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Assessment of the 2016 Convergence Programme for

Czech Republic

(Note prepared by DG ECFIN staff)

CONTENTS

1. INTRODUCTION

The following document assesses the Czech Republic's 2016 Convergence Programme (hereafter called Convergence Programme), which was approved by the government and submitted to the Commission with delay on 11 May. It covers the period 2015-2019.

The Czech Republic is subject to the preventive arm of the Stability and Growth Pact (SGP) and should preserve a sound fiscal position that ensures compliance with the medium-term budgetary objective.

This document complements the Country Report published on 26 February 2016 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 2016 spring forecast. The following section presents the recent and planned budgetary developments, according to the Convergence Programme. In particular, it includes an overview on the medium-term budgetary plans, an assessment of the measures underpinning the Convergence Programme and a risk analysis of the budgetary plans based on the Commission 2016 spring forecast. Section 4 assesses compliance with the rules of the SGP, including an assessment on the basis of the Commission forecast. Section 5 provides an overview on long-term sustainability risks. Section 6 provides an overview of recent developments and plans regarding the fiscal framework and the quality of public finances. Section 7 provides a summary.

2. MACROECONOMIC DEVELOPMENTS

The macroeconomic scenario in the Convergence Programme projects a slowdown in real GDP growth in 2016 followed by a slight acceleration in 2017. Following exceptionally high growth of 4.2% in 2015, mainly due to a substantial drawdown of EU funds, real GDP is expected to increase by 2.5% in 2016 and by 2.6% in 2017. In 2016, growth is expected to largely be driven by private consumption, reflecting growth of real disposable income and a declining savings rate. Gross fixed capital formation, public consumption and net exports are also expected to contribute positively to real GDP growth. All of these factors are expected to contribute positively to growth also in 2017, with a higher contribution from gross fixed capital formation.

The output gap as recalculated by the Commission based on information in the programme, following the commonly agreed methodology, is expected to have almost closed in 2015 and to be slightly positive in 2016 and 2017.[1] This profile is similar to the output gap implied by the Commission 2016 spring forecast, although the Commission estimates a more positive output gap, in particular in 2017.

Compared to the Commission 2016 spring forecast, the programme projects a higher rate of real GDP growth in 2016 but the same rate in 2017. The difference in 2016 is mainly due to the fact that the programme forecasts an increase in gross fixed capital formation while the Commission 2016 spring forecast projects a fall, driven by a substantial decline in public investment. The programme also forecasts a slightly higher growth rate of private consumption than the Commission 2016 spring forecast. At the same time, the Commission

[1] In contrast, the output gap taken at face value as presented in the programme is already slightly positive in 2015.

2016 spring forecast projects a larger increase in public consumption than the programme. The programme scenario does not include the impact of any structural reforms.

Overall, the programme's assumptions for real GDP growth are plausible in both 2016 and 2017, despite the fact that there are differences in composition compared to the Commission forecast. The programme's assumption for the contribution of gross fixed capital formation is favourable in 2016, whereas the programme's assumption for the contribution of public consumption is cautious for the same year.

Table 1: Comparison of macroeconomic developments and forecasts

	2015		2016		2017		2018	2019
	COM	CP	COM	CP	COM	CP	CP	CP
Real GDP (% change)	4.2	4.2	2.1	2.5	2.6	2.6	2.4	2.4
Private consumption (% change)	2.8	2.8	2.8	3.1	2.7	2.7	2.4	2.3
Gross fixed capital formation (% change)	7.3	7.3	-0.5	0.6	3.0	3.0	3.1	3.1
Exports of goods and services (% change)	7.0	7.0	5.7	5.5	5.4	5.9	6.0	6.0
Imports of goods and services (% change)	7.9	7.9	5.8	5.6	5.7	6.1	6.1	6.1
Contributions to real GDP growth:								
- Final domestic demand	3.7	3.7	1.8	2.1	2.4	2.4	2.2	2.1
- Change in inventories	0.7	0.7	0.0	0.1	0.0	0.0	0.0	0.0
- Net exports	-0.2	-0.2	0.3	0.2	0.2	0.2	0.3	0.4
Output gap[1]	0.0	-0.1	0.2	0.1	0.7	0.2	0.3	0.4
Employment (% change)	1.2	1.2	0.4	0.5	0.3	0.1	0.1	0.1
Unemployment rate (%)	5.1	5.1	4.5	4.4	4.4	4.3	4.2	4.2
Labour productivity (% change)	3.0	3.0	1.7	1.9	2.3	2.5	2.4	2.4
HICP inflation (%)	0.3	0.3	0.5	0.6	1.4	1.5	1.8	1.9
GDP deflator (% change)	0.7	0.7	1.0	1.0	1.3	1.3	1.6	1.8
Comp. of employees (per head, % change)	2.4	2.4	3.2	3.3	3.6	4.4	4.5	4.5
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	1.1	1.1	0.3	-0.4	0.5	-0.3	0.0	0.3

Note:

[1]In % 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 2016 spring forecast (COM); Convergence Programme (CP).

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. Deficit developments in 2015

The Czech Republic recorded a general government deficit of 0.4% of GDP in 2015, which is a substantially better outcome compared to the 1.9% of GDP deficit forecast in the 2015 Convergence Programme. Part of the fiscal improvement was due to an exceptionally high absorption rate of EU funds, which boosted GDP growth and contributed to a swift closing of the output gap. The headline deficit was also positively impacted by one-off revenues received by the Deposit Insurance Fund, which are related to a winding-up of lawsuits from bankruptcy claims.
On the revenue side, total revenue was higher by 1.9% of GDP compared to the 2015 Convergence Programme forecast. In particular, corporate taxes and taxes on production provided the strongest boost. Corporate taxes recorded an increase of 6.8% year-on-year, mirroring the strong growth of the economy and outperforming the estimate from the 2015 Convergence Programme. Tobacco duties grew strongly in 2015, bouncing back from a low level due to limited pre-stocking of tobacco products in 2014.[2] VAT revenues grew despite the introduction of an additional lower tax bracket for certain goods.

Overall expenditure also increased compared to expectations in the 2015 Convergence Programme by 0.5% of GDP. The increase was driven by co-financing of public investment financed by EU funds, which rose significantly as the 2007-2013 programming period came to a close. The public investment growth figures were broadly in line with the 2015 Convergence Programme but the structure was different. National investment grew at a much slower pace compared to investment financed through EU sources, which resulted in an improvement of the headline deficit (EU-funded investment increase the deficit only by the amount of domestic co-financing). Interest expenditure decreased due to favourable financial market borrowing conditions. Robust growth of government spending, driven by an increase in the wage bill and strong intermediate consumption, was not fully captured ex ante in the 2015 Convergence Programme. On the other hand, social payments declined by 2.8% of GDP compared to the 2015 Convergence Programme.

The budgetary outcome in 2015 was positively influenced by one-off revenues received by the Deposit Insurance Fund (0.1% of GDP). On the other hand, a one-off refund from already collected taxes on emission allowances increased expenditures (0.1% of GDP) as it had to be reimbursed to companies according to a national court ruling. The Czech authorities also include a one-off measure related to a long-term lease of military expenditure (0.2% of GDP), which is not considered a one-off measure according to the Commission methodology[3].

[2] As a result of shortening of the permitted period for sales of tobacco products purchased with the previous lower exercise duty rates, tobacco distributors limited their pre-stocking in 2014 which translated into a drop in revenues.

[3] As specified in the 2015 Report on Public Finances in EMU, expenditure on military equipment are considered a structural expenditure.

3.2. Medium-term strategy and targets

The Convergence Programme aims at continuing to meet its medium-term objective (MTO) - a structural deficit of 1% of GDP - over the programme horizon. The Czech Republic, having achieved a structural balance well above its MTO in 2015, plans to use its fiscal space over the coming two years while remaining above the MTO. After 2017, the fiscal stance would again turn slightly more restrictive. The MTO is more stringent than that required by the SGP.

The recalculated structural balance[4] in 2016 (Table 2) points to a deterioration by 0.1 pps mainly due to the worsening of the headline deficit. A further worsening of the (recalculated) structural balance by 0.2 pps is expected in 2017. This would be still in line with the Czech MTO.

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

Table 2: Composition of the budgetary adjustment

(% of GDP)	2015	2016		2017		2018	2019	Change: 2015-2019
	COM	COM	CP	COM	CP	CP	CP	CP
Revenue	**42.2**	**40.7**	**40.6**	**40.7**	**40.7**	**40.5**	**40.2**	**-2.0**
of which:								
- Taxes on production and imports	12.5	12.5	12.4	12.5	12.4	12.3	12.1	-0.4
- Current taxes on income, wealth, etc.	7.4	7.3	7.3	7.4	7.5	7.6	7.6	0.2
- Social contributions	14.8	15.0	14.9	15.0	15.1	15.2	15.2	0.4
- Other (residual)	7.5	5.9	5.9	5.8	5.7	5.5	5.3	-2.2
Expenditure	**42.6**	**41.4**	**41.2**	**41.3**	**41.2**	**41.0**	**40.6**	**-2.0**
of which:								
- Primary expenditure	41.5	40.4	40.2	40.3	40.2	40.0	39.7	-1.9
of which:								
Compensation of employees	8.9	9.0	8.9	9.1	9.0	9.0	8.9	0.0
Intermediate consumption	6.4	6.5	6.4	6.3	6.3	6.2	6.2	-0.2
Social payments	15.9	16.0	15.8	15.9	15.7	15.6	15.5	-0.4
Subsidies	2.3	2.3	2.3	2.3	2.3	2.3	2.3	0.0
Gross fixed capital formation	5.2	3.8	4.0	3.9	4.0	4.1	4.1	-1.1
Other (residual)	2.8	2.8	2.7	2.8	2.8	2.8	2.6	-0.2
- Interest expenditure	1.1	1.0	1.0	1.0	1.0	1.0	1.0	-0.1
General government balance (GGB)	**-0.4**	**-0.7**	**-0.6**	**-0.6**	**-0.5**	**-0.5**	**-0.5**	**0.0**
Primary balance	**0.7**	**0.3**	**0.4**	**0.4**	**0.5**	**0.5**	**0.5**	**-0.1**
One-off and other temporary	0.0	0.0	-0.1	0.0	0.0	0.1	0.0	0.0
GGB excl. one-offs	**-0.4**	**-0.7**	**-0.5**	**-0.6**	**-0.6**	**-0.5**	**-0.5**	**0.0**
Output gap[1]	0.0	0.2	0.1	0.7	0.2	0.3	0.4	0.4
Cyclically-adjusted balance[1]	-0.4	-0.8	-0.6	-0.9	-0.6	-0.6	-0.6	-0.2
Structural balance[2]	**-0.4**	**-0.7**	**-0.5**	**-0.9**	**-0.7**	**-0.7**	**-0.6**	**-0.2**
Structural primary balance[2]	0.6	0.3	0.5	0.1	0.3	0.3	0.4	-0.3

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.

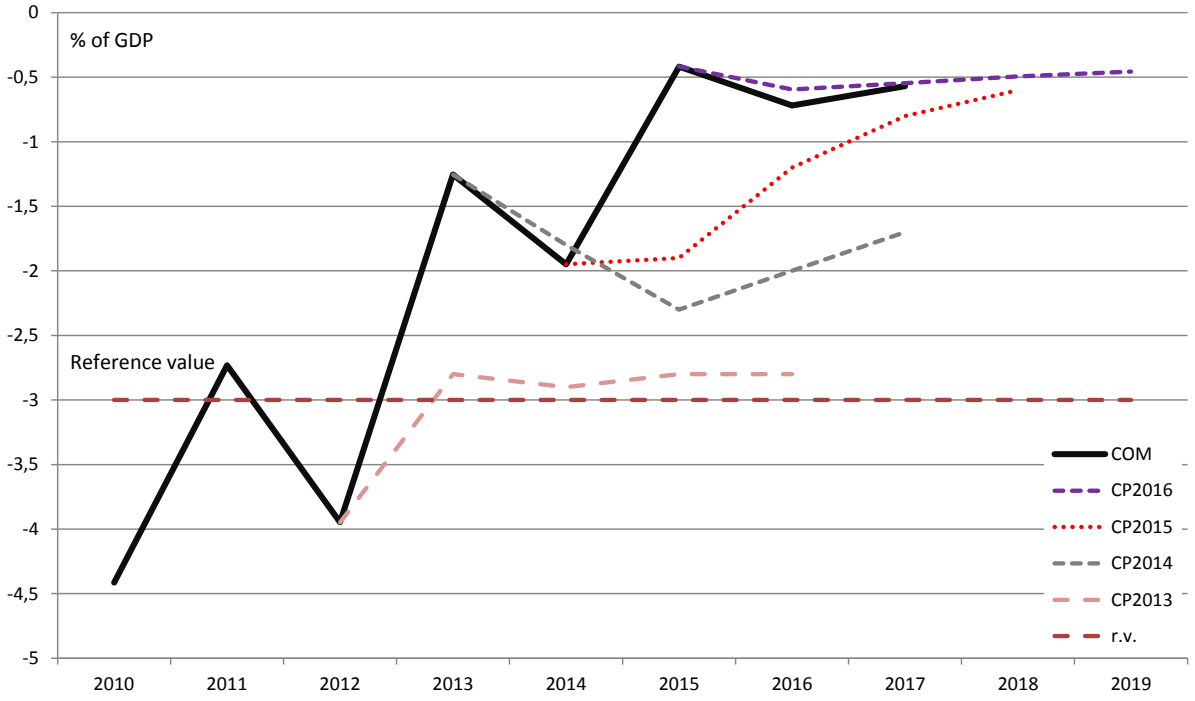
Source:

Convergence Programme (CP); Commission 2016 spring forecasts (COM); Commission calculations.

The Convergence Programme targets a headline general government deficit of 0.6% of GDP in 2016. This is a substantially lower target compared to the 1.2% of GDP expected in the previous 2015 Convergence Programme (Figure 1). The difference can be mainly attributed to a higher revenue-to-GDP ratio reflecting better tax and social security revenues, whereas the expenditure[5] ratio is expected to grow less compared to the 2015 Convergence Programme.

[5] A comparison on the expenditure side is complicated by the fact that the composition of government consumption changed in late 2015 due to the reclassification of hospitals into the general government sector.

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



Source: Commission 2016 spring forecast. Stability or convergence programmes

According to the Commission 2016 spring forecast, the headline deficit is expected to deteriorate to 0.7% of GDP in 2016 (only marginally more than in the Convergence Programme), largely as a result of fading one-off factors and a stabilisation of tax revenues in line with lower projected macroeconomic growth. Revenues are broadly in line with the programme and take partially into account new measures aimed at curbing tax evasion. On the expenditure side, government consumption in percentage of GDP is slightly higher than envisaged in the programme. Counteracting this is the significant decrease in overall investment spending (expected to be slightly more pronounced than planned in the Convergence Programme) on account of lower expected EU funds absorption at the beginning of the new programming period, although investment funded from purely domestic sources is likely to pick up. The programme envisages a one-off measure (0.1% of GDP) related to an exceptional increase in pensions above the increase implied by the existing indexation scheme [6] and smaller one-off proceeds from the auction of licences for frequency bands in 2016.

In 2017 and over the medium-term horizon of the programme, the authorities plan to stabilize the headline deficit at 0.5% of GDP, while the Commission 2016 spring forecast under the no-policy change assumption envisages a slightly higher deficit of 0.6% of GDP for 2017. The main difference is that social payments are forecast to grow by more than the programme expects.

[6] This is not considered a one-off measure according to the Commission classification principles used in fiscal surveillance (see 2015 Report on Public Finances in EMU) due to the deficit-increasing nature of the policy.

3.3. Measures underpinning the programme

The Convergence Programme provides an overview of the main revenue and expenditure measures, which are summarized in the table below. In 2016, the main budgetary measures include the introduction of VAT reporting (control statement) which provides means to match transactions between suppliers and buyers and hence facilitates faster detection of fictitious invoices and an increase in excise duties on tobacco. On the expenditure side, the wage bill and healthcare expenditure are expected to increase (encompassing also planned wage growth of doctors and nurses). Additionally, pension benefits were temporarily increased above the indexation provided by the automatic formula in February 2016. Overall discretionary measures are tilted to the revenue side, according to the programme.

Fiscal measures in 2017 and beyond rely on revenues stemming from the fight against tax evasion, according to the Convergence Programme. Two flagship measures include the VAT control statement (a smaller additional impact in 2017) and the evidence of electronic sales (phased-in throughout the period 2017-2018). These measures are likely to improve the VAT gap and reduce tax evasion. On the expenditure side, the Convergence Programme includes measures related to public wages and social benefits, some of which are not fully specified due to ongoing negotiations (see 3.5 Risk assessment).

Overall, in both 2016 and 2017 the Commission 2016 spring forecast does not take on board the full amount of measures aimed at fighting tax evasion. For 2016, the Commission 2016 spring forecast assumes an additional one-off measure compared to the programme, stemming from the retroactive implementation of the 2014 Own Resources Decision[7]. No significant one-off measures are projected for 2017.

Main budgetary measures

Revenue	**Expenditure**
2015	
• Reintroduction of tax credit for working pensioners (-0.1% of GDP) • Increase in notional social security contribution for state employees (+0.1% of GDP) • Introduction of a second reduced VAT rate (-0.1% of GDP) • Increase in excise duties on tobacco products (0.1% of GDP)	• Inrease in the public sector wage bill (+0.2% of GDP) • Changes in pension indexation (+0.1% of GDP) • Military expenditure related to a long-term lease of fighter jets (+0.2% of GDP) • Reimbursement of collected taxes on emission allowances (+0.1% of GDP)
2016	
• Introduction of VAT control statement (0.2% of GDP) • Increase in notional social security	• Inrease in the public sector wage bill (+0.3% of GDP) • Lump-sum increase in pensions beyond the

[7] This relates to a correction in contributions for the EU budget following the adoption of the 2014 Own Resources Decision by the European Council of 26 May 2014.

contributions for state employees (+0.1% of GDP) • Increase in excise duties on tabacoo products (+0.1% of GDP)	current indexation scheme (+0.1% of GDP) • Increase in healthcare expenditure (+0.2% of GDP)
2017	
• Revenues from implementation of electronic evidence of sales (+0.3% of GDP)	Increase in public wages including wages for doctors (+0.4% of GDP)
2018	
• Additional revenues from implementation of electronic evidence of sales (+0.2% of GDP)	
2019	
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.	

3.4. Debt developments

Gross debt decreased by 1.6% of GDP in 2015 (from 42.7% in 2014), mainly because the central treasury system incorporated other government entities and actively managed debt. The Convergence Programme forecasts a level of general government debt at 41.1% of GDP in 2016, unchanged compared to 2015. The state treasury system will be further extended to include accounts of health insurance companies (related to healthcare expenses) and other public organisations, which could provide an additional buffer for liquidity management purposes.[8] Interest expenditures are on a declining path due to favourable financing conditions and a partial replacement of maturing long-term bonds with short-term debt, which has lower or even negative average yields. This development contributes to a declining debt level via lower expenditures of the state budget.

[8] All institutions in question should transfer their bank accounts to the Czech National Bank within 9 months after the legislation has been approved.

Table 3: Debt developments

(% of GDP)	Average 2010-2014	2015	2016		2017		2018	2019
			COM	CP	COM	CP	CP	CP
Gross debt ratio[1]	**42.1**	**41.1**	**41.3**	**41.1**	**40.9**	**40.7**	**40.2**	**39.3**
Change in the ratio	1.7	-1.6	0.2	0.0	-0.3	-0.3	-0.5	-0.9
Contributions[2] *:*								
1. Primary balance	**1.5**	**-0.7**	**-0.3**	**-0.4**	**-0.4**	**-0.5**	**-0.5**	**-0.5**
2. "Snow-ball" effect	**0.7**	**-0.9**	**-0.2**	**-0.3**	**-0.5**	**-0.5**	**-0.6**	**-0.6**
Of which:								
Interest expenditure	1.3	1.1	1.0	1.0	1.0	1.0	1.0	1.0
Growth effect	-0.4	-1.7	-0.8	-1.0	-1.0	-1.0	-1.0	-0.9
Inflation effect	-0.3	-0.3	-0.4	-0.4	-0.5	-0.5	-0.6	-0.7
3. Stock-flow adjustment	**-0.4**	**0.0**	**0.8**	**0.8**	**0.6**	**0.7**	**0.6**	**0.3**
Of which:								
Cash/accruals diff.				0.0		0.0	0.0	0.0
Acc. financial assets				0.8		0.7	0.6	0.3
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.

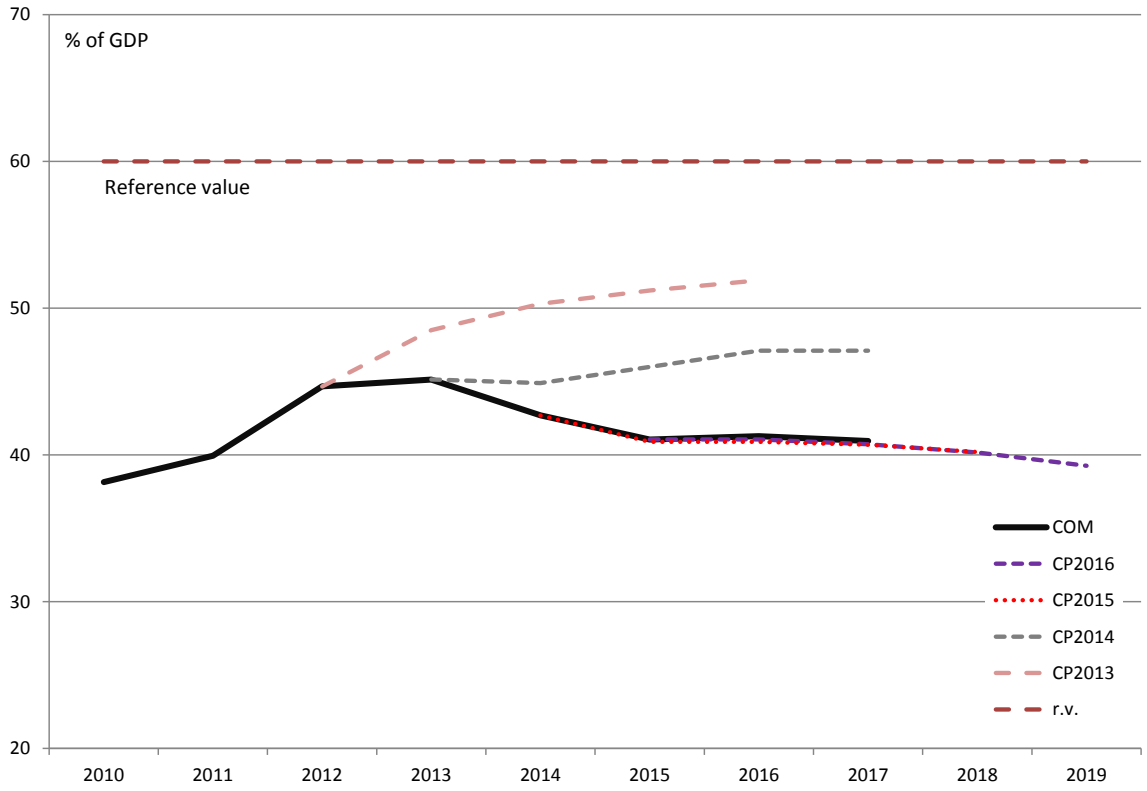
[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets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

Source :

Commission 2016 spring forecast (COM); Convergence Programme (CP), Comission calculations.

The projected primary surplus in the Convergence Programme, coupled with falling interest expenditures and growing GDP (denominator effect) give rise to a declining debt-to-GDP ratio after 2016, which is forecast to eventually drop below 40% of GDP in 2019. This trend is broadly in line with the Commission 2016 spring forecast, although higher deficit figures and slower nominal GDP growth translate into slightly slower debt dynamics (higher debt ratios by 0.2 pps in both 2016 and 2017). A positive stock-flow adjustment is expected over the programming horizon, stemming from an accumulation of financial assets. Convergence programmes prior to 2015 assumed an increasing path of gross debt, but the more recent programmes predict a declining trajectory due to increased use of available liquidity for debt management purposes (Figure 2).

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



Source: Commission 2016 spring forecast. Stability or convergence programmes

3.5. Risk assessment

Based on the current assessment of the 2016 Convergence Programme and in light of the Commission 2016 spring forecast, the national projections seem to be generally prudent, although some risks can be identified.

With regards to the expenditure side, the main risk is related to the expected significant drop in investment in 2016. The precise size of the reduction remains subject to a smooth roll-out of the 3rd programming period for EU funds (2014-2020). Furthermore, some risk exists for transport projects approved under legislation not compliant with the Environment Impact Assessment (EIA) Directive that may have to go through a re-assessment in order to ensure eligibility for EU funding. The Czech government is currently considering several options for different groups of projects, including a legislative amendment to tackle this issue. Although any potential impact will only be known at a later stage, some risks related to postponed investments remain. Furthermore, calls to raise the minimum wage could further push up compensations of public sector employees. In this context, there is a risk that expenditure savings, particularly on the wage bill and intermediate consumption, may be overestimated.

The budgetary impact of measures aimed at fighting tax evasion is subject to risks. Extra revenue stemming from the VAT control statement (especially in the first year) is dependent on the quality of data submitted by taxpayers and the subsequent identification of possible fraud. The initial implementation appears to have been successful, as some 85% of eligible

VAT taxpayers have submitted the control statement by end of April 2016.[9] The adopted measure on the electronic evidence of sales will be slowly phased in for all entrepreneurs[10] which makes it harder to estimate in which year possible extra revenues may materialise. A crucial element to reduce budgetary risks is the timely development of appropriate IT systems enabling a smooth functioning of sales evidence. Therefore, the Commission 2016 spring forecast only partly takes into account the impact of measures to fight tax evasion. Additionally, the higher-than-expected tax returns in 2015 were to some extent temporary and based on exceptionally high GDP growth. A more pronounced decline of tax elasticities than incorporated in the Commission 2016 spring forecast therefore represents a general downside risk for revenues.

The government announced new measures mainly related to the public wage bill and social payments, which are likely to take effect as of 2017. These measures are broadly included in the Convergence Programme but not all of them are fully described and specified. Wages are expected to increase in the healthcare and education sector and for state administration employees. The government will also have more leeway to adopt higher pension increases up to 2.7%, if the indexation formula yields a lower increase[11]. However, the government postponed the decision on the state budget spending limits, including among others the exact size of wage increases for state employees, until end of May, when the outline of the whole 2017 state budget will be presented.

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

Starting from an initial budgetary position at the MTO in 2014, the recalculated structural balance is estimated to have improved by 0.3% of GDP in 2015, therefore above the MTO.[12] Based on the outturn data and the Commission 2016 spring forecast, the structural balance was above the MTO in 2015. The 2015 Council recommendation in the area of public finance is in Box 1. [13]

Box 1. Council recommendations addressed to Czech Republic

– On 14 July 2015, the Council addressed recommendations to Czech Republic in the context of the European Semester. In particular, in the area of public finances the Council recommended to Czech Republic to achieve a fiscal adjustment of 0.5% of GDP in 2016.

According to the information in the Convergence Programme, the recalculated structural balance in 2016 and 2017 is projected to remain above the MTO with a structural deficit of 0.5% and 0.7% of GDP, respectively (Table 2). This equals a structural deterioration of 0.1% of GDP in 2016 and 0.2% of GDP in 2017. The real growth rate of government expenditure,

[9] The Tax Administration expects that half of the VAT payers which did not submit the required control statement in time had no taxable income and hence are excluded from the reporting requirement.

[10] The phasing-in is divided according to categories of entrepreneurs and should be completed within 18 months after its adoption in February 2016.

[11] For 2017, an increase of 1.7% is specified in the programme.

[12] The favourable structural outcome is in part due to a swift closing of the output gap, which narrowed by more than 2 pps in 2015.

[13] Countries overachieving their MTO have an allowed deviation from the required adjustment. Since the Czech Republic overachieved the MTO in 2015, the required structural adjustment for 2016 takes this into account.

net of discretionary revenue does not exceed the expenditure benchmark rate. Both indicators are respected also over the years 2015- 2016 and 2016-2017 taken together.

Based on the Commission 2016 spring forecast, the structural balance is projected to deteriorate slightly, reaching a deficit of 0.7% of GDP in 2016 and 0.9% of GDP in 2017. The real growth rate of government expenditure net of discretionary measures is in line with the requirements both in 2016 and 2017. The assessment over two years leads to the same conclusion. Therefore, the ex-ante assessment suggests that the adjustment path towards the MTO seems to be in line with the requirements of the preventive arm over 2016 and 2017.

Table 4: Compliance with the requirements under the preventive arm

(% of GDP)	2015	2016		2017	
Initial position[1]					
Medium-term objective (MTO)	-1.0	-1.0		-1.0	
Structural balance[2] (COM)	-0.4	-0.7		-0.9	
Structural balance based on freezing (COM)	-0.4	-0.7		-	
Position vis-a -vis the MTO[3]	At or above the MTO	At or above the MTO		At or above the MTO	
(% of GDP)	**2015**	**2016**		**2017**	
	COM	**CP**	**COM**	**CP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.0	0.0		0.0	
Required adjustment corrected[5]	-0.3	-0.6		-0.3	
Change in structural balance[6]	0.3	-0.1	-0.3	-0.2	-0.1
One-year deviation from the required adjustment [7]	0.6	0.4	0.3	0.1	0.1
Two-year average deviation from the required adjustment [7]	0.3	0.5	0.4	0.3	0.2
Expenditure benchmark pillar					
Applicable reference rate[8]	2.3	3.0		2.1	
One-year deviation [9]	1.3	1.1	0.2	0.2	0.1
Two-year average deviation [9]	0.8	1.2	0.8	0.6	0.2
Conclusion					
Conclusion over one year	Compliance	Compliance	Compliance	Compliance	Compliance
Conclusion over two years	Compliance	Compliance	Compliance	Compliance	Compliance

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 (p.p.) 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 38.).

[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. Ex post assessment (for 2014) is carried out on the basis of Commission 2015 spring forecast.

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

[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 adjusting towards its MTO, including in year t.

[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 2016 spring forecast (COM); Commission calculations.

5. FISCAL SUSTAINABILITY

The Czech Republic does not appear to face fiscal sustainability risks in the short run.[14]

Based on Commission forecasts and a no-fiscal policy change scenario beyond the forecast horizon, government debt (41.1% of GDP in 2015) is expected to rise (to 43.7% in 2026), thus remaining below the 60% of GDP Treaty threshold. Over this horizon, government debt is projected to peak in 2026. This highlights low risks for the country from debt sustainability analysis in the medium term. The full implementation of the Convergence Programme would put debt on a broadly stable path by 2026.

The medium-term fiscal sustainability risk indicator S1 is at -1.1 pps of GDP, primarily thanks to the government debt ratio below the 60% Treaty reference value translating into a negative distance to the debt target (contributing with -1.4 pps of GDP), thus indicating low risks in the medium term. The full implementation of the Convergence Programme would put the sustainability risk indicator S1 at -2.1 pps of GDP, leading to even lower medium-term risk. Overall, risks to fiscal sustainability over the medium-term are, therefore, low. Fully implementing the fiscal plans in the Convergence Programme would decrease those risks.

The long-term fiscal sustainability risk indicator S2 (which shows the adjustment effort needed to ensure that the debt-to-GDP ratio is not on an ever-increasing path) is at 2.8 pps of GDP. In the long-term, the Czech Republic therefore appears to face medium fiscal sustainability risks, primarily related to the projected ageing costs (2.4 pps of GDP). Full implementation of the programme would put the S2 indicator at 2.3 pps of GDP, leading to a broadly similar long-term risk.

The projected increase in public expenditure on healthcare and pensions poses a challenge to the long-term sustainability of public finances. Furthermore, recent proposals to amend provisions of the pension system such as capping the statutory retirement age and a leeway for the government to adjust the indexation mechanism more flexibly would, if implemented, deteriorate the sustainability of the pension system. For the healthcare sector, a number of measures aimed at improving the cost-effectiveness and governance of the healthcare sector are in various stages of implementation, such as a disclosure of contracts between health insurers and providers and the adjustment of the existing reimbursement mechanism for the inpatient care. However, options to strengthen outpatient care coordination, improve the gate-keeping role of practitioners and to limit unnecessary consumption have not been sufficiently explored and the available data do not seem to be used effectively for the planning of inpatient care capacities and the rationalisation of acute care beds.

[14] This conclusion is based on the short-term fiscal sustainability risk indicator S0, which incorporates 14 fiscal and 14 financial-competitiveness variables. The fiscal and financial-competitiveness sub-indexes (reported in table 5) are based on the two sub-groups of variables respectively. For sustainability risks arising from the individual variables, by country, see the Commission's Fiscal Sustainability Report 2015 (page 67).

Table 5: Sustainability indicators

Time horizon			No-policy Change Scenario		Stability / Convergence Programme Scenario	
Short Term			**LOW risk**			
S0 indicator [1]			0.2			
Fiscal subindex (2015)			0.1	LOW risk		
Financial & competitiveness subindex (2015)			0.2	LOW risk		
Medium Term			**LOW risk**			
DSA [2]			LOW risk			
S1 indicator [3]			-1.1	LOW risk	-2.1	LOW risk
of which						
	IBP		-0.3		-0.8	
	Debt Requirement		-1.4		-1.9	
	CoA		0.7		0.6	
Long Term			**MEDIUM risk**		**MEDIUM risk**	
S2 indicator [4]			2.8		2.3	
of which						
	IBP		0.4		0.1	
	CoA		2.4		2.2	
	of which					
		Pensions	0.6		0.6	
		HC	0.8		0.7	
		LTC	0.5		0.5	
		Other	0.5		0.4	

Source: Commission services; 2016 stability/convergence programme.

Note: the 'no-policy-change' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commissions' spring 2016 forecast until 2017. The 'stability/convergence 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.

[1] 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.

[2] Debt Sustainability Analysis (DSA) is performed around the no fiscal policy change scenario in a manner that tests the response of this scenario to different shocks presented as sensitivity tests and stochastic projections. See Fiscal Sustainability Report 2015.

[3] 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 forecast 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 2017) 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.

[4] 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.

6. FISCAL FRAMEWORK

Fiscal policy is determined by the legislated headline state budget deficits and by the national medium-term expenditure framework. The 2015 headline state budget deficit in cash terms amounted to CZK 63 billion (1.4% of GDP), thus complying with the legislated state budget deficit limit of CZK 100 billion (2.3% of GDP) by a wide margin.

The Convergence Programme projects the 2016 and 2017 headline general government deficits at 0.6% and 0.5% of GDP, respectively. These targets take into account the 2016 legislated headline state budget deficit at CZK 70 billion (1.6% of GDP), the draft national medium-term expenditure framework 2017-19 and the assumptions on the fiscal development of other units in the general government sector.

However, the current Czech fiscal framework suffers from several shortcomings. The expenditure ceilings set for the central government in the medium-term framework can be easily modified, which tends to lead to pro-cyclical fiscal policy.The medium-term fiscal planning applied by the sub-national governments is only indicative. The Czech Republic is currently one of the very few Member States that still lack a dedicated independent fiscal institution with responsibility for assessing compliance with fiscal rules and thus contributing to enhancing the transparency of public finances. A long-delayed reform addressing the main weaknesses of the current fiscal framework was approved by the government in February 2015, but its ratification by the Parliament is still pending. The proposed reform envisages strengthening expenditure limits and directly linking them to the medium-term budgetary objective of -1.0% of GDP in structural terms. It also introduces a debt rule for general government, which would be activated once public debt breaches the 55% of GDP threshold. Specific provisions for municipalities should ensure a prudent level of indebtedness, limiting debt to 60% of average municipal revenues. Finally, the reform package provides for the establishment of an independent fiscal council to – among others – monitor the respect of fiscal rules and an expert forecasting body which would verify the Ministry of Finance's macroeconomic and fiscal projections.

The Convergence Programme is based on the macroeconomic forecast published by the Ministry of Finance in April 2016. The macroeconomic forecasts of the Ministry of Finance, which underpin budgetary planning, are currently not submitted to independent verification but are subject to comparison with forecasts of other institutions and discussed with those institutions before publication.

7. CONCLUSIONS

In 2015, the Czech Republic achieved an improvement of the structural balance of 0.3% of GDP and was above its MTO. The Czech Republic is therefore in line with the requirements of the preventive arm of the SGP in 2015.

The Czech Republic plans a deterioration in the recalculated structural balance by 0.1% in 2016 and by 0.2% of GDP in 2017. However, since the structural balance is maintained above the MTO in both years according to the Convergence Programme and this is also confirmed by the Commission 2016 spring forecast, the Czech Republic is assessed to continue to be in line with the requirements of the preventive arm of the SGP also in 2016 and 2017.

8. ANNEX

Table I. Macroeconomic indicators

	1998-2002	2003-2007	2008-2012	2013	2014	2015	2016	2017
Core indicators								
GDP growth rate	2.0	5.5	0.2	-0.5	2.0	4.2	2.1	2.6
Output gap [1]	-0.9	2.7	-0.2	-2.8	-2.2	0.0	0.2	0.7
HICP (annual % change)	4.3	1.8	2.8	1.4	0.4	0.3	0.5	1.4
Domestic demand (annual % change) [2]	2.3	4.4	-0.8	-0.5	2.3	4.7	1.9	2.6
Unemployment rate (% of labour force) [3]	7.9	7.3	6.4	7.0	6.1	5.1	4.5	4.4
Gross fixed capital formation (% of GDP)	30.1	28.6	27.1	25.1	25.0	25.8	25.1	25.2
Gross national saving (% of GDP)	27.3	26.1	23.5	23.6	23.3	24.6	24.5	24.7
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	**-4.6**	**-3.0**	**-3.7**	**-1.3**	**-1.9**	**-0.4**	**-0.7**	**-0.6**
Gross debt	**19.0**	**28.1**	**37.1**	**45.1**	**42.7**	**41.1**	**41.3**	**40.9**
Net financial assets	**25.2**	**11.0**	**-3.8**	**-15.2**	**-17.1**	**n.a**	**n.a**	**n.a**
Total revenue	37.4	39.6	39.2	41.6	40.8	42.2	40.7	40.7
Total expenditure	42.0	42.6	42.9	42.8	42.8	42.6	41.4	41.3
of which: Interest	1.0	1.1	1.3	1.3	1.3	1.1	1.0	1.0
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	**-0.3**	**-2.4**	**-1.1**	**0.4**	**-0.7**	**-0.2**	**-1.6**	**-1.5**
Net financial assets; non-financial corporations	**-107.8**	**-95.8**	**-94.9**	**-86.0**	**-84.1**	**n.a**	**n.a**	**n.a**
Net financial assets; financial corporations	**1.5**	**-4.7**	**-2.2**	**-2.9**	**-1.0**	**n.a**	**n.a**	**n.a**
Gross capital formation	21.2	19.5	17.6	16.8	16.5	17.1	17.9	17.7
Gross operating surplus	28.4	29.1	29.2	28.7	30.7	31.2	30.6	30.6
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	**1.9**	**1.7**	**2.3**	**1.8**	**2.4**	**1.5**	**2.0**	**2.0**
Net financial assets	**72.0**	**63.1**	**65.3**	**75.9**	**78.8**	**n.a**	**n.a**	**n.a**
Gross wages and salaries	29.6	30.1	30.6	31.5	30.9	30.8	30.9	31.1
Net property income	4.4	3.7	3.4	3.3	2.9	2.7	2.6	2.6
Current transfers received	16.3	16.2	17.7	18.0	17.6	17.6	17.7	17.5
Gross saving	6.4	6.1	6.6	6.0	5.9	5.5	5.5	5.5
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	**-3.0**	**-3.8**	**-2.6**	**1.1**	**-0.2**	**1.1**	**0.3**	**0.5**
Net financial assets	**9.4**	**26.7**	**35.8**	**28.4**	**23.6**	**n.a**	**n.a**	**n.a**
Net exports of goods and services	-1.0	1.4	3.6	5.8	6.7	6.4	6.8	6.8
Net primary income from the rest of the world	-2.2	-5.0	-7.0	-6.0	-7.8	-7.7	-7.4	-7.2
Net capital transactions	0.3	0.1	1.5	2.2	1.7	3.1	1.8	1.8
Tradable sector	54.4	53.2	51.1	51.0	52.4	52.3	n.a	n.a
Non tradable sector	36.9	37.8	39.4	38.7	38.0	37.7	n.a	n.a
of which: Building and construction sector	6.1	5.9	5.8	5.2	5.1	5.1	n.a	n.a
Real effective exchange rate (index, 2000=100)	66.3	85.3	100.6	97.6	91.4	89.1	90.7	90.3
Terms of trade goods and services (index, 2000=100)	100.2	102.3	99.7	99.0	100.5	100.9	101.4	101.3
Market performance of exports (index, 2000=100)	61.0	82.9	100.6	104.9	109.7	111.1	112.5	112.4

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 :
AMECO data, Commission 2016 spring forecast