of the planned tax collection measures.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2014	2015		2016		2017	2018	Change: 2014-2018
	COM	COM	CP	COM	CP	CP	CP	CP
Revenue	**40.1**	**40.0**	**40.3**	**39.3**	**39.2**	**39.4**	**39.4**	**-0.7**
of which:								
- Taxes on production and imports	12.1	12.0	12.0	12.0	12.1	12.1	12.0	-0.1
- Current taxes on income, wealth, etc.	7.2	7.1	7.1	7.2	7.2	7.3	7.4	0.2
- Social contributions	14.7	14.6	14.6	14.5	14.6	14.8	14.8	0.1
- Other (residual)	6.0	6.3	6.6	5.6	5.3	5.2	5.2	-0.8
Expenditure	**42.0**	**42.0**	**42.1**	**40.8**	**40.5**	**40.3**	**40.0**	**-2.0**
of which:								
- Primary expenditure	40.7	40.8	40.9	39.6	39.4	39.2	38.9	-1.8
of which:								
Compensation of employees	7.1	7.1	7.1	7.0	7.0	6.9	6.7	-0.4
Intermediate consumption	4.9	4.8	4.8	4.7	4.7	4.6	4.5	-0.4
Social payments	18.9	18.7	18.7	18.5	18.5	18.4	18.3	-0.6
Subsidies	2.7	2.7	2.5	2.6	2.5	2.5	2.4	-0.3
Gross fixed capital formation	3.9	4.5	4.8	3.8	3.6	3.7	3.7	-0.2
Other (residual)	3.2	3.0	3.1	3.1	3.2	3.2	3.2	0.0
- Interest expenditure	1.3	1.2	1.2	1.2	1.1	1.1	1.1	-0.2
General government balance (GGB)	**-2.0**	**-2.0**	**-1.9**	**-1.5**	**-1.2**	**-0.8**	**-0.6**	**1.4**
Primary balance	**-0.7**	**-0.8**	**-0.7**	**-0.3**	**-0.1**	**0.3**	**0.5**	**1.2**
One-off and other temporary	-0.1	0.0	-0.2	0.0	0.0	0.0	0.0	0.1
GGB excl. one-offs	**-1.8**	**-2.0**	**-1.7**	**-1.5**	**-1.2**	**-0.8**	**-0.6**	**1.2**
Output gap[1]	-1.9	-0.9	-0.9	0.2	-0.2	0.0	0.3	2.2
Cyclically-adjusted balance[1]	-1.2	-1.6	-1.5	-1.6	-1.1	-0.8	-0.7	0.4
Structural balance (SB)[2]	**-1.0**	**-1.6**	**-1.3**	**-1.6**	**-1.1**	**-0.8**	**-0.7**	**0.3**
Structural primary balance[2]	0.3	-0.4	-0.1	-0.4	0.0	0.3	0.4	0.1

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology.

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

Source:

Convergence Programme (CP); Commission 2015 spring forecasts (COM); Commission calculations.

Measures underpinning the programme

The table below with the main budgetary measures provides an overview of the discretionary budgetary measures presented in the programme with a significant budgetary impact. It is apparent from the table that discretionary measures in 2015 are mostly deficit-increasing. The 2015 budget includes an increase in the public sector wage bill in the central administration by 3.5%, higher indexation of pensions, introduction of a second reduced VAT rate of 10% on books, medicines and child nutritional products, and a reintroduction of tax credits for working pensioners and families with two and more children. Apart from these measures, the programme also highlights a projected significant (almost 30%) increase in public investment, which is due to military expenditure related to the long-term lease of fighter jets and to increased absorption of EU funds.

Fiscal adjustment in the period 2016-18 relies predominantly on revenue measures, in particular on measures aimed at improving tax collection and fighting tax evasion. Two main measures in this area are planned to be implemented in the course of 2016, notably the introduction of electronic evidence of sales and VAT reporting. Both measures should contribute to increased revenue collection, although the largest impact is expected for VAT (about 1.2% of GDP cumulatively over the period 2016-2018).

The personal income tax, corporate income tax and social security contributions are expected to be boosted by the introduction of electronic evidence of sales, although to a lesser extent. Almost no discretionary measures are envisaged on the expenditure side. Nevertheless, the programme mentions continuous efforts to increase transparency and efficiency of public expenditure, in particular by centralised purchases of goods and equipment and establishment of a central registry of contracts and administrative buildings owned by the state.

The Commission 2015 spring forecast includes the discretionary measures for 2015 but does not consider the planned military expenditure as a one-off measure. Concerning the year 2016, the Commission forecast does not include the impact of tax collection measures, as they have not yet been adopted by the Czech authorities and their impact is, therefore, still uncertain and estimates in the Convergence Programme may be optimistic.

Main budgetary measures

Revenue	**Expenditure**
2014	
• Reduction of a special tax on photovoltaic power plants (-0.1% of GDP) • One-off revenue from sales of mobile licences (+0.2% of GDP) • Increase in excise duties on tobacco (+0.1% of GDP)	• Reimbursement of tax credit for working pensioners (+0.2% of GDP) • Increase in healthcare expenditure (+0.2% of GDP) • One-off payment from the Deposit Insurance Fund (+0.3 % of GDP) • Increase in the public sector wage bill (+0.1% of GDP) • Increase in subsidies for renewable energy sources (+0.1% of GDP)
2015	
• Introduction of a second reduced VAT rate (-0.1% of	• Increase in the public sector wage bill (+0.2% of

GDP) • Changes in personal income tax (-0.1% of GDP) • Increase in excise duties on tobacco (+0.1% of GDP) • Increase in social security contributions (+0.1% of GDP) • Other – not specified (-0.2% of GDP)	GDP) • Higher indexation of pensions (+0.1% of GDP) • Increase in healthcare expenditure (+0.1% of GDP) • One-off military expenditure related to a long-term lease of flighter jets (+0.2% of GDP)
2016	
• Increase in excise duties on tobacco (+0.1% of GDP) • Introduction of a lottery tax (+0.1% of GDP) • Increase in VAT resulting from tax collection measures (electronic evidence of sales) (+0.4% of GDP) • Increase in PIT, CIT and SSC revenue resulting from tax collection measures (+0.1% of GDP)	
2017	
• Increase in SSC – accident insurance and tax collection measures (+0.2% of GDP) • Increase in VAT resulting from tax collection measures (+0.1% of GDP) • Increase in PIT and CIT resulting from tax collection measures (+0.1% of GDP)	• Increase in social benefits – accident insurance (+0.1% of GDP)
2018	
• Increase in VAT resulting from tax collection measures (+0.1% of GDP)	
Note: The budgetary impact in the table is the impact reported in the programme, i.e. by the national authorities. A positive sign implies that revenue / expenditure increases as a consequence of this measure.	

3.3. Debt developments

The 2015 Convergence Programme projects a decreasing trend in the debt-to-GDP ratio from its peak in 2013 (45%). A significant fall in the debt ratio by more than 2 pps to 42.6% was registered in 2014. This development was mainly due to increased use of available liquidity in debt management. The Czech authorities plan to continue using additional available liquidity also in 2015. There are also plans to involve more government institutions in the centralised state treasury system (e.g. public research institutions, health insurance companies, etc.) that would allow to further reduce cash reserves. Overall, the debt-to-GDP ratio is projected to fall to 40.9% in 2015 and remain unchanged in 2016 according to the programme. This is slightly optimistic in view of the Commission 2015 spring forecast, which projects the debt ratio to hover around 41½ % in both 2015 and 2016 as it assumes somewhat higher headline deficits in both years and a somewhat lower use of available liquid assets for debt reduction. There is a significant difference in the debt projections compared to last year's Convergence Programme, when the debt ratio was projected to increase from 46% in 2013 to 47.1% in 2017. Several factors explain this change: lower deficit projections, higher nominal GDP projections and increased use of cash buffers and available liquidity. At the same time, the debt ratio was influenced by the reclassification of several financial institutions into the government sector, which took place in 2014 and led to an increase in gross debt by more than 1% of GDP.

Table 3: Debt developments

(% of GDP)	Average 2009-2013	2014	2015		2016		2017	2018
			COM	CP	COM	CP	CP	CP
Gross debt ratio[1]	**40.3**	**42.6**	**41.5**	**40.9**	**41.6**	**40.9**	**40.7**	**40.2**
Change in the ratio	3.3	-2.5	-1.1	-1.7	0.2	0.0	-0.2	-0.5
Contributions[2]:								
1. Primary balance	**2.2**	**0.7**	**0.8**	**0.7**	**0.3**	**0.1**	**-0.3**	**-0.5**
2. "Snow-ball" effect	**1.1**	**-0.6**	**-0.5**	**-0.7**	**-0.5**	**-0.5**	**-0.3**	**-0.4**
Of which:								
Interest expenditure	1.3	1.3	1.2	1.2	1.2	1.1	1.1	1.1
Growth effect	0.1	-0.9	-1.0	-1.1	-1.0	-1.0	-0.9	-0.9
Inflation effect	-0.3	-1.0	-0.7	-0.8	-0.6	-0.6	-0.5	-0.6
3. Stock-flow adjustment	**-0.1**	**-2.5**	**-1.3**	**-1.7**	**0.3**	**0.4**	**0.5**	**0.4**
Of which:								
Cash/accruals diff.				0.1		0.0	0.0	0.0
Acc. financial assets				-1.7		0.3	0.4	0.4
Privatisation				0.0		0.0	0.0	0.0
Val. effect & residual				0.0		0.0	0.0	0.0

Notes:

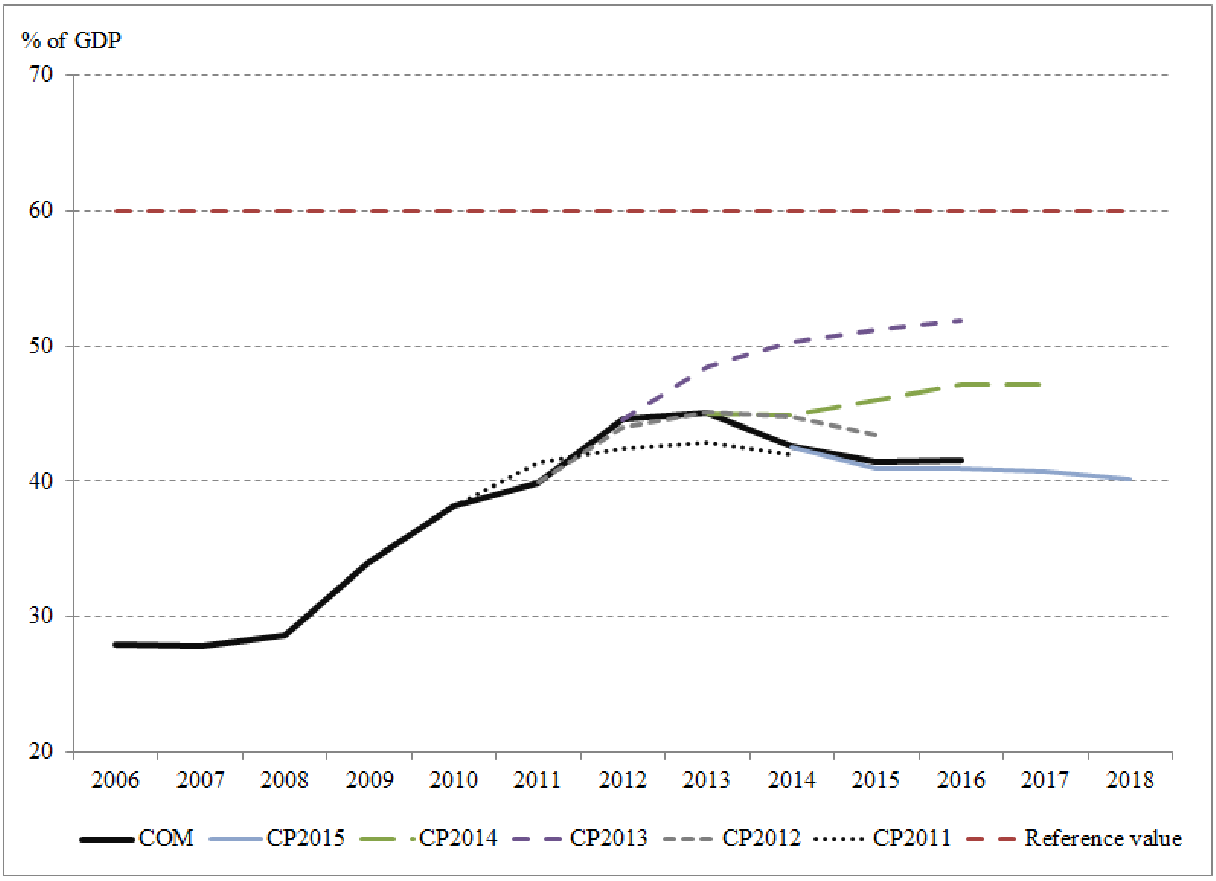
[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source:

Commission 2015 spring forecast (COM); Convergence Programme (CP), Comission calculations.

Figure 1: Government balance projections in successive programmes (% of GDP)



Source: Commission 2015 spring forecast; Convergence Programmes

3.4. Risk assessment

There are several risks that point to higher deficits than what is presented in the Convergence Programme. In particular, the projected fiscal impact of the planned measures to improve tax collection (particularly revenue from VAT) appears rather optimistic, in particular in the first year of their planned implementation[6]. While the envisaged measures have a potential to contribute to better tax collection, their implementation in practice appears to be rather complex and may be subject to delays.

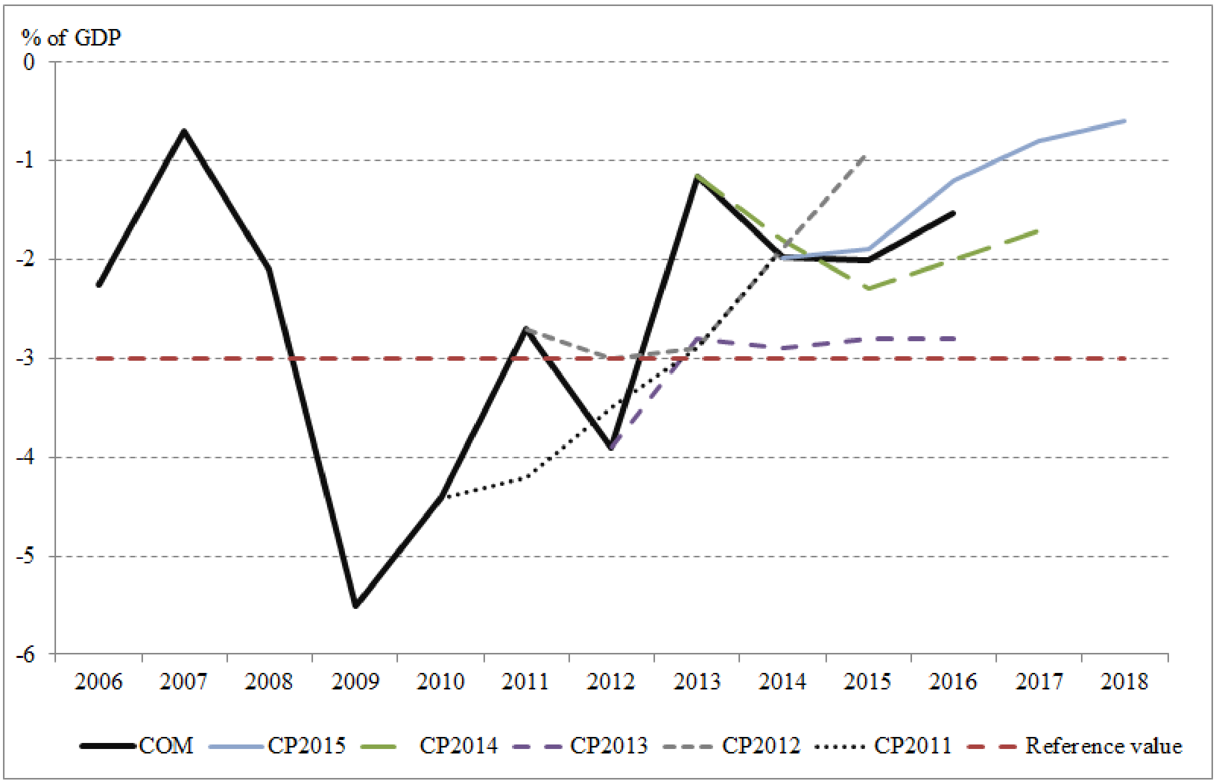
Moreover, projections of government expenditure, and in particular of government consumption, are also subject to risks. The future development of the public sector wage bill depends on the implementing provisions of the new Civil Service Act, which are currently under discussion and may lead to higher wage growth than assumed by the programme (in particular after 2016). Also, intermediate consumption as a share of GDP has fallen quite sharply since 2009 and a further decrease is conditional on the effectiveness of the envisaged measures (in particular the centralised government purchases).

Finally, given the high volatility of public investment in recent years, there is high uncertainty about its future development. Public investment projections in the programme are based on the assumption of a significant increase in absorption of EU funds in 2015, a subsequent sharp fall in 2016, and a moderate growth thereafter. The magnitude of these developments is

[6] The above mentioned VAT reporting has already been adopted and should be implemented from January 2016. Electronic evidence of sales is currently in the legislative process.

however subject to a risk as successful implementation of EU projects depends on the stage of their preparation and the absorption capacity. In addition, while public investment by municipalities increased significantly in 2014 after several years of retrenchment, forecasts of its future development are complicated by the fact that information on investment plans is not easily available. As shown in Figure 2, the Czech authorities have mostly overachieved their own deficit targets in recent years, which was however partly due to unexpected retrenchment in public investment, in particular in the period 2010-2013.

Figure 2: Government balance projections in successive programmes (% of GDP)



Source: Commission 2015 spring forecast; Convergence Programmes

4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

Following the correction of the excessive deficit in 2013, The Czech Republic is currently in the preventive arm of the Stability and Growth Pact and should remain at its MTO.

Box 1. Council recommendations addressed to the Czech Republic

On 8 July 2014, the Council addressed recommendations to the Czech Republic in the context of the European Semester. In particular, in the area of public finances the Council recommended that the Czech Republic, following the correction of its excessive deficit, preserve a sound fiscal position in 2014. The Czech Republic was also recommended to: (a) significantly strengthen the budgetary strategy in 2015 to ensure that the medium-term objective is achieved and remain at the medium-term objective thereafter; (b) prioritise growth-enhancing expenditure to support the recovery and improve growth prospects; and (c) adopt and implement measures to strengthen the fiscal framework, and in particular to establish an independent fiscal institution to monitor fiscal policies, to introduce fiscal rules for local and regional governments and to improve coordination between all layers of government.

In 2014, the Czech Republic complied with the requirements of the preventive arm of the Stability and Growth Pact. The structural balance was at the MTO (a deficit of 1% of GDP) and net expenditure growth was lower than the applicable expenditure benchmark.

According to the information provided by the Convergence Programme, the growth rate of government expenditure, net of discretionary measures, in 2015 will not exceed the applicable expenditure benchmark rate (1.6% of GDP). The (recalculated) structural balance indicator does not point to any deviation from the MTO in 2015. Both the expenditure benchmark and the structural balance indicator are respected also over the years 2014 and 2015 taken together. In 2016, the recalculated structural balance is expected to be at the MTO (i.e. within the applicable margin) according to the programme scenario[7] suggesting compliance with the preventive arm of the Pact.

Based on the Commission spring 2015 forecast, the structural balance is expected to deteriorate by 0.6 pp of GDP in 2015, resulting in some deviation from the MTO (gap of 0.3% of GDP). At the same time, the Czech Republic is expected to be compliant with the expenditure benchmark (projected net expenditure growth is 0.6% of GDP lower than the benchmark), warranting an overall assessment. A similar although somewhat narrower difference between the two pillars occurs over the years 2014 and 2015 taken together. The difference between the two indicators is due primarily to two factors. First, the apparent revenue elasticity is lower than the standard one, which means that revenue shortfalls are contributing to the deterioration of the structural balance. This may be partly due to temporary volatility in certain tax categories, in particular in excise duties on tobacco products, and partly to a less tax-rich recovery as revenue from both the personal income tax and the corporate income tax are expected to be lower than suggested by the standard elasticity. Second, the structural effort is affected by the volatility of investment, which is not the case for the assessment based on the expenditure pillar due to the smoothing (four year averaging) of investment expenditure applied under this method. As mentioned earlier, public investment is projected to increase significantly in 2015 after several years of negative growth, partly as a result of expenditure in military equipment which will not be repeated in the coming years, and partly because of the projected increase in investment co-financed by EU funds. Overall, the expenditure benchmark is considered a more relevant indicator of the fiscal stance, suggesting compliance with the requirements in 2015.

In 2016, the Commission 2015 Spring forecast projects the structural balance to remain unchanged at -1.6% of GDP, pointing to a risk of some deviation from the required 0.5% of GDP adjustment towards the MTO (gap of 0.47% of GDP). The expenditure benchmark also points to a risk of some deviation (gap of 0.3% of GDP). The average deviation of the structural balance from the required adjustment over the years 2015 and 2016 taken together is significant (gap of 0.4% of GDP), reflecting revenue shortfalls in both years, while the expenditure benchmark is complied with over the two-year horizon. The assessment based on the Commission 2015 Spring forecast data thus points to some deviation from the required adjustment path towards the MTO in 2016.

[7] Table 4 shows that the structural balance indicator points to some deviation from the required adjustment after considering the relevant factors (gap of 0.3% of GDP). The (corrected) required adjustment in Table 4 is based on the Commission 2015 spring forecast. If it were based on the programme scenario, there would be no deviation from the MTO in 2016.

Table 4: Compliance with the requirements under the preventive arm

(% of GDP)	2014	2015		2016	
Initial position[1]					
Medium-term objective (MTO)	-1.0	-1.0		-1.0	
Structural balance[2] (COM)	-1.0	-1.6		-1.6	
Structural balance based on freezing (COM)	-0.7	-1.6		-	
Position vis-a -vis the MTO[3]	At or above the MTO	At or above the MTO		Not at MTO	
(% of GDP)	**2014**	**2015**		**2016**	
	COM	**CP**	**COM**	**CP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.0	0.0		0.5	
Required adjustment corrected[5]	-1.2	-0.3		0.5	
Change in structural balance[6]	-1.2	-0.3	-0.6	0.2	0.0
One-year deviation from the required adjustment [7]	0.0	0.0	-0.3	-0.3	-0.5
Two-year average deviation from the required adjustment [7]	In EDP	0.0	-0.2	-0.2	-0.4
Expenditure benchmark pillar					
Applicable reference rate[8]	n.a.	2.3		0.5	
One-year deviation [9]		0.6	0.6	-0.8	-0.3
Two-year average deviation [9]	In EDP	0.5	0.5	-0.1	0.2
Conclusion					
Conclusion over one year	Compliance	Compliance	Overall assessment	Overall assessment	Overall assessment
Conclusion over two years	In EDP	Compliance	Overall assessment	Overall assessment	Overall assessment

Notes

[1] The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance = cyclically-adjusted government balance excluding one-off measures.

[3] Based on the relevant structural balance at year t-1.

[4] Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 28.).

[5] Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.

[6] Change in the structural balance compared to year t-1.

[7] The difference of the change in the structural balance and the required adjustment corrected.

[8] Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is not at its MTO.

[9] Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

Source :

Convergence Programme (CP); Commission 2015 spring forecasts (COM); Commission calculations.

The difference between the assessment based on the programme data (compliance in 2016) and the one based on the Commission 2015 spring forecast (some deviation in 2016) is mainly due to the fact that the Commission forecast, in line with the no-policy-change assumption, does not include revenue from the planned tax collection measures. As mentioned in Section 3.4, the implementation and the estimated fiscal impact of these measures are subject to some risks.

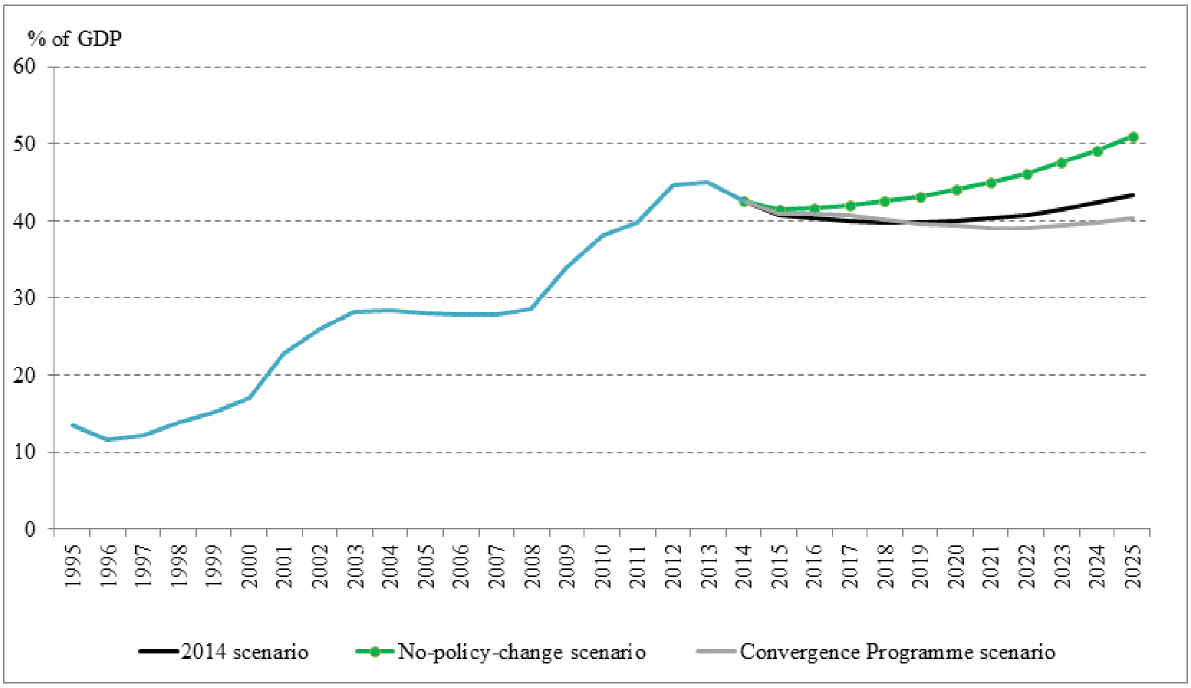
To conclude, following an overall assessment, the adjustment path towards the MTO seems to be appropriate and compliant with the requirement of the preventive arm of the Pact in 2015. In 2016, there is a risk of some deviation from the adjustment path towards the MTO.

5. Long-term sustainability

The analysis in this section includes the new long-term budgetary projections of age-related expenditure (pension, health care, long-term care, education and unemployment benefits) from the 2015 Ageing Report[8] published on 12 May. It therefore updates the assessment made in the Country Reports[9] published on 26 February.

Government debt stood at 42.6% of GDP in 2014. As shown in Figure 3, it is expected to rise gradually (to 50.9% in 2025) but still remain below the 60% of GDP Treaty threshold. The full implementation of the programme would put debt on a decreasing path by 2030, remaining below the 60% of GDP reference value in 2025.

Figure 3: Gross Debt as % of GDP – Medium-Term Debt Projections



The Czech Republic appears to face low fiscal sustainability risks in the medium-term (sustainability gap of 0). In the long-term, the Czech Republic appears to face medium fiscal sustainability risks, primarily related to the projected ageing costs contributing with 2.5 pp of GDP. The long-term sustainability gap, which shows the adjustment effort needed to ensure that the debt-to-GDP ratio is not on an ever-increasing path, is at 3.5 % of GDP. The contribution of pension expenditure to the long-term sustainability gap amounts to 0.6% of

[8] See http://ec.europa.eu/economy_finance/publications/european_economy/2015/ee3_en.htm

[9] See http://ec.europa.eu/europe2020/making-it-happen/country-specific-recommendations/index_en.htm

GDP over 2016-2060 (i.e. some 0.5 pp higher than the EU average). The contribution of healthcare expenditure amounts to 0.8% of GDP and is 0.1 pp higher than the EU average. It is therefore appropriate for the Czech Republic to continue to implement measures that reduce risks to fiscal sustainability. Further containing age-related expenditure growth appears necessary in order to contribute to the sustainability of public finances in the long term.

Table 5: Sustainability indicators

	Czech Republic			European Union		
	2014 scenario	**No-policy-change scenario**	**Convergence Programme scenario**	**2014 scenario**	**No-policy-change scenario**	**Stability/ Convergence Programme scenario**
S2*	2.7	3.5	2.7	1.4	1.7	0.4
of which:						
Initial budgetary position (IBP)	0.3	1.0	0.4	0.4	0.5	-0.7
Long-term cost of ageing (CoA)	2.5	2.5	2.3	1.0	1.1	1.1
of which:						
pensions	0.6	0.6	0.6	0.0	0.1	0.1
healthcare	0.8	0.8	0.8	0.8	0.7	0.6
long-term care	0.5	0.5	0.5	0.7	0.7	0.6
others	0.6	0.5	0.4	-0.4	-0.3	-0.2
S1**	-0.8	0.0	-1.6	1.4	1.8	0.5
of which:						
Initial budgetary position (IBP)	-0.5	0.5	-0.7	-0.4	-0.3	-1.6
Debt requirement (DR)	-1.1	-1.3	-1.6	1.7	1.9	1.8
Long-term cost of ageing (CoA)	0.7	0.8	0.6	0.1	0.3	0.4
S0 (risk for fiscal stress)***	0.09	:		:		
Fiscal subindex	0.11	:		:		
Financial-competitiveness subindex	0.08	:		:		
Debt as % of GDP (2014)	42.6			88.6		
Age-related expenditure as % of GDP (2014)	19.1			25.6		

Source: Commission, 2015 Convergence Programme

Note: the '2014' scenario depicts the sustainability gap under the assumption that the structural primary balance position remains at the 2014 position according to the Commission 2015 spring forecast; the 'no-policy-change' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commission 2015 spring forecast until 2016. The 'stability programme' scenario depicts the sustainability gap under the assumption that the budgetary plans in the programme are fully implemented over the period covered by the programme. Age-related expenditure as given in the 2015 Ageing Report.

* The long-term sustainability gap (S2) indicator shows the immediate and permanent adjustment required to satisfy an inter-temporal budgetary constraint, including the costs of ageing. The S2 indicator has two components: i) the initial budgetary position (IBP) which gives the gap to the debt stabilising primary balance; and ii) the additional adjustment required due to the costs of ageing. The main assumption used in the derivation of S2 is that in an infinite horizon, the growth in the debt ratio is bounded by the interest rate differential (i.e. the difference between the nominal interest and the real growth rates); thereby not necessarily implying that the debt ratio will fall below the EU Treaty 60% debt threshold. The following thresholds for the S2 indicator were used: (i) if the value of S2 is lower than 2, the country is assigned low risk; (ii) if it is between 2 and 6, it is assigned medium risk; and, (iii) if it is greater than 6, it is assigned high risk.

** The medium-term sustainability gap (S1) indicator shows the upfront adjustment effort required, in terms of a steady adjustment in the structural primary balance to be introduced over the five years after the foercast horizon, and then sustained, to bring debt ratios to 60% of GDP in 2030, including financing for any additional expenditure until the target date, arising from an ageing population. The following thresholds were used to assess the scale of the sustainability challenge: (i) if the S1 value is less than zero, the country is assigned low risk; (ii) if a structural adjustment in the primary balance of up to 0.5 p.p. of GDP per year for five years after the last year covered by the spring 2015 forecast (year 2016) is required (indicating an cumulated adjustment of 2.5 pp.), it is assigned medium risk; and, (iii) if it is greater than 2.5 (meaning a structural adjustment of more than 0.5 p.p. of GDP per year is necessary), it is assigned high risk.

*** The S0 indicator reflects up to date evidence on the role played by fiscal and financial-competitiveness variables in creating potential fiscal risks. It should be stressed that the methodology for the S0 indicator is fundamentally different from the S1 and S2 indicators. S0 is not a quantification of the required fiscal adjustment effort like the S1 and S2 indicators, but a composite indicator which estimates the extent to which there might be a risk for fiscal stress in the short-term. The critical threshold for the overall S0 indicator is 0.43. For the fiscal and the financial-competitiveness sub-indexes, thresholds are respectively at 0.35 and 0.45.

As highlighted in the 2015 Country Report, the Czech authorities plan to implement some measures in both the pension and the healthcare systems. The government is currently working on the proposal of a review mechanism introducing a link between the statutory retirement age and life expectancy. In addition, discussions are ongoing in an advisory body set up by the government (the Expert Committee on Pension Reform) with the aim of introducing further reforms of the pension system. The impact of possible measures on the long-term sustainability of public finances is, however, unclear. In the area of healthcare, the focus should be on introduction of incentives promoting cost-effectiveness of medical treatment and rolling out of a reimbursement system for costs incurred by hospitals. Measures are being taken to improve the cost efficiency and governance of the healthcare sector, although many of them are still under preparation, including addressing shortcomings in the current hospital funding scheme, increasing transparency in service delivery contracts and introduction of the centralised public procurement in the healthcare sector.

6. FISCAL FRAMEWORK AND QUALITY OF PUBLIC FINANCES10

6.1. Fiscal framework

As mentioned in the 2015 Country Report on the Czech Republic, the current fiscal framework includes important elements, such as a numerical fiscal rule and medium-term budgetary planning, but the scope is limited and enforcement has been weak.

A comprehensive reform of the fiscal framework is currently underway and is also meant to transpose into national legislation key elements of the Council Directive 2011/85/EU on budgetary frameworks. The reform package has been approved by the government in February 2015 and is currently under discussion in parliament. The Convergence Programme provides a detailed overview of its main elements as well as other measures aimed at strengthening transparency and efficiency of public finances (open data portal, new act on management and financial control in public administration, etc.). The key elements of the reform package on fiscal frameworks include a modified expenditure rule that is consistent with the medium-term objective, the introduction of debt rules for the general government and for local governments, and establishment of an independent fiscal council. Macroeconomic forecasts underpinning the medium-term budgetary plans are currently produced by the Ministry of Finance and they are not reviewed by external independent bodies. The reform package envisages establishing a "Committee for budgetary projections" whose members would be nominated by the fiscal council and appointed by the government. The Committee would regularly assess macroeconomic and fiscal projections of the Ministry of Finance.

6.2. Quality of public finances

The Convergence Programme outlines several measures aimed at improving the quality of public finances both on the revenue and the expenditure side. The programme reiterates that the key priority for the Czech authorities is improving tax collection and reducing tax evasion. Measures in this area include, in particular, the introduction of electronic evidence of sales, VAT reporting (both planned for 2016), strengthened international co-operation and an extended reverse charge mechanism. As mentioned in the 2015 Country Report, progress in other areas, such as harmonisation of tax bases, reducing the cost of tax administration and reducing tax burden on labour, has been limited and no significant changes are currently planned in these areas.

Measures envisaged on the expenditure side, such as centralised government purchases or the establishment of the central register of contracts, would contribute to improving cost-efficiency of public expenditure. However, it is necessary that they are adopted without further delays and that appropriate implementation at all levels is ensured.

[10] This section complements the Country Report published on 26 February 2015 and updates it with the information included in the Convergence programme.

7. CONCLUSIONS

In 2014, the Czech Republic achieved a structural deficit of 1% of GDP, thus achieving its MTO. The growth rate of government expenditure, net of discretionary revenue measures was below the applicable expenditure benchmark rate. The Czech Republic thus complied with the requirements of the preventive arm of the Stability and Growth Pact in 2014.

Based on data in the Convergence Programme, the recalculated structural deficit is projected to deteriorate by 0.3 pp in 2015 and return to the MTO in 2016. According to the Commission 2015 spring forecast, the overall assessment points to compliance with the requirements of the preventive arm of the Stability and Growth Pact in 2015 while there is a risk of some deviation from the required adjustment of 0.5 pp of GDP in 2016.

ANNEX

Table I. Macroeconomic indicators

	1997-2001	2002-2006	2007-2011	2012	2013	2014	2015	2016
Core indicators								
GDP growth rate	1.6	4.7	1.5	-0.8	-0.7	2.0	2.5	2.6
Output gap [1]	-1.2	1.6	1.4	-1.8	-2.8	-1.9	-0.9	0.2
HICP (annual % change)	5.6	1.5	2.6	3.5	1.4	0.4	0.2	1.4
Domestic demand (annual % change) [2]	1.3	3.8	1.0	-2.2	-0.7	2.2	2.9	2.4
Unemployment rate (% of labour force) [3]	7.4	7.7	6.1	7.0	7.0	6.1	5.6	5.5
Gross fixed capital formation (% of GDP)	30.6	28.5	27.8	26.1	24.9	25.3	25.8	25.6
Gross national saving (% of GDP)	27.6	25.7	24.1	24.1	22.8	24.2	25.9	26.3
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	**-4.1**	**-4.2**	**-3.1**	**-3.9**	**-1.2**	**-2.0**	**-2.0**	**-1.5**
Gross debt	**16.2**	**27.7**	**33.7**	**44.6**	**45.0**	**42.6**	**41.5**	**41.6**
Net financial assets	**30.9**	**11.1**	**2.7**	**-11.0**	**n.a**	**n.a**	**n.a**	**n.a**
Total revenue	37.3	39.4	38.7	39.9	40.8	40.1	40.0	39.3
Total expenditure	41.4	43.5	41.8	43.8	41.9	42.0	42.0	40.8
of which: Interest	0.9	1.1	1.2	1.4	1.3	1.3	1.2	1.2
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	**-1.3**	**-1.4**	**-1.9**	**-1.0**	**0.1**	**1.2**	**2.7**	**2.2**
Net financial assets; non-financial corporations	**-110.4**	**-94.3**	**-90.4**	**-85.2**	**n.a**	**n.a**	**n.a**	**n.a**
Net financial assets; financial corporations	**1.7**	**-2.4**	**-3.1**	**-2.7**	**n.a**	**n.a**	**n.a**	**n.a**
Gross capital formation	21.6	19.2	18.5	17.9	17.1	17.0	17.0	17.7
Gross operating surplus	28.1	28.5	29.6	28.6	29.0	31.2	31.8	32.1
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	**2.1**	**1.9**	**1.8**	**3.8**	**1.2**	**1.5**	**1.6**	**1.4**
Net financial assets	**70.5**	**62.9**	**58.1**	**65.4**	**n.a**	**n.a**	**n.a**	**n.a**
Gross wages and salaries	29.8	30.2	30.3	31.3	31.1	30.3	30.0	29.8
Net property income	4.9	3.7	3.5	3.2	2.9	2.6	2.1	2.0
Current transfers received	16.1	16.3	17.3	18.3	18.0	17.6	17.3	17.2
Gross saving	6.6	6.1	6.6	6.3	5.3	5.4	5.2	5.0
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	**-3.3**	**-3.7**	**-3.2**	**-1.2**	**0.0**	**1.0**	**2.3**	**2.0**
Net financial assets	**7.7**	**22.8**	**33.3**	**34.3**	**n.a**	**n.a**	**n.a**	**n.a**
Net exports of goods and services	-1.6	0.7	3.1	5.0	5.8	6.9	7.6	8.1
Net primary income from the rest of the world	-1.8	-4.4	-7.0	-6.3	-7.1	-6.7	-6.6	-6.7
Net capital transactions	0.1	0.3	1.5	1.0	2.2	1.8	1.9	1.4
Tradable sector	54.6	53.3	51.4	51.4	50.9	52.5	n.a	n.a
Non tradable sector	36.7	37.8	39.2	38.6	38.8	38.1	n.a	n.a
of which: Building and construction sector	6.3	5.9	6.0	5.2	5.0	4.8	n.a	n.a
Real effective exchange rate (index, 2000=100)	62.3	82.5	98.9	99.8	96.9	92.0	89.7	89.4
Terms of trade goods and services (index, 2000=100)	98.6	102.7	100.3	97.9	99.0	100.5	102.1	102.6
Market performance of exports (index, 2000=100)	59.5	77.1	97.5	107.4	105.2	110.0	111.8	113.1

Notes:

[1] The output gap constitutes the gap between the actual and potential gross domestic product at 2005 market prices.

[2] The indicator on domestic demand includes stocks.

[3] Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.

Source :
Commission 2015 spring forecast