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**ECONOMIC ASSESSMENT
OF THE CONVERGENCE PROGRAMME OF THE CZECH REPUBLIC
(UPDATE OF MARCH 2007)**

(Note for the Economic and Financial Committee)

The Stability and Growth Pact requires each EU Member State to present an annual update of its medium-term fiscal programme, called “stability programme” for countries that have adopted the euro as their currency and “convergence programme” for those that have not. The most recent update of the Czech Republic’s convergence programme was submitted on 15th March 2007.

The attached technical analysis of the programme, prepared by the staff of, and under the responsibility of, the Directorate-General for Economic and Financial Affairs of the European Commission, was finalised on 30 May 2007. Comments should be sent to Neil Kay (neil.kay@ec.europa.eu). The main aim of the technical analysis is to assess the realism of the budgetary strategy presented in the programme as well as its compliance with the requirements of the Stability and Growth Pact. However, the analysis also looks at the overall macro-economic performance of the country and highlights relevant policy challenges.

Based on this technical analysis, the European Commission adopted an assessment of the programme as well as a recommendation for a Council opinion on the programme on 30 May 2007. The ECOFIN Council is expected to adopt its opinion on the programme on 10 July 2007.

* * *

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

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

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SUMMARY AND CONCLUSIONS¹

As part of the preventive arm of the Stability and Growth Pact, each Member State that does not use the single currency, such as the Czech Republic, has to submit a convergence programme and annual updates thereof. The most recent programme, covering the period 2006-2009, was submitted on 15 March 2007. Under the corrective arm of the Pact, the Czech Republic was placed in excessive deficit by the Council in July 2004. The deadline for correcting the excessive deficit is 2008.

Progress of the Czech economy toward EU income levels has been uneven. During 1995-2000, the income differential of the Czech economy and the EU average widened due mainly to the recession. Since 2000, real convergence has proceeded steadily with the Czech Republic reaching 73% of GDP per capita in purchasing power standard (PPS) of the EU-25 average in 2005. The annual government deficit has averaged 4.5% of GDP during 1996-2005 and has remained higher than the 3% of GDP reference value for virtually all the period. The gross government debt has averaged 22% of GDP between 1996 and 2005 and has been steadily increasing over the period from 13% to 30.4% in 2005. Growth in the Czech economy has been particularly strong since 2005 at over 6% of GDP annually.

While unemployment has fallen since 2000, the proportion of long-term unemployed remains high and further falls are likely to be tempered by structural factors including the high tax wedge on employment. The current macroeconomic environment gives ample opportunity to broach the main challenges of fiscal policy:

- As concerns medium-term macroeconomic *stabilisation*, the main problem is the slow pace of budgetary consolidation. Despite very strong GDP growth, the structural deficit worsened in 2005. Effective consolidation would be assisted by more reliable budgetary planning and execution. A medium-term expenditure framework was introduced into the annual budget in 2004 whereby nominal expenditure ceilings are set for two years in advance, at the time of an annual budget.
- The annual budget includes a high proportion of social expenditures including pension and health care, the size of which is increasing constantly due to the ageing process; putting the *long-term sustainability* of public finances in the Czech Republic at high risk. While the pension system is broadly in balance, the position will deteriorate in the medium-term.
- The challenge in improving the *efficiency* of public spending will be to focus resources towards the promotion of growth. The recent moves to shift the tax burden from direct to indirect taxation and to lower taxes on labour are positive moves in this direction. The Czech Republic has also introduced recent measures to improve the transparency and accountability of public finances.

The programme foresees a moderation in the growth of the Czech economy. After growing at some 6% of GDP in 2006. Real GDP growth rate is expected to decrease to

¹The analysis takes into account (i) the Commission services' spring 2007 forecast, (ii) the code of conduct ("Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005) and (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

4.9% in 2007 and to 4.8% in 2008 and 2009. The programme predicts a continuation of the current growth composition, the main contribution coming from domestic demand, particularly gross fixed capital formation. The rise in private consumption, on average just above 4% over the programme period is assumed to be fuelled by falling unemployment, rising wage levels and rapid credit growth, although household debt still remains low by international comparisons. The contribution from net exports, which was the principal driver in 2005, has continued to decrease in 2006 due mainly to rising imports. The programme foresees a continuation of this trend in 2007 before reversing in 2008 and 2009 due to a minor fall off in import growth. Both domestic and external demand are expected to remain positive over the programming period. According to the Commission services' calculations, the output gap turned positive in 2006, after being negative since 1997, and will stay positive during the programme period. Growth is projected to be 6% in 2006 moderating to potential during the rest of the programme period. Unemployment is expected to continue falling. In this respect, the Czech economy is likely to be in economic "good times" during the programming period.

The annual deficit target for the 2006 headline deficit was 3.8% of GDP, set in the November 2005 convergence programme. The new programme estimates the actual deficit to be 3.5% of GDP partly reflecting higher-than-expected growth. According to the 2007 spring notification as validated by Eurostat² and included in the Commission services' spring 2007 forecast, the 2006 deficit was 2.9% of GDP, 0.5 percentage point of GDP less than estimated in the convergence programme. Corporate tax revenues were higher than anticipated due to increasing profit margins. On the expenditure side, government consumption continued to be restrained in contrast to rising investment spending.

The roll-over of reserve funds in 2006 (0.3% of GDP), and a surplus in social security of a similar amount (higher than estimated in the convergence programme), due to higher accrual-based social contributions and lower-than-expected outlays from the public health insurance scheme, contributed to the better outturn.

The main goal of the programme's medium-term budgetary strategy is to achieve long-term sustainability of public finances, notably by making progress towards the medium-term objective (MTO) for the budgetary position of a structural balance (i.e. cyclically-adjusted balance net of one-off and other temporary measures) of 1% of GDP. According to the programme, the headline deficit should widen to 4.0% of GDP in 2007 mainly as a result of discretionary increases in social expenditure and then gradually decline, to 3.5% of GDP in 2008 and 3.2% of GDP in 2009. The primary deficit is projected to narrow from 2.4% of GDP in 2006 to 1.6% of GDP in 2009. The envisaged fiscal consolidation, after 2007, relies on increased revenue by 0.4 percentage point of GDP over the programme period, in particular 'other revenues' (without specifying the actual measures, but which presumably concern EU transfers), which will more than compensate for a decline in taxes and social contributions. On substance, however, the consolidation is expenditure driven with a consistent decline in public consumption mainly due to government sector wage restraint, which will more than offset the increase in public investment and interest expenditure. Compared with the previous update, the new programme postpones the planned reduction of the deficit below the 3% of GDP reference value by at least two years against a more favourable macroeconomic scenario.

² Eurostat News Release No 55/2007 of 23 April 2007. For the most recent notification: http://epp.eurostat.ec.europa.eu/portal/page?_pageid=2373,58110711&_dad=portal&_schema=portal

It has to be noted that the programme also presents an alternative considered by the government which presents lower deficit targets of 3.2% of GDP in 2008 and 2.8% of GDP in 2009. This relies on a range of policy measures as well as introducing greater flexibility into public finances by reducing the proportion of mandatory expenditures. However, these are based on still to be finalised and approved policy measures and the programme offers a coherent and sufficiently quantified medium-term fiscal framework only for the higher deficit targets mentioned above.

The structural deficit calculated according to the commonly agreed methodology is planned to deteriorate from around 3½% of GDP in 2006 to some 4½% of GDP in 2007 before gradually improving to 3½% of GDP in 2009. As in the previous update, the medium-term objective (MTO) for the budgetary position presented in the programme is a structural deficit of 1% of GDP. In comparison with previous update the achievement of the MTO has been postponed by one year, until 2013. As the MTO is more demanding than the minimum benchmark (estimated at a deficit of around 1½% of GDP), achieving it should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The MTO adequately reflects the debt ratio and average potential output growth in the long term.

The risks to the budgetary projections in the programme appear broadly balanced. The risks from the macroeconomic scenario are broadly neutral, while tax projections seem on the whole based on prudent assumptions. The envisaged fiscal consolidation in the programme relies heavily on public consumption expenditure restraint, but the programme does not provide sufficient supporting information on how this will be achieved. On the other hand, the Czech Republic has built up a good track-record in recent years, although achieving its budgetary targets has been facilitated by higher-than-expected growth. There is also a political risk associated with the finely balanced parliamentary situation.

In view of this risk assessment, the budgetary stance in the programme is inconsistent with a correction of the excessive deficit by 2008 as recommended by the Council on 5 July 2004. Given that the economy is currently enjoying “good times” and that growth is higher than anticipated at the time of the July 2004 Council recommendation, there is ample opportunity to strengthen the consolidation effort and achieve a steeper reduction than projected in the programme.

The long-term budgetary impact of ageing in the Czech Republic is well above the EU average, influenced notably by a considerable increase in pension expenditure as a share of GDP. Implementation of structural reform measures notably in the field of pensions aimed at containing the significant increase in age-related expenditures would contribute to reducing risks to the sustainability of public finances. The initial budgetary position, which has worsened compared with 2005, constitutes a risk to sustainable public finances even before the long-term budgetary impact of an ageing population is considered. Consolidation the public finances further than currently planned would contribute to reducing risks to the sustainability of public finances. Overall, the Czech Republic appears to be at high risk with regard to the sustainability of public finances.

The convergence programme does not contain a qualitative assessment of the overall impact of the November 2006 implementation report of the National Reform Programme within the medium-term fiscal strategy. In addition, it provides no systematic information on the direct budgetary costs (or savings) associated with the main reforms envisaged in the National Reform Programme with the exception of the increase in research and

development expenditure in the 2007 budget, but the budgetary projections in the programme seemingly take into account the public finance implications of the actions envisaged in the National Reform Programme. The measures in the area of public finances envisaged in the convergence programme seem consistent with those foreseen in the National Reform Programme. In particular, the shift in the tax burden from direct to indirect taxation and additional support for research and development. The budgetary strategy in the programme is not consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008 given, in particular, the deviation from the adjustment path set by the Council in July 2004 for the correction of the excessive deficit and the lack of progress on pension and health care reform.

The overall conclusion is that, in spite of better growth prospects, and a lower deficit outcome in 2006 than anticipated, the programme postpones the correction of the excessive deficit by at least one year, compared with the 2008 deadline set in the July 2004 Council recommendation under Article 104(7). Given the sustained growth, the postponement, which reflects the higher deficit due primarily to planned increases in social expenditure in 2007, would also result in a pro-cyclical expansionary stance of fiscal policy.

Comparison of key macroeconomic and budgetary projections

		2005	2006	2007	2008	2009
Real GDP (% change)	CP Mar 2007	6.1	6.0	4.9	4.8	4.8
	COM May 2007	6.1	6.1	4.9	4.9	n.a.
	CP Nov 2005	4.8	4.4	4.2	4.3	n.a.
HICP inflation (%)	CP Mar 2007	1.6	2.4	2.6	2.5	2.5
	COM May 2007	1.6	2.1	2.4	2.9	n.a.
	CP Nov 2005	1.5	2.2	2.0	2.1	n.a.
Output gap (% of potential GDP)	CP Mar 2007¹	-0.7	0.9	1.1	1.0	1.0
	COM May 2007 ³	-1.1	0.4	0.5	0.5	n.a.
	CP Nov 2005 ¹	-0.8	-0.1	0.3	0.8	n.a.
General government balance (% of GDP)	CP Mar 2007⁶	-3.6	-3.5	-4.0	-3.5	-3.2
	COM May 2007	-3.5	-2.9	-3.9	-3.6	n.a.
	CP Nov 2005	-4.8	-3.8	-3.3	-2.7	n.a.
Primary balance (% of GDP)	CP Mar 2007	-2.5	-2.4	-2.6	-2.0	-1.6
	COM May 2007	-2.4	-1.8	-2.8	-2.6	n.a.
	CP Nov 2005	-4.1	-3.0	-2.4	-1.7	n.a.
Cyclically-adjusted balance (% of GDP)	CP Mar 2007¹	-3.4	-3.9	-4.4	-3.9	-3.5
	COM May 2007	-3.1	-3.1	-4.1	-3.8	n.a.
	CP Nov 2005 ¹	-4.5	-3.8	-3.4	-3.0	n.a.
Structural balance ² (% of GDP)	CP Mar 2007	-3.4	-3.9	-4.4	-3.9	-3.5
	COM May 2007 ⁴	-2.0	-2.8	-4.1	-3.8	n.a.
	CP Nov 2005 ⁵	-3.4	-3.8	-3.4	-3.0	n.a.
Government gross debt (% of GDP)	CP Mar 2007	30.4	30.6	30.5	31.3	32.2
	COM May 2007	30.4	30.4	30.6	30.9	n.a.
	CP Nov 2005	37.4	37.1	37.9	37.8	n.a.

Notes:

¹Commission services calculations on the basis of the information in the programme.

²Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures.

³Based on estimated potential growth of 4.2%, 4.6%, 4.8% and 4.9% respectively in the period 2005-2008.

⁴One-off and other temporary measures taken from the Commission services' spring 2007 forecast
(1.1% of GDP in 2005 and 0.2% of GDP in 2006 - both deficit increasing)

⁵One-off and other temporary measures taken from the CP 2005 programme
(1.1% of GDP in 2005 - deficit increasing)

⁶Alternative deficit targets: 3.2% of GDP in 2008, 2.8% of GDP in 2009

Source:

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

1. INTRODUCTION

The third update of the Czech Republic's convergence programme was submitted on 15 March 2007³. It covers the period 2006-2009 and, in addition, provides indicative projections until 2010. The update was adopted by the Czech government on 9 March 2007. The programme is based on the 2007 budget and the medium-term budgetary framework for 2008/2009 which was approved by parliament on 13 December 2006. The submission of the third update was delayed with respect to the 1 December deadline for stability and convergence programme updates due to the transitory period between the June 2006 elections and the approval of a new government on 19 January 2007.

The programme broadly follows the model structure for stability and convergence programmes specified in the code of conduct. The programme provides all compulsory data prescribed by the code of conduct and presents some gaps in the optional data⁴. (Annex 3 provides a detailed overview of all aspects of compliance with the code of conduct.

In addition to the standard chapters, the programme contains an additional chapter on the 'programme declaration of the new government'. While the additional chapter has been taken into consideration, the following assessment is based only on the standard chapters of the convergence programme, since only these present a coherent and sufficiently quantified medium-term fiscal framework for the period 2006-2009.

2. ECONOMIC TRENDS AND POLICY CHALLENGES

This section is in five parts. The first provides a brief overview of the macroeconomic performance in terms of growth and other major macro-variables. The second part presents the results of a growth accounting exercise and tries to identify the main reasons for low or high average annual economic growth vis-à-vis the reference aggregate (EU10). The third looks at the volatility of growth and other key macroeconomic variables and the stabilising or destabilising role of macro-policies. The fourth part focuses on trends in public finances. The fifth part then identifies major economic challenges with implications for public finances.

2.1. Economic performance

Following transition, the Czech economy grew rapidly due to early privatisations and a substantial currency devaluation in 1990 which helped raise export performance. The favourable conditions for enterprises, and easy credit through a mainly state-controlled banking system did not, however, encourage modernisation and restructuring. Underlying weaknesses were exposed in 1997 when rising wages and high domestic inflation wore away the effects of the devaluation and drove the external deficit to 11% of GDP, triggering a round of speculation that forced the koruna from its currency peg in

³ The English version of the 2007 update was also submitted on 15 March 2007

⁴ Data on General Government Expenditure by Function (Annex 2: Table 3) have not been provided, as well as data on Liquid Financial Assets and Net Financial Debt in Table 4.

1997. In consequence, investor confidence was shaken and FDI flows declined sharply to 2.3% of GDP.

In an attempt to rebalance the economy, the central bank raised interest rates to above 20% and devalued the koruna by 10% in 1997. The government introduced two stabilisation packages in May/June 1997 with a range of measures aimed at fiscal tightening, the privatisation of the banking sector and improved corporate governance. These measures were successful in curtailing domestic demand, stemming inflation, and shrinking the burgeoning current account deficit to 2% of GDP by 1998. Investment activity continued to slow and unemployment rose to 8.6% in 1999, dampening private consumption. GDP growth was negative in 1997 and 1998.

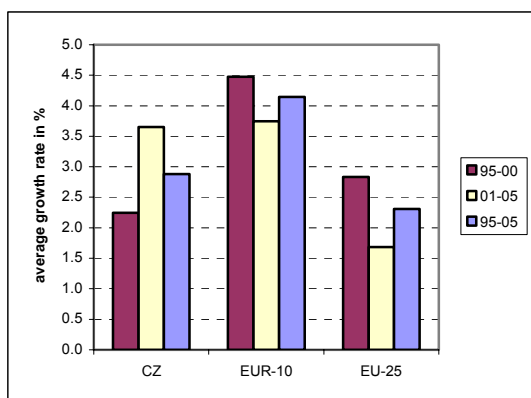
Growth in the economy resumed in 1999 with inflation reduced to below 2% and a marked moderation in wage levels from public sector restraint and a looser labour market. Export growth picked-up, benefiting from the currency devaluation and resumed flows of FDI which rebounded to 11% of GDP in 1999. The renewed foreign investment helped modernise industrial capacity and increase productivity. However, fiscal policy became increasingly expansionary with annual deficits rising to 6% between 2001 and 2003, in part related to the effects of severe flooding in 2002, estimated at a cost of around 5% of GDP, and pre-election public spending increases. Since EU entry in 2004, annual deficits have declined to 2.9% in 2004 and 3.6% in 2005.

The monetary tightening in 1997-98 was successful in bringing down inflation, which subsequently became the new monetary target for the central bank after the currency crisis encouraged it to abandon the fixed exchange-rate anchor. Falling from levels of up to 9% pre-recession inflation has averaged just below 2.0% between 2001 and 2005. Inflation targeting has remained the cornerstone of the Czech National Bank's (CNB) monetary policy since 1998 (see Box 1).

The annual government deficit has averaged 4.5% of GDP during 1996-2005 and has remained higher than the 3% of GDP reference value for virtually all the period. The Czech economy entered into an excessive deficit procedure in 2004 on the basis of an annual deficit of 6.6% of GDP in 2003. The gross government debt has averaged 22% of GDP between 1996 and 2005 and has been steadily increasing over the period from 13% to 30.4% in 2005.

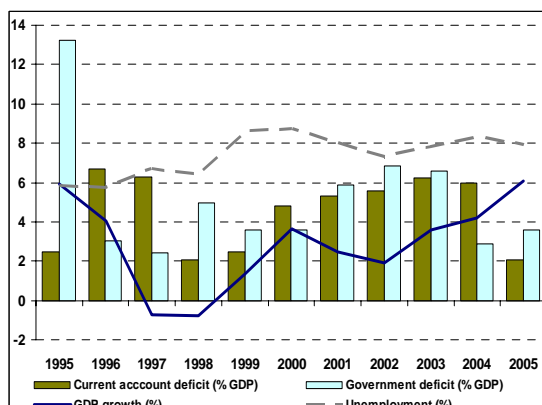
Progress of the Czech economy toward EU income levels has been uneven. During 1995-2000, the income differential of the Czech economy and the EU average widened due mainly to the recession. Since 2000, real convergence has proceeded steadily with the Czech Republic reaching 73% of GDP per capita in purchasing power standard (PPS) of the EU-25 average in 2005. (see comment above). Similar to other RAMS (write RAMS in full. In the following sections, CZ economy is often compared to RAMS performance. It would be better to compare CZ to the EU-10 aggregate), the level of domestic savings has remained low; hence much investment has been financed by foreign capital contributing to the widening of the external balance deficit.

Figure 1: Average GDP growth: Czech Republic vs. EU10 and EU25



Source: Commission services

Figure 2: Czech Republic historical macro-economic profile



Source: Commission services

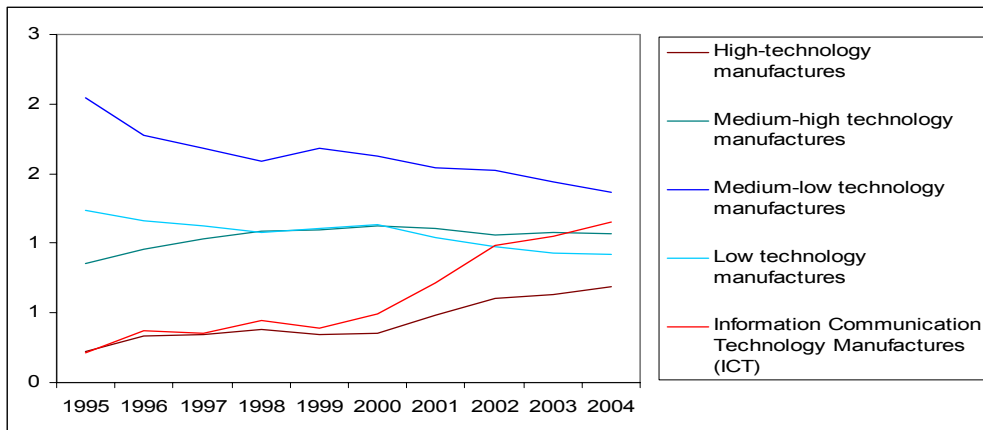
Box 1: Monetary policy and the exchange rate regime of the Czech Republic

<i>Regime combining exchange rate targeting with monetary targeting (January 1993 - May 1997)</i>	The fixed exchange rate of the Czech koruna (against a basket of currencies) served as an effective nominal stabilising anchor, while monetary targeting was used to react to specific economic developments during transition. In February 1996, the fluctuation band of the exchange rate peg was widened from $\pm 0.5\%$ to $\pm 7.5\%$.
<i>Regime combining monetary targeting and managed floating (May – December 1997)</i>	Interim regime for the short period following the exchange rate turbulence in May 1997.
<i>Inflation targeting (since January 1998)</i>	Inflation targeting followed the abandonment of the fixed exchange rate peg as another way of achieving price stability, the primary monetary policy objective of the Czech National Bank (CNB). The current form of the medium-term strategy dates from January 2006, when the CNB announced a 3% point target for the CPI (with a 'tolerance' band of ± 1 percentage point). However, the 3% target may be too high to ensure entry into the euro.

Substantial foreign investment has been focused on export industries supplying mainly the EU region, including large privatizations. Germany remains the main destination with over 30% of exports. While a high proportion of exports are still in low-medium technology manufacturing, the Balassa index⁵ of relative export performance indicates that the strongest increases since 1995 have been in high-technology and ICT manufacturing.

⁵ The [Balassa index](#) is defined as the ratio of a country's share in global exports of a given sector and the country's share in global exports of the economy as a whole.

Figure3: Balassa specialisation index



Source: OECD STAN Database

Within the Czech Republic there are marked regional imbalances. All regions except Prague have Objective 1 status, GDP per capita below 75% of the EU average, and unemployment in the North West and Moravia-Silesia regions is approximately three-times the level in the capital. In this respect, labour mobility is still hampered by a government system of rent controls which ties up housing stock in urban areas.

2.2. Anatomy of medium-term growth

The expansion of the Czech economy was seriously interrupted by the recession in the late nineties making growth much slower than in the RAMS during 1996-2000: 1.45% of GDP compared with 4.3% of GDP. This period was marked by the effects of earlier privatisations in which substantial capital investment was not converted into increased productivity due to a lack of pressure on enterprises to modernise and restructure. The contribution of factor productivity to growth was negative during 1996-2000 despite above average capital deepening compared to the RAMS.

Prior to the recession in 1996, unemployment was below 6% due mainly to rapid employment growth from new small Czech enterprises. This placed pressure on salaries which rose at twice the rate of productivity fuelling inflation and swelling the current account deficit. The fiscal and monetary stabilisation measures undertaken in 1997/98 contributed to a swift rise in unemployment, also bringing down wage growth in parallel with a decrease in government spending. Private spending declined while the export market began to improve partly due to the currency devaluation in 1997. Going into recession, the current account deficit was partially financed by short-term speculative foreign capital attracted by high interest rates tied into the fixed exchange-rate policy. Subsequently, the current account has been supported by more stable longer-term FDI.

Since the recession, unemployment has remained at about 8%. The steep rise that followed the 1997 stabilisation measures has led to a persistent level of structural unemployment including high long-term unemployment, particularly amongst those with low education and skills, as well as large regional disparities.

Comprehensive structural reforms in the financial and enterprise sectors helped the economy to recover quite rapidly. Despite the effects of substantial flood damage in the

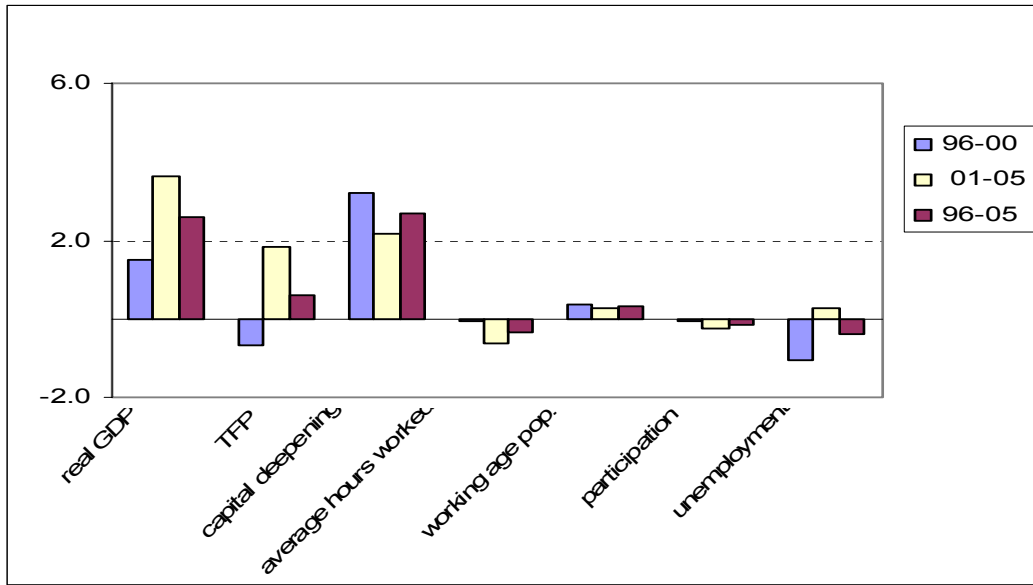
summer of 2002 and rather sluggish growth in its main export markets, during 2001-2005 GDP growth has been virtually on a par with the RAMS.

Since 2000, the economy has enjoyed substantial foreign investment. On average, the Czech Republic has been the recipient of higher FDI inflows than any other recently acceded Eastern-European member state in percentage of GDP. These have been largely concentrated in three industries: motor vehicles, food products and tobacco and non-metallic minerals. Both imports and exports have consistently grown faster than GDP underlining the openness of the Czech economy.

The influx of foreign investment has helped to modernise production capacity. During the period 2001-2005, the contribution of factor productivity to GDP growth has increased markedly, attributable to new production technologies and processes in foreign owned industries and services. However, average hours worked and participation rates contributed negatively to GDP growth over the same period, and were below average compared with the RAMS, indicating a relatively underperforming labour market.

The recent sharp increase in household sector loans is a sign of financial deepening, but household sector indebtedness is still relatively low by international standards. While there are currently no signs of overheating or asset bubbles, credit development should be carefully monitored.

Chart 4: Real GDP growth and its components



Note:

Assuming a Cobb-Douglas-production function $Y = A(L \cdot H)^\alpha K^{1-\alpha}$ where Y denotes the level of GDP , L employment, H the average hours worked per person employed, K the capital stock and α the labour share in income, real GDP can be written as $Y = \frac{Y}{H \cdot L} H \cdot L = A \cdot \left(\frac{K}{H \cdot L} \right)^{1-\alpha} H \cdot WP \cdot PART \cdot (1 - ur)$ where WP stands for working age population, $PART$ denotes the participation ratio as a share of WP and ur the rate of unemployment. In terms of growth rates g this is:

$$g_Y = g_A + (1 - \alpha)(g_K - g_L - g_H) + g_H + g_{WP} + g_{PART} - g_{ur} \cdot \frac{ur}{1 - ur}$$

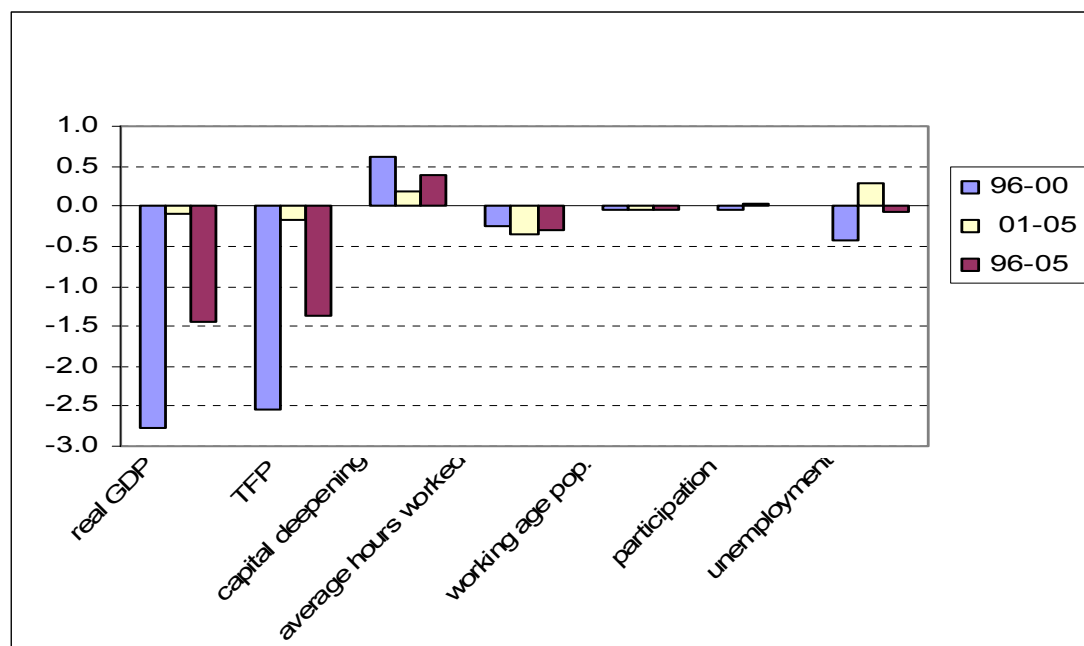
The expression $(g_K - g_L - g_H)$ is referred to as capital deepening, i.e. the increase in the capital labour ratio.

Source: Commission services

Compared to the growth profile of the RAMS as a whole, capital deepening was the only component to make a larger than average contribution to the expansion of the economy during the period 1996-2005. This was mainly due to the traditionally high investment rates in the Czech economy, supported by exceptionally high FDI inflows.

As regards growth composition, private consumption and investment have been the main driving forces of GDP growth. The negative contribution of external trade in the late 1990's turned positive after 2000. Public consumption has also made a positive contribution to GDP growth since 2000.

Chart 5: Real GDP growth and its components: Difference vis-à-vis the EU10 average



Note: See note of Figure 4

Source: Commission services

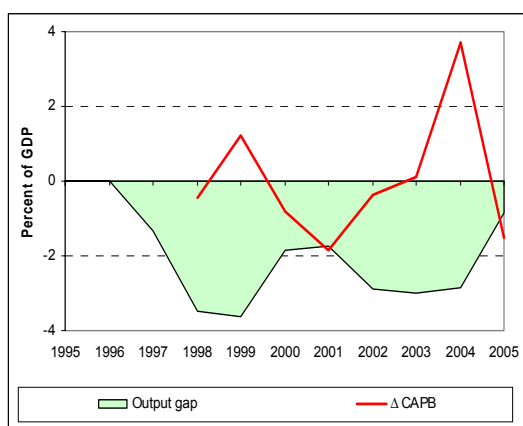
2.3. Macro-policies against the backdrop of the economic cycle

The rapid growth of the Czech economy following transition was accompanied by annual government deficits in balance or in surplus together with low levels of government debt prior to 1995. Following the currency crisis in 1997, the government managed to stabilise the economy with a series of macro-economic and structural measures. Monetary policy was tightened through interest rate rises and inflation targeting while a range of fiscal restraint measures were introduced including a reduction in social and investment spending as well as public sector wage freezing. In addition, the government accelerated the privatization programme, tailoring it towards foreign investors. The monetary and fiscal restraint measures led to a significant reduction in inflation but also arrested the growth of the economy, driving down domestic demand.

The deepening negative output gap represented 4% of potential GDP in 1999 before starting to close due to a pick-up in real GDP growth, accompanied by increased investment including an upsurge of FDI, which broadly marked the start of the current economic cycle. The output gap has been negative until 2005 due largely to sustained capital deepening which has increased potential output.

The stabilisation package of 1997 was successful in setting the Czech economy on a more stable footing. GDP has increased consistently since 1999, gradually closing on the annual average growth rates of the RAMS, with a record growth rate of 6% in 2005. However, the growth has been partly stimulated by a relatively lax fiscal stance whereby annual deficits in excess of 3% of GDP have been consistently accumulated, peaking at 6.6% and 6.8% in 2002 and 2003. This has been a reflection of rising expenditures rather than cyclical factors which have played a lesser role. In this respect, the annual deficits have been mainly due to structural effects. Thus, the accumulation of high deficits may hinder the symmetrical functioning of automatic stabilisers.

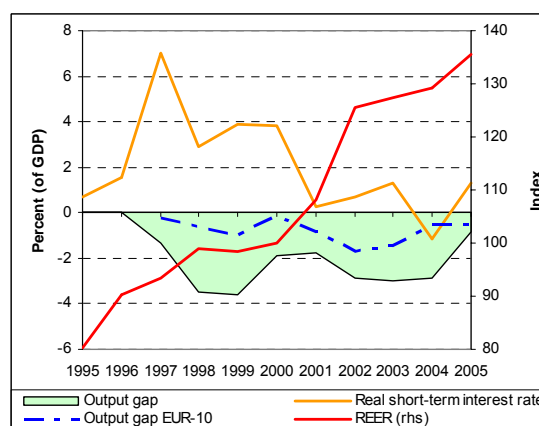
Figure 6 : Output gap and fiscal stance



Note: Δ CAPB denotes the change in the cyclically-adjusted primary budget balance

Source: Commission services

Figure 7: Output gap and monetary conditions



Source: Commission services

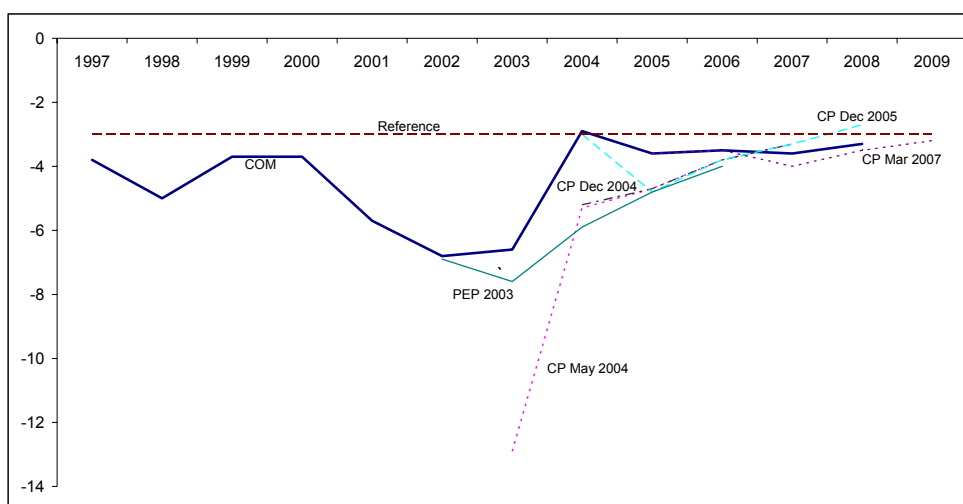
The gradual appreciation of the Czech koruna since 2000, has not adversely affected export performance. This is most likely attributable to increases in productivity as well as earlier devaluations.

2.4. Public finances

The annual government deficit from 1996-2005 has averaged 4.5% of GDP. Fiscal loosening in 1998 and 1999 was largely a reaction to the 1997 recession, whereas the increase in government deficits after 2000 has mainly reflected restructuring costs, rising mandatory expenditures, and bad debts from earlier privatisations taken over by the Czech Consolidation Agency. The lower deficits in 2004 and 2005 mainly reflect the favourable economic situation and the government's authorization of budget carry-overs, permitting an accumulation of unspent funds for future disbursement. These cumulative savings currently amount to about 1¾% of GDP and may therefore swell future budget deficits.

Deficits of around 6% of GDP in three consecutive years (2001-2003) resulted in a significant increase in the accumulated debt level. Though the share of public debt has increased substantially over the last 10 years, it remains low at about 30% of GDP.

Chart 8: General government balance projections in successive stability programmes (% of GDP)



Source: Commission services and national convergence programmes

Tax revenue is comparatively high as a percentage of GDP, including high taxes on labour. Therefore, room for consolidation should be found in expenditures which have risen as a percentage of GDP between 1996-2000 and 2001-2005. The high level of social and welfare spending is steadily increasing and risks hampering more active investment in human capital and R&D necessary to underpin future growth.

Though the tax burden has been partly shifted from direct to indirect taxation, the combination of high income tax and social transfers appears to have had a negative effect on the labour supply. This concerns mainly low-paid workers and the unemployed – the most vulnerable groups. The total rate of health and social security contributions is approximately 47.5% of gross wage of which about ¼ is paid by employees and about ¾ by employers. The recent reduction in effective taxation on low-income groups was a

positive move to improve the labour market and turn it toward making a positive contribution to growth.

Public finances will come under increased pressure from ageing effects through the pension and health care systems as demographically the Czech Republic has one of the most rapidly changing profiles in the European Union. An all-party pension report was compiled in 2005, presenting a range of reform proposals from parametric changes to structural overhaul, but this has not been followed up by government action. Reform of the health care system is also delayed.

2.5. Medium and long-term policy challenges for public finances.

The Czech economy continues to grow strongly with rising employment rates. While unemployment has fallen since 2000, the proportion of long-term unemployed remains high and further falls are likely to be tempered by structural factors including the high tax wedge on employment. The current macroeconomic environment gives ample opportunity to broach the main challenges of fiscal policy: to improve medium-term budgetary consolidation and to achieve sustainable public finances for the long-term. Although actions have been undertaken to restructure taxation to favour employment and to improve budgetary control, budgetary expenditure remains relatively inflexible and medium-term budgetary ceilings continue to be broken. The demographic shift in the population will place further pressure on public finances, in particular through the pension and health care systems.

As concerns medium-term macroeconomic *stabilisation*, the main problem is the slow pace of budgetary consolidation. Despite very strong GDP growth, the structural deficit worsened in 2005. Effective consolidation would be assisted by more reliable budgetary planning and execution. A medium-term expenditure framework was introduced into the annual budget in 2004 whereby nominal expenditure ceilings are set for two years in advance, at the time of an annual budget.

The annual budget includes a high proportion of social expenditures including pension and health care, the size of which is increasing constantly due to the ageing process: the Czech Republic was classified as being at high risk regarding the long-term sustainability of public finances and has one of the fastest ageing populations in the EU. While the pension system is broadly in balance, the position will deteriorate in the medium-term. An all-party report on pension reform was conducted in 2005 bringing together a range of proposals aimed at long-term sustainability.

The challenge in improving the *efficiency* of public spending will be to focus resources towards the promotion of growth. The recent moves to shift the tax burden from direct to indirect taxation and to lower taxes on labour are positive moves in this direction. The Czech Republic has also introduced recent measures to improve the transparency and accountability of public finances. While the government debt level remains comparatively low, it is on a rising trend and without remedial action will progressively draw resources from active spending.

Table 1: Key economic indicators

	Czech Republic						EU-10					
	Averages			2003	2004	2005	Averages			2003	2004	2005
	'96 - '05	'96 - '00	'01 - '05				'96 - '05	'96 - '00	'01 - '05			
Economic activity												
Real GDP (% change)	2.6	1.5	3.6	3.6	4.2	6.1	4.2	4.3	4.1	4.0	5.1	4.8
Contributions to real GDP growth:												
<i>Domestic demand</i>	2.7	2.0	3.4	4.2	2.8	2.1	4.5	5.3	3.8	4.1	5.6	3.3
<i>Net exports</i>	-0.1	-0.5	0.3	-0.6	1.4	4.0	-0.3	-1.0	0.3	0.0	-0.5	1.5
Prices, costs and labour market												
HICP inflation (% change)	4.3	6.5	2.0	-0.1	2.6	1.6	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Labour productivity (% change)	2.9	2.3	3.4	4.7	4.1	4.7	4.1	4.6	3.7	4.3	4.5	2.9
Real unit labour costs (% change)	0.6	0.3	0.8	2.8	-1.9	-1.0	-0.7	-0.6	-0.7	-0.6	-2.6	-1.0
Employment (% change)	-0.3	-0.8	0.1	-1.2	-0.3	1.3	0.1	-0.3	0.5	-0.2	0.6	1.8
Unemployment rate (% of labour force)	7.5	7.2	7.9	7.8	8.3	7.9	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Competitiveness and external position												
Real effective exchange rate (% change) (1)	5.4	4.6	6.1	1.5	1.3	4.9	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Export performance (% change) (2)	2.7	0.0	5.4	2.1	12.0	3.2	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
External balance (% of GDP)	-4.8	-4.4	-5.1	-6.3	-6.2	-3.2	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Public finances												
General government balance (% of GDP)	-4.5	-3.9	-5.1	-6.6	-2.9	-3.5	n.a.	n.a.	-4.8	-5.7	-4.5	-4.1
General government debt (% of GDP)	22.0	15.1	29.0	30.1	30.7	30.4	39.0	35.8	41.6	41.1	45.2	43.6
Structural budget balance (% of GDP) (3)	n.a.	n.a.	n.a.	-5.5	-1.2	-2.0	n.a.	n.a.	n.a.	-5.0	-4.2	-3.7
Financial indicators (4)												
Long term real interest rate (%) (5)	n.a.	n.a.	2.1	3.2	1.2	2.8	n.a.	n.a.	n.a.	3.4	2.1	2.3
Household debt (% of GDP) (6)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector debt (% of GDP) (7)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Notes:

More detailed tables summarising the economic performance of the country are included in Annex 4.

(1) Unit labour costs relative to rest of a group of industrialised countries (USD): EU24 (=EU25 excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and NZ.

(2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets.

(3) Cyclically-adjusted budget balance net of one-off and other temporary measures.

(4) Data available up to 2004.

(5) Using GDP deflator.

(6) Households' and non-profit institutions serving households' debt, defined as loans and securities other than shares.

(7) Non-financial corporate sector debt, defined as loans and securities other than shares.

Source :

Commission services

3. MACROECONOMIC OUTLOOK

This section is in seven parts, six of which refer to various dimensions of the macroeconomic scenario, notably: the external assumptions, economic activity, potential output growth, the labour market, costs and prices and sectoral balances. The final part summarises the assessment and includes (i) an overall judgement on the plausibility of the macroeconomic scenario and (ii) an indication of whether economic conditions over the programme period can be characterised as economic ‘good’ or ‘bad’ times.

3.1. External assumptions

The programme's external assumptions are broadly in line with those underlying the Commission services' spring 2007 forecast. The programme assumes a gradual appreciation in the nominal exchange rate while the Commission's spring 2007 forecast applies a fixed nominal exchange rate during the forecast period.

In 2006, the Czech National Bank raised interest rates by 0.5 per cent in two 25 basis-point increases. Given the anticipated moderation in growth and recent relaxation of inflationary pressure, it is not expected that interest rates will be raised significantly in 2007.

3.2. Economic activity

The programme foresees a moderation in the growth of the Czech economy. After growing at some 6% of GDP in 2006. Real GDP growth rate is expected to decrease to 4.9% in 2007 and to 4.8% in 2008 and 2009. The programme predicts a continuation of the current growth composition, the main contribution coming from domestic demand, particularly gross fixed capital formation. The rise in private consumption, on average just above 4% over the programme period is assumed to be fuelled by falling unemployment, rising wage levels and rapid credit growth, although household debt still remains low by international comparisons. The contribution from net exports, which was the principal driver in 2005, has continued to decrease in 2006 due mainly to rising imports. The programme foresees a continuation of this trend in 2007 before reversing in 2008 and 2009 due to a minor fall off in import growth. Both domestic and external demand are expected to remain positive over the programming period.

The programme's real GDP growth projections are broadly in line with the Commission services' 2007 spring forecast. Both the programme and the Commission services' 2007 spring forecast project growth to remain above potential in 2006 and 2007, easing back toward the potential level in 2008. Both the convergence programme and the Commission services' spring 2007 forecast foresee the main impetus coming from domestic demand.

Table 2: Comparison of macroeconomic developments and forecasts

	2006		2007		2008		2009
	COM	CP	COM	CP	COM	CP	CP
Real GDP (% change)	6.1	6.0	4.9	4.9	4.9	4.8	4.8
Private consumption (% change)	4.6	3.9	4.7	4.2	4.4	4.1	4.1
Gross fixed capital formation (% change)	7.3	6.5	7.6	7.8	7.8	7.9	8.0
Exports of goods and services (% change)	14.6	12.7	12.1	10.6	10.4	10.3	10.4
Imports of goods and services (% change)	14.2	11.4	11.0	10.2	10.0	9.6	9.7
<i>Contributions:</i>							
- Final domestic demand	4.2	3.3	4.3	4.2	4.4	4.0	4.0
- Change in inventories	1.4	1.6	-0.5	0.3	0.0	0.1	0.0
- External balance on g&s	0.5	1.1	1.1	0.5	0.5	0.7	0.9
Output gap ¹	0.4	0.9	0.5	1.1	0.5	1.0	1.0
Employment (% change)	1.3	1.6	1.0	1.0	0.7	0.5	0.2
Unemployment rate (%)	7.1	7.2	6.5	6.7	6.2	6.5	6.5
Labour productivity growth (%)	4.7	4.3	3.9	3.9	4.2	4.3	4.6
HICP inflation (%)	2.1	2.4	2.4	2.6	2.9	2.5	2.5
GDP deflator (% change)	1.7	1.4	1.8	2.6	2.7	2.9	2.9
Comp. of employees (% change)	7.5	7.8	4.9	7.8	4.4	7.6	7.3
Real unit labour costs (% change)	-1.6	-1.3	-3.2	-0.8	-4.6	-0.7	-0.8
External balance (% of GDP)	-4.6	-2.8	-3.5	-1.4	-3.3	0.2	1.1
<i>Note:</i>							
¹ In percent of potential GDP, with potential GDP growth as reported in Table 4 below.							
<i>Source:</i>							
<i>Commission services' spring 2007 economic forecasts (COM); Convergence programme</i>							

Table 3: Output gap estimates in successive Commission services' forecasts and convergence programmes

	2006		2007		2008	
	COM	CP	COM	CP	COM	CP
Spring 2007	0.4	-	0.5	-	0.5	-
CP Mar 2007	-	0.9	-	1.1	-	1.0
Autumn 2006	0.9	-	1.4	-	1.5	-
Spring 2006	1.0	-	1.4	-	-	-
CP Nov 2005	-	-0.1	-	0.3	-	0.8
Autumn 2005	0.6	-	1.2	-	-	-
Spring 2005	1.4	-	-	-	-	-
CP Dec. 2004	-	-0.4	-	0.3	-	-
<i>Note:</i> Commission services' calculations according to the the commonly agreed method based on the figures of the programme						
<i>Source:</i> Commission services' 2007 spring forecast and 2007 March update of the Convergence programme (CP)						

3.3. Potential growth and its determinants

Commission services' calculations according to the commonly agreed methodology, based on the information provided in the programme, project potential growth to rise up to 2008 to around 5%, moderating slightly in 2009. This is above the previous five year growth average (2001-2005) reflecting *inter alia* the positive effects of earlier reforms and technological innovation, not least through substantial foreign direct investment. The main contribution is calculated to come from TFP, in line with the recent trend. Capital accumulation is expected to play an important role where as well as the contribution of

labour is considered to remain low. The estimates are in line with the Commission services' spring 2007 forecast.

The output gaps recalculated by the Commission services according to the commonly agreed method based on the figures of the programme, are larger than the output gap estimates of the Commission services' forecast.

Table 4: Sources of potential output growth

	2006		2007		2008		2009
	COM	CP ²	COM	CP ²	COM	CP ²	CP ²
Potential GDP growth ¹	4.6	4.4	4.8	4.7	4.9	5.0	4.8
<i>Contributions:</i>							
- Labour	0.4	0.1	0.5	0.3	0.5	0.4	0.1
- Capital accumulation	1.3	1.3	1.4	1.4	1.5	1.5	1.6
- TFP	2.7	2.9	2.8	3.0	2.8	3.0	3.0
Notes:							
¹ based on the production function method for calculating potential output growth							
² Commission services' calculations on the basis of the information in the programme							
Source:							
<i>Commission services' spring 2007 economic forecasts (COM); Commission services' calculations</i>							

3.4. Labour market developments

The strong growth of the Czech economy has positively influenced the labour market. The programme foresees a continuation of the current trend with employment increasing up to 2009 albeit at a decelerating rate. The unemployment rate is projected to continue falling to 6.5% in 2008. The recent improvement in the labour market is accounted for by cyclical factors as well as the influence of substantial foreign direct investment. The predicted slow down in employment growth is consistent with a moderation in GDP growth and the restraining effect of remaining labour market rigidities, such as the relatively high tax wedge on labour. The labour market developments foreseen in the convergence programme are broadly consistent with the Commission's spring 2007 forecast.

3.5. Costs and price developments

Inflationary pressures increased in 2006 due to rises in regulated prices, as well as increases in the cost of energy and food. The impact of two rises in excise duties in 2007 is expected to add to inflationary pressure while the overall outlook should be mitigated by falling unit labour costs and a gradually appreciating koruna. Both the programme and the Commission service's spring forecast foresee inflation to remain between 2½ and 3% of GDP over the programme period.

3.6. Sectoral balances

The programme foresees the continuing strengthening of the trade balance, registering a growing surplus. The deficit in net lending vis-à-vis rest of the world is expected to narrow while still reflecting a large proportion of repatriated and reinvested profits from foreign direct investment. This is partly due to transfers from abroad which will be

boosted by an increased inflow of EU funds from 2007 onwards. The Commission services' spring forecast foresees similar trends.

3.7. Assessment

The assessment of the macroeconomic outlook covers two questions: first, whether the macroeconomic scenario is plausible, and, second, whether the economy should be considered to be in economic 'good' or 'bad' times.

3.7.1. Plausibility of the macroeconomic scenario

The programme's macroeconomic outlook is broadly in line with the Commission services' spring 2007 GDP forecast for the period 2007-2008 including the relative contribution of domestic and external demand, and foreseeing a moderation in growth from 2007 to 2009. The programme projects for 2009 growth remaining at 4.8% which is about potential growth. Therefore, it is considered that the programme is based on plausible macroeconomic assumptions.

3.7.2. Economic good vs. bad times

According to the Commission services' calculations, the output gap turned positive in 2006, after being negative since 1997, and will stay positive during the programme period. Growth is projected to be 6% in 2006 moderating to potential during the rest of the programme period. Unemployment is expected to continue falling. In this respect, the Czech economy is likely to be in economic "good times" during the programming period.

4. GENERAL GOVERNMENT BALANCE

This section consists of four parts. The first part discusses budgetary implementation in the year 2006 and the second presents the budgetary strategy in the new update, including the programme's medium-term objective (MTO) for the budgetary position. The third analyses the risks attached to the budgetary targets in the programme. The final part contains the assessment of the fiscal stance and of the country's position in relation to the budgetary objectives of the Stability and Growth Pact.

4.1. Budgetary implementation in 2006

The target for the 2006 headline deficit was 3.8% of GDP, set in the November 2005 convergence programme. The new programme estimates the actual deficit to be 3.5% of GDP partly reflecting higher-than-expected growth. Corporate tax revenues were higher than anticipated due to increasing profit margins while personal income tax revenues were partly affected by in the introduction of joint taxation for couples. On the expenditure side, government consumption continued to be restrained in contrast to rising investment spending.

According to the 2007 spring notification as validated by Eurostat⁶ and included in the Commission services' spring 2007 forecast, the 2006 deficit was 2.9% of GDP, 0.5 percentage point of GDP less than estimated in the convergence programme. This is

⁶ Eurostat News Release No 55/2007 of 23 April 2007. For the most recent notification: http://epp.eurostat.ec.europa.eu/portal/page?_pageid=2373,58110711&_dad=portal&_schema=portal

accounted for by the roll-over of reserve funds in 2006 (0.3% of GDP), and a surplus in social security of a similar amount (higher than estimated in the convergence programme), due to higher accrual-based social contributions and lower-than-expected outlays from the public health insurance scheme.

Table 5: Evolution of budgetary targets in successive programmes

		2005	2006	2007	2008	2009
General government balance (% of GDP)	CP Mar 2007	-3.6	-3.5	-4.0	-3.5	-3.2
	CP Nov 2005	-4.8	-3.8	-3.3	-2.7	n.a.
	<i>CP Dec 2004</i>	-4.7	-3.8	-3.3	<i>n.a.</i>	<i>n.a.</i>
	COM May 2007	-3.5	-2.9	-3.9	-3.6	n.a.
General government expenditure (% of GDP)	CP Mar 2007	44.0	43.4	43.9	43.9	43.4
	CP Nov 2005 ¹	45.9	44	43.1	43.6	n.a.
	<i>CP Dec 2004</i>	45.8	44.7	43.9	<i>n.a.</i>	<i>n.a.</i>
	COM May 2007	44.0	42.5	43.1	43.0	n.a.
General government revenues (% of GDP)	CP Mar 2007	40.4	39.9	39.9	40.4	40.3
	CP Nov 2005	41.1	40.2	39.8	40.9	n.a.
	<i>CP Dec 2004</i>	41.1	40.9	40.6	<i>n.a.</i>	<i>n.a.</i>
	COM May 2007	40.4	39.5	39.2	39.4	n.a.
Real GDP (% change)	CP Mar 2007	6.1	6.0	4.9	4.8	4.8
	CP Nov 2005	4.8	4.4	4.2	4.3	n.a.
	<i>CP Dec 2004</i>	3.6	3.7	3.8	<i>n.a.</i>	<i>n.a.</i>
	COM May 2007	6.1	6.1	4.9	4.9	n.a.
<i>Source:</i> <i>Convergence programme (CP); Commission services' spring 2007 economic forecasts (COM)</i>						

4.2. The programme's medium-term budgetary strategy

This section covers in turn the following aspects of the medium-term budgetary strategy outlined in the programme: (i) the main goal of the budgetary strategy; (ii) the composition of the budgetary adjustment, including the broad measures envisaged; and (iii) the programme's medium-term objective and the adjustment path towards it in structural terms.

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

The convergence programme presents two scenarios which are inconsistent with each other. On the one hand, the additional chapter of the programme, entitled "Programme Declaration of the New Government", gives the impression that the government plans to correct the excessive deficit in 2009 (one year later than the deadline set by the Council), based on as yet unknown measures. This chapter announces that in the next update detailed and quantified measures will be presented. On the other hand, the programme's medium-term budgetary outlook presented in the preceding chapters foresees reducing the government deficit to 3.5% of GDP in 2008 and only 3.2% in 2009. The assessment in this and the next sections is based on the latter projections since only these present a coherent and sufficiently quantified medium-term fiscal framework for the period 2006-2009.

At any rate, the correction of the excessive deficit is planned to be completed at least one year later than the deadline in the July 2004 EDP Council recommendation, even taking

into account the declaration in the additional chapter of the programme. This is a change from the previous convergence programme which was in line with the Council recommendation and aimed to reduce the deficit to 2.7% of GDP by 2008. The programme's budgetary strategy is based on the 2007 budget, implying a no-policy change assumption for the medium-term outlook 2008/2009.

Box 2: The excessive deficit procedure for the Czech Republic

According to the excessive deficit procedure (EDP), the Commission and the Council monitor the development of the budgetary position in each Member State, notably in relation to the reference values of 3% of GDP for the deficit and 60% of GDP for the debt, in order to assess the existence (or risk) of an excessive deficit and to ensure its correction. The EDP is laid down in Article 104 of the Treaty and further clarified in the Stability and Growth Pact.

On 5th July 2004 the Council adopted a decision stating that the Czech Republic had an excessive deficit in accordance with Article 104(6). At the same time, the Council addressed a recommendation under Article 104(7) specifying that the excessive deficit had to be corrected by 2008. In particular, the Czech Republic was recommended to put an end to the excessive deficit as rapidly as possible by taking action in a medium-term framework in order to achieve their objective of bringing the deficit below 3% of GDP by 2008 in a credible and sustainable manner and in accordance with the path for deficit reduction specified in the Council Opinion of 5 July 2004 on the convergence programme submitted in May 2004. The Czech Republic was recommended to implement with vigour the measures envisaged in the May 2004 convergence programme, in particular a cut in the wage bill of central government and a reduction in spending of individual ministries, and to take effective action by 5 November 2004 regarding the measures envisaged to achieve the 2005 deficit target.

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

Table 6: Composition of the budgetary adjustment

(% of GDP)	2005	2006	2007	2008	2009	Change: 2009-2006
Revenues	40.4	39.9	39.9	40.4	40.3	0.4
<i>of which:</i>						
- Taxes & social contributions	36.0	35.5	35.1	34.7	34.1	-1.3
- Other (residual)	4.4	4.4	4.8	5.6	6.2	1.7
Expenditure	44.0	43.4	43.9	43.9	43.4	0.0
<i>of which:</i>						
- Primary expenditure	42.9	42.3	42.5	42.4	41.9	-0.4
<i>of which:</i>						
Consumption	22.3	21.9	21.6	21.2	20.8	-1.1
Transfers other than in kind & subsidies	13.4	13.5	13.9	13.9	13.7	0.3
Gross fixed capital formation	5.0	5.1	5.2	5.6	5.7	0.6
Other (residual)	2.2	1.8	1.8	1.7	1.7	-0.1
- Interest expenditure	1.2	1.2	1.4	1.5	1.5	0.4
General government balance (GGB)	-3.6	-3.5	-4.0	-3.5	-3.2	0.4
Primary balance	-2.5	-2.4	-2.6	-2.0	-1.6	0.7
One-offs ¹	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	-3.6	-3.5	-4.0	-3.5	-3.2	0.4
Notes:						
¹ One-off and other temporary measures.						
NB Section 4.2 of the convergence programme describes one-off measures for 2005 amounting to 0.9% of GDP						
² Alternative deficit targets based on as yet unapproved measures						
of the new Czech government: 3.2% of GDP in 2008, 2.8% of GDP in 2009						
Source :						
<i>Convergence programme update; Commission services' calculations</i>						

4.2.2. The composition of the budgetary adjustment

After the expenditure-induced budgetary slippage in 2007, as a consequence of election promises, the annual deficit should improve again. The principal reason for the postponement of the correction of the excessive deficit by at least one year, in comparison to the previous convergence programme, is the anticipated fiscal expansion in 2007 due to substantial increases in social transfers. The budget also contained an increase in public R&D expenditure by approximately 0.1% of GDP. As mentioned above, for the remaining years 2008 and 2009, the projections are essentially on a no-policy change basis.

The proposed consolidation be mainly achieved through increased revenue by 0.4% of GDP over the programme period, in particular, 'other revenues', which will presumably be derived from EU transfers, will more than compensate for an overall decline in taxes and social contributions as a percent of GDP due to lower-than-unit elasticity of overall tax revenues and reductions in labour taxation, which will more than offset increases in excise duties on tobacco in 2007 to comply with EU minimum rates. The primary balance is projected to improve more than the overall balance due to increases in interest rate expenditure.

From a policy point of view, the consolidation should be seen as expenditure driven given the projection of a consistent decline in public consumption over the programme period. The reasons for the decline are not clearly specified, but can be assumed to in

part relate to government sector expenditure and wage restraint, as compensation of government employees is planned to fall by ½ percentage point of GDP between 2006 and 2009, which will more than offset the increase in public investment and interest expenditure.

Box 3: The budget for 2007

The draft budget for 2007 was proposed on 16 August 2006 in one of the final sessions of the outgoing government. It was adopted by the Czech parliament on 13 December 2006. The target for the general government balance is a deficit of 4.0% of GDP. The 2007 budget includes rises in social expenditure and gross fixed capital formation which principally account for the predicted widening of the deficit.

Table: Main measures in the budget for 2007

Revenue measures*	Expenditure measures**
	<ul style="list-style-type: none"> ○ Increase in social transfers (1.1% of GDP) ○ Increase in public R&D expenditure (0.1% of GDP)

* Estimated impact on general government revenues.

** Estimated impact on general government expenditure.

Sources: Commission services and 2007 budget

4.2.3. The medium-term objective (MTO) and the structural adjustment

Box 4: The medium-term objective (MTO) for the budgetary position

According to the Stability and Growth Pact, stability and convergence programmes must present a medium-term objective (MTO) for the budgetary position. The MTO is country-specific to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risk to the sustainability of public finances.

The MTO should fulfil a triple aim. First, it should provide a safety margin with respect to the 3% of GDP deficit limit. Second, it should ensure rapid progress towards sustainability. Third, taking into account the first two goals, it should allow room for budgetary manoeuvre, considering in particular the needs for public investment. The code of conduct further specifies that, as long as the methodology for incorporating implicit liabilities is not fully developed and agreed by the Council, the country-specific MTOs are set taking into account the current government debt ratio and potential growth (in a long-term perspective), while preserving a sufficient margin against breaching the 3% of GDP deficit reference value. Member States are free to set an MTO that is more demanding than strictly required by these provisions.

The MTO is defined in structural terms, i.e. it is adjusted for the cycle and one-off and other temporary measures are excluded. For countries belonging to the euro area or participating in the exchange-rate mechanism (ERM II), the MTO should be in a range between a deficit of 1% of GDP and balance or surplus (in structural terms).

The MTO put forward in the programme is a structural deficit (cyclically-adjusted deficit excluding one-off and other temporary measures) of 1% of GDP, which is planned to be achieved by 2013, outside the programme period. In comparison with the previous convergence programme update, the achievement of the MTO is postponed by one year.

Table 7: Output gaps and cyclically-adjusted and structural balances

% of GDP	2005		2006		2007		2008		2009	Change: 2009-2006
	COM	CP ¹	COM	CP ¹	COM	CP ¹	COM	CP ¹	CP ¹	CP ¹
Gen. gov't balance	-3.5	-3.6	-2.9	-3.5	-3.9	-4.0	-3.6	-3.5	-3.2	0.4
One-offs ²	-1.1	0.0	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Output gap ³	-1.1	-0.7	0.4	0.9	0.5	1.1	0.5	1.0	1.0	0.1
CAB ⁴	-3.1	-3.4	-3.1	-3.9	-4.1	-4.4	-3.8	-3.9	-3.5	0.3
change in CAB	-1.3	:	0.1	-0.5	-1.0	-0.5	0.2	0.5	0.3	:
CAPB ⁴	-2.0	-2.2	-2.0	-2.7	-3.0	-3.0	-2.8	-2.4	-2.0	0.7
Structural balance ⁵	-2.0	-3.4	-2.8	-3.9	-4.1	-4.4	-3.8	-3.9	-3.5	0.3
change in struct. bal.	-0.9	:	-0.8	-0.5	-1.2	-0.5	0.2	0.5	0.3	:
Struct. prim. bal. ⁶	-0.9	-2.2	-1.7	-2.7	-3.0	-3.0	-2.8	-2.4	-2.0	0.7
Notes: ¹ Output gaps and cyclical adjustment according to the convergence programme (CP) as recalculated by Commission services on the basis of the information in the programme. ² One-off and other temporary measures. See Table 6 above. ³ In percent of potential GDP. See Table 2 above. ⁴ CAB = cyclically-adjusted balance; CAPB = cyclically-adjusted primary balance. ⁵ CAB excluding one-off and other temporary measures. ⁶ Structural primary balance = CAPB excluding one-off and other temporary measures. Source: <i>Commission services' spring 2007 economic forecast (COM); Commission services' calculations</i>										

The MTO satisfies the condition of providing a safety margin (most recent estimate of the minimum benchmark for the Czech Republic is a cyclically-adjusted deficit of 1.6% of GDP). It is appropriate in view of the debt ratio and average potential growth in the long run. In structural terms, the deficit is projected in the programme to worsen significantly in 2007 after a deterioration in 2006. The expansionary stance in 2007 is planned to be followed by a (mildly) restrictive one in both 2008 and 2009.

4.3. Risk assessment

This section discusses the plausibility of the programme's budgetary projections by analysing various risk factors. For the period until 2008, Table 8 compares the detailed revenue and expenditure projections in the Commission services' spring 2007 forecast, which are derived under a no-policy change scenario, with those in the updated programme.

As assessed in Section 3 above, the macroeconomic scenario is plausible as it is similar to the Commission services' forecast. There is buoyant growth in the economy and the output gap is in positive territory hence the country is enjoying economic 'good times' and there appears to be ample opportunity to reach the proposed targets.

Similarly, the programme's tax revenue projections are based on prudent assumptions about tax elasticities. In particular, the programme's estimate of the overall impact of discretionary measures is more conservative than the Commission services' estimate. In addition, the Czech Republic has a track record of achieving lower-than-planned deficits.

As the envisaged consolidation, does not rely on one-off or temporary measures, there are no risks stemming from these elements.

The downside risks to meeting these targets stem from a lack of information on the measures envisaged by the new government and the political risk associated with the finely balanced parliamentary situation. Also, the possibility to spend carried-over budgetary allocations represents a risk for fiscal consolidation. Both the Commission services' and the programme's projections are based on the assumption that the size of budgetary carry-overs in the coming years will be stabilized at their level.

The projections of interest expenditures appear to be on the cautious side as they assume a strongly rising implicit rate.

Table 8: Comparison of budgetary developments and projections

(% of GDP)	2005	2006		2007		2008		2009
		COM	CP	COM	CP	COM ¹	CP	CP
Revenues	40.4	39.5	39.9	39.2	39.9	39.4	40.4	40.3
<i>of which:</i>								
- Taxes & social contributions	36.0	34.8	35.5	34.4	35.1	34.4	34.7	34.1
- Other (residual)	4.5	4.7	4.4	4.8	4.8	5.0	5.6	6.2
Expenditure	44.0	42.5	43.4	43.0	43.9	42.7	43.9	43.4
<i>of which:</i>								
- Primary expenditure	42.8	41.4	42.3	41.8	42.5	41.4	42.4	41.9
<i>of which:</i>								
Consumption	22.3	21.5	21.9	21.6	21.6	21.2	21.2	20.8
Transfers other than in kind & subsidies	13.4	13.3	13.5	12.9	13.9	12.4	13.9	13.7
Gross fixed capital formation	4.9	5.1	5.1	5.3	5.2	5.3	5.6	5.7
Other (residual)	2.2	1.5	1.8	2.0	1.8	2.5	1.7	1.7
- Interest expenditure	1.2	1.1	1.2	1.2	1.4	1.3	1.5	1.5
GGB²	-3.5	-2.9	-3.5	-3.9	-4.0	-3.6	-3.5	-3.2
Primary balance	-2.4	-1.8	-2.4	-2.8	-2.6	-2.6	-2.0	-1.6
One-offs	-1.1	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
GGB² excl. one-off	-2.4	-2.7	-3.5	-3.9	-4.0	-3.6	-3.5	-3.2
Notes:								
¹ On a no-policy change basis.								
² General government balance								
Source:								
Commission services' spring 2007 economic forecast (COM); Convergence programme (CP) update; Commission services' calculations								

Table 9: Assessment of tax projections

	2007			2008			2009
	CP	COM	OECD ³	CP	COM ¹	OECD ³	CP
Change in tax-to-GDP ratio	-0.4	-0.4	0.0	-0.3	0.0	0.0	-0.7
Difference (CP – COM)	0.0		/	-0.3		/	/
of which ² :							
- discretionary and elasticity component	-0.2		/	-0.7		/	/
- composition component	0.3		/	0.9		/	/
Difference (COM - OECD)	/	-0.3		/	0.0		/
of which ² :							
- discretionary and elasticity component	/	-0.3		/	0.5		/
- composition component	/	0.0		/	-0.4		/
p.m.: Elasticity to GDP	0.8	0.8	1.0	0.9	1.0	1.0	0.8
Notes: ¹ On a no-policy change basis ² The decomposition is explained in Annex 5 ³ Based on OECD ex-ante elasticity relative to GDP Source: <i>Commission services' spring 2007 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)</i>							

4.4. Assessment of the fiscal stance and budgetary strategy

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

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

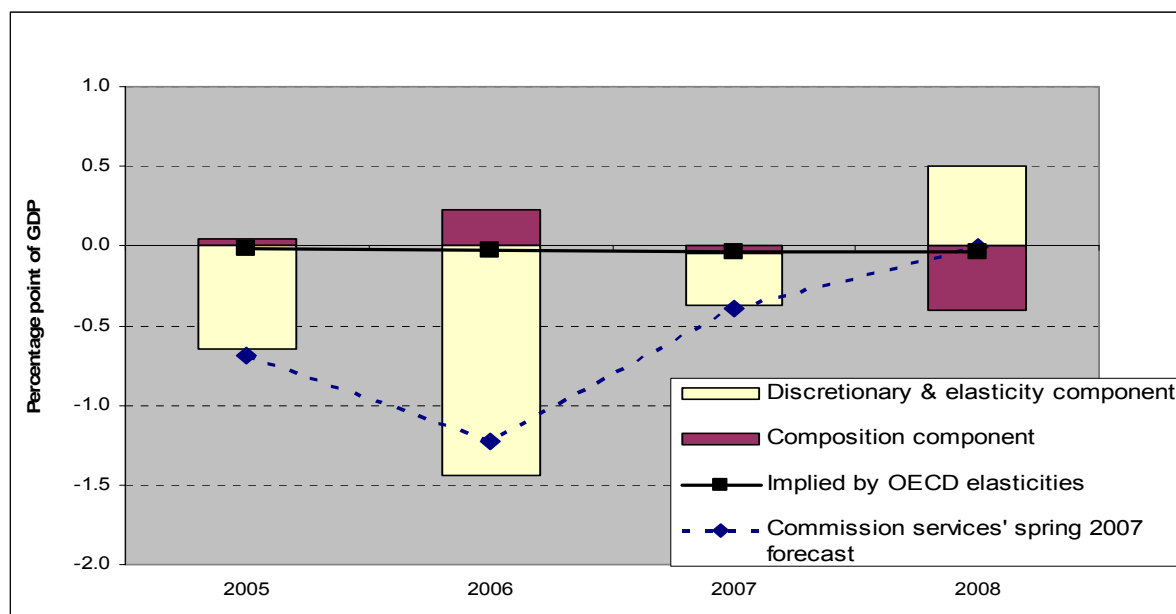
	Based on programme ¹ (with targets taken at face value)	Assessment (taking into account risks to targets)
Consistency with correction of excessive deficit by 2008 deadline	No, not even by 2009	No, not even by 2009. Adjustment should be strengthened
Notes: ¹ Targets in structural terms as recalculated by Commission services on the basis of the information in the programme. Source: <i>Commission services</i>		

The budgetary stance in the programme, in particular the planned loosening in 2007, implies that the correction of the excessive deficit will not be reached by 2009, therefore at least two years later than the correction deadline (2008) in the 2004 Council Recommendation under Article 104(7). The Czech government should undertake

measures to strengthen the proposed adjustment path and attempt to meet the 2008 deadline for the correction.

The planned change in the structural balance as recalculated by the Commission services is of an improvement of around 0.5% of GDP per year in 2008-2009 after a strong deterioration in the previous year. However, this is not ambitious taking into account the prospects of economic good times, including the behaviour of tax elasticities, prevailing throughout the programme period.

**Figure 1: Changes in the tax-to-GDP ratio:
actual/projected changes vs. changes implied by OECD elasticity**



Note:

The dashed line displays the change in the tax ratio in the Commission services' 2007 spring forecast, for 2008, on a no-policy-change basis. The solid line shows the change in the tax ratio implied by the ex-ante OECD elasticity with respect to GDP. The difference between the two is explained by the bars. The composition component captures the effect of differences in the composition of aggregate demand (more tax rich or more tax poor components). The discretionary and elasticity component captures the effect of discretionary fiscal policy measures as well as variations of the yield of the tax system that may result from factors such as time lags, variations of taxable income that do not necessarily move in line with GDP e.g. capital gains. Both components may not add up to the total difference because of a residual component, which is generally small. The decomposition is explained in detail in Annex 5.

Source:

Commission services

5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY

Government debt is the result of the financing needs of government over the years. It corresponds primarily to an accumulation of deficits, although the build-up of financial assets and other adjustments may also play a role.⁷ The reform of the Stability and Growth Pact has raised attention to the crucial importance of government debt and of sustainability in fiscal surveillance.

⁷ On the factors other than the deficit which explain the evolution of the government debt, see "The dynamics of government debt: decomposing the stock-flow adjustment", chapter II.2.2 of *Public Finances in EMU 2005*, European Economy, N°3/2005.

This section is in two parts: a first part describes recent developments and the medium-term prospects for government gross debt; it describes the convergence programmes targets, compares them with the Commission services' forecasts and assesses the associated risks. A second part looks into the government debt from a longer-term perspective with the aim of assessing the long-term sustainability of public finances.

5.1. Recent debt developments and medium-term prospects

5.1.1. Debt projections in the programme

The debt to GDP ratio has remained at about 30% of GDP on average since 2000. The debt has been sustained at this level in relation to GDP, in spite of expansionary fiscal policy, due to strong growth in the Czech economy and debt-decreasing stock-flow adjustments. The latter is linked to the large privatisation programme with proceeds of almost 2% of GDP per year, on average, from 2000 to 2006. However, the debt level is anticipated to increase somewhat through the programme period reaching 32.0% of GDP, as the primary balance remains in deficit and privatisation receipts fall.

Figure 2: Debt projections in successive convergence programmes (% of GDP)

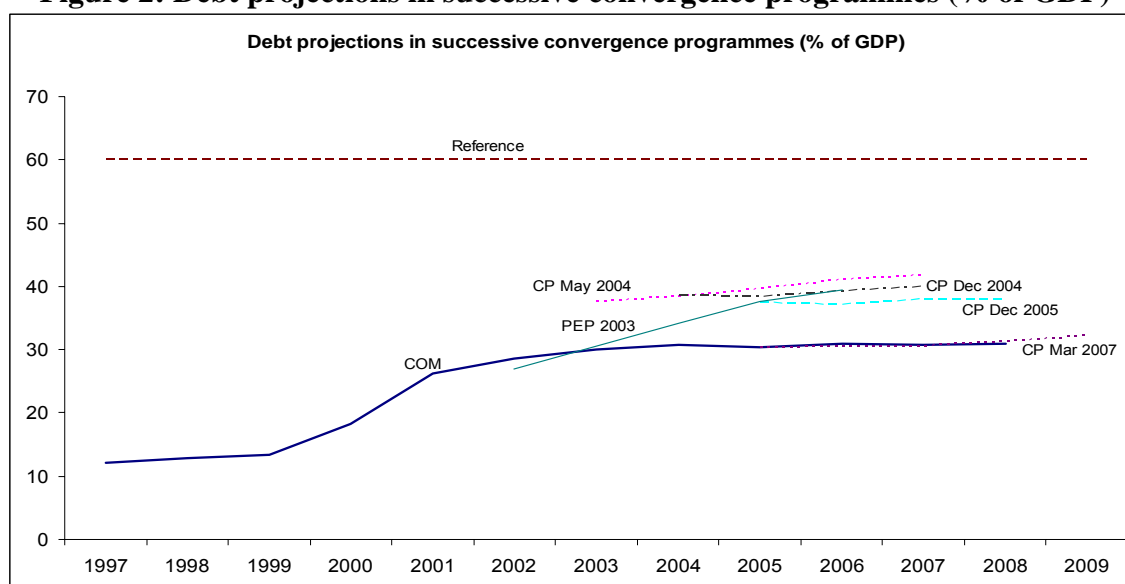


Table 11: Debt dynamics

(% of GDP)	average 2000-04	2005	2006		2007		2008		2009
			COM	CP	COM	CP	COM	CP	CP
Gross debt ratio¹	30.7	30.4	30.4	30.6	30.6	30.5	30.9	31.3	32.2
Change in the ratio	3.0	-0.3	0.0	0.2	0.3	-0.1	0.3	0.8	0.9
<i>Contributions²:</i>									
Primary balance	4.1	2.5	1.8	2.4	2.8	2.6	2.6	2.0	1.6
“Snow-ball” effect	-0.2	-0.8	-1.1	-1.0	-0.9	-0.8	-1.2	-0.7	-0.7
<i>Of which:</i>									
Interest expenditure	1.1	1.2	1.1	1.2	1.1	1.4	1.0	1.5	1.5
Growth effect	-0.7	-1.7	-1.7	-1.7	-1.4	-1.4	-1.4	-1.4	-1.4
Inflation	-0.6	-0.2	-0.5	-0.4	-0.6	-0.8	-0.8	-0.8	-0.9
Stock-flow adjustment	-0.8	-2.0	-0.8	-1.2	-1.7	-2.0	-1.1	-0.5	0.0
<i>Of which:</i>									
Cash/accruals diff.	-0.4	-1.6	-	0.4	-	0.0	-	0.0	0.0
Acc. financial assets	-1.8	-0.3	-	-1.5	-	-1.9	-	-0.5	0.0
Privatisation	-1.9	-3.2	-	-0.1	-	-1.0	-	0.0	0.0
Val. effect & residual	1.4	0.0	-	0.0	-	0.0	-	0.0	0.0
Notes:									
¹ End of period.									
² The change in the gross debt ratio can be decomposed as follows:									
$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$									
where t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth (in the table, the latter is decomposed into the growth effect, capturing real GDP growth, and the inflation effect, measured by the GDP deflator). The term in parentheses represents the “snow-ball” effect. The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.									
<i>Source:</i>									
Convergence programme update (CP); Commission services’ spring 2007 economic forecasts (COM); Commission services’ calculations									

5.1.2. Assessment

The programme's debt projections are broadly in line with the Commission services' spring 2007 forecast. As for risks, all outstanding government guarantees have been risk-assessed by the authorities, and called-on or likely-to-be-called-on guarantees are already included in the government debt. No new state guarantees will be issued during the programme period and the government agency, the Czech consolidation agency, will be dissolved at the end of 2007 posing no further burden on the government debt.

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

The issue of long-term sustainability is a multi-faceted one. It involves avoiding imposing an excessive burden on future generations and ensuring the country's capacity to appropriately adjust budgetary policy in the medium and long run.⁸

⁸ For a detailed analysis of long-term sustainability issues, see “The Long Term Sustainability of Public Finances – A report by the Commission services”, European Economy n°4/2006, published in October 2006.

Debt sustainability is derived from the government's *intertemporal budget constraint*. It imposes that current total liabilities of the government, i.e. the current public debt and the discounted value of future expenditure including the budgetary impact of ageing populations, should be covered by the discounted value of future government revenue. If current policies ensure that the intertemporal budget constraint is fulfilled, current policies are sustainable.

The approach adopted by the Commission services and the Ageing Working Group of the Economic Policy Committee (EPC) is to project the debt, and to calculate the associated sustainability indicators (See box 5), on the basis of two different scenarios. The first scenario assumes that the structural primary balance will remain unchanged from 2006 through 2009, the final year of the convergence programme; it is called the “2006 scenario”. Debt projections in this scenario start in 2007. The second scenario assumes that the macroeconomic and budgetary plans until 2009 provided in the convergence programme will be fully respected. This is the “programme scenario”. Debt and primary balance projections in this scenario start in 2010. In addition to this quantitative analysis, other relevant factors are taken into account, which allows to better qualify the assessment with regard to where the main risks are likely to stem from and to reach an overall assessment.

5.2.1. Sustainability indicators and long-term debt projections

Table 12 shows the evolution of government spending on pensions, healthcare, long-term care for the elderly, education and unemployment benefits according to the EPC's projections⁹. Non age-related primary expenditure and revenue are assumed to remain constant as a share of GDP.

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

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

Source: Economic Policy Committee and Commission services.

The projected increase in age-related spending in the Czech Republic is considerably above the average of the EU, rising by 7.2% of GDP between 2004 and 2050. The bulk of this increase is due to the expected high increase in expenditure on pensions, projected to rise in the Czech Republic by 5.6% of GDP. The increase in health-care expenditure is

⁹ These assumptions cover labour productivity growth, real GDP growth, participation rates, unemployment rate, demographic developments, government spending in pensions, healthcare, long-term care for the elderly, education and unemployment benefits. See Economic Policy Committee and European Commission (DG ECFIN) (2006), “The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health-care, long-term care, education and unemployment transfers (2004-2050)”, European Economy, Special Report No 1.

projected to be 2.0% of GDP, which is also above the EU average. For long-term care, the projected increase of 0.4% of GDP up to 2050 is below the average in the EU.¹⁰

Based on the long-term budgetary projections, sustainability indicators can be calculated.

Table 13: Sustainability indicators and the required primary balance

	2006 scenario			Programme scenario		
	S1	S2	RPB	S1	S2	RPB
Value	5.2	8.0	5.3	4.3	7.1	5.3
of which:						
Initial budgetary position	3.2	3.3	-	2.3	2.4	-
Debt requirement in 2050	-0.5	-	-	-0.5	-	-
Future changes in budgetary position	2.5	4.7	-	2.5	4.7	-

Source: Commission services.

Box 5 – Sustainability indicators*

- The **sustainability gap S1** shows the permanent budgetary adjustment (often presented as an increase in the tax burden**) required to reach a debt ratio in 2050 of 60% of GDP.
- The **sustainability gap S2**, shows the permanent budgetary adjustment that guarantees the respect of the intertemporal budget constraint of the government. In order to estimate S2, the revenue and expenditure ratios (age-related and non age-related) after 2050 are assumed to remain constant at the 2050 level.
- The sustainability indicators can be decomposed into the***: (i) **initial budgetary position (IBP)**; and, (ii) **long-term change in the budgetary position (LTC)**;
- In addition, the **required primary balance (RPB)** can be derived from the S2 indicator. It measures the average primary balance over the first five years after the programme horizon (i.e. 2010-2014) that results from a permanent budgetary adjustment carried out to comply fully with the S2 indicator.

Summarizing the sustainability indicators

Impact of			
Initial budgetary position		Long-term changes in the primary balance	
S1***=	Gap to the debt-stabilizing primary balance	+	Additional adjustment required to finance the increase in public expenditure <i>up to 2050</i>
S2=	Gap to the debt-stabilizing primary balance	+	Additional adjustment required to finance the increase in public expenditure <i>over an infinite horizon</i>

* For a complete description of the sustainability indicators, see Annex I of the “The Long Term Sustainability of Public Finances – A report by the Commission services”, European Economy n°4, published in October 2006.

** Although the sustainability gap indicators (S1, S2) are usually defined as differences between revenue ratios, this does not mean that countries are asked to increase taxes to reach sustainability. There are several ways to ensure sustainability and governments typically choose a combination of budget consolidation over the medium term (either through expenditure reduction and/or tax hikes) and the implementation of structural reforms aiming at curbing long-term public spending (e.g. pension reforms).

*** Moreover, in the case of S1, the decomposition also separates the impact of the debt position (60% of GDP in 2050); the debt requirement in 2050 (DR). In particular, if the current debt/GDP ratio is below 60% of GDP debt is allowed to rise and this component reduces the sustainability gap as measured by the S1 indicator, and

¹⁰ The long-term budgetary projections presented in the updated programme differ slightly from the EPC common projections. The age-related expenditure ratio is projected to rise by 7.8% of GDP up to 2050 in the update compared with 7.2% of GDP according to the common projections in the Ageing Report. According to the update, the somewhat larger projected increase is due to: (i) updated information for 2005 and for the period 2006 to 2009; and, (ii) the health-care expenditure ratio is projected to increase slightly more up to 2050, by some ½ p.p. of GDP in the update compared with the common projections reference scenario.

Table 13 shows the sustainability indicators for the two scenarios. In the “2006 scenario”, the sustainability gap (S1) that assures reaching the debt ratio of 60% of GDP by 2050 would be 5.2% of GDP. The sustainability gap (S2) which satisfies the intertemporal budget constraint would be 8.0% of GDP. Compared with the results of the Commission's Sustainability Report, the sustainability gaps are larger in the present assessment, by about 2½ % of GDP. This is due to a much higher structural primary deficit for 2006 (of 2.8% of GDP), as currently estimated, compared with the structural primary deficit in 2005 estimated in spring 2006 (at 0.2% of GDP) that was used in the Sustainability Report.

The initial budgetary position, with a large structural deficit poses a risk to sustainable public finances even before considering the considerable long-term budgetary impact of ageing. The programme plans a strengthening of a structural budgetary balance of 0.4% point of GDP between 2006 and 2009, in spite of a substantial increase in interest expenditure which appears to be somewhat cautious. The planned improvement in structural primary balance would implies a slight decrease in risks to long-term sustainability of public finances reflected in a lowering of the sustainability gaps (“programme scenario”) of almost 1% of GDP. The Czech Republic would however still have large sustainability gaps, with the S2 indicator at some 7% of GDP. According to both sustainability gaps, the long-term budgetary impact of ageing is relatively high.

The required primary balance (RPB) is about 5.3% of GDP, significantly higher than the structural primary deficit of about 2% of GDP in the last year of the programme's period.

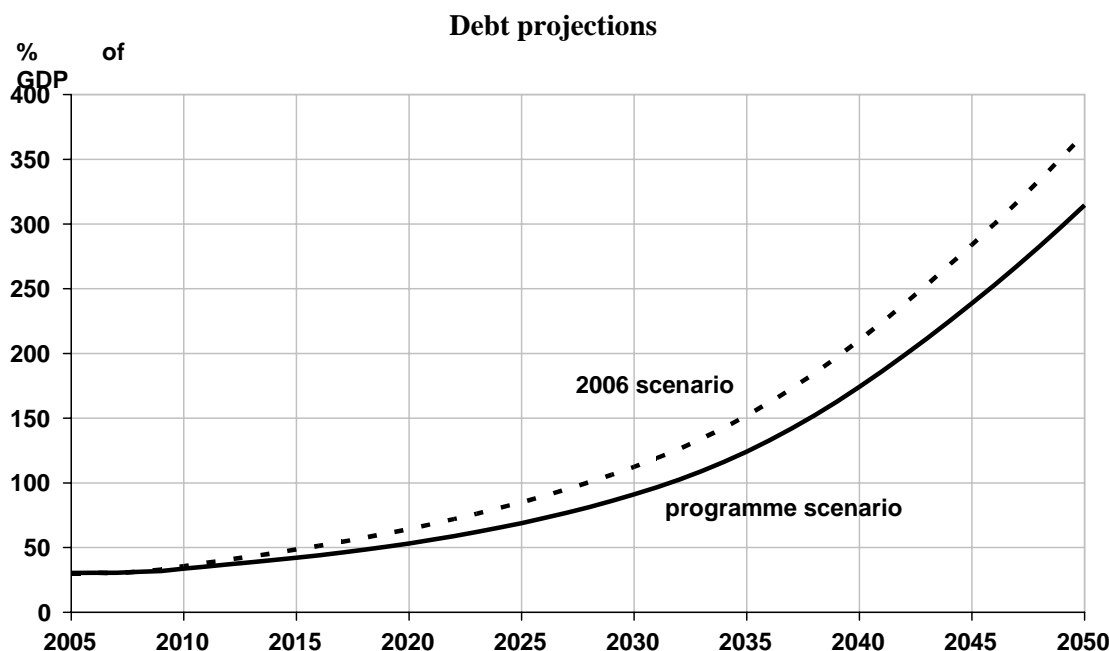
Moreover, the sustainability gap indicators would increase by about ¾% of GDP if the planned adjustment were to be postponed by 5 years, highlighting that savings can be made over time if action is taken sooner rather than later.

Another way to look at the prospects for long-term public finance sustainability is to project the debt/GDP ratio over the long-term using the same assumptions as for the calculations of S1 and S2. The long-term projections for government debt under the two scenarios are shown in Figure 2.

The gross debt ratio is currently well below the 60% of GDP reference value, estimated in the programme at 30.6% of GDP in 2006. According to the “2006 scenario”, the debt ratio would be on an unsustainable path and increase progressively over the coming decades, breaching the 60% reference value before 2020. In the “programme scenario”, the debt dynamics would be slightly less pronounced thanks to the consolidation of public finances over the programme period. However, the debt-to-GDP ratio would still rise above 300% of GDP by 2050.¹¹

¹¹ It should be recalled, however, that being a mechanical, partial-equilibrium analysis, the long-term debt projections are bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels should not be seen as a forecast similar to the Commission services' short-term forecasts, but as an indication of the risks faced by Member States.

Figure 2: Long-term projections for the government debt ratio



Source: Commission's services

5.2.2. Additional factors

To reach an overall assessment of the sustainability of public finances, other relevant issues are taken into account, which in addition allow to better qualify the assessment with regard to where the main risks are likely to stem from.

The programme acknowledges the need to prepare for the long-term budgetary challenges of an ageing population using a broad approach. According to the update, reform measures notably in the fields of pension and health-care are still under discussion and the government has not yet reached any decisions.¹² With respect to fiscal consolidation, the update's goal is to speed up fiscal consolidation in 2008-09 beyond the programme's projections (which suggests limited progress), though the size of this consolidation has not yet been specified.¹³

The long-term budgetary projections presented in the updated programme differ slightly from the EPC common projections. The age-related expenditure ratio is projected to rise by 7.8% of GDP up to 2050 in the update compared with 7.2% of GDP according to the common projections in the Ageing Report. Therefore, the sustainability gaps reported

¹² Preparations for the pension system reform were launched in 2004 with the creation of an independent expert team. The latter prepared detailed material for making decisions on the pension reform. Nevertheless, the subsequent political negotiations were interrupted by the elections of June 2006. Despite the difficult post-election political situation, negotiations on the basic parametric changes have continued across the political spectrum. Moreover, the update notes that the draft reform stabilising the healthcare system is under preparation. However, in view of a complex political situation, the timing of effective measures is very uncertain.

¹³ The update notes that such measures will be incorporated into the budget for 2008 and hence will be contained in the next convergence programme.

above, which were calculated on the basis of the EPC common projections, may even underestimate ageing costs.

5.2.3. *Assessment*

The long-term budgetary impact of ageing in the Czech Republic is well above the EU average, influenced notably by a considerable increase in pension expenditure as a share of GDP. Implementation of structural reform measures notably in the field of pensions aimed at containing the significant increase in age-related expenditures would contribute to reducing risks to the sustainability of public finances.

The initial budgetary position, which has worsened compared with 2005, constitutes a risk to sustainable public finances even before the long-term budgetary impact of an ageing population is considered. Consolidation the public finances further than currently planned would contribute to reducing risks to the sustainability of public finances.

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

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

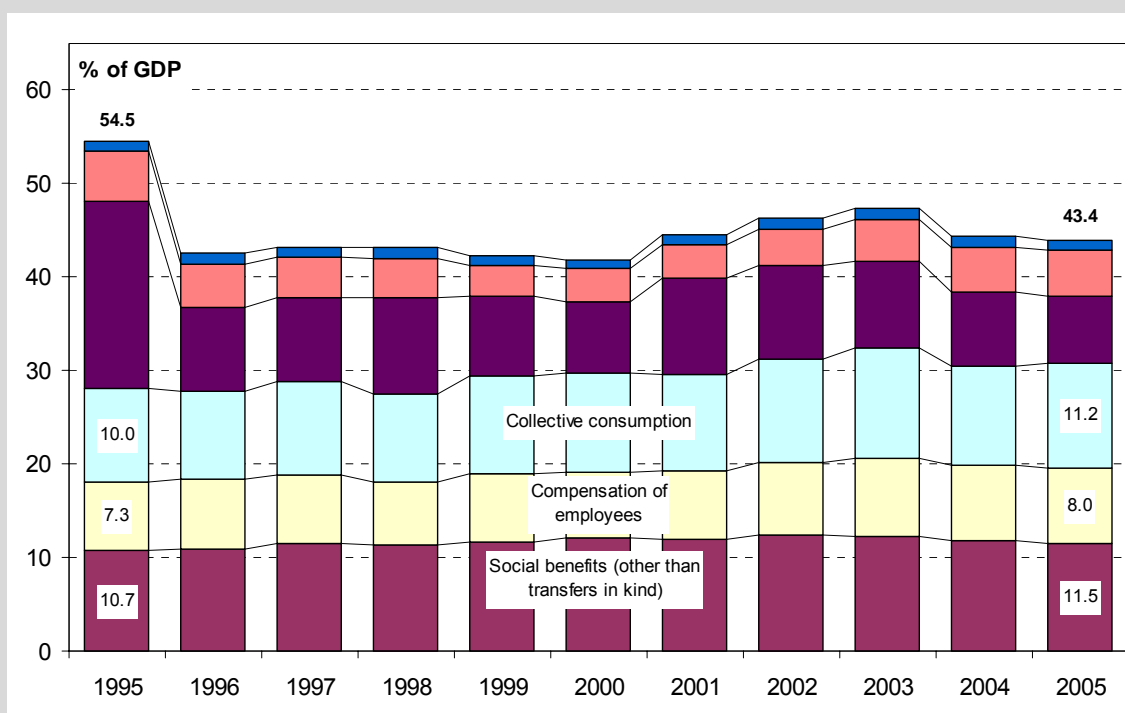
The new government has presented a declaration in the programme in an additional chapter (Chapter 9). This describes proposals aimed towards bringing about a steeper reduction in the annual deficit and an improvement in the quality of public finances. The declaration is currently at the policy stage having been approved within the cabinet on 2 April 2007 and is planned to be presented to Parliament in June 2007. The government's strategy is based on a range of factors including the strengthening of the medium-term expenditure frameworks; restructuring the expenditure side of public budgets; improving the transparency of public finances by accounting for extra-budgetary items within the general budget; increasing the efficiency of public spending by, for example, the introduction of programme budgeting; increasing the flexibility of public spending by reducing the proportion of mandatory expenditures and, finally, stabilising the accumulation of unspent budgetary allocations which currently amount to 2% of GDP. However, the budgetary impact of the new government's proposed measures is not quantified in the convergence programme.

The government is committed to shifting the tax burden from direct to indirect taxation with the aim of promoting growth. From 2004 to 2006, the marginal rate of corporate income tax has been reduced from 28% to 24%. In January 2006, there was a reduction in the level of personal income tax applied to the two lowest bands, from 15% to 12% and from 20% to 19%. The declaration of the new government, in Chapter 9, indicates further reductions to personal, and corporate, taxation will be proposed. The level of sickness contributions paid by employers will also be reduced during the course of 2008. The shift towards indirect taxation will be furthered by the ecological tax reform that will come into effect in 2008. This will also be complemented by two rises in excise duties on tobacco products in order to comply with minimum EU rates by 2008. The government has also pledged to raise the reduced level of VAT from 5% to 9% from January 2008. In order to strengthen the effectiveness of tax collection as a whole, a number of administrative measures are being introduced including the use of electronic registration forms.

In terms of the long-term sustainability of public finances, the new government intends to reform the pension and health care systems while there have been no substantial changes since last year's update of the convergence programme. The new government's declaration, noted above, includes proposals on parametric changes to the pension system, principally raising the retirement age, as well as reform of health insurance aimed at improving the longer-term sustainability of public finances (cf. section 5.2.2). Reform of the health system is still under consideration. A draft proposal aimed at long-term sustainability is currently under preparation.

Box 8: The level and composition of government expenditure in the Czech Republic since 1995

The evolution of government expenditure (economic classification, % of GDP)



Note: The three small components from the top are respectively: Interest, Gross fixed capital formation, Other (subsidies and other current and capital expenditure). Numbers at the top of the columns indicate total expenditure.

Source: Commission services

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

The convergence programme is structured around three priorities: budgetary consolidation and long-term fiscal sustainability, monetary stability and structural reforms to promote economic growth. These are in line with the main key challenges identified in the National Reform Programme. Also, the measures in the convergence programme are in line with the National Reform Programme and the Implementation Report submitted in November 2006 in the context of the renewed Lisbon strategy for growth and jobs.

However, the convergence programme does not contain a qualitative assessment of the overall impact of the National Reform Programme within the medium-term fiscal strategy. Furthermore, it does not provide systematic information on the direct budgetary costs (or savings) associated with the main reforms envisaged in the National Reform Programme with the exception of the increase in research and development expenditure in the 2007 budget, while the budgetary projections in the programme seemingly take into account the public finance implications of the actions envisaged in the National Reform Programme.

Box 6: The Commission assessment of the implementation report of the National Reform Programme

The implementation report of the National Reform Programme of the Czech Republic, provided in the context of the renewed Lisbon strategy for growth and jobs, was submitted on 21 November 2006. The Commission's assessment of this report was adopted on 12 December 2006 as part of its Annual Progress Report, can be summarised as follows:

The Czech Republic is making limited progress in the implementation of its National Reform Programme, which identified the following key challenges: to continue public finance reform; to strengthen and increase industrial competitiveness while respecting the need for sustainable resources; and to increase labour market flexibility. Although the Czech Republic is generally moving ahead relatively well in the microeconomic field, progress on R&D is moderate. In the employment area more efforts are required to respond to the key challenge of improving labour market flexibility.

Among the strengths of the implementation of the National Reform Programme are positive measures to increase the control and transparency of public finances; to improve regulation and the business environment; to reform curricula for primary education and to stimulate participation in tertiary education.

The policy areas in the Czech National Reform Programme where weaknesses need to be tackled with the highest priority are: the sustainability of public finances, since the 2007 budget anticipates a breach of the expenditure ceilings and an increased deficit; increasing the amount and effectiveness of public R&D expenditure; improving security and flexibility in the labour market; improving education and training and increasing participation in lifelong learning. Against this background the Czech Republic is recommended to:

- with a view to improving the long-term sustainability of public finances, take steps to implement reforms of the pension and healthcare systems, in particular on the basis of the 2005 all-party pensions report, and fix a timetable for their implementation;
- strengthen efforts to improve collaboration between business and public R&D institutions, while keeping up the pace of increasing public R&D investment;
- modernise employment protection, including legislation and tax and benefit systems, improve education and training systems, and provide incentives to invest in training, particularly for older workers and the low-skilled.

In addition, it will be important for the Czech Republic over the period of the National Reform Programme to focus on: improving the system for patenting and the protection of intellectual property rights; speeding up progress in the ICT area, including by implementing and monitoring the development of a fully enabling legal environment for e-Government; meet targets for reducing the administrative burden on enterprises; further developing access to finance for innovative companies; developing links between foreign-owned and domestic companies; introducing entrepreneurship education into the curricula; better integrating disadvantaged groups into the labour market; reducing regional employment disparities; reconciling work and family life; tackling the gender pay gap and implementing the active ageing strategy.

The table below provides an overview of whether the strategy and policy measures in the programme are consistent with the broad economic policy guidelines in the area of public finances, which are included in the integrated guidelines for the period 2005-2008. The assessment of guideline 1 corresponds to the assessment in Section 4.4 above, whereas that of the pace of debt reduction in guideline 2 (relevant for high-debt countries only) is

covered in Section 5.1.2 above. Information on the different elements covered by the remaining guidelines in the table can be found in Sections 5.2 and 6.

Overall, the budgetary strategy in the convergence programme is not consistent with the broad economic policy guidelines.

Table 14: Consistency with the broad economic policy guidelines

Broad economic policy guidelines	Yes	Steps in right direction	No	Not applicable
1. To secure economic stability				
– Member States should respect their medium-term budgetary objectives. As long as this objective has not yet been achieved, they should take all the necessary corrective measures to achieve it ¹ .			X	
– Member States should avoid pro-cyclical fiscal policies ² .				X
– Member States in excessive deficit should take effective action in order to ensure a prompt correction of excessive deficits ³ .			X	
– Member States posting current account deficits that risk being unsustainable should work towards (...), where appropriate, contributing to their correction via fiscal policies.				X
2. To safeguard economic and fiscal sustainability				
In view of the projected costs of ageing populations,				
– Member States should undertake a satisfactory pace of government debt reduction to strengthen public finances.				X
– Member States should reform and re-enforce pension, social insurance and health care systems to ensure that they are financially viable, socially adequate and accessible (...)			X	
3. To promote a growth- and employment-orientated and efficient allocation of resources				
Member States should, without prejudice to guidelines on economic stability and sustainability, re-direct the composition of public expenditure towards growth-enhancing categories in line with the Lisbon strategy, adapt tax structures to strengthen growth potential, ensure that mechanisms are in place to assess the relationship between public spending and the achievement of policy objectives and ensure the overall coherence of reform packages.		X		
Notes: ¹ As further specified in the Stability and Growth Pact and the code of conduct, i.e. with an annual 0.5% of GDP minimum adjustment in structural terms for euro area and ERM II Member States. ² As further specified in the Stability and Growth Pact and the code of conduct, i.e. Member States that have already achieved the medium-term objective should avoid pro-cyclical fiscal policies in “good times”. ³ As further specified in the country-specific Council recommendations and decisions under the excessive deficit procedure. Source: <i>Commission services</i>				

Annex 1: Glossary

Automatic stabilisers Various features of the tax and spending regime which tend to have a dampening effect on economic fluctuations without requiring a discretionary intervention of the fiscal authorities. As a result, the budget balance in percent of GDP tends to improve in years of high growth and deteriorate during economic slowdowns. See also *cyclically-adjusted balance*, *structural balance* and *minimum benchmark*.

Broad economic policy guidelines (BEPGs) Guidelines for the economic and budgetary policies of the Member States. Together with the Employment Guidelines, they form the Integrated Guidelines, prepared by the Commission and adopted by the Council of Ministers responsible for Economic and Financial Affairs (ECOFIN). See also *Lisbon strategy*.

Budget balance The balance between total public revenue and expenditure (according to *ESA95*); with a positive balance indicating a surplus (also known as *government net lending*) and a negative balance indicating a deficit (also known as *government net borrowing*). For the monitoring of Member States' budgetary positions, the EU uses *general government* aggregates. See also *cyclically-adjusted balance*, *primary balance*, *structural balance* and *reference values*.

Budget constraint A basic condition applying to the public finances, according to which total public expenditure in any one year must be financed by taxation, borrowing or changes in the monetary base; the latter is prohibited in the EU. See also *stock-flow adjustment* and *long-term sustainability*.

Budgetary sensitivity The variation in the *budget balance* brought about by a change in the *output gap*. In the EU, it is estimated to be 0.5 on average, i.e. for any percentage point of GDP below or above potential, the budget-balance-to-GDP ratio deteriorates or improves by half a percentage point. The size of the budgetary sensitivity essentially reflects (i) the revenue and expenditure elasticities of the budget and (ii) the size of discretionary government expenditure. See also *cyclically-adjusted balance*, *structural balance* and *tax elasticity*.

Code of conduct Policy document adopted by the Economic and Financial Committee (an advisory committee gathering high-level officials from national governments, national central banks, the European Central Bank and the European Commission which prepares the meetings of the Council of Ministers responsible for Economic and Financial Affairs (ECOFIN)) and endorsed by the ECOFIN Council in October 2005, containing specifications on the implementation of the *Stability and Growth Pact* and guidelines on the format and content of *stability programmes* and *convergence programmes*.

Contingent liabilities A possible government obligation to pay, the existence of which will be confirmed by the occurrence of one or more uncertain events in the future not wholly under the control of the government. For instance, government guarantees on debt issued by private or public companies are contingent liabilities since the government obligation to pay depends on the non-ability of the original debtor to honour its obligations. See also *implicit liabilities*.

Convergence programme Medium-term budgetary strategy presented by each Member State that has not yet adopted the euro; updated annually, according to the provisions of the *Stability and Growth Pact*. See also *stability programme*, *code of conduct* and *medium-term objective*.

Cyclically-adjusted balance The *budget balance* adjusted for its cyclical component (which captures the part of public revenue and expenditure that is linked to the *output gap*), i.e. the budget balance that would prevail if GDP were at its potential level. See also *structural balance*, *budgetary sensitivity* and *output gap*.

Cyclically-adjusted primary balance The *cyclically-adjusted balance* net of interest expenditure on *general government* debt. See also *interest burden*.

Debt dynamics The evolution of *government debt* as a ratio to GDP; it depends on the primary deficit, the debt-increasing impact of interest payments, the dampening effect of GDP growth on the ratio and the *stock-flow adjustment*.

EDP notification See *notification of deficit and debt*.

ERM II Exchange rate mechanism linking some currencies of non-euro Member States to the euro, which is the centre of the mechanism. For the currency of each Member State participating in the mechanism, a central rate against the euro and a standard fluctuation band of $\pm 15\%$ are defined.

ESA95 European accounting standards for the compilation and reporting of macroeconomic (including budgetary) data by the EU Member States.

Excessive deficit procedure (EDP) A procedure, laid down in the EC Treaty, according to which the Commission and the Council monitor the development of national *budget balances* and *public debt* in relation to the *reference values*, in order to assess the existence (or risk) of an excessive deficit in each Member State and to ensure its correction. Its application has been further clarified in the *Stability and Growth Pact*.

Fiscal stance A measure of the thrust of discretionary fiscal policy such as, in this document, the change in the *structural balance* (or in the *structural primary balance*) relative to the preceding year. When the change is positive (negative) the fiscal stance is said to be restrictive (expansionary).

Funded pension scheme Pension system in which current pension expenditures are financed by running down assets accumulated over the years on the basis of contributions by the scheme beneficiaries. According to *ESA95*, defined-contribution funded pension schemes are not considered as part of the *general government* sector. See also *pay-as-you-go pension scheme*.

Government debt See *public debt*.

General government The focus of EU budgetary surveillance under the *Stability and Growth Pact* and the *excessive deficit procedure* is on general government aggregates, with the general government sector covering national, regional and local government, as well as social security. In principle, public enterprises are excluded.

Government net lending/borrowing See *budget balance*.

Implicit liabilities Future government expenditure which has not yet been funded, even when future expenditure is not backed by law or contractual obligations, but is simply grounded in strong expectations of the public. To be meaningful for economic analysis, implicit liabilities should be assessed net of future revenue assuming that the government will keep collecting taxes (and other non-tax revenue) at rates comparable to current levels. See also *contingent liabilities*.

Interest burden *General government* interest expenditure on *government debt* as a share of GDP.

Intertemporal budget constraint A basic condition imposing that current total liabilities of the government, i.e. the current public debt and the discounted value of future expenditure including the budgetary impact of ageing populations, be covered by the discounted value of future government revenue.

Lisbon strategy Partnership between the EU and Member States for growth and more and better jobs. Originally approved in 2000, the Lisbon Strategy was revamped in 2005. Based on the Integrated Guidelines (merger of the *broad economic policy guidelines* and the employment guidelines, dealing with macro-economic, micro-economic and employment issues) for the period 2005-2008, Member States drew up 3-year national reform programmes in autumn 2005. They reported on the implementation of the national reform programmes for the first time in autumn 2006. The Commission analyses and summarises these reports in an EU Annual Progress Report each year, in time for the Spring European Council.

Long-term sustainability A combination of *budget balance* and *public debt* that ensures that the latter does not grow without bound. While conceptually intuitive, an agreed operational definition of sustainability has proven difficult to achieve.

Maturity structure of public debt The profile of *public debt* in terms of when it is due to be paid back. Interest rate changes affect the *budget balance* directly to the extent that the *general government* sector has debt with a relatively short maturity structure. Long maturities reduce the sensitivity of the *budget balance* to changes in the prevailing interest rate. See also *interest burden*.

Medium-term objective (MTO) According to the *Stability and Growth Pact*, *stability programmes* and *convergence programmes* must present a medium-term objective for the budgetary position. It is country-specific to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risk to the sustainability of public finances, and is defined in structural terms (see *structural balance*).

Minimum benchmark Estimated budgetary position (in *cyclically-adjusted* terms) that provides a “safety margin” that is enough for the *automatic stabilisers* to operate freely during normal economic slowdowns without breaching the 3% of GDP deficit *reference value*. The minimum benchmarks are estimated by the European Commission. They do not cater for other risks such as unexpected budgetary developments and interest rate shocks.

National reform programme (NRP) See *Lisbon strategy*.

Notification of deficit and debt (EDP notification) Twice a year (by 1 April and 1 October), EU Member States have to notify their *general government* deficit and debt figures (and a number of associated data) to the Commission, the quality of which is then checked by Eurostat, the Commission department in charge of statistics. See also *budget balance* and *public debt*.

One-off and temporary measures Government transactions having a transitory budgetary effect that does not lead to a sustained change in the intertemporal budgetary position. See also *structural balance*.

Output gap The difference between actual GDP and potential GDP in any given year, usually expressed as a percent of potential GDP. Potential GDP is an unobserved variable and needs to be estimated from actual data. It is the level of real GDP in a given year that is consistent with a stable rate of inflation. If actual output rises above its potential level, then constraints on capacity begin to bind and inflationary

pressures build; if output falls below potential, then resources are lying idle and inflationary pressures abate. See also *production function method*.

Pay-as-you-go pension scheme (PAYG) Pension system in which current pension expenditures are financed by the contributions of current employees. Also known as *unfunded pension scheme*. See also *funded pension scheme*.

Primary balance The *budget balance* net of interest expenditure on *general government* debt. See also *interest burden*.

Pro-cyclical fiscal policy A *fiscal stance* which amplifies the economic cycle by lowering the *structural balance* when the *output gap* is positive or improving, or by increasing the *structural balance* when the *output gap* is negative or widening, as opposed to a counter-cyclical fiscal policy stance. A neutral fiscal policy keeps the *structural balance* unchanged over the economic cycle by letting the *automatic stabilisers* work.

Production function method A method to estimate potential GDP typically based on a Cobb-Douglas production function. Potential GDP is estimated as the level of GDP consistent with a full utilisation of capital, an unemployment rate that does not accelerate inflation and factor productivity at its trend level. See also *output gap*, *cyclically-adjusted balance*, *budgetary sensitivity*.

Public debt (or government debt) Consolidated gross debt for the *general government* sector. It includes the total nominal value of all debt owed by government units, except that part of the debt which is owed to government units in the same Member State. It is a gross debt measure meaning that government financial assets on other sectors are not netted out. See also *debt dynamics* and *reference values*.

Public investment The component of total public expenditure which consists in the acquisition of durable assets and through which governments increase and improve the stock of capital employed in the production of the goods and services they provide. Also known as government gross fixed capital formation (GFCF).

Public-private partnerships (PPP) Agreements between government and corporations according to which the latter build and operate public-use infrastructure (roads, tunnels, bridges, but also hospitals, prisons, concert halls, etc.) which were traditionally directly controlled by government. In exploiting the infrastructure, the corporation receives prices paid by final users, rentals or fees from the government or both. Infrastructure built under PPPs is considered as either *public investment* or corporate investment depending on a number of specific criteria.

Quality of public finances A multi-dimensional concept which refers to the contribution that public finances make to the efficient allocation of resources in the economy and to achieving the government's strategic objectives (sustainable growth, macroeconomic stability, competitiveness, social cohesion etc.). It concerns notably the overall level of expenditure and taxation, their composition, the budgeting and control mechanisms and the institutional arrangements for deciding on public finance issues.

Reference values for public deficit and debt Respectively, a 3 percent *general government* deficit-to-GDP ratio and a 60 percent *general government* debt-to-GDP ratio. See also *excessive deficit procedure*, *government debt* and *budget balance*.

Sensitivity analysis An econometric or statistical simulation designed to test the robustness of an estimated economic relationship or projection to changes in the underlying assumptions.

'Snow-ball' effect The self-reinforcing effect of *public debt* accumulation or decumulation arising from a positive or negative differential between the implicit interest rate on public debt and the GDP growth rate. See also *debt dynamics*.

Stability and Growth Pact (SGP) Approved in 1997 and reformed in 2005, the SGP clarifies the provisions on budgetary surveillance in the EC Treaty. The "preventive" arm of the SGP obliges Member States to submit annual *stability programmes* or *convergence programmes*, while the "corrective" arm of the SGP clarifies and speeds up the *excessive deficit procedure*.

Stability programme Medium-term budgetary strategy presented by each Member State that has already adopted the euro; updated annually, according to the provisions of the *Stability and Growth Pact*. See also *convergence programme*, *code of conduct* and *medium-term objective*.

Stock-flow adjustment (SFA) The stock-flow adjustment (also known as the debt-deficit adjustment) ensures consistency between *government net borrowing*, which is a flow variable, and the variation in *government debt*, which is a stock variable. It includes differences between cash and accrual accounting, accumulation of financial assets, changes in the value of debt denominated in foreign currency and remaining statistical adjustments. See also *debt dynamics*.

Structural balance The *budget balance* in *cyclically-adjusted* terms and excluding *one-off and temporary measures*. See also *fiscal stance*.

Structural primary balance The *structural balance* net of interest expenditure on *general government* debt. See also *interest burden*.

Tax elasticity A parameter measuring the relative change in tax revenues with respect to a relative change in GDP. The tax elasticity is an input to the *budgetary sensitivity*.

Annex 2: Summary tables from the programme update

The tables below present the information provided in the programme in the format prescribed by the code of conduct (Annex 2 thereof).

Table 1a. Macroeconomic prospects

	ESA Code	2005	2005	2006	2007	2008	2009
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g	2950	6.1	6.0	4.9	4.8	4.8
2. Nominal GDP	B1*g	2978	7.1	7.5	7.6	7.8	7.9
Components of real GDP							
3. Private consumption expenditure	P.3	1442	2.3	3.9	4.2	4.1	4.1
4. Government consumption expenditure	P.3	628	0.7	-1.0	0.5	-0.3	-0.3
5. Gross fixed capital formation	P.51	756	3.6	6.5	7.8	7.9	8.0
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	30	1.0	2.4	2.5	2.4	2.3
7. Exports of goods and services	P.6	2184	10.6	12.7	10.6	10.3	10.4
8. Imports of goods and services	P.7	2089	4.9	11.4	10.2	9.6	9.7
Contributions to real GDP growth							
9. Final domestic demand		-	2.3	3.3	4.2	4.0	4.0
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	-0.2	1.6	0.3	0.1	0.0
11. External balance of goods and services	B.11	-	4.0	1.1	0.5	0.7	0.9

Table 1b. Price developments

	ESA Code	2005	2005	2006	2007	2008	2009
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator		113.8	0.9	1.4	2.6	2.9	2.9
2. Private consumption deflator		109.9	1.8	2.7	2.9	2.9	2.8
3. HICP¹		110.4	1.6	2.4	2.6	2.5	2.5
4. Public consumption deflator		124.7	5.7	4.5	4.3	4.7	4.7
5. Investment deflator		101.5	0.4	1.0	0.5	0.5	0.7
6. Export price deflator (goods and services)		94.5	-2.2	-1.7	0.0	1.8	1.7
7. Import price deflator (goods and services)		90.1	-0.5	-0.3	-0.2	1.4	1.3

¹ Optional for stability programmes.

Table 1c. Labour market developments

	ESA Code	2005	2005	2006	2007	2008	2009
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons¹		4966	0.7	1.6	1.0	0.5	0.2
2. Employment, hours worked ²		9572	0.9	1.6	1.0	0.5	0.2
3. Unemployment rate (%)³		7.9	7.9	7.2	6.7	6.5	6.5
4. Labour productivity, persons⁴		600	5.3	4.3	3.9	4.3	4.6
5. Labour productivity, hours worked ⁵		311	5.1	4.3	3.9	4.3	4.6
6. Compensation of employees	D.1	1202	6.5	7.8	7.8	7.6	7.3

¹ Occupied population, domestic concept national accounts definition.

² National accounts definition.

³ Harmonised definition, Eurostat; levels.

⁴ Real GDP per person employed.

⁵ Real GDP per hour worked.

Table 1d. Sectoral balances

% of GDP	ESA Code	2005	2006	2007	2008	2009
1. Net lending/borrowing vis-à-vis rest of the world	B.9	-3.3	-2.8	-1.4	0.2	1.1
<i>of which:</i>						
- Balance on goods and services		1.9	1.8	2.2	3.1	4.0
- Balance of primary incomes and transfers		-4.6	-4.8	-4.2	-4.1	-4.1
- Capital account		-0.5	0.4	0.7	1.3	1.3
2. Net lending/borrowing of the private sector	B.9	0.3	0.7	2.6	3.7	4.1
3. Net lending/borrowing of general government	EDP B.9	-3.6	-3.5	-4.0	-3.5	-3.0
4. Statistical discrepancy		0.0	0.0	0.0	0.0	0.0

Table 2. General government budgetary prospects

	ESA code	2005	2005	2006	2007	2008	2009
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP

Net lending (EDP B.9) by sub-sector

1. General government	S.13	-108	-3.6	-3.5	-4.0	-3.5	-3.0
2. Central government	S.1311	-107	-3.6	-3.7	-3.8	-3.3	-2.8
3. State government	S.1312	-	-	-	-	-	-
4. Local government	S.1313	-2	-0.1	0.0	-0.2	-0.2	-0.2
5. Social security funds	S.1314	2	0.1	0.1	0.0	0.0	0.0

General government (S13)

6. Total revenue	TR	1200	40.4	39.9	39.9	40.4	40.3
7. Total expenditure	TE ¹	1308	44.0	43.4	43.9	43.9	43.2
8. Net lending/borrowing	EDP B.9	-108	-3.6	-3.5	-4.0	-3.5	-3.0
9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	35	1.2	1.2	1.4	1.5	1.5
p.m.: 9a. FISIM		0	0.0	0.0	0.0	0.0	0.0
10. Primary balance	²	-94	-3.2	-3.1	-3.4	-2.8	-2.1

Selected components of revenue

11. Total taxes (11=11a+11b+11c)		620	20.9	20.4	20.0	19.9	19.4
11a. Taxes on production and imports	D.2	344	11.6	11.3	11.2	10.9	10.5
11b. Current taxes on income, wealth, etc	D.5	275	9.3	9.0	8.8	9.0	8.9
11c. Capital taxes	D.91	1	0.0	0.0	0.0	0.0	0.0
12. Social contributions	D.61	448	15.1	15.1	15.1	14.8	14.7
13. Property income	D.4	21	0.7	0.8	0.8	0.7	0.7
14. Other (14=15-(11+12+13))		111	3.7	3.7	4.1	4.9	5.5
15=6. Total revenue	TR	1200	40.4	39.9	39.9	40.4	40.3
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)³		1069	36.0	35.5	35.1	34.7	34.1

Selected components of expenditure

16. Collective consumption	P.32	332	11.2	10.9	10.6	10.3	10.1
17. Total social transfers	D.62+D.63	674	22.7	22.6	23.0	23.0	22.5
17a. Social transfers in kind	P.31=D.63	331	11.2	11.0	10.9	10.9	10.7
17b. Social transfers other than in kind	D.62	343	11.5	11.6	12.1	12.1	11.8
18.=9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	35	1.2	1.2	1.4	1.5	1.5
19. Subsidies	D.3	55	1.9	1.9	1.9	1.8	1.7
20. Gross fixed capital formation	P.51	148	5.0	5.1	5.2	5.6	5.7
21. Other (21=22-(16+17+18+19+20))		64	2.2	1.8	1.8	1.7	1.7
22=7. Total expenditure	TE ¹	1308	44.0	43.4	43.9	43.9	43.2
p.m.: Compensation of employees	D.1	237	8.0	7.7	7.6	7.4	7.2

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

²The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41 + FISIM recorded as intermediate consumption, item 9).

³Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

Table 3. General government expenditure by function

% of GDP	COFOG Code	2004	2009
1. General public services	1	-	-
2. Defence	2	-	-
3. Public order and safety	3	-	-
4. Economic affairs	4	-	-
5. Environmental protection	5	-	-
6. Housing and community amenities	6	-	-
7. Health	7	-	-
8. Recreation, culture and religion	8	-	-
9. Education	9	-	-
10. Social protection	10	-	-
11. Total expenditure (=item 7=26 in Table 2)	TE ¹	-	-

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

Table 4. General government debt developments

% of GDP		2005	2006	2007	2008	2009
1. Gross debt¹		30.4	30.6	30.5	31.3	32.0
2. Change in gross debt ratio		-0.3	0.2	-0.1	0.8	0.7

3. Primary balance²		2.5	2.4	2.6	2.0	1.4
4. Interest expenditure (incl. FISIM)³		1.2	1.2	1.4	1.5	1.5
5. Stock-flow adjustment		-2.0	-1.1	-1.9	-0.5	0.0
<i>of which:</i>						
- Differences between cash and accruals ⁴		-1.6	0.4	0.0	0.0	0.0
- Net accumulation of financial assets ⁵		-0.4	-1.5	-1.9	-0.5	0.0
<i>of which:</i>						
- privatisation proceeds		-3.6	-0.1	-1.0	0.0	0.0
- Valuation effects and other ⁶		0.0	0.0	0.0	0.0	0.0
p.m.: implicit interest rate on debt⁷		4.0	4.1	4.9	5.2	5.3

Other relevant variables

6. Liquid financial assets ⁸		-	-	-	-	-
7. Net financial debt (7=1-6)		-	-	-	-	-

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

²Cf. Item 10 in Table 2.

³Cf. Item 9 in Table 2.

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

⁵Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted

assets could be distinguished when relevant.

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

⁷Proxied by interest expenditure (incl. FISIM recorded as consumption) divided by the debt level of the previous year.

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

Table 5. Cyclical developments

% of GDP	ESA Code	2005	2006	2007	2008	2009
1. Real GDP growth (%)		6.1	6.0	4.9	4.8	4.8
2. Net lending of general government	EDP B.9	-3.6	-3.5	-4.0	-3.5	-3.3
3. Interest expenditure (incl. FISIM recorded as consumption)	EDPD.41 incl. FISIM	-1.2	-1.2	-1.4	-1.5	-1.5
4. Potential GDP growth (%)		4.8	5.0	5.1	5.1	5.2
contributions:						
- labour		0.4	0.5	0.3	0.2	0.1
- capital		0.8	0.9	1.0	1.1	1.2
- total factor productivity		3.6	3.6	3.8	3.8	4.0
5. Output gap		-0.1	0.9	0.7	0.4	0.1
6. Cyclical budgetary component		0.0	0.3	0.2	0.1	0.0
7. Cyclically-adjusted balance (2-6)		-3.6	-3.8	-4.2	-3.6	-3.2
8. Cyclically-adjusted primary balance (7-3)		-2.5	-2.6	-2.8	-2.2	-1.7

Table 6. Divergence from previous update

	ESA Code	2005	2006	2007	2008	2009
Real GDP growth (%)						
Previous update		4.8	4.4	4.2	4.3	
Current update		6.1	6.0	4.9	4.8	4.8
Difference		1.3	1.6	0.7	0.5	
General government net lending (% of GDP)	EDP B.9					
Previous update		-4.8	-3.8	-3.3	-2.7	
Current update		-3.6	-3.5	-4.0	-3.5	-3.2
Difference		1.2	0.3	-0.7	-0.8	
General government gross debt (% of GDP)						
Previous update		37.4	37.1	37.9	37.8	
Current update		30.4	30.6	30.5	31.3	32.0
Difference		7	6.5	7.4	7.3	

Table 7. Long-term sustainability of public finances

% of GDP	2005	2010	2020	2030	2040	2050
Total expenditure	44.0	42.5	43.3	46.2	52.0	59.2
Of which: age-related expenditures	19.9	18.5	18.9	20.9	24.5	27.7
Pension expenditure ¹	8.4	7.7	8.3	9.5	12.1	14.2
Social security pension	8.4	7.7	8.3	9.5	12.1	14.2
Old-age and early pensions ²	7.6	7.0	7.5	8.7	11.4	13.5
Other pensions (disability, survivors)	0.8	0.7	0.7	0.8	0.7	0.7
Occupational pensions (if in general government)	-	-	-	-	-	-
Health care ³	6.5	6.4	6.7	7.3	8.1	8.9
Long-term care (<i>this was earlier included in health care</i>)	0.3	0.3	0.3	0.4	0.5	0.6
Education expenditure ⁴	3.6	3.1	2.7	2.8	2.9	3.0
Other age-related expenditures ⁴	1.2	1.0	1.0	0.9	1.0	1.1
Interest expenditure	1.2	0.9	1.3	2.2	4.3	8.4
Total revenue	40.4	40.3	40.3	40.3	40.3	40.3
Of which: property income	0.7	0.7	0.7	0.7	0.7	0.7
<i>of which: from pensions contributions (or social contributions if appropriate)</i>	8.7	8.7	8.7	8.7	8.7	8.7
Pension reserve fund assets	0.5	4.9	12.9	12.4	0.0	0.0
Of which: consolidated public pension fund assets (assets other than government liabilities)	0	0	0	0	0	0
Assumptions						
Labour productivity growth	4.8	3.4	3.0	2.7	1.9	1.7
Real GDP growth	6.1	3.6	2.5	1.9	0.4	0.8
Participation rate males (aged 15-64) ⁵	83.5	84.6	87.4	87.1	84.4	85.6
Participation rates females (aged 15-64) ⁵	68.2	70.6	76.4	76.1	72.9	74.0
Total participation rates (aged 15-64) ⁵	75.8	77.6	81.9	81.6	78.7	79.8
Unemployment rate	7.9	7.3	6.5	6.5	6.5	6.5
Population aged 65+ over total population	14.2	16.5	20.8	23.6	26.8	31.0
¹ Including pension payments from other funds than Social Security Fund. Projection of the Ministry of Finance until 2010, projection of the EPC AWG afterwards, corrected with the effect of the stabilisation measures of 2006-2007. ² Including survivor pension paid after the retirement age and other pension-type benefits. ³ 2005-2050: projection of the EPC AWG, 2000: OECD Health Data 2005. ⁴ Projection of the EPC AWG. ⁵ In the Code of conduct the age limits are 20-64						

Table 8. Basic assumptions

	2005	2006	2007	2008	2009
Short-term interest rate ¹ (annual average)	2.0	2.0			
Long-term interest rate (annual average)	3.5	3.9	4.5	4.3	4.2
<i>for countries in euro area or ERM II:</i> USD/€exchange rate (annual average)	1.24	1.25	1.26	1.26	1.26
Nominal effective exchange rate	123.5	129.3	131.5	133.4	135.3
<i>for countries not in euro area or ERM II:</i> exchange rate vis-à-vis the €(annual average)	29.8	28.4	28.0	27.5	27.1
World excluding EU, GDP growth	5.3	5.7	5.2	5.2	5.0
EU GDP growth	1.7	2.7	2.2	2.3	2.4
Growth of relevant foreign markets	8.2	10.9	7.9	8.0	8.0
World import volumes, excluding EU	8.5	9.0	8.2	7.8	7.7
Oil prices (Brent, USD/barrel)	54.4	67.5	59.8	55.0	52.0

¹If necessary, purely technical assumptions.

Annex 3: Compliance with the code of conduct

standard text: The table below provides a detailed assessment of whether the programme respects the requirements of Section II of the code of conduct. It is in four parts, covering compliance with (i) the window for the date of submission of the programme; (ii) the model structure (table of contents) in Annex 1 of the code; (iii) the data requirements (model tables) in Annex 2 of the code; and (iv) other information requirements.

Guidelines in the code of conduct	Yes	No	Comments
1. Submission of the programme			
Programme was submitted not earlier than mid-October and not later than 1 December ¹ .		x	Programme delayed due to political situation
2. Model structure			
The model structure for the programmes in Annex 1 of the code of conduct has been followed.	x		
3. Model tables (so-called data requirements)			
The quantitative information is presented following the standardised set of tables (Annex 2 of the code of conduct).	x		
The programme provides all compulsory information in these tables.	x		
The programme provides all optional information in these tables.		x	Functional breakdown of government expenditure missing, as well as liquid financial assets
The concepts used are in line with the European system of accounts (ESA).	x		

Guidelines in the code of conduct	Yes	No	Comments
4. Other information requirements			
<i>a. Involvement of parliament</i>			
The programme mentions its status vis-à-vis the national parliament.	<i>x</i>		
The programme indicates whether the Council opinion on the previous programme has been presented to the national parliament.	<i>x</i>		
<i>b. Economic outlook</i>			
Euro area and ERM II Member States uses the “common external assumptions” on the main extra-EU variables.	<i>x</i>		But not on the exchange rate
Significant divergences between the national and the Commission services’ economic forecasts are explained ² .	<i>x</i>		
The possible upside and downside risks to the economic outlook are brought out.	<i>x</i>		
The outlook for sectoral balances and, especially for countries with a high external deficit, the external balance is analysed.	<i>x</i>		
<i>c. Monetary/exchange rate policy</i>			
The convergence programme presents the medium-term monetary policy objectives and their relationship to price and exchange rate stability.	<i>x</i>		
<i>d. Budgetary strategy</i>			
The programme presents budgetary targets for the general government balance in relation to the MTO, and the projected path for the debt ratio.	<i>x</i>		
In case a new government has taken office, the programme shows continuity with respect to the budgetary targets endorsed by the Council.		<i>x</i>	Targets for 2007 and 2008 have been raised
When applicable, the programme explains the reasons for possible deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify the situation, and provide information on them.	<i>x</i>		
The budgetary targets are backed by an indication of the broad measures necessary to achieve them and an assessment of their quantitative effects on the general government balance is analysed.		<i>x</i>	(the government has included a declaration based on as yet unapproved measures)
Information is provided on one-off and other temporary measures.		<i>x</i>	No one-off and temporary measures were considered

Guidelines in the code of conduct	Yes	No	Comments
			appropriate by the Czech authorities
The state of implementation of the measures (enacted versus planned) presented in the programme is specified.	x		
If for a country that uses the transition period for the classification of second-pillar funded pension schemes, the programme presents information on the impact on the public finances.			(not applicable)
<i>e. "Major structural reforms"</i>			
If the MTO is not yet reached or a temporary deviation is planned from the achieved MTO, the programme includes comprehensive information on the economic and budgetary effects of possible 'major structural reforms' over time.		x	
The programme includes a quantitative cost-benefit analysis of the short-term costs and long-term benefits of such reforms.		x	
<i>f. Sensitivity analysis</i>			
<p>The programme includes comprehensive sensitivity analyses and/or develops alternative scenarios showing the effect on the budgetary and debt position of:</p> <p>a) changes in the main economic assumptions</p> <p>b) different interest rate assumptions</p> <p>c) for non-participating Member States, different exchange rate assumptions</p> <p>d) if the common external assumptions are not used, changes in assumptions for the main extra-EU variables.</p>	x		
In case of "major structural reforms", the programme provides an analysis of how changes in the assumptions would affect the effects on the budget and potential growth.			not applicable
<i>g. Broad economic policy guidelines</i>			
The programme provides information on the consistency with the broad economic policy guidelines of the budgetary objectives and the measures to achieve them.		x	
<i>h. Quality of public finances</i>			
The programme describes measures aimed at improving the quality of public finances on both the revenue and expenditure side (e.g. tax reform, value-for-money initiatives, measures to improve tax collection efficiency and expenditure control).	x		
<i>i. Long-term sustainability</i>			

Guidelines in the code of conduct	Yes	No	Comments
The programme outlines the country's strategies to ensure the sustainability of public finances, especially in light of the economic and budgetary impact of ageing populations.	x		
Common budgetary projections by the AWG are included in the programme. The programme includes all the necessary additional information. (...) To this end, information included in programmes should focus on new relevant information that is not fully reflected in the latest common EPC projections.	x		
<i>j. Other information (optional)</i>			
The programme includes information on the implementation of existing national budgetary rules (expenditure rules, etc.), as well as on other institutional features of the public finances, in particular budgetary procedures and public finance statistical governance.	x		
<p><u>Notes:</u></p> <p>¹The code of conduct allows for the following exceptions: (i) Ireland should be regarded as complying with the deadline in case of submission on "budget day", i.e. traditionally the first Wednesday of December, (ii) the UK should submit as close as possible to its autumn pre-budget report; and (iii) Austria and Portugal cannot comply with the deadline but will submit no later than 15 December.</p> <p><u>Source:</u></p> <p><i>Commission services</i></p>			

Annex 4: Key economic indicators of past economic performance

standard text: This Annex includes two tables. The first displays key economic indicators that summarise the economic performance of the country. To put the country's performance into perspective, the second table displays the same set of indicators for the EU10.

Czech Republic - Key economic indicators

	Averages			2003	2004	2005
	1996 – 2005	1996 – 2000	2001 – 2005			
Economic activity						
Real GDP (% change)	2.6	1.5	3.6	3.6	4.2	6.1
Private consumption (% change)	4.5	4.7	4.3	0.2	4.2	7.0
Government consumption (% change)	2.0	1.0	3.1	7.1	-3.2	1.0
Investment (% change)	2.3	1.0	3.6	0.4	4.7	1.3
Exports (% change)	9.8	9.3	10.4	7.2	21.1	10.4
Imports (% change)	9.7	9.7	9.7	8.0	18.2	4.8
Contributions to real GDP growth:						
<i>Domestic demand</i>	2.7	2.0	3.4	4.2	2.8	2.1
<i>Net exports</i>	-0.1	-0.5	0.3	-0.6	1.4	4.0
Output gap (% of potential GDP)	n.a.	n.a.	-2.3	-3.0	-2.8	-0.9
Prices and costs						
HICP inflation (% change)	4.3	6.5	2.0	-0.1	2.6	1.6
Unit labour costs (% change)	5.3	7.2	3.4	3.6	1.9	-0.3
Labour productivity (% change)	2.9	2.3	3.4	5.0	4.1	4.4
Real unit labour costs (% change)	0.6	0.4	0.8	2.7	-1.6	-1.0
Comparative price levels (EUR25=100)	48.3	43.4	53.2	53.3	53.4	56.3
Labour market						
Employment (% change)	-0.3	-0.8	0.1	-1.2	-0.3	1.3
Employment (% of working age population)	68.3	69.6	67.0	66.6	66.2	66.9
Unemployment rate (% of labour force)	7.5	7.2	7.9	7.8	8.3	7.9
NAIRU (% of labour force)	n.a.	n.a.	7.3	7.3	7.1	7.1
Participation rate (% of working age population)	73.3	74.1	72.6	72.2	72.0	72.6
Working age population (% change)	0.3	0.3	0.2	0.4	0.4	0.1

Competitiveness and external position						
Real effective exchange rate (% change) (1)	5.5	4.6	6.4	1.4	1.5	4.9
Export performance (% change) (2)	2.7	0.0	5.5	2.1	12.0	3.2
External balance of g & s (% of GDP)	-2.2	-3.3	-1.1	-2.3	-0.6	1.9
External balance (% of GDP)	-4.8	-4.4	-5.1	-6.3	-6.2	-3.2
FDI inflow (% of GDP)	n.a.	n.a.	7.3	2.3	4.6	8.9
Public finances						
Total expenditure (% of GDP)	44.0	42.6	45.3	47.3	44.4	44.1
Total revenue (% of GDP)	39.4	38.7	40.2	40.7	41.5	40.4
General government balance (% of GDP)	-4.5	-3.9	-5.1	-6.6	-2.9	-3.6
General government debt (% of GDP)	22.0	15.1	29.0	30.1	30.7	30.4
Structural budget balance (% of GDP) (3)	n.a.	n.a.	n.a.	-5.5	-1.1	-2.2
Financial indicators (4)						
Short term real interest rate (%) (5)	2.2	3.8	0.5	1.3	-1.1	1.3
Long term real interest rate (%) (5)	n.a.	n.a.	2.1	3.2	1.2	2.8
Household debt (% change) (6)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector debt (% change) (7)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Household debt (% of GDP) (6)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector debt (% of GDP) (7)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Notes: (1) Unit labour costs relative to rest of a group of industrialised countries (USD): EU24 (= EU25 excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and NZ. (2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets. (3) Cyclically-adjusted budget balance net of one-off and other temporary measures. (4) Data available up to 2004. (5) Using GDP deflator. (6) Households' and non-profit institutions serving households' debt, defined as loans and securities other than shares. (7) Non-financial corporate sector debt, defined as loans and securities other than shares. Source: <i>Commission services</i>						

EU10 - Key economic indicators

	Averages			2003	2004	2005
	1996 – 2005	1996 – 2000	2001 – 2005			
Economic activity						
Real GDP (% change)	4.0	4.3	3.7	4.0	5.1	4.6
Private consumption (% change)	4.2	4.7	3.8	3.9	4.1	3.7
Government consumption (% change)	2.5	1.9	3.1	5.0	1.8	2.0
Investment (% change)	5.6	8.4	2.9	1.7	7.2	6.2
Exports (% change)	10.0	11.0	9.0	9.1	14.5	10.3
Imports (% change)	10.2	12.7	7.8	8.5	14.6	6.9
Contributions to real GDP growth:						
Domestic demand	4.3	5.3	3.4	4.0	5.6	3.0
Net exports	-0.3	-1.0	0.4	0.0	-0.5	1.6
Output gap (% of potential GDP)	n.a.	n.a.	-1.0	-1.4	-0.5	-0.4
Prices and costs						
HICP inflation (% change)	n.a.	n.a.	3.3	1.9	4.1	2.5
Unit labour costs (% change)	5.7	9.2	2.3	1.3	1.4	0.7
Labour productivity (% change)	4.2	4.6	3.7	4.3	4.5	2.9
Real unit labour costs (% change)	-0.8	-0.6	-1.0	-0.7	-2.5	-1.8
Comparative price levels (EUR25=100)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Labour market						
Employment (% change)	-0.1	-0.3	0.0	-0.2	0.6	1.7
Employment (% of working age population)	58.0	59.4	56.6	56.1	56.2	57.0
Unemployment rate (% of labour force)	12.8	11.3	14.2	14.3	14.2	13.4
NAIRU (% of labour force)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Participation rate (% of working age population)	66.4	66.7	66.1	65.7	65.6	65.8
Working age population (% change)	0.3	0.4	0.3	0.4	0.4	0.3
Competitiveness and external position						
Real effective exchange rate (% change) (1)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Export performance (% change) (2)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
External balance of g & s (% of GDP)	-3.4	-4.2	-2.6	-2.9	-2.6	-1.3
External balance (% of GDP)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
FDI inflow (% of GDP)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Public finances						
Total expenditure (% of GDP)	n.a.	n.a.	44.2	44.9	43.4	43.6
Total revenue (% of GDP)	n.a.	n.a.	40.0	39.9	39.6	40.3
General government balance (% of GDP)	n.a.	n.a.	-4.2	-5.1	-3.7	-3.3
General government debt (% of GDP)	37.9	35.8	40.1	39.9	43.4	41.3
Structural budget balance (% of GDP) (3)	n.a.	n.a.	n.a.	-4.5	-3.4	-3.0
Financial indicators (4)						
Short term real interest rate (%) (5)	n.a.	n.a.	3.5	3.3	1.8	1.8
Long term real interest rate (%) (5)	n.a.	n.a.	n.a.	3.5	2.2	2.2
Household debt (% change) (6)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector debt (% change) (7)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Household debt (% of GDP) (6)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector debt (% of GDP) (7)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Notes: (1) Unit labour costs relative to rest of a group of industrialised countries (USD): EU24 (=EU25 excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and NZ. (2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets. (3) Cyclically-adjusted budget balance net of one-off and other temporary measures. (4) Data available up to 2004. (5) Using GDP deflator. (6) Households' and non-profit institutions serving households' debt, defined as loans and securities other than shares. (7) Non-financial corporate sector debt, defined as loans and securities other than shares. Source: <i>Commission services</i>						

Annex 5: Assessment of tax projections

entire annex is standard text: Table 9 in the main text compares the tax projections of the programme with those of the Commission services' spring 2007 forecast and those obtained by using standard ex-ante elasticities, as estimated by the OECD. It summarises the results for the total tax-to-GDP ratio. The underlying analysis exploits information for the four major tax categories, i.e. indirect taxes, corporate and private income taxes and social contributions (see results in the table below)¹⁴.

Conceptually, the analysis draws on the definition of a semi-elasticity, which measures the change in a ratio vis-à-vis the relative change in the denominator. The semi-elasticity of the tax-

to-GDP ratio of the i -th tax $\frac{T_i}{Y}$ can be written as:

$$\eta_i = \frac{d\left(\frac{T_i}{Y}\right)}{dY} Y = \left(\frac{dT_i}{dY} \frac{Y}{T_i} - 1\right) \frac{T_i}{Y} = \left(\frac{dT_i}{dB_i} \frac{B_i}{T_i} \frac{dB_i}{dY} \frac{Y}{B_i} - 1\right) \frac{T_i}{Y} = (\varepsilon_{T_i, B_i} \varepsilon_{B_i, Y} - 1) \frac{T_i}{Y}$$

¹⁴ Private and corporate income taxes are generally not provided, neither in the programme nor in the Commission services' spring 2007 forecast. Only the aggregate, direct income taxes, is given. For the purpose of this exercise the breakdown is obtained using the average shares over the past ten years, i.e. the composition of direct taxes is assumed to stay constant.

where ε_{T_i, B_i} and $\varepsilon_{B_i, Y}$ denote the elasticity of the i -th tax T_i relative to its tax base B_i and the elasticity of the tax base B_i relative to aggregate GDP Y respectively.

To the extent that ε_{T_i, B_i} is derived from observed or projected data, it will typically reflect (i) the effect of discretionary measures (including one-offs) and (ii) the tax elasticity¹⁵. By contrast, if ε_{T_i, B_i} is the standard *ex-ante* elasticity, as estimated by the OECD, it will be net of discretionary measures.

The second elasticity $\varepsilon_{B_i, Y}$ can be used as an indicator of the tax intensity of GDP growth; for instance, a higher elasticity of consumption relative to GDP means that for the same GDP growth indirect taxes will be higher.

The definition of a semi-elasticity has two practical implications. First, any change in the tax-to-GDP ratio of the i -th tax can be written as the product of the semi-elasticity and GDP growth:

$$d\left(\frac{T_i}{Y}\right) = \eta_i \cdot \frac{dY}{Y}$$

and the change in the total tax-to-GDP ratio is the sum:

$$\sum_i d\left(\frac{T_i}{Y}\right) = \sum_i \eta_i \frac{dY}{Y}.$$

Second, differences between two tax projections can be decomposed into an elasticity component and a composition component:

$$d\left(\frac{T_i}{Y}\right)' - d\left(\frac{T_i}{Y}\right) \approx \left[\left(\varepsilon_{T_i, B_i}' - \varepsilon_{T_i, B_i} \right) \frac{T_i}{Y} - \left(\varepsilon_{B_i, Y}' - \varepsilon_{B_i, Y} \right) \frac{T_i}{Y} \right] \frac{dY}{Y}$$

If $(\varepsilon_{T_i, B_i}' - \varepsilon_{T_i, B_i}) = \alpha_i$; $(\varepsilon_{B_i, Y}' - \varepsilon_{B_i, Y}) = \beta_i$,

$$\text{then } d\left(\frac{T_i}{Y}\right)' - d\left(\frac{T_i}{Y}\right) \approx \left[(\alpha_i \varepsilon_{B_i, Y} + \beta_i \varepsilon_{T_i, B_i} + \alpha_i \beta_i) \frac{T_i}{Y} \right] \frac{dY}{Y}$$

where $\alpha_i \varepsilon_{B_i, Y} \frac{T_i}{Y} \frac{dY}{Y}$ determines the elasticity component and $\beta_i \varepsilon_{T_i, B_i} \frac{T_i}{Y} \frac{dY}{Y}$ the composition component. The third component in the equation $\alpha_i \beta_i \frac{T_i}{Y} \frac{dY}{Y}$ measures the interaction of the

¹⁵The observed or projected elasticity (ex-post elasticity) of the i -th tax also includes the effect of other factors (OF) such as discretionary measures: $\frac{\Delta T_i}{T_i} = \varepsilon_{T_i, B_i, ex ante} \frac{dB_i}{B_i} + \frac{OF_i}{T_i} = \varepsilon_{T_i, B_i, ex post} \frac{dB_i}{B_i}$.

elasticity and the composition components. It is generally small but can become important in some cases. The tax elasticity relative to GDP of total taxes is obtained as $\varepsilon = \sum_i w_i \varepsilon_{T_i B_i} \varepsilon_{B_i Y}$

with w_i the share of the i -th tax in the overall tax burden.

Assessment of tax projections by major tax category

	2007			2008			2009
	CP	COM	OECD ¹	CP	COM ²	OECD ¹	CP
Taxes on production and imports:							
Change in tax-to-GDP ratio	-0.1	-0.1	0.0	-0.3	0.0	0.0	-0.4
<i>Difference CP – COM</i>	0.0			-0.4			/
<i>of which</i> ³ :							
- discretionary & elasticity component	0.1			-0.3			/
- composition component	-0.1			0.0			/
<i>Difference COM – OECD¹</i>	/	-0.1		/	0.0		/
<i>of which</i> ³ :							
- discretionary & elasticity component	/	-0.1		/	0.1		/
- composition component	/	0.0		/	-0.1		/
p.m.: Elasticity							
- of taxes to tax base ⁴	0.9	0.8	1.0	0.7	1.1	1.0	0.6
- of tax base ⁴ to GDP	0.9	1.0	1.0	0.9	0.9	1.0	0.9
Social contributions:							
Change in tax-to-GDP ratio	0.0	-0.3	-0.2	-0.3	-0.3	-0.2	-0.1
<i>Difference CP – COM</i>	0.3		/	0.0		/	/
<i>of which</i> ³ :							
- discretionary & elasticity component	0.0		/	-0.4		/	/
- composition component	0.3		/	0.6		/	/
<i>Difference COM – OECD¹</i>	/	-0.1		/	0.0		/
<i>of which</i> ³ :							
- discretionary & elasticity component	/	-0.1		/	0.2		/
- composition component	/	0.0		/	-0.2		/
p.m.: Elasticity							
- of taxes to tax base ⁵	1.0	1.0	1.1	0.8	1.3	1.1	1.0
- of tax base ⁵ to GDP	1.0	0.7	0.7	1.0	0.6	0.7	0.9
Personal income tax⁶:							
Change in tax-to-GDP ratio	-0.1	0.0	0.1	0.1	0.1	0.1	-0.1
<i>Difference CP – COM</i>	-0.2		/	0.0		/	/
<i>of which</i> ³ :							
- discretionary & elasticity component	-0.2		/	-0.2		/	/
- composition component	0.1		/	0.4		/	/
<i>Difference COM – OECD¹</i>	/	-0.1		/	0.1		/
<i>of which</i> ³ :							
- discretionary & elasticity component	/	-0.1		/	0.2		/
- composition component	/	0.0		/	-0.1		/
p.m.: Elasticity							
- of taxes to tax base ⁵	0.6	1.5	1.7	1.4	2.4	1.7	0.8
- of tax base ⁵ to GDP	1.0	0.7	0.7	1.0	0.6	0.7	0.9
Corporate income tax⁶:							
Change in tax-to-GDP ratio	-0.1	0.0	0.1	0.1	0.1	0.1	-0.1
<i>Difference CP – COM</i>	-0.1		/	0.0		/	/
<i>of which</i> ³ :							
- discretionary & elasticity component	-0.1		/	0.1		/	/
- composition component	-0.1		/	-0.1		/	/
<i>Difference COM – OECD¹</i>	/	-0.1		/	0.0		/
<i>of which</i> ³ :							
- discretionary & elasticity component	/	-0.1		/	0.0		/
- composition component	/	0.0		/	0.0		/
p.m.: Elasticity							
-of taxes to tax base ⁷	0.6	0.9	1.1	1.4	1.0	1.1	0.7
-of tax base ⁷ to GDP	1.0	1.2	0.7	1.0	1.3	0.7	1.1
Notes:							
¹ Based on OECD ex-ante elasticities							
² On a no-policy change basis							
³ The decomposition is explained in the text above							
⁴ Tax base = private consumption expenditure							
⁵ Tax base = compensation of employees							
⁶ Taxes on income and wealth are split into private and corporate income tax using the average tax share over the past ten years, i.e. the share is assumed to be constant over the programme period							
⁷ Tax base = gross operating surplus							
Source:							
Commission services' spring 2007 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)							