Ministry of Finance
Czech Republic

Convergence Programme
of the Czech Republic

April 2024

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Ministry of Finance of the Czech Republic
Letenská 15, 118 10 Prague 1

Tel.: +420 257 041 111
E-mail: podatelna@mfcr.cz

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Contents

The Convergence Programme is submitted on the basis of Article 121 of the Treaty on the Functioning of the European Union and the current version of Council Regulation (EC) No. 1466/97 on the Strengthening of the Surveillance of Budgetary Positions and the Surveillance and Coordination of Economic Policies. As such, it has been drawn up in accordance with the rules in force in the Council's Economic and Financial Committee (EFC, 2017) and is consistent with the National Reform Programme of the Czech Republic (Government Office, 2024).

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List of Abbreviations

CNB .... Czech National Bank
COFOG .... Classification of the Functions of Government
CP .... Convergence Programme of the Czech Republic
CZK .... Czech koruna currency code
CZSO .... Czech Statistical Office
EC .... European Commission
ESA 2010 .... European System of National and Regional Accounts from year 2010
EU .... European Union containing 27 countries
EUR .... euro currency code
GDP .... gross domestic product
MF CR .... Ministry of Finance of the Czech Republic
p. a. .... *per annum*
pp .... percentage point
PPP .... public-private partnership
US .... United States of America
USD .... US Dollar currency code
YoY .... year-on-year

Symbols Used in Tables

A dash (–) in place of a number indicates that the phenomenon did not occur or is not possible for logical reasons.
“Billion” means a thousand million.

Cut-off Date for Data Sources

Macroeconomic data used pertain to the 4 April 2024 release and fiscal data and policies to the 22 April 2024 release. Notification of general government deficit and debt was specified and approved by Eurostat on 22 April 2024.

Note

In some cases, published aggregate data do not match the sums of individual items to the last decimal place due to rounding.

Introduction and Summary

Adverse events in the form of the pandemic followed by the Russian invasion of Ukraine and the associated extreme volatility in the energy markets have placed a heavy burden on society and the economy. In 2020, for the first time in history, the European Commission activated the general escape clause from the rules of the Stability and Growth Pact to allow EU Member States to respond flexibly through fiscal policy to cushion the impact of these shocks.

As risks recede and markets stabilise, fiscal policy stance in the Union is also changing - from purely expansionary in 2020–2022 and neutral in 2023, to restrictive in 2024 and beyond. There is also a change in emphasis from quick and rather across-the-board solutions to largely targeted solutions, focusing only on the most vulnerable in the economy. Economic policy in the Czech Republic has evolved broadly in line with these recommendations in recent years. The same assessment can be made for the period ahead, when fiscal policy should be restrictive this year and in the next few years.

Before 2020, the Czech Republic had a relatively low general government debt, among the four least indebted countries in the EU. The significant increase in debt and the structural imbalance between public revenues and expenditures made consolidation of public finances inevitable. The Czech government has therefore prepared measures to reduce the state budget deficit by around CZK 150 billion in 2024 and 2025. Act No. 349/2023 Coll. amending certain acts in connection with the consolidation of public budgets contains amendments to more than 60 legal acts. Among the most significant budgetary changes contained in the consolidation package are a reduction in subsidies, savings in the state's operating expenses, the corporate income tax rate increase, the reintroduction of sickness insurance for employees, an increase in property tax, and the elimination or limitation of a number of tax exemptions. The content of the package is in line with a number of recommendations that the Czech Republic has repeatedly received from international organisations. The package also includes an amendment to the Fiscal Responsibility Rules Act, which accelerates the return to the medium-term budgetary objective.

In terms of economic dynamics, the consolidation is set at the beginning of a recovery, which, after a slight decline last year, is already confirmed by data from the end of last year and the beginning of this year. We expect the economy to grow by 1.4% this year driven by renewed household consumption and investment. Inflation will fall significantly this year and is forecast to remain below 3% for most of the year. Labour market imbalances related to labour shortages continue to manifest themselves. As a result, despite the weak economic momentum, the unemployment rate should not rise much in 2024. Moreover, the persistent labour market tightness will not allow nominal wage growth to slow down significantly, and earnings will increase in real terms after two years of decline. In terms of the business cycle, the economy is in a negative output gap, which should close next year.

Public finances in 2023 reflected extraordinary revenue and expenditure related to the energy crisis, rising social spending and sustained assistance to Ukrainian refugees. The overall general government deficit reached 3.7% of GDP last year. Despite the increase in state debt in 2023, general government debt declined to 44% of GDP year-on-year due to high nominal GDP growth.

For 2024, we estimate that consolidation and a minimum of one-off or other temporary expenditure should be reflected in a year-on-year reduction in the deficit to 2.3% of GDP, despite the negative position of the economy over the business cycle. Debt is expected to increase and exceed 45% of GDP. Public finances in the coming years will be primarily determined by the need for consolidation in line with the provisions of the Fiscal Responsibility Rules Act. At the end of the projection horizon, the maximum allowed structural deficit for expenditure ceilings is set at 1.25% of GDP.

In addition to addressing the current structural imbalances in public finances, the government is preparing a set of measures to strengthen the long-term sustainability of the pension system. The first phase of the pension reform concerned pension indexation and early retirement scheme. The second part is now in the final stage of preparation, which, from the point of view of financial sustainability, comes with the fundamental measures of linking the retirement age to life expectancy and a change in the calculation of pensions leading to lower replacement rates; on the other hand, the sharing of assessment bases for spouses or the introduction of a notional assessment base for carers is envisaged.

In April 2024, the Convergence Programme of the Czech Republic was subject to an inter-ministerial comment procedure. The document was approved by the Government of the Czech Republic on 24 April 2024.

As a result of the reform of the Stability and Growth Pact, the European Semester is undergoing significant changes. This year, the convergence programme has been put together for the last time and will be replaced by a so-called medium-term fiscal-structural plan, which will be prepared primarily for a period of 4 or 5 years. Member States should submit the first version of the plan by 20 September 2024. In the case of the Czech Republic, the specific setting of the plan will depend on the assessment of the excessive deficit procedure later this year.

1 Economic Policy Intentions and Objectives

Fiscal and monetary policy in the Czech Republic reacted expansively at the beginning of the pandemic. However, while the Czech National Bank moved to tighten monetary policy in mid-2021 to weaken domestic demand pressures and anchor inflation expectations, public finances were still dealing with the epidemic and its health, social and economic consequences. The consolidation of public finances begun in 2022 was disrupted by the Russian aggression in Ukraine, whose consequences for European energy supplies and prices forced further fiscal expansion. To address the security of energy supply and the renewed decline in energy and commodity prices on world markets, the Czech government proceeded last year to prepare a set of consolidation measures with a total impact of around 1.5% of GDP. In response to price and exchange rate developments, the Czech National Bank increased interest rates, peaking at 7%, and intervened in foreign exchange. However, due to a substantial weakening of inflationary pressures, interest rates started to be gradually reduced in December last year.

1.1 Fiscal Policy

In 2023, public budgets continued to be affected by external shocks and measures taken to mitigate their impact on households and firms. Measures were mainly related to high energy prices, with compensation for energy price caps, full state coverage of renewable energy fees, compensation for losses to distributors in the transmission system, etc. On the other hand, the state budget revenues benefited from windfall profits tax revenues and a levy on excess revenues (see Chapter 3 for details).

Among the energy measures, only the partial reimbursement for renewable energy sources, which applies only to a select group of energy-intensive businesses, and the windfall profits taxation continue in 2024.

Public finances are significantly affected by Act No. 349/2023 Coll., amending certain acts in connection with the consolidation of public budgets (the so-called consolidation package). The law brings changes to 63 legal acts and significantly reduces the structural imbalances in public finances.

In principle, both of the above-mentioned drivers of the public finance settings, i.e. the removal of the vast majority of one-off measures related to energy prices and consolidation, are fully in line with the EC's (2023a) recommendations for 2024 and beyond:

"*Wind down the energy support measures in force by the end of 2023 using related savings to reduce the government deficit…*

Ensure prudent fiscal policy, in particular by limiting nominal increase in nationally financed net primary expenditure in 2024 to no more than 6.0%.

Preserve nationally financed public investment and ensure the effective absorption of RRF grants and other EU funds, in particular to foster green and digital transitions. For the period beyond 2024, continue to pursue a medium-term fiscal strategy of gradual and sustainable consolidation, combined with investments and reforms conducive to higher sustainable growth, to achieve a prudent medium-term fiscal position."

The consolidation package also included an amendment to Act No. 23/2017 Coll., on the Fiscal Responsibility Rules, which confirmed the tightening of the budgetary framework for the state budget and state funds for 2024 and maintained the reduction of the maximum permitted structural deficits by 0.5 percentage points for the following years. The medium-term budgetary objective of −0.75% of GDP should thus be reached by 2028 at the latest (instead of 2031). This development is sufficient to meet the EC's requirement to maximise primary expenditure growth while contributing to a reversal of the debt ratio.

The composition and timing of the consolidation reflects good practice examples of countries that have succeeded in correcting their fiscal imbalances in the past. In relation to the EC recommendations, it is worth noting that the government's fiscal consolidation measures avoid cuts in capital expenditure. On the contrary, the aim is to strengthen investment, either through the consistent use of EU funds or through projects paid for entirely from national resources (defence, transport infrastructure, etc.).

1.2 Monetary Policy

Since 1998, the CNB's monetary policy has been conducted in an inflation targeting regime. Since 1 January 2010, the inflation target has been defined as annual consumer price index growth of 2% with a tolerance band of ±1 percentage point. The CNB defines the inflation target as medium-term and therefore tolerates some temporary deviations of actual inflation from the inflation target (e.g. due to adjustments to indirect taxes), the primary effects of which are not normally addressed by monetary policy, which focuses only on secondary effects.

In response to significantly rising demand and supply-side inflation pressures, the CNB started to increase interest rates in the second half of 2021. The primary interest rate was gradually raised by a cumulative 6.75 percentage points to 7% between June 2021 and June 2022. In 2022, the CNB also faced excessive pressure on the depreciation of the koruna due to uncertainties stemming from the Russian invasion of Ukraine. Therefore, in order not to allow a prolonged depreciation of the koruna in a situation of high inflation, the central bank decided to support the koruna with foreign exchange interventions worth EUR 25.5 billion (for May to September 2022). The CNB did so in line with the managed floating exchange rate regime in which it operates. The primary interest rate remained at 7% until December 2023, when the CNB decided to start easing the restrictive monetary conditions on the basis of improving inflation prospects. At the end of March this year, the CNB's base rate stood at 5.75%.

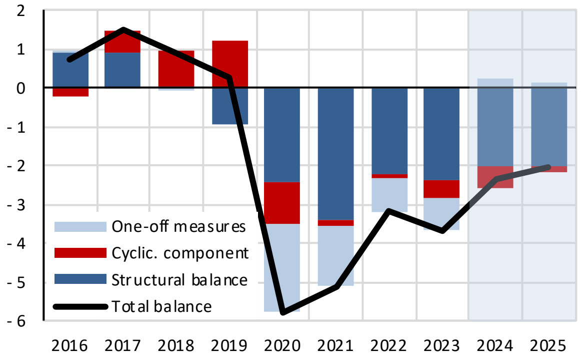
The average rate of inflation according to the national Consumer Price Index fell to 10.7% in 2023. However, despite the still significant increase in the price level, annual price growth slowed rapidly over the past year and reached the 2% inflation target in February this year. The easing of inflationary pressures was mainly due to weak domestic demand (the impact of falling real incomes and restrictive monetary policy) and the fading of supply-side frictions (improved conditions in supply chains, falling energy prices). Inflationary pressures should remain moderate this year. Relatively high nominal wage growth, as well as a significantly weaker koruna against the euro and the dollar, should act in the direction of higher inflation. Average consumer price inflation should thus slow considerably to 2.7% this year and further to 2.4% in 2025. The koruna appreciated by 2.3% YoY to CZK 24.01/EUR on average in 2023. The persistent impact of the positive interest rate differential vis-à-vis the euro area from the beginning of 2023, together with a temporary calming of the situation on global markets, contributed to this. The expected start of the CNB's key interest rate cuts, together with the unfavourable global economic outlook in the second half of 2023, exerted downward pressure on the koruna. The koruna is likely to remain at weaker levels in the first half of 2024. Subsequently, the koruna should benefit from the gradual resumption of real convergence of the Czech economy towards the euro area.

The CNB's future monetary policy stance will depend mainly on the persistence of core inflation. In view of the forecasted consumer price developments, we expect a gradual reduction in monetary policy interest rates over the course of this year.

In February 2024, the Government of the Czech Republic took note of a joint document by the MF CR and the CNB (2023), "Assessment of the Fulfilment of the Maastricht Convergence Criteria and the Degree of Economic Alignment of the Czech Republic with the Euro Area", which deals with the assessment of the Czech Republic's readiness to adopt the euro. In 2023, the Czech Republic did not fulfil the price benchmarks and formally the exchange rate fluctuation criterion, as the Czech Republic does not participate in the relevant exchange rate mechanism. Although the general government deficit benchmark was not met in 2023, as the EC did not terminate the general escape clause and thus did not propose to initiate the excessive deficit procedure, citing persistent macroeconomic uncertainties, the general government deficit criterion was still formally met by the Czech Republic. In 2024, the Czech Republic could already fulfil all criteria except the exchange rate fluctuation criterion.

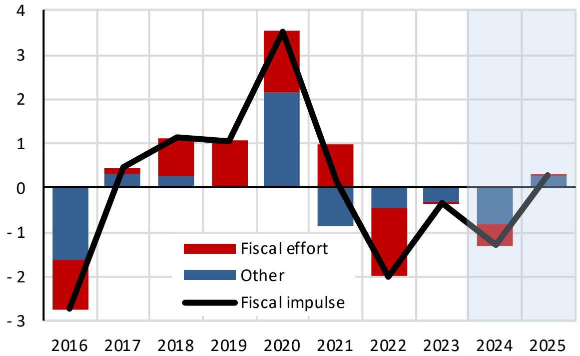
In terms of the Czech Republic's own readiness to adopt the euro, weaknesses remain. The structure of the Czech economy continues to diverge significantly from the euro area and the convergence process, in particular of price and wage levels, is advanced but not complete. Given the ageing population, the long-term sustainability of public finances, whose stabilising effect should partly compensate for the loss of autonomous monetary policy after euro adoption, has not yet been resolved. On the other hand, the high degree of openness of the Czech economy, its high degree of trade and ownership interdependence with the euro area and, in recent years, the progressive "euroisation" of the business sector (payments for goods, rents, loans) in order to avoid exchange rate fluctuations and high domestic interest rates have long been factors supporting euro adoption.

Graph 1.1: General Government Balance
in % of GDP



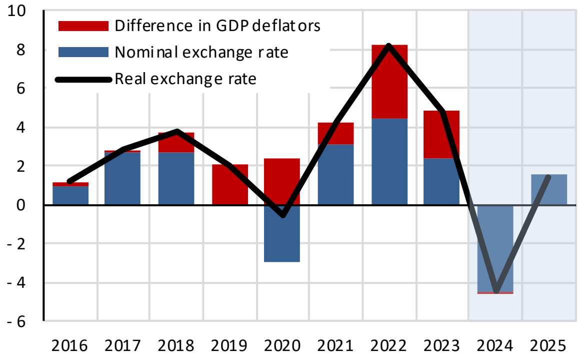
Source: CZSO (2024a, 2024b). MF CR forecast and calculations.

Graph 1.2: Fiscal Effort and Fiscal Impulse
in pp, primary fiscal effort with opposite sign



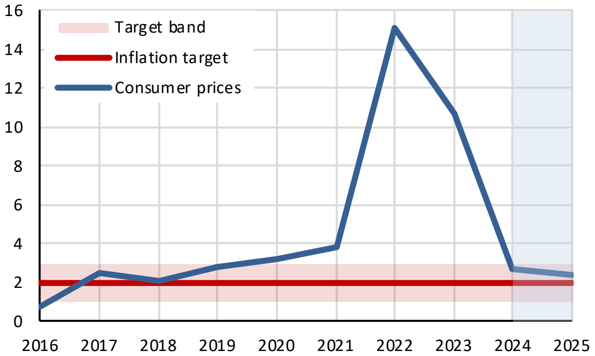
Source: CZSO (2024a, 2024b). MF CR forecast and calculations.

Graph 1.3: Real Exchange Rate to the Euro Area
real exchange rate appreciation in %, contributions in pp



Source: CNB (2024a), CZSO (2024a), Eurostat (2024). MF CR forecast and calculations.

Graph 1.4: Consumer Prices
change in %, national consumer price index



Source: CNB (2024b), CZSO (2024a). MF CR forecast and calculations.

2 Macroeconomic Scenario

Last year, the Czech economy teetered on the edge of recession. Gross domestic product fell by 0.3% in 2023 and is expected to increase by 1.4% in 2024. Inflation will fall significantly this year and remain below 3% for most of the year. The impact of weak economic dynamics on the labour market should not be significant given the persistent imbalances. Risks to economic growth are skewed to the downside.

2.1 Global Economy and Technical Assumptions

Global economic growth was slowing in 2023. While supply chains were already functioning without major problems, inflation remained high in many countries despite a gradual decline, continuing to reduce household purchasing power. Economic activity has also been dampened by the previous tightening of monetary policy by central banks, while ongoing wars and the associated heightened uncertainty have had a negative impact on international trade and investment activity. The world economy is also still constrained by persistent problems in China's real estate sector and low consumer confidence. Global economic growth could thus slow to 2.5% this year. However, it could accelerate to 3.6% in 2025, given the expected improvement in international trade and stronger household consumption.

The EU's gross domestic product increased by 0.5% in 2023, driven by household and government consumption and, in particular, the external trade balance. In contrast, growth momentum was dampened by the change in inventories due to the completion of work in progress. Economic growth in the EU could reach 0.7% this year and accelerate to 1.6% in 2025. In both years, it should be supported by rising consumer confidence, a relatively resilient labour market and lower interest rates. In the first half of this year, however, economic activity will be hampered by a lack of industrial orders.

In 2023, the price of a barrel of Brent crude oil fell on average by 18% to USD 82. The expected evolution of the oil price in the coming years reflects the downward sloping futures curve, but the average price of a barrel of Brent crude oil is still expected to increase YoY to USD 84 in 2024. In the following years, the price should gradually decline.

The forecast for the USD/EUR exchange rate is based on the development of forward contracts before the input data cut-off date. For this year, we thus estimate the average exchange rate at USD 1.09/EUR, while the dollar could weaken slightly to USD 1.11/EUR in the following year. The koruna appreciated by 2.3% YoY to CZK 24.0/EUR on average in 2023. For this year, we expect the currency to depreciate by 4.5% to CZK 25.1/EUR, while in the following years the koruna should benefit from the renewed economic convergence of the Czech economy towards the euro area.

Taking into account the assumed monetary policy stance of the CNB and the ECB and inflation developments, we believe that long-term interest rates could average 3.7% in 2024 and fall further to 3.4% in 2025.

2.2 Current Developments and a Medium-term Scenario

2.2.1 Economic Growth and the Demand Side

For the full year 2023, GDP fell by 0.3%. Households faced high inflation and their real consumption fell further. Investment activity was affected by economic problems in euro area countries and restrictive monetary conditions, but was positively influenced by government spending and projects co-financed by EU funds, mainly from the previous financial perspective. Weaker YoY inventory accumulation, mainly related to the completion of work in progress, slowed the economy noticeably. This factor, together with the unwinding of problems in supply chains, boosted exports, but imports declined slightly due to generally weak domestic demand. The contribution of the external trade balance to GDP growth was thus strongly positive.

In 2024, the economic output could increase by 1.4%, mainly due to renewed growth in household consumption and a moderation in the decline in gross capital formation. However, economic activity will be slightly dampened by the effects of the consolidation package, which will also contribute to reducing inflationary pressures. In the coming years, the economy could grow at a rate of around 2.5%, mainly on the back of rising consumption.

Real household consumption fell by 3.1% in 2023 as a result of a strong increase in the savings rate, with real disposable income effectively stagnating. This year, the saving rate could already start to fall slightly, but the decline will initially be dampened by the efforts of lower-income households to rebuild their financial buffer. The decrease in the saving rate should stimulate household consumption more strongly only in 2025, but the savings rate should remain well above its long-term average. In both years, interest rate cuts should also contribute to the decline in the savings rate, although at the beginning of the forecast horizon the incentive to save will still be relatively strong given the level of interest rates. Real household incomes should increase this year and next, thanks to the decline in inflation. However, private consumption dynamics will be slightly dampened by the consolidation package, and household consumption expenditure could rise by 2.7% this year and 3.5% in 2025. Against the backdrop of continued normalization of the savings rate and rising real income, private consumption growth should gradually slow in the following years.

General government consumption increased by 3.5% in 2023; in 2024, its growth could slow to 1.6%. In addition to fiscal consolidation, the transition to the new 2021–2027 Financial Perspective will also have an impact, but this will be somewhat offset by a surge in current spending from other EU instruments, notably the Recovery and Resilience Facility. In 2025, government consumption growth could accelerate to 2.2%, driven by an increase in government employment and stronger dynamics in purchases of goods and services, but is expected to slow down in the following years.

The forecast for gross fixed capital formation is influenced by the EU funds cycle. Private investment activity should remain relatively robust in 2024, thanks to a moderate recovery in economic activity in the euro area and a gradual easing of monetary conditions, but will be dampened by the transition to the new financial perspective of EU cohesion funds. This factor will also lead to a decline in general government investment. As a result, gross fixed capital formation may increase by 2.2% in 2024, but growth could accelerate to 2.4% in 2025, thanks to the economic recovery in the euro area and government investment supported by EU funding from the Recovery and Resilience Facility. Investment could grow at a similar pace in 2026–27.

We assume that over the entire horizon of the CP, the extent of stock accumulation will be broadly in line with the normal range for the given phase of the business cycle. However, given the high accumulation in previous years due to firms' efforts to ensure continuity of the production process in the event of recurrent supply disruptions of key components, we expect the change in inventories to have a negative impact on GDP growth until 2026.

We expect exports of goods and services to increase by 1.5% this year. The growth dynamics will be limited by the weak development of export markets and will be negatively affected by the decline in export performance. The projected acceleration of export growth to 3.7% in 2025 reflects the recovery of the main export markets. The dynamism of exports and domestic demand, especially import-intensive investment, is then reflected in the pace of imports of goods and services, which could rise by 1.2% in 2024. The acceleration to 3.4% in 2025 reflects the continued recovery in domestic and external demand. In the following years, exports and imports could grow at around 3% and the external trade balance should contribute positively to GDP growth.

2.2.2 Potential Output and Business Cycle

We estimate that potential output increased by 1.5% last year, a pace that continued to lag behind the long-term average. The growth was driven equally by labour and capital factors of production (contributing 0.8 percentage points each), while the trend component of total factor productivity was almost neutral (contributing −0.1 percentage points).

Potential output growth should be close to 1.5% over the entire CP horizon. This year, potential growth should be supported in particular by the expected dynamics of investment activity and an increase in the population aged 15 and over.

The output gap, i.e. the difference between real GDP and potential output, returned to negative territory in mid-2022 and widened until the end of last year in view of weak economic activity. Going forward, it should gradually close, but due to only a moderate pace of economic recovery, economic output should reach the potential level only in 2026.

2.2.3 Prices

The inflation rate, as measured by the Harmonised Index of Consumer Prices, averaged 12.0% in 2023. Strong demand as well as receding supply pressures contributed to the high inflation. However, annual consumer price inflation slowed rapidly during the year to 7.6% in December, when it was boosted by the base effect of the energy savings tariff.

Within administrative prices, energy prices were the dominant factor, which also significantly reflected the inclusion of the aforementioned energy savings tariff that reduced reported electricity prices at the end of 2022. The positive contribution of the change in indirect taxes reflected an increase in excise duties on tobacco products and changes in excise duties on fuel.

Supply chains were already functioning without major problems, and inflationary pressures stemming from supply-side frictions were therefore not as significant as in 2022. The price of oil, as well as the exchange rate of the koruna against major world currencies, were anti-inflationary. Inflation was further dampened by high monetary-policy rates and a reduction in private household consumption due to a strong decline in real incomes.

This year, inflationary pressures will be significantly lower than in the past two years. However, the contribution of regulated prices to the average inflation rate should still be elevated. While the market component of both electricity and gas prices should become noticeably cheaper, the very strong increase in the regulated components of total electricity and gas prices at the beginning of the year offsets this. Increases in excise duties on alcohol and tobacco products will push inflation higher this year, while the contribution of changes in value added tax rates reported in the price statistics is negative.

The restrictive effect of monetary policy is amplified by the income effect of the consolidation package, and together they significantly moderate inflationary pressures. Conversely, not only the relatively high nominal wage growth, but also the depreciation of the koruna against the euro and the dollar, as well as oil price developments, should be pro-inflationary factors.

In 2025, inflationary pressures will be shaped almost exclusively by market factors. The contribution of regulated prices to the average inflation rate could be zero thanks to the expected cheaper commodity components of electricity and gas prices. Increases in excise duties on alcohol and tobacco products should result in a positive contribution from indirect taxes. The oil price and the renewed appreciation of the koruna against the euro and the US dollar should be anti-inflationary next year. Due to the length of transmission, monetary policy will continue to moderate inflationary pressures through interest rates. Continued relatively high nominal wage growth should be an inflationary factor. Price dynamics in services could be still elevated next year, and the market component of inflation should thus rise slightly after the current anti-inflationary effect of the decline in prices of many production inputs will have partially dissipated.

In line with the above, we expect the average inflation rate as measured by the Harmonised Index of Consumer Prices to fall significantly to 2.7% in 2024 and reach 2.4% in 2025. Similarly, growth of GDP deflator could slow to 2.9% this year and 2.2% in 2025, thanks to lower price dynamics across all components of domestic demand and only a slight improvement in the terms of trade.

2.2.4 Labour Market and Wages

Weak economic activity and the influx of refugees from Ukraine are easing the mismatch between demand and supply in the labour market, but the number of job vacancies still exceeds the number of job applicants. Thus, the tight labour market continues to put upward pressure on nominal earnings, which are expected to exceed inflation from this year onwards.

The arrival of workers from Ukraine, accompanied by strong demand for labour, resulted in a 0.8% increase in employment (in the national accounts methodology) last year. Given the demographic developments and the acute shortage of workers in many sectors, the scope for further employment growth (except for new foreign workers) is very limited. Nevertheless, employment is expected to increase moderately until 2026 due to continued strong labour demand and the expected recovery in economic activity. It could grow by 0.4% on average this year, with a further slowdown in subsequent years. Employment could then decline slightly in 2027 due to unfavourable demographic developments, but the labour market effects of the decline in the working-age population will be cushioned by a continued increase in the participation rate.

The unemployment rate remains very low, averaging 2.6% in 2023. Due to the lagged effects of the weak growth dynamics of the Czech economy, we expect a slight increase in unemployment during the first half of this year. After that, however, the unemployment rate should start to decline gradually thanks to the recovery in economic activity. On average, it could rise to 2.8% in 2024 and then gradually decline to 2.6% in 2026 and 2027.

The extension of the statutory retirement age will play a dominant role in the expected increase of the participation rate over the CP horizon, while demographic aspects in the form of changes in the age structure of the working-age population will already have a slightly negative effect. In 2023, the economic activity rate increased by 1.1 percentage points to 83.8%, despite the increased use of early retirement in the context of extraordinary pension indexations (it is possible that people of pre-retirement age applied for early retirement to benefit from the favourable conditions but remained active in the labour market). The gradual increase in the participation rate should continue over the entire horizon of the CP macroeconomic scenario.

Compensation of employees rose by 7.6% last year and could increase by 6.8% this year. After that, growth could slow to near 4.5%. The dynamics of nominal earnings are being boosted by the tight labour market and the associated labour shortages in many occupations and sectors. Continued high consumer price inflation is in turn pushing wage demands of employees upwards, and a moderately rising number of employees (in the national accounts methodology) is expected to have the same effect on compensation until 2026. The minimum wage was raised by 9.2% to CZK 18,900 from 1 January 2024. The guaranteed wages have increased by the same amount (CZK 1,600) in the second and third job groups, while in the eighth group it has increased to twice the minimum wage, as required by law. The other grades remained unchanged. We assume that in the following years the minimum wage will gradually approach the level of 47% of the average wage. In 2024, the automatic indexation of teaching staff salaries will support compensation of employees, but the consolidation measures will result in a significant YoY reduction in the contribution of the non-market sector. Thus, the growth in compensation of employees will be driven by market entities over the CP horizon.

2.3 Foreign Relations and Sectoral Balances

The Czech economy has mostly posted a slight surplus in net lending/borrowing vis-à-vis non-residents (in ESA 2010 methodology) between 2013 and 2020. The disruption of global supply chains and the subsequent energy crisis triggered by the invasion of Ukraine by Russian troops led to a deficit in the following two years. The main cause was a deterioration in the balance of goods and services. The surplus on the trade balance declined over the two years from 6.7% of GDP in 2020 to 1.0% of GDP in 2022. However, last year, the surplus increased significantly to 5.1% of GDP as supply chain frictions receded and energy price pressures eased.

Positive impulse also came from the balance of primary income, where persistent deficits result mainly from income distributed by foreign-controlled firms. In fact, the primary income deficit narrowed from 4.5% of GDP in 2022 to 2.8% of GDP in 2023 due to lower profits of these entities (especially financial institutions). The significant reduction in the deficit is also due to the record high amount of dividends paid in 2022, when the share of the profits of the domestic banking sector from 2019–2020 was paid. The deficit on the secondary income balance (0.9% of GDP) narrowed compared to previous years.

The current external balance (corresponding to the current account of the balance of payments) thus ended up with a surplus of 1.5% of GDP.

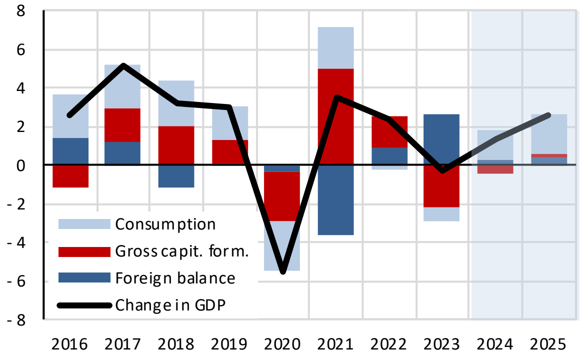
In 2023, the balance of capital transfers showed a surplus of 1.5% of GDP thanks to capital subsidies from the EU budget for investment purposes, thus increasing slightly in relative terms compared to the previous year.

In the CP scenario, we assume that the surplus of the current external balance will rise to 1.6% of GDP this year due to the continued unwinding of price pressures in the industry and energy sectors. Thus, the current external balance should remain positive at the end of the CP horizon, as should net lending/borrowing.

In terms of sectoral balances, the private sector balance should show significant surpluses under the projected trajectory of the general government sector balance.

Graph 2.1: GDP Development

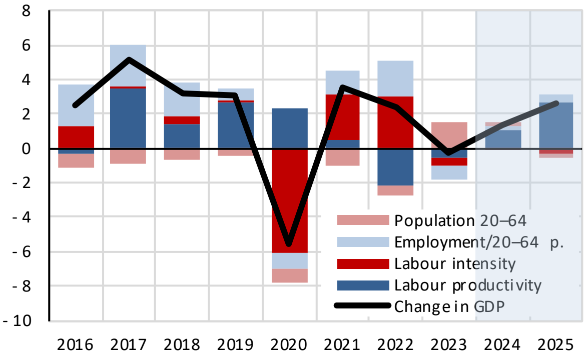
change in %, contributions in pp



Source: CZSO (2024a), MF CR (2024a). MF CR calculations and forecast.

Graph 2.2: GDP, Productivity and Labour Intensity

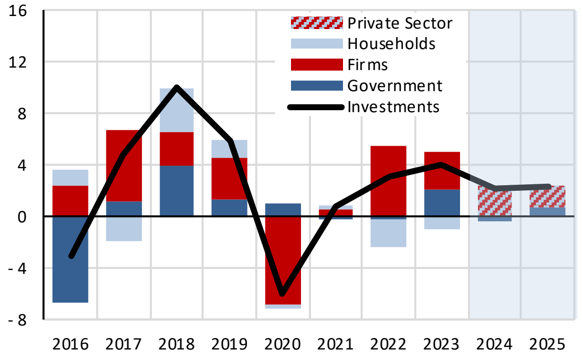
change in %, contributions in pp



Source: CZSO (2024a), MF CR (2024a). MF CR calculations and forecast.

Graph 2.3: Investment by Sector

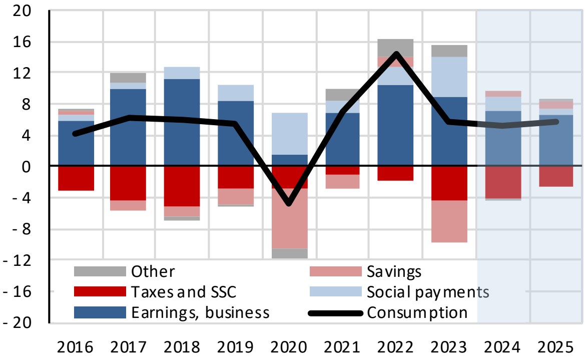
change of real gross fixed capital formation in %, contributions in pp



Source: CZSO (2024a), MF CR (2024a). MF CR calculations and forecast.

Graph 2.4: Nominal Consumption of Households

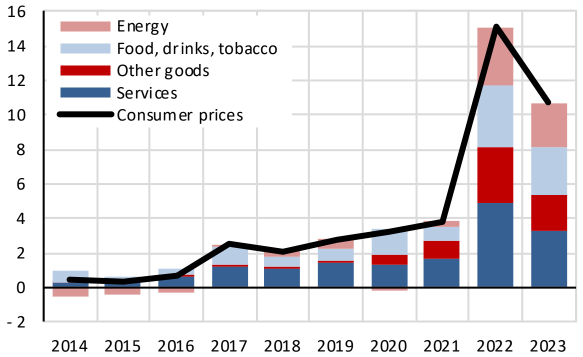
national concept, change in %, contributions in pp



Source: CZSO (2024a), MF CR (2024a). MF CR calculations and forecast.

Graph 2.5: Consumer Prices in Main Divisions

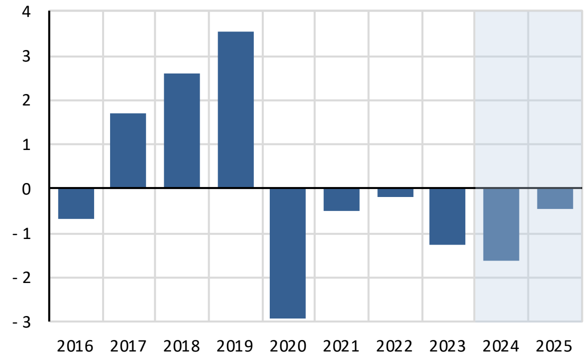
national concept, YoY change in %, contributions in pp



Source: CZSO (2024a). MF CR calculations.

Graph 2.6: Output Gap

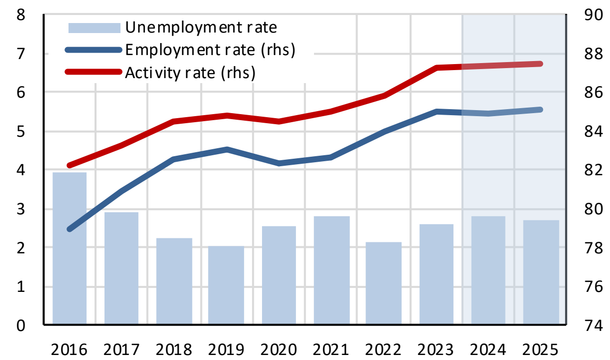
in % of potential product



Source: MF CR (2024a).

Graph 2.7: Unemployment, Employment, Activity Rates

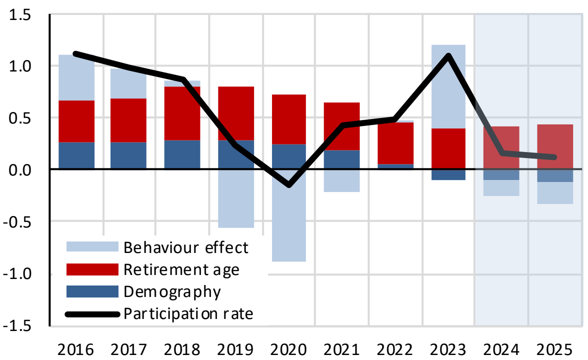
in %



Source: CZSO (2024c). MF CR calculations and forecast.

Graph 2.8: Changes in Participation Rate

change and contributions in pp



Source: CZSO (2024c), Eurostat (2024). MF CR calculations and forecast.

Table 2.1: Economic Output

levels in CZK billions, change in %, contributions in pp

	ESA Code	2023 Level	2023	2024	2025	2026	2027
			Rate of change				
Real GDP	B1*g	**6 766**	**-0.3**	**1.4**	**2.6**	**2.4**	**2.5**
Nominal GDP	B1*g	**7 344**	**8.2**	**4.3**	**4.9**	**4.5**	**4.5**
Components of real GDP							
Private consumption expenditure	P.3	**3 068**	**-3.1**	**2.7**	**3.5**	**2.9**	**2.5**
Government consumption expenditure	P.3	**1 419**	**3.5**	**1.6**	**2.2**	**2.0**	**1.6**
Gross fixed capital formation	P.51g	**1 891**	**4.0**	**2.2**	**2.4**	**2.6**	**2.2**
Changes in inventories and net acquis. of valuables (% of GDP)	P.52+P.53	**143**	**1.9**	**1.0**	**0.5**	**0.3**	**0.3**
Exports of goods and services	P.6	**5 331**	**2.8**	**1.5**	**3.7**	**3.2**	**3.1**
Imports of goods and services	P.7	**5 087**	**-0.7**	**1.2**	**3.4**	**3.2**	**2.9**
Contributions to real GDP growth							
Final domestic demand		-	**0.3**	**2.1**	**2.7**	**2.4**	**2.1**
Changes in inventories and net acquis. of valuables	P.52+P.53	-	**-3.3**	**-1.0**	**-0.5**	**-0.2**	**0.0**
External balance of goods and services	B.11	-	**2.6**	**0.2**	**0.4**	**0.2**	**0.3**

Note: Real levels are in 2022 prices. Changes in inventories and net acquisition of valuables on the sixth row express change in inventories as a per cent of GDP in current prices. The contribution of the change in inventories and net acquisition of valuables is calculated from real values.

Source: CZSO (2024a), MF CR (2024). MF CR calculations and forecast.

Table 2.2: Prices of Goods and Services

indices 2015=100, rate of change in %

	2023 Level	2023	2024	2025	2026	2027
		Rate of change				
GDP deflator	**138.7**	**8.6**	**2.9**	**2.2**	**2.0**	**2.0**
Private consumption deflator	**144.0**	**9.3**	**2.4**	**2.3**	**2.0**	**2.0**
Harmonised index of consumer prices	**147.9**	**12.0**	**2.7**	**2.4**	**2.0**	**2.0**
Public consumption deflator	**140.4**	**5.5**	**2.9**	**2.6**	**2.2**	**2.3**
Investment deflator	**134.0**	**4.7**	**2.7**	**1.9**	**1.7**	**1.6**
Export price deflator (goods and services)	**111.3**	**-0.8**	**1.7**	**0.6**	**0.4**	**0.3**
Import price deflator (goods and services)	**110.5**	**-3.4**	**1.4**	**0.5**	**0.3**	**0.2**

Source: CZSO (2024a), Eurostat (2024). MF CR calculations and forecast.

Table 2.3: Employment and Compensation of Employees

price levels in current prices, rate of change in %

	ESA Code	2023 Level	2023	2024	2025	2026	2027
			Rate of change				
Employment (thous. of persons)		**5 479**	**0.8**	**0.4**	**0.2**	**0.1**	**-0.2**
Employment (mil. hours worked)		**9 675**	**0.3**	**0.3**	**-0.1**	**0.0**	**-0.2**
Unemployment rate (%)		**2.6**	**2.6**	**2.8**	**2.7**	**2.6**	**2.6**
Labour productivity (thous. CZK/person)		**1 235**	**-1.1**	**1.0**	**2.4**	**2.4**	**2.6**
Labour productivity (CZK/hours)		**699**	**-0.6**	**1.1**	**2.7**	**2.5**	**2.7**
Compensation of employees (bn. CZK)	D.1	**3 235**	**7.6**	**6.8**	**5.5**	**4.7**	**4.6**
Compensation per employee (thous. CZK/person)		**679**	**7.0**	**6.4**	**5.3**	**4.6**	**4.8**

Note: Employment and compensation of employees are based on domestic concept of national accounts. Unemployment rate is based on the Labour Force Survey methodology. Labour productivity is calculated as GDP in 2022 prices per employed person or hour worked.

Source: CZSO (2024a, 2024c). MF CR calculations and forecast.

Table 2.4: Sectoral Balances
in % of GDP

	ESA Code	2023	2024	2025	2026	2027
Net lending/borrowing vis-à-vis the rest of the world	B.9	**2.5**	**2.8**	**2.9**	**2.7**	**2.8**
Balance of goods and services		5.1	5.4	5.6	5.7	5.9
Balance of primary incomes and transfers		-3.6	-3.8	-4.0	-4.1	-4.2
Capital account		1.6	1.8	1.8	1.7	1.5
Net lending/borrowing of the private sector	B.9	**6.1**	**5.2**	**5.0**	**4.3**	**4.0**
Net lending/borrowing of general government	B.9	**-3.7**	**-2.3**	**-2.1**	**-1.6**	**-1.2**
Statistical discrepancy		**0.0**	**0.0**	**0.0**	**0.0**	**0.0**

Note: National Accounts Methodology.
Source: CZSO (2024a). MF CR calculations and forecast.

Table 2.5: Basic Macroeconomic Assumptions
interest rates and change in %

		2023	2024	2025	2026	2027
Short-term interest rate (CZ) (annual average)	*% p.a.*	**7.1**	**5.1**	**3.3**	**3.2**	**3.2**
Long-term interest rate (CZ) (annual average)	*% p.a.*	**4.4**	**3.7**	**3.4**	**3.4**	**3.4**
Nominal effective exchange rate	*2015=100*	**118.3**	**113.3**	**115.2**	**117.5**	**119.8**
Exchange rate CZK/EUR (annual average)	*CZK/EUR*	**24.0**	**25.1**	**24.7**	**24.3**	**23.9**
World excluding EU, real GDP growth	*change in %*	**3.5**	**2.8**	**3.9**	**3.6**	**3.4**
EU real GDP growth	*change in %*	**0.5**	**0.7**	**1.6**	**1.6**	**1.5**
Real growth of relevant foreign markets	*change in %*	**-4.8**	**0.7**	**3.6**	**3.3**	**3.1**
World import volumes, excluding EU	*change in %*	**1.0**	**3.3**	**3.7**	**3.5**	**3.3**
Oil prices (Brent)	*USD/barel*	**82.4**	**83.8**	**78.4**	**74.7**	**72.2**

Source: CNB (2024a), EIA (2024), Eurostat (2024a). MF CR calculations and forecast.

3 General Government Sector Finances

The Czech Republic's public finance deficit widened YoY in 2023 and was notified at 3.7% of GDP. The deficit included a number of one-off or temporary measures such as various forms of support for economic agents with high energy prices, expenditure related to the refugee crisis, etc. The cash deficit of the state budget of CZK 288.5 billion was cushioned by a positive local government balance of more than CZK 72 billion. From a structural perspective, the deficit increased by 0.1 percentage point. We expect a general government deficit of 2.3% of GDP this year, which should be significantly contributed by the measures of the consolidation package.

3.1 Current Developments of the General Government Sector

3.1.1 Outcome in 2023

According to CZSO data, the **general government sector** ended with a deficit of 3.7% of GDP in 2023 (CZSO, 2024e) and a deficit of 2.4% of GDP in structural terms. Although last year's deficit was mainly attributable to the state budget, the social security funds (health insurance companies) also ended in a slight deficit. On the other hand, local governments recorded a significant surplus.

Total **general government revenue** grew by 9% to reach 41.7% of GDP. High nominal GDP growth led to only a slight increase in the composite tax quota by 0.3 percentage points to 35.5% of GDP, despite a 9.1% increase in tax and social security contributions revenue.

Personal income tax revenue grew by 14.9%, with capital income tax registering an increase of almost 34% in addition to the almost 13% growth in employment tax. On the other hand, the capital income tax was reduced by the sustained exemption of government bond yields, with a CZK 0.9 billion higher YoY impact (Act No. 609/2020 Coll.). The extension of the flat-rate regime to taxpayers with income up to CZK 2 million a year reduced tax revenue by CZK 0.4 billion (Act No. 366/2022 Coll.).

Wages and salaries in the economy also contributed to **social security contributions**, which rose by 7.8%. In addition, the monthly payment per state insured person increased to CZK 1,900. The additional revenue for health insurers from this amounted to CZK 9.3 billion. In addition, the YoY income positively reflected the end of the payment of the extraordinary allowance for persons quarantined in case of covid-19, with an impact of up to CZK 2 billion (Act No. 518/2021 Coll.). The positive effect of the CZK 1.5 billion increase in the contribution rate for hazardous occupations (Act No. 455/2022 Coll.) was reduced by the introduction of a discount on employers' paid contributions (5% of the aggregate of the monthly assessment bases of the employees to whom the discount is applied) for the arrangement of part-time work (Act No. 216/2022 Coll.). Last year's revenue was also slightly reduced YoY by a change in the taxation of low-emission company cars used also for private purposes (Act No. 142/2022 Coll.) and the broadening of the flat-rate regime (Act No. 366/2022 Coll.).

The growth of **corporate income tax** revenue by more than 19% was influenced by higher profits, which were subject to taxation at an additional rate of 60% from the established threshold in selected sectors and formed the basis for a windfall profits tax of CZK 39.1 billion (Act No. 366/2022 Coll.). On the other hand, the continued exemption of government bond yields had a negative effect, as in the case of personal income tax, with a YoY increase of CZK 2.5 billion (Act No. 609/2020 Coll.).

The **value-added tax** grew by 6.7%, with the autonomous development being corrected by a revenue shortfall due to the shift of the threshold for tax registration from CZK 1 to CZK 2 million with an impact of CZK 3 billion (Act No. 366/2022 Coll.). In contrast, the end of the tax waiver for the purchase of vaccines and tests for covid-19 had a positive impact on tax revenue.

Excise tax revenue, as defined by national legislation, remained almost unchanged YoY, despite the mineral oil tax, which benefited from the earlier abolition of the reduced rate on diesel (Act No. 234/2023 Coll.). However, this was counteracted by the tax on tobacco products, where lower sales (partly related to cross-border purchases in neighbouring countries) and a continued shift towards less taxed alternatives outweighed the increase in tax rates (Act No. 609/2020 Coll.). In response to the increase in the tax on alcohol from 2024 (Act No. 349/2023 Coll.), a frontloading effect on spirits took effect at the end of last year with an impact of CZK 0.9 billion.

The levy on excess revenues brought CZK 17.2 billion to public budgets (Act No. 365/2022 Coll.). In contrast, the waiving of the renewable energy levy on households and companies, effective until the end of 2023, represented an annual revenue shortfall of CZK 12.7 billion. The introduction of the Excluded Persons Register had a negative impact on gambling tax revenue, by an additional CZK 0.5 billion (Act No. 186/2016 Coll.).

Within **property income**, relatively higher dividend income and interest on loans granted under the Treasury liquidity management (reverse repo operations) improved the state's performance.

General government expenditure grew faster than revenue (10.1%), but only by 0.8 percentage points to 45.4% of GDP in relative terms, given the high nominal GDP growth. The expenditure growth was to a great extent due to support to households and businesses during the energy crisis.

The rate of **final consumption expenditure** more than doubled to 9.3%. This increase was mainly driven by a strong 10% growth in **intermediate consumption**, reflecting the slowing, but still high, inflation rate and the impact of EU co-financed projects. **Compensation of employees** showed a 7% increase. The 12.1% growth in **social transfers in kind** reflected expenditure on health and social services, also financed by higher payments for the state insured persons. The increase in the amounts of the living and subsistence minima, reflected in the amount of the housing supplement, together with the adjustment of the housing allowance (Act No. 456/2022 Coll.), entailed additional expenditure of around CZK 1 billion. The increased mobility allowance approved with effect from December 2022 required an additional CZK 0.7 billion last year (Act No. 358/2022 Coll.).

Pension benefits recorded a double-digit growth (16.4%) in the area of **cash social benefits**. The average pension increased by CZK 825 from January 2023 according to the statutory indexation formula (Government Regulation No. 290/2022 Coll. and No. 291/2022 Coll.). In addition, there was an increase of CZK 500 per month for each child raised, with an impact exceeding CZK 18 billion (Act No. 323/2021 Coll.). Expenditure on pension benefits was further increased by the modified extraordinary indexation in June (Act No. 71/2023 Coll.), when all pensions were increased by CZK 400, plus a percentage increase of 2.3%. The average old-age pension was thus further increased by CZK 750. The budgetary impact of the extraordinary indexation was thus around CZK 15 billion. However, there was also an additional impact from the cost of the extraordinary indexation in 2022 for the corresponding part of last year. The amendment to the Pension Insurance Act (Act No. 270/2023 Coll.) brought, among other things, a tightening of the conditions for early retirement, which led to increased interest in its granting in the period before the Act came into force (we estimate the fiscal cost of the extraordinary interest at CZK 1.5 billion).

In the area of pro-family policy, the child allowance in the basic and increased rates was increased by CZK 200 from January 2023 (Act No. 456/2022 Coll.) and foster care benefits were increased from October 2022 (Government Regulation No. 292/2022 Coll.) with a total impact of approximately CZK 1.3 billion. Substitute maintenance for dependent children required an additional CZK 0.2 billion (Act No. 588/2020 Coll.).

A further CZK 0.8 billion in expenditure on cash social benefits was related to the increase of the living and subsistence minima from July 2022 (Government Regulation No. 204/2022 Coll.) and January 2023 (Government Regulation No. 436/2022 Coll.). Unemployment benefits also required YoY higher expenditure. Humanitarian benefits for Ukrainian refugees, including countable housing costs, cost the state budget CZK 7 billion (Acts No. 66/2022 Coll., No. 198/2022 Coll. And No. 75/2023 Coll.). The termination of the payment of the crisis care allowance (Act No. 520/2021 Coll.) and the one-off child allowance paid in 2022 (Act No. 196/2022 Coll.) dampened the dynamics of social benefits last year to 10.5%.

The exceptionally high dynamics of **subsidies** was primarily due to assistance to households, companies, public and other institutions in the form of capping energy prices in the accrual amount of CZK 48.4 billion (Government Regulation No. 5/2023 Coll.). Furthermore, in order to prevent the full impact of high electricity prices on consumers, a subsidy of CZK 20 billion was provided to the transmission system operator (Government Resolution No. 112/2023). The State also compensated distributors for part of the costs of electricity losses in regional and local distribution systems and for losses in gas systems in the total accrual amount of CZK 13.6 billion (Government Regulation No. 463/2022 Coll.). In connection with the ongoing conflict in Ukraine and the accommodation of Ukrainian refugees in private accommodation facilities paid for by the regions with a State contribution, CZK 6.8 billion was paid (Government Regulation No. 206/2022, as amended by Government Regulation No. 322/2022). This resulted in a 37.8% increase in subsidies in 2023.

The pace of **transfers** was hampered by the 2022 base year, which was increased by extraordinary expenditures, mainly the CZK 7.5 billion payment to the Czech Post and the CZK 17.4 billion so-called energy savings tariff. CZK 1.2 billion was paid as the solidarity household allowance for Ukrainian refugees, i.e. CZK 0.4 billion less than in 2022. The end of the payment of the compensation bonus also had a positive effect on the YoY dynamics, but the implementation of guarantees provided by the National Development Bank and the Export Guarantee and Insurance Corporation in the total amount of CZK 2.9 billion had the opposite effect.

Investment in fixed assets, with growth of 16.9%, was mainly driven by investment from national sources. From the EU budget, it was still a case of drawing down funds from the 2014–2020 programming period, but also already using funds from the current 2021–2027 programming period, as well as funds from the NextGenerationEU Instrument.

3.1.2 Outcome in 2024

The government's consolidation efforts should be reflected in the **public finance** outturn in 2024, when we expect the deficit to fall to 2.3% of GDP YoY and to improve to 2.0% of GDP in structural terms. Both the state budget and state funds are expected to reach a deficit, and social security funds are also likely to end with a slightly negative balance. Local governments should post a surplus again.

We foresee **general government revenues** to grow by 4.0%, while tax revenues, including social security contributions, are expected to increase by 6.5%. This is also related to the forecasted 0.8 percentage point increase in the tax quota to 36.3% of GDP.

The **personal income tax** growth should slow to 7.1%. The estimated benefit of the consolidation package in the amount of CZK 8.1 billion in tax revenue stems mainly from the shift of the threshold for applying the 23% tax rate to 36 times the average wage (was 48 times up to 2023), the limitation of the tax credit for a spouse caring for a child under 3 years of age and, last but not least, the abolition of the tax credit for placing a child in a pre-school institution. The termination of the temporary increase in the limit for claiming the deduction for gifts to 30% of the tax base will probably be associated with a positive impact of CZK 0.3 billion (Act No. 128/2022 Coll., as amended by Act No. 349/2023 Coll.). By contrast, adjustments to the tax treatment of retirement savings products are expected to have a negative impact of CZK 0.6 billion (Act No. 462/2023 Coll.).

As in the case of personal income tax, the dynamics of **social security contributions** are primarily determined by the development of wages and salaries in the economy. The measures of the consolidation package are expected to generate over CZK 20 billion, of which the largest fiscal impact is associated with the reintroduction of sickness insurance for employees at 0.6% (CZK 12.3 billion), the increase in contributions for the self-employed (CZK 4.5 billion) and the capping of tax relief for work performance agreements (CZK 3 billion). In connection with the automatic indexation of the payment for the state insured persons based on price and real wage increases (Act No. 260/2022 Coll.), we are expecting an increase in the revenues of health insurance companies by CZK 13–14 billion.

In the case of **corporate income tax,** we expect a decline of 1.1%, driven by a YoY reduction in the windfall profits tax yield (Act No. 366/2022 Coll.). The deepening negative effect of the exemption on government bond yields will reduce the yield by a further CZK 2.9 billion (Act No. 609/2020 Coll.). On the other hand, the increase in the corporate income tax rate by 2 percentage points has a positive effect, with an estimated impact of CZK 22 billion (Act No. 349/2023 Coll.). A compensatory tax ensuring a minimum level of taxation of large multinational and national groups will increase tax revenue by an estimated CZK 1 billion (Act No. 416/2023 Coll.). Similarly to the personal income tax, the end of the temporary increase in the limit for claiming the donation deduction and the extension of the range of beneficiaries and purposes to support Ukraine will have a slightly positive budgetary impact (Act No. 128/2022 Coll., as amended by Act No. 349/2023 Coll.).

Value-added tax revenue will be negatively affected by the consolidation package, which reduces the number of tax rates to two (21% and 12%) while shifting some goods and services to a different rate (impact of CZK 3.7 billion). On the other hand, it should bring higher value-added tax revenue due to an increase in **excise duties** (CZK 1 billion). Their growth should accelerate to 6.4%. The significant expected increase in revenue in 2024 is due to the low base of 2023 mineral oil tax due to the temporary reduction of the tax rate on diesel fuel (CZK 5.6 billion) and the higher tax rates on tobacco products (CZK 3.4 billion impact) and on alcohol (CZK 1 billion more YoY, impact already in 2023 due to frontloading) as part of the consolidation package. The package also abolishes the exemption of metallurgical and mineralogical processes from excise duties with an estimated revenue of CZK 0.7 billion.

The YoY dynamics of tax revenues is dampened by the end of the effectiveness of an extraordinary measure during the energy crisis in the form of a levy on excess revenues of electricity producers. However, this effect is corrected by the end of the across the board waiver of the renewable energy levy for households and companies at the end of 2023, which this year will only apply to energy-intensive businesses, for which the government has allocated CZK 3.5 billion (Government Resolution No. 973/2023). The introduction of the Excluded Persons Register is expected to have a negative impact on gambling tax revenue, by an additional CZK 0.6 billion (Act No. 186/2016 Coll.). This impact is likely to be outweighed by the increase in the second gambling tax rate from 23% to 30% as part of the consolidation measures. The real estate tax (revenue of CZK 10 billion) will also increase revenue from this year onwards.

Overall revenue dynamics are likely to be negatively affected by the development of **transfers from the EU**, reflecting the end of the 2014–2020 financial perspective, partly offset by the start of projects co-financed from the 2021–2027 programming period and funds from the NextGenerationEU Instrument. **Dividend** receipts, as well as **interest** on loans granted under the Treasury's liquidity management, are expected to decline given the above-average base in 2023.

General government expenditure is expected to be held back by the adopted consolidation package, and we expect it to fall by 1 percentage point as a ratio to GDP to 44.3% of GDP. We estimate that the pace of **final consumption expenditure** will slow significantly to 4.6% YoY. After a double-digit growth in **intermediate consumption** last year, its momentum should also slow down substantially to 4.8% due to the 5% savings in operating expenditure of each department. We expect a similar slowdown in **social transfers in kind**, which should grow at a 6.5% rate. For housing benefits, we expect the relatively higher level to be maintained, but the increase should be driven mainly by health insurance companies' spending, made possible by an increase in their revenues. **Compensation of employees** will be affected by the new regulation of salaries in the education sector, where an amendment to the Education Act (Act No. 183/2023 Coll.) guarantees that the total amount of funds earmarked for teachers' salaries will correspond to at least 130% of the average gross wage in the national economy. In addition to this, we are also counting on an increase in the amount of funds in the health sector. By contrast, the consolidation brings savings in the salary area totalling an estimated CZK 9.4 billion, of which CZK 4.1 billion is attributable to a 2% reduction in public sector wage bill.

Expenditures on **pension benefits** were slowed down by the adjustment of the parameters of the extraordinary indexation of pensions from June 2023. The standard indexation from January 2024 increased the average pension by CZK 360 per month (Government Regulation No. 286/2023 Coll. and No. 287/2023 Coll.). The measures approved by the amendment to the Pension Insurance Act (Act No. 270/2023 Coll.) are expected to be associated with a positive impact of around CZK 2 billion this year. A further CZK 1 billion will be generated by the change in the pension payment period from the so-called sliding month to the calendar month and the related abolition of the one-off supplementary payment during the regular indexation in January of the calendar year (Act No. 321/2023 Coll.).

As part of the pro-family policy, an increase in the parental allowance by CZK 50,000 (CZK 75,000 in the case of multiples) was approved for children born from 1 January 2024, which will mean additional costs of CZK 0.4 billion in this year (Act No. 407/2023 Coll.). The amendment to the Act on Social and Legal Protection of Children (Chamber of Deputies Print No. 573) introduces changes in the area of foster family care with an impact of CZK 0.5 billion.

Tightening the conditions for entitlement to unemployment benefits in the event of repeated registration should lead to savings of CZK 0.8 billion (Act No. 349/2023 Coll.). The humanitarian benefit for Ukrainian refugees, including countable housing costs, will burden the state budget with an estimated CZK 7.5 billion this year, which is CZK 0.5 billion more than in 2023.

Stabilization of energy markets and savings under the consolidation package should lead to a reduction of **subsidies** by almost 30% to 1.9% of GDP. The forecast foresees a CZK 5.2 billion YoY reduction in the amount for accommodation of Ukrainian refugees. By contrast, the increase in the maximum amount of the contribution to support the employment of people with disabilities should amount to CZK 1.1 billion (Government Regulation No. 70/2024 Coll.).

Investment in fixed assets will be affected by increased spending in the areas of transport infrastructure or defence, which should amount to at least 2% of GDP (Act No. 177/2023 Coll.). In the case of expenditure co-financed by the EU, the ramp-up of investments financed in connection with the National Recovery Plan or the unfolding financial perspective 2021–2027 will play a role. The total investment dynamic should reach 1.8%.

3.2 General Government Outlook

The **fiscal policy stance** in the Czech Republic is based on a statutory commitment to gradually achieve at least the **medium-term budgetary objective** of 0.75% of GDP in terms of the structural deficit. The Act on Fiscal Responsibility Rules sets an explicit trajectory of structural deficits for the purpose of setting expenditure limits for the state budget and state funds. A comparison of structural deficits with and without discretionary measures (see MF CR, 2024c) and the values specified in the law leads to two main conclusions. The first is that part of the effect of the consolidation package is offset by increased investment in transport and national defence. Without the package, general government deficits would probably not fall below 3% of GDP until 2027, i.e. it would not be possible to meet the expenditure ceilings. In other words, the consolidation package was absolutely necessary to comply with both national and European fiscal rules. The second conclusion is that the consolidation package ensures compliance with the rule for the years 2024 to 2026, but further consolidation measures will have to be taken for 2027, at the latest at the beginning of the next government's term of office. Of course, the remoteness of the forecast period and the associated risks increase the degree of estimation uncertainty.

For the entire CP period, we forecast persistent public finance deficits, which will be primarily determined by the **state budget**. The general government deficit is expected to fall below the 3% of GDP reference threshold as early as 2024, and deficits should decline further to 1.2% of GDP in 2027.

For **local governments**, we expect continued surpluses, albeit somewhat lower in magnitude than in recent years. Indeed, deferred capital projects that had to be re-tendered because of high inflation should gradually be implemented at higher costs.

Estimates of the performance of the **social security funds** are based in particular on the predicted volume of wages and salaries in the economy, which is a crucial factor in future revenue growth. Given its dynamics

(Chapter 2.2.4) and the rather moderate growth in expenditure after 2024, we expect the health insurance funds to be in balance, or slightly in surplus at most. The non-state budget and state funds components of the central government as a whole are expected to run small surpluses on average.

3.2.1 Revenue Outlook

General government revenue is expected to grow by 3.6% on average over the projection years. However, we expect tax revenues, including social security contributions, to grow at a higher rate of 4.2% on average.

In the case of **personal income tax**, discretionary measures have an absolutely negligible impact over the 2025–2027 horizon. In connection with the introduction of the long-term investment product, we expect a reduction in revenue of about CZK 0.5 billion. The yield is thus mainly determined by wage and salary growth, which implies a rate of 4.1% in 2025 and less than 5% in the outlook years.

Social security contributions should also be determined to a decisive extent by the evolution of wage and salary levels in the economy. However, the measures adopted as part of the consolidation package should have a positive impact, namely the reintroduction of sickness insurance and the increase in contributions of self-employed totalling CZK 4.1 billion and CZK 3.6 billion in 2025 and 2026 respectively. The introduction of the long-term investment product will have an opposite effect of CZK 0.6 billion. Furthermore, in 2025 and 2026, the dynamics will be slightly weakened by the additional effect of the lower contributions for selected groups of part-time employees. In the ESA 2010 methodology, the aggregate also includes payments from the state budget for the state insured persons to the public health insurance system. These payments will be indexed according to the inflation rate (real wage growth should not be effective by the end of the outlook horizon). Another factor in the total number of insured persons will be possible changes in the number of refugees from Ukraine (especially children). Contributions should thus rise by less than 5% on average.

For **corporate income tax**, the pace in 2025 will be influenced by the continued effectiveness of the windfall profits tax. However, revenue will gradually weaken, thus holding back momentum. The tax growth should be positively influenced by the extraordinary depreciation introduced during the pandemic and prolonged as a result of the energy crisis, the effect of which will end within the outlook horizon, as well as the additional effects arising from the higher tax rate introduced from 2024. The compensation tax for large multinational and domestic groups will increase tax revenue by an estimated CZK 1 billion from 2025. Conversely, the exemption of government bond yields will have a negative effect of CZK 1.3 billion per year. Combined with the growth in the gross operating surplus, the YoY change in the tax yield averages 2.3%.

Excise duties in terms of the national legislation are expected to increase by 1.5% on average. Revenue should be supported by higher taxation of tobacco products, including alternatives, with a total impact of over CZK 2 billion in each year. Collections will then be boosted by around CZK 0.5 billion next year by a higher tax on alcohol. In addition, autonomous developments related to the economic recovery and rising real household earnings should have a positive impact.

Value-added tax revenue depends primarily on developments in nominal household consumption, part of consumption and investment by the general government sector. The average growth in tax revenue of 4.5% is practically in line with the growth of the macroeconomic base. Among discretionary measures, only higher tax growth is recorded due to the increase in excise duties (around CZK 0.7 billion in 2025).

For **other revenues**, revenue transfers will be determined by the evolution of EU funding. Cohesion funds are expected to build up gradually, while the National Recovery Plan is expected to peak in 2025 and 2026, when this programme ends. For property income, we expect a steady decline in line with the evolution of interest yields, while dividends are expected to be relatively stable.

3.2.2 Expected Expenditure Developments

We forecast average growth of 2.8% in **total** general government **expenditure** over the outlook years. The dynamics gradually declines over time.

Cash social benefits are expected to rise by 2.4% on average. The growth is primarily determined by the evolution of pension benefits, which we assume to be at the level of the statutory indexation formula according to the predicted inflation rate and real wage growth (which, however, should not be strong enough to effectively affect the indexation rate until the end of the horizon). The increase in the parental allowance should increase expenditure growth by less than CZK 2 billion per year. The dynamics should be slowed by the end of the humanitarian benefit or at least its significantly lower level compared to previous years.

Nominal general government consumption is projected to grow by between 4% and 5% in all years. **Compensation of employees** is expected to grow especially in the education sector. However, given the consolidation, we expect rather moderate growth for the rest of general government employees. For **social transfers in kind**, we expect health care payments to rise in line with developments of system's revenues. The rising level of real earnings and the lower need for payments of state social assistance benefits (housing benefit) could play a positive role. For **intermediate consumption**, we forecast an acceleration of the dynamics in 2025 in connection with the start of the new perspective 2021–2027 and the funds related to the National Recovery Plan. Thereafter, there should be a slowdown as purchases can decelerate also due to efforts to consolidate public finances.

In the area of **investment**, we foresee a surge in funds from the Recovery and Resilience Facility, the Just Transition Fund and programmes co-financed by the European Structural and Investment Funds, where the peak phase of the 2021–2027 financial perspective cycle should already be underway. We also foresee an increase in national investment in transport infrastructure and higher purchases of military equipment over virtually the entire horizon of the outlook.

We expect only a small increase in **subsidies**, and **transfers** should develop similarly. We expect negative dynamics in 2025 due to the additional effects of the consolidation package. In the following years, we forecast a return to growth, but this should be reflecting savings efforts to reduce structural deficits. The pace should therefore be relatively moderate, even in terms of the longer-term average. Nevertheless, we expect an increase in transfers to the EU budget.

In line with our assumptions on interest rates, the volume of debt refinanced and the level of cash balances, we estimate that **interest expenditure** will grow by 5.3% on average in absolute terms. However, the dynamics should be significantly downward. In relative terms, interest expenditure should remain at 1.5% of GDP over the outlook horizon (see also Section 3.4).

3.2.3 Autonomous and so-called By-the-law Scenario

The forecast works with discretionary measures that are approved at least by the government, regardless of whether the measures are sufficient in terms of their impact to comply with Act No. 23/2017 Coll., on the Fiscal Responsibility Rules, as amended. The latter states that structural deficits for the purposes of deriving expenditure ceilings must be no more than 2.25% of GDP for 2025, 1.75% of GDP for 2026 and 1.25% of GDP for 2027. The forecast would meet the legal requirements for 2025 and 2026 under the current state of the measures adopted and given macroeconomic developments, but for 2027 it indicates that further measures will be needed to reduce the structural deficit. The magnitude of these measures is around 0.4% of GDP. If these changes were to be implemented, the general government balance would be −0.9% of GDP (instead of −1.2% of GDP) and the debt ratio would be 0.3 percentage points lower.

3.3 Structural Balance and Fiscal Position

The general government structural balance **in 2023** was −2.4% of GDP. The cyclical component was −0.5% of GDP.

One-off and other temporary operations amounted to −0.8% of GDP in 2023, mostly as energy measures. The revenue side was supported by levies on excess revenues of CZK 17.2 billion and a windfall profits tax with an estimated revenue of CZK 39.1 billion. In contrast, revenues were reduced by the remission of the renewable energy levy for households and firms of CZK −17.3 billion and the reduced excise duty rates on diesel until the end of July with an impact of CZK −5.6 billion. On the expenditure side, subsidies were provided to the state transmission system operator in the amount of CZK 20.0 billion, to energy distributors in the amount of CZK 13.6 billion and especially to households, firms and public and other institutions through the capping of energy prices in the amount of CZK 48.4 billion. The payment of a one-off child allowance for children up to 18 years of age to households with an annual gross income of up to CZK 1 million continued from the previous year. Humanitarian benefits and the accommodation allowance for refugees from Ukraine further increased the balance, with an impact of CZK 13.7 billion.

The slightly negative **fiscal effort** in 2023 was exacerbated on the expenditure side by increases in social benefits and interest expenditure, while on the revenue side it was improved by increases in personal income tax or property income. Growth in subsidies was largely one-off in nature.

The **structural balance** is projected to improve to −2.0% of GDP **in 2024**. The YoY change is smaller than for the general government balance, whose improvement is mainly due to a moderation in one-off expenditure. We expect the cyclical component to worsen to −0.6% of GDP in the period to Q2 2024 as the negative output gap widens.

We expect **one-off and temporary measures** of only 0.2% of GDP this year. The revenue side is mainly made up of windfall profits tax revenue. On the expenditure side, no measures are planned in the energy sector. The only expenditure measures are the humanitarian benefits for refugees and the allowances on their accommodation.

The recovery in economic growth should lead to a closure of the negative cyclical component by the end of 2025, while we expect a positive cyclical component in 2026 and 2027. The **structural balance should gradually improve** to −1.6% of GDP after stagnating in 2025. The positive fiscal effort in the outlook years will be mainly supported by the expenditure side, which is expected to grow more moderately than in 2022 and 2023, and at a slower pace than future revenues. For one-offs, we assume only windfall profits tax revenue in 2025.

3.4 General Government Debt, Strategy and Stability of State Debt

General government debt reached 44% of GDP at the end of 2023, down 0.2 percentage points YoY. The level of public debt in the Czech Republic remains below the 60% of GDP threshold contained in the Stability and Growth Pact, and it also meets the debt quota level set by the Act on the Fiscal Responsibility Rules (55% of GDP net of the cash reserve for financing the state debt).

Central government accounts for the largest share of general government debt (Table 3.6). The central government debt exceeded CZK 3,346 billion in 2023, accounting for 97.5% of total (unconsolidated) general government debt. Local government debt accounts for the remaining 2.5%. It reached CZK 85.4 billion in 2023 and is expected to decline slightly in the following years due to the forecasted surplus. Social security funds show a negligible level of indebtedness.

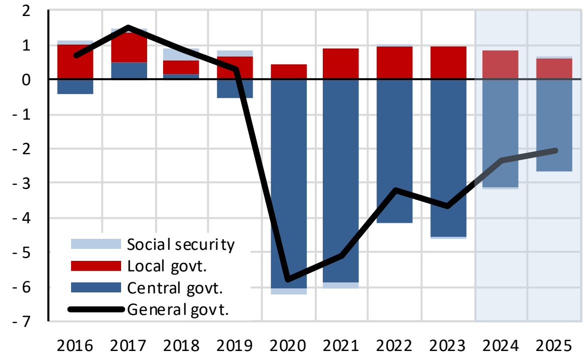
The evolution of the general government debt in 2023 was affected by the state budget deficit caused, among other things, by persistent support for households and businesses in the ongoing energy crisis. Nevertheless, given the high growth of nominal GDP, the general government debt fell in relative terms from 42.7% to 42.4% of GDP YoY. Interest costs increased to 1.3% of GDP in line with the increase in debt and interest rate developments.

We expect the debt ratio to continue to rise slightly over almost the entire horizon of the outlook, as the absolute level of public deficits will remain relatively significant despite consolidation efforts. However, the debt ratio should peak at over 47% of GDP in 2026 and then start to decline slightly.

In terms of contributions to the change in debt, the importance of the primary balance declines slightly in the coming years compared to 2019–2023. In relative terms, interest rates are projected to rise to 1.4% of GDP in 2024, increase further by 0.1 percentage points in 2025 and remain at 1.5% of GDP until the end of the outlook, although the forecast assumes a gradual decline in government bond yields. The long-term interest rate for convergence purposes should decrease from 4.4% p.a. in 2023 to 3.4% p.a. between 2025 and 2027.

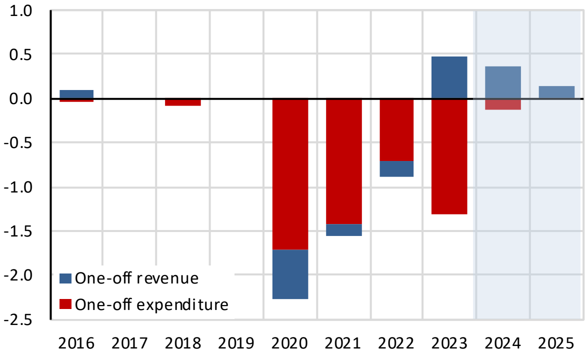
The forecast does not assume any significant privatisation revenues under Act No. 92/1991 Coll., on the Conditions of Transfer of State Property to Other Persons, as amended.

Graph 3.1: Government Balance by Sub-sectors
in % of GDP



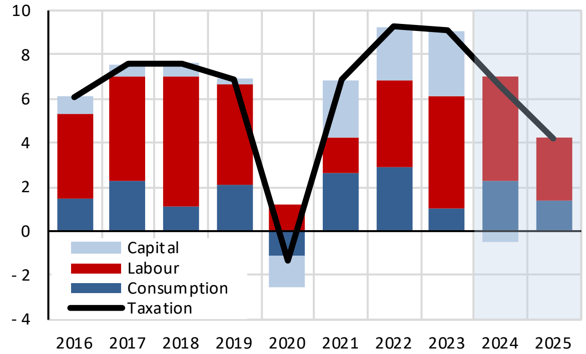
Source: CZSO (2024b). MF CR calculations and forecast.

Graph 3.2: One-off Measures
in % of GDP



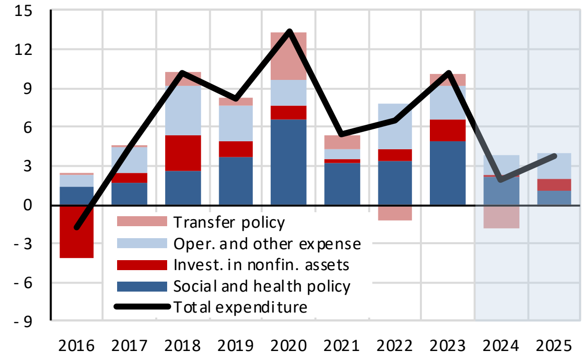
Source: CZSO (2024a), MF CR (2024a). MF CR calculations and forecast.

Graph 3.3: General Government Tax Revenue
change in %, contributions in pp



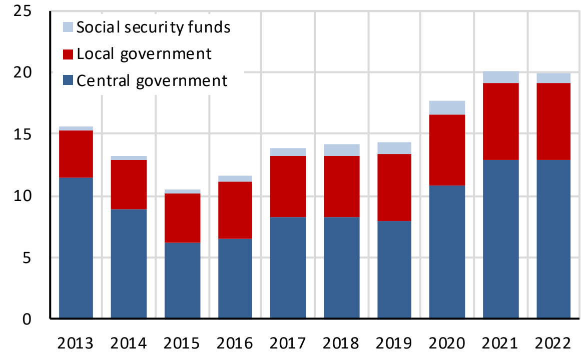
Source: CZSO (2024a, 2024b). MF CR calculations and forecast.

Graph 3.4: General Government Expenditure
change in %, contributions in pp



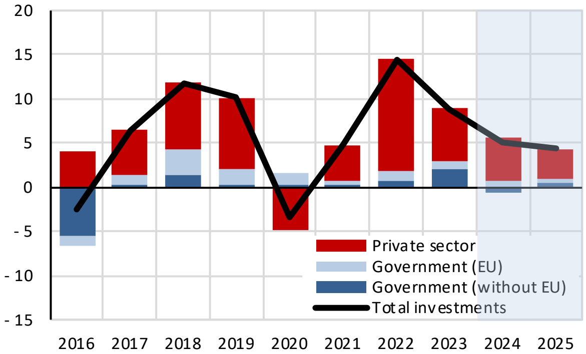
Source: CZSO (2024a, 2024b). MF CR calculations and forecast.

Graph 3.5: Liquid Financial Assets
in % of GDP, non-consolidated values



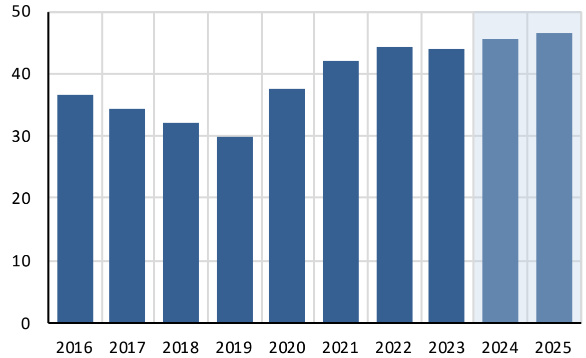
Source: CZSO (2024a, 2024b). MF CR calculations.

Graph 3.6: Investment Co-financing from EU Funds
nominal gross fixed capital formation change in %, contributions in pp



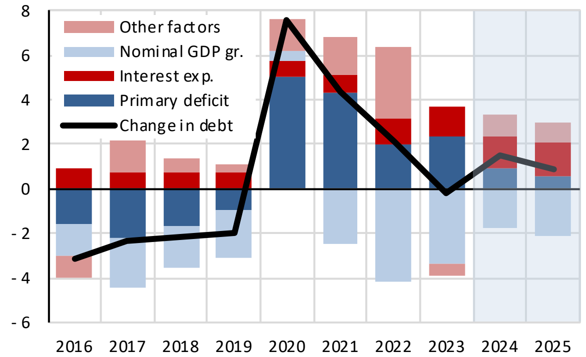
Source: CZSO (2024a), MF CR (2024a). MF CR calculations and forecast.

Graph 3.7: General Government Debt
in % of GDP



Source: CZSO (2024a, 2024b). MF CR calculations and forecast.

Graph 3.8: Changes in Debt-to-GDP Ratio
in pp



Source: CZSO (2024a, 2024b). MF CR calculations and forecast.

Table 3.1: General Government Budgetary Prospects

level in CZK billion, others in % of GDP

	ESA Code	2023 Level	2023	2024	2025	2026	2027
			In % of GDP				
Net lending (+)/borrowing (-) (B.9) by sub-sectors							
General government	S.13	**-268**	**-3.7**	**-2.3**	**-2.1**	**-1.6**	**-1.2**
Central government	S.1311	-334	-4.5	-3.1	-2.7	-2.2	-1.9
Local government	S.1313	70	1.0	0.8	0.6	0.6	0.6
Social security funds	S.1314	-5	-0.1	-0.1	0.0	0.0	0.0
General government (S.13)							
Total revenue	TR	**3064**	**41.7**	**42.0**	**41.8**	**41.6**	**40.9**
Total expenditure	TE	**3332**	**45.4**	**44.3**	**43.9**	**43.2**	**42.1**
Net lending (+)/borrowing (-)	B.9	**-268**	**-3.7**	**-2.3**	**-2.1**	**-1.6**	**-1.2**
Interest expenditure	D.41	97	1.3	1.4	1.5	1.5	1.5
Primary balance		-172	-2.3	-0.9	-0.6	-0.1	0.2
One-off and other temporary measures		**-61**	**-0.8**	**0.2**	**0.1**	**0.0**	**0.0**
Components of revenues							
Total taxes		**1437**	**19.6**	**19.6**	**19.3**	**19.2**	**19.1**
Taxes on production and imports	D.2	809	11.0	11.2	11.2	11.2	11.0
Current taxes on income, wealth etc.	D.5	629	8.6	8.4	8.2	8.0	8.1
Capital taxes	D.91	0	0.0	0.0	0.0	0.0	0.0
Social security contributions	D.61	**1169**	**15.9**	**16.6**	**16.7**	**16.7**	**16.7**
Property income	D.4	**93**	**1.3**	**0.8**	**0.7**	**0.7**	**0.6**
Other		**364**	**5.0**	**4.9**	**5.1**	**5.0**	**4.4**
Total revenue	TR	**3064**	**41.7**	**42.0**	**41.8**	**41.6**	**40.9**
p. m.: Tax burden		**2607**	**35.5**	**36.3**	**36.0**	**36.0**	**35.8**
Components of expenditures							
Compensation of employees + Intermediate consumption	D.1+P.2	**1171**	**15.9**	**15.9**	**15.9**	**15.8**	**15.7**
Compensation of employees	D.1	739	10.1	10.0	9.9	9.9	9.9
Intermediate consumption	P.2	432	5.9	5.9	5.9	5.9	5.8
Social payments		**1289**	**17.5**	**17.7**	**17.4**	**17.1**	**16.8**
of which: Unemployment benefits [1)]		17	0.2	0.2	0.2	0.2	0.2
Social transfers in kind supplied via market producers	D.632	253	3.4	3.5	3.5	3.5	3.5
Social transfers other than in kind	D.62	1036	14.1	14.2	13.9	13.6	13.3
Interest expenditure	D.41	**97**	**1.3**	**1.4**	**1.5**	**1.5**	**1.5**
Subsidies	D.3	**208**	**2.8**	**1.9**	**1.9**	**1.8**	**1.7**
Gross fixed capital formation	P.51g	**370**	**5.0**	**4.9**	**5.1**	**4.9**	**4.3**
Capital transfers	D.9	**34**	**0.5**	**0.5**	**0.4**	**0.3**	**0.3**
Other		**165**	**2.2**	**2.0**	**1.8**	**1.8**	**1.8**
Total expenditures	TE	**3332**	**45.4**	**44.3**	**43.9**	**43.2**	**42.1**
p. m.: Government consumption (nominal)	P.3	**1498**	**20.4**	**20.5**	**20.5**	**20.4**	**20.3**

1) Includes cash benefits (D.621 and D.624) and transfers in kind (D.631) related to unemployment benefits.
Source: CZSO (2024b). MF CR calculations and forecast.

Table 3.2: Amounts to Be Excluded from the Expenditure Benchmark

level in CZK billion, others in % of GDP

	2023 Level	2023	2024	2025	2026	2027
		In % of GDP				
Expenditure on EU programmes fully matched by EU funds revenue	**82**	**1.1**	**1.1**	**1.2**	**1.3**	**0.7**
Non-investment expenditure	22	0.3	0.3	0.3	0.4	0.2
Investment expenditure	60	0.8	0.7	0.9	0.9	0.5
Cyclical unemployment benefit expenditure	**0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Effect of discretionary revenue measures (year-on-year changes)	**45**	**0.6**	**0.7**	**0.0**	**0.0**	**0.0**
Revenue increases mandated by law	-	-	-	-	-	-

Note: Revenue increases mandated by law can be defined as revenue increases that occur automatically to offset corresponding increases in specified expenditures (such as an automatic increase of social security contributions in reaction to a surge in social security expenditure).
Source: MF CR.

Table 3.3: A Structure of Approved Discretionary Measures in 2023–2027

YoY discretional change, in CZK billion

	2023	2024	2025	2026	2027
Revenue Discretioanry Measures	**44.5**	**55.9**	**-3.1**	**-3.6**	**0.4**
Taxation on labour	1.2	29.9	3.1	4.4	-
Taxation on capital	54.6	-0.2	-15.9	-10.9	1.2
Taxation on consumption	-11.1	22.5	9.3	2.6	-1.1
Other revenue measures	-0.2	3.6	0.4	0.3	0.3
Expenditure Discretionary Measures	**-69.6**	**134.6**	**17.8**	**-2.3**	**-1.8**
Cash social benefits	7.7	16.8	4.7	-2.2	-1.5
Compensation of employees	-25.7	-6.9	-0.1	-	-
Health care	-1.4	-3.3	-	-	-
Subsidies	-76.9	117.9	10.3	-0.0	0.0
Capital transfers	13.3	0.9	0.0	-	-
Other expenditure measures	13.2	9.2	2.9	-0.1	-0.3
Total	**-25.1**	**190.5**	**14.7**	**-5.9**	**-1.4**
% of GDP	-0.3	2.5	0.2	-0.1	-0.0

Source: MF CR calculations and forecast.

Table 3.4: Revenue and Expenditure Forecast and Outlook in No-policy-change Scenario

in % of GDP

	2023	2023	2024	2025	2026	2027
	Level	*In % of GDP*				
Total revenue at unchanged policies	**3062**	**41.7**	**41.1**	**40.8**	**40.5**	**39.8**
Total expenditure at unchanged policies	**3345**	**45.6**	**44.7**	**44.4**	**43.6**	**42.4**

Source: MF CR calculations and forecast.

Table 3.5: Cyclical Developments

change in %, output gap in % of potential product, contributions in pp, other in % of GDP

	ESA Code	2023	2024	2025	2026	2027
Real GDP growth (%)		**-0.3**	**1.4**	**2.6**	**2.4**	**2.5**
Net lending of general government	B.9	**-3.7**	**-2.3**	**-2.1**	**-1.6**	**-1.2**
Interest expenditure	D.41	**1.3**	**1.4**	**1.5**	**1.5**	**1.5**
One-off and other temporary measures		**-0.8**	**0.2**	**0.1**	**0.0**	**0.0**
on the revenue side		0.5	0.4	0.1	0.0	0.0
on the expenditure side		1.3	0.1	0.0	0.0	0.0
Potential GDP growth (%)		**1.5**	**1.3**	**1.5**	**1.6**	**1.7**
contribution of labour		0.8	0.4	0.1	-0.1	-0.1
contribution of capital		0.8	0.7	0.6	0.5	0.5
total factor productivity		-0.1	0.3	0.8	1.2	1.3
Output gap		**-1.3**	**-1.6**	**-0.4**	**0.5**	**1.1**
Cyclical budgetary component		**-0.5**	**-0.6**	**-0.2**	**0.2**	**0.4**
Cyclically-adjusted balance		**-3.2**	**-1.7**	**-1.9**	**-1.7**	**-1.6**
Cyclically-adjusted primary balance		**-1.9**	**-0.3**	**-0.4**	**-0.3**	**-0.2**
Structural balance		**-2.4**	**-2.0**	**-2.0**	**-1.7**	**-1.6**

Source: CZSO (2024b). MF CR calculations and forecast.

Table 3.6: General Government Debt Developments

in % of GDP, average maturity in years, contributions in % of debt

	ESA Code	2023	2024	2025	2026	2027
General government gross debt (consolidated)		**44.0**	**45.5**	**46.4**	**47.1**	**47.0**
Central government		45.6	47.0	48.0	48.8	48.8
Local government		1.2	1.1	1.0	1.0	0.9
Social security funds		0.0	0.0	0.0	0.0	0.0
Change in gross debt ratio		**-0.2**	**1.5**	**0.9**	**0.7**	**-0.1**
Contributions to changes in gross debt						
Primary balance		**-2.3**	**-0.9**	**-0.6**	**-0.1**	**0.2**
Interest expenditure	D.41	**-1.3**	**-1.4**	**-1.5**	**-1.5**	**-1.5**
Stock-flow adjustment		**-0.5**	**1.0**	**1.0**	**1.1**	**0.6**
Difference between cash and accruals		-0.5	0.3	0.2	0.0	0.0
Net accumulation of financial assets		0.1	0.4	0.3	0.0	0.0
Privatisation proceeds		0.0	0.0	0.0	0.0	0.0
Valuation effects and other		0.0	0.0	0.0	0.0	0.0
p. m.: Implicit interest rate on debt		**-3.0**	**-3.2**	**-3.2**	**-3.2**	**-3.1**
Debt according to Act No. 23/2017 Coll., art. 13 [1)]		44.0	45.5	46.4	47.1	47.0
Liquid financial assets [2)]		18.4	18.1	17.6	16.8	16.1
Net financial debt [3)]		25.6	27.4	28.8	30.3	30.8

1) Difference between gross debt and liquid financial assets (monetary gold, Special Drawing Rights, currency and deposits, market value of securities other than shares, shares and other equity quoted in stock exchange) according to Act No. 218/2000 Coll.

2) Liquid financial assets are defined as monetary gold, Special Drawing Rights, currency and deposits, securities other than shares (consolidated at market value), shares and other equity quoted in stock exchange.

3) Net financial debt is the difference between gross debt and liquid financial assets.

Source: CZSO (2024b). Calculations and forecast of MF CR.

Table 3.7: The State Debt's Refinancing, Interest and Foreign Currency Exposition

in % of debt, average maturity in years, data in the national methodology

		2023	2024	2025	2026	2027
Refinancing						
Average maturity	*years*	**6.4**	**6.5**	**6.5**	**6.5**	**6.5**
Debt due within 1 year	*% of debt*	**6.7**	**10.5**	**10.7**	**9.9**	**9.5**
Debt amortization (existing bonds) since the end of the previous year	*% of GDP*	**2.7**	**2.1**	**3.3**	**3.2**	**3.4**
State Debt's Interest						
Debt with interest fixation within 1 year	*% of debt*	**18.5**	**22.3**	**22.5**	**18.7**	**17.8**
Fixed interest long-term debt due within 1 year	*% of debt*	4.3	7.7	7.8	4.2	6.2
Variable interest long-term debt	*% of debt*	12.7	12.1	12.3	12.3	9.4
Monetary instruments	*% of debt*	1.4	2.6	2.4	2.2	2.1
Effect of derivative operations	*% of debt*	0.0	0.0	0.0	0.0	0.0
Foreign Currency Exposition						
Foreign-currency exposition of the state debt [1)]	*% of debt*	**5.5**	**5.1**	**4.7**	**4.4**	**4.2**
EUR exposition	*% of debt*	5.0	4.6	4.2	3.9	3.7

1) State debt denominated in foreign currencies adjusted for collateral and assets.

Source: MF CR.

4 Comparison with the Previous Convergence Programme, Risks of Forecast and Sensitivity Analysis

The comparison between this year's and last year's CP focuses on the assessment of the forecast for 2023 and the change in the forecast for 2024. However, as in previous years, the comparison is highly problematic. The energy crisis gradually necessitated a number of measures on the national and international scene, the impact of which was difficult to estimate. Last year's CP also did not include the consolidation package. The following years can be viewed in a similar way, while being furthermore affected by differences between forecast and reality.

Sensitivity analyses of macroeconomic and fiscal forecasts, including their outlook, are carried out on the basis of changes in selected assumptions. The first scenario considers lower economic growth in the EU and its effects on the highly open Czech economy. The other scenario assesses the sensitivity to a possible sudden increase in interest rates.

4.1 Comparison with the Scenario of the Previous Convergence Programme of the Czech Republic

4.1.1 Macroeconomic Scenario

The macroeconomic scenario of last year's CP was based on similar assumptions as the scenario of this year's CP. However, supply chains were already operating without major problems during 2023 (the development was therefore more favourable compared to CP 2023), which was reflected in a more positive contribution of the foreign trade balance and a more negative contribution of the change in inventories. The scenario of the previous CP, on the other hand, could not have anticipated the escalation of geopolitical tensions in the Middle East that occurred at the end of last year, though the impact of this factor on the Czech economy was not significant last year.

According to the CP 2023 scenario, economic activity in the Czech Republic should have been recovering from Q2 2023, but in the end the economy remained on the verge of recession throughout the year (Section 2.2.1). GDP growth thus lagged behind the CP 2023 forecast by 0.4 percentage points. Within effective domestic demand, weaker developments in household consumption were offset by stronger dynamics in investment and government consumption. The GDP forecast for 2024 also differs significantly in the two macroeconomic scenarios (among other things, the weaker carry-over effect from 2023 is reflected here), also within the individual expenditure components (see Table 4.1). In subsequent years, the expected economic growth dynamics converge.

Consumer price developments in 2023 (Section 2.2.3) were consistent with the previous CP scenario. However, for the period 2024–2026, this year's CP envisages a later sustained return of annual inflation to the vicinity of 2% (in mid-2025) than the CP 2023 scenario (in mid-2024).

Compared to the previous CP scenario (Section 2.2.4), the labour market developed slightly more favourably in 2023 despite the worse economic situation, but for the following years the differences in the expected development of key indicators are rather small, or even negligible.

4.1.2 Fiscal Scenario

The situation at the time of drafting the 2023 CP was significantly different from further developments in at least two key aspects. The first was the estimates of exceptional one-off measures, either on the revenue or expenditure side. The second was the later enacted Act No. 349/2023 Coll., which very substantially affected the forecast for 2024 and subsequent years through a number of consolidation measures (see Chapter 3 for details). Thus, last year, the general government balance was projected at −3.5% of GDP for 2023 and −2.9% of GDP for 2024.

Last year's CP worked for 2023 with an 8.4% growth in tax revenues including social security contributions. These actually grew by 9.1% (Section 3.1.1). Personal income tax and social security contributions performed better, reflecting almost 1 percentage point stronger growth in wages and salaries. Discretionary measures also play a role in social security contributions, whether differential assessment of reduced contribution rate for part-time workers or rate increases for risky occupations. By contrast, corporate income tax revenue grew more than 6 percentage points less. This is again related to the macroeconomic base, with gross operating surplus' lower growth by around 4 percentage points. Value-added tax was also actually lower than projected in the 2023 CP due to relatively lower growth in nominal household consumption. Of the non-tax revenues, property income in particular ended up higher.

Actual expenditure in 2023 grew exactly as projected, by 10.1% (Section 3.1.1). However, the CP 2023 forecast and the actual figures differ in the composition of expenditure. General government consumption increased by 1.5 percentage points more compared to last year's forecast. Both social transfers in kind and consumption of fixed capital contributed to this difference. The other components, i.e. intermediate consumption, compensation of employees or sales, were estimated almost exactly. Public investment grew by 16.9%, 1.1 percentage points higher than in the previous year's CP. In terms of the impact on the balance, the fact that national investment was significantly higher while EU co-financed investment was lower played a role. Cash social benefits grew by 10.5%, lower than the forecast (12.5%), while subsidies grew significantly faster due to the higher-than-expected cost of the measures on account of high energy prices. The pace of debt service costs was also faster due to relatively higher government bond yields, with a difference of around 7 percentage points.

Compared to last year's CP, 2024 is affected both by errors in the forecast for 2023 and by the inclusion of the consolidation package. On the revenue side, we expect higher growth in personal income tax or social security contributions due to different macroeconomic assumptions. In contrast, corporate income tax revenue should be slightly lower compared to CP 2023 (Section 3.1.2). In the case of expenditure, the impact of subsidies and transfers is crucial, where we record measures from the consolidation package to a decisive extent.

4.2 Risks of Macroeconomic and Fiscal Forecast

4.2.1 Risks of Macroeconomic Forecast

The macroeconomic framework of the Convergence Programme is burdened by a number of **risks** that, taken together, we consider to be **skewed to the downside**.

The possibility of **renewed problems in supply chains**, e.g. in the context of the situation in the Middle East, poses a significant risk for some sectors of the economy (in particular the automotive industry). In addition to the negative impact on economic performance, supply-side frictions would create additional inflationary pressures. These could also be triggered by an increase in energy commodity prices in the event of **an escalation of geopolitical tensions**.

Natural gas and oil supply from Russia to the European Union is suspended and we do not expect it to be restored. We anticipate that it will continue to be replaced by increased imports from other countries or demand-side measures such as investment in new sources and energy savings.

The evolution of **inflation expectations** also remains a risk, despite a significant decline in inflation at the start of this year. It is crucial that inflation expectations return to the vicinity of the Czech National Bank's inflation target. Otherwise, we would expect a tight monetary policy stance for a longer period, which would entail additional economic costs. Also related to inflationary pressures is the **fiscal policy** stance. Different macroeconomic effects of the consolidation package, or measures that would erode fiscal efforts, would affect the dynamics of economic growth and other variables.

The shortage of employees, evident in almost all sectors of the economy, is a significant barrier to output growth, especially in the construction sector. However, in addition to the weak economic dynamics, the influx of refugees from Ukraine is also contributing to the easing of the mismatch between demand and supply in the labour market and the associated upward pressure on wages. It turns out that thanks to the still high demand for labour by companies and the nature of vacancies (mostly with low qualification requirements), Ukrainian refugees do not have any significant problems with finding employment on the Czech labour market, even though their qualification structure may not match the demand. Legislative changes in this area are also helping to facilitate the employment of foreigners. The successful **integration of refugees** and the full use of their human capital can significantly boost economic growth in the coming years.

Persistently high interest rates and substantial price increases in recent years increase the likelihood that some households and firms will run into repayment problems, which would lead to a deterioration in the quality of banks' loan portfolios. For the time being, however, the share of non-performing loans in total loans to households remains at very low levels or continues to decline slowly for loans to non-financial corporations. The overvaluation of residential property prices also remains a potential risk.

4.2.2 Risks of Fiscal Forecast

The **fiscal forecast** then assumes these macroeconomic risks, both through the effects on the revenue side and in the case of some expenditure items. On the revenue side, the realisation of most macroeconomic risks would be reflected in a reduction in government revenue. Higher inflation would have the opposite effect.

Further developments in **electricity and gas prices** remain a risk to the fiscal forecast. These will affect both the revenue and expenditure side. This year, the government is supporting selected energy-intensive industries with renewable energy levies.

In the case of higher **inflation** due to the anchoring of inflation expectations, we would see worse developments in the area of social expenditure linked to price developments, be it pension benefits or health care (linked to transfers from the state budget in payment for state insured persons).

In the area of **gross fixed capital formation**, the dynamics will depend on the further development of the use of the Recovery and Resilience Facility, as well as on the start of the new financial perspective 2021–2027.

The forecast is based on the discretionary measures approved so far, but the fact remains that the trajectory for reducing structural deficits is also legally anchored. Achieving it will require the adoption of additional measures that should lead to a better-than-projected performance at the end of the outlook horizon (see Subchapter 3.2.3 for details).

4.3 Sensitivity Analysis

The sensitivity analysis is calculated using a dynamic stochastic general equilibrium model developed by the MF CR. The alternative scenarios focus on some actual issues of possible future developments. The first scenario considers lower economic growth in the EU and its impact on the highly open Czech economy, which is dependent on the external environment. The second alternative scenario assesses a possible sudden increase in interest rates. Both alternative scenarios are derived from the baseline CP scenario. In the alternative scenarios, we assume different developments from the baseline scenario in the first half of 2025.

4.3.1 Lower GDP Growth in the EU in 2025

Economic developments in EU trading partners are important for the economic growth of the small open economy of the Czech Republic. The first scenario assumes **slower GDP growth in the EU for 2025** by 2.6 percentage points, which corresponds to the standard deviation over the period 2002–2023.

Initially, a reduction in foreign demand for domestic products would be reflected in a drop in net exports. However, the subsequent pressure on currency depreciation would dampen the negative effects on net exports through more expensive imports. A worse outcome for foreign trade would be reflected in a slowdown in real GDP growth in the Czech Republic by 0.6 percentage points in 2025 relative to the baseline scenario. Lower growth in corporate profits due to weaker exports would slow investment growth by 0.5 percentage points. Lower output of firms would also have a negative impact on labour demand and, consequently, a reduction in the nominal wage growth rate. The negative income effect in the form of relatively lower wages and returns on capital would exacerbate the decline in household consumption by 0.3 percentage points.

The impact on the general government balance is negative by 0.2 percentage points in the first year of the outlook, with a maximum differential of 0.1 percentage points in subsequent years. The lower economic performance has an impact on taxes and social security contributions on the revenue side, while on the expenditure side it leads mainly to an increase in spending on unemployment benefits. In the projection years, the effect of lower inflation on the statutory indexation of pension benefits is slightly positive. Debt would then increase by 0.2 percentage points more in 2025 than in the baseline scenario, and then the differential would increase to 0.4 percentage points by the end of the outlook. In addition to a higher deficit, this would reflect a lower level of nominal GDP over the entire horizon.

4.3.2 Rise in the National Interest Rate

The dynamic model in the second scenario simulates an **additional monetary tightening** for 2025 of 1.1 percentage points above the baseline scenario. This value corresponds to the standard deviation of short-term interest rates between 2002 and 2023.

A more restrictive monetary policy would have a negative effect on economic development. Pressure on the appreciation of koruna would lead to more expensive exports, while imported goods would become relatively cheaper. However, a slight slowdown in exports by 0.3 percentage points would put downward pressure on imports, given the high import intensity of exports. Lower earnings and a fall in profits of economic agents would have a similar effect. The result would be a slight reduction in import growth relative to the baseline scenario.

Lower household incomes due to slower wage growth would also affect consumption adversely. In addition, a higher interest rate would motivate households to save and thus postpone consumption for the future. As a result, a restrictive monetary policy would lead to a deepening of the decline in household consumption by 0.2 percentage points.

Firms' profitability would fall as a result of the decline in foreign and domestic demand. Firms would react to the fall in profits and the rise in the cost of credit by slowing investment growth by 0.1 percentage point. Furthermore, the slowdown in aggregate demand would lead to a 0.3 percentage point increase in the unemployment rate compared with the baseline scenario, as well as to lower wage growth.

Given the negative impact of higher interest rates on investment, consumption and exports, the resulting impact on GDP growth would also be negative, in the range of 0.3 percentage points. A slowdown in growth would lead to a 0.4 percentage point reduction in the inflation rate.

The impact on public finances in this scenario is relatively small. The effects on revenue and expenditure almost offset each other, with the most important expenditure items, i.e. social expenditure, rising less due to lower inflation and real wage dynamics. As a result, the general government debt ratio at the end of the projection horizon differs from the baseline scenario by only 0.2 percentage points.

4.4 Verification of the Macroeconomic Scenario by the Committee on Budgetary Forecasts

In accordance with Act No. 23/2017 Coll., on 16 April 2024, the macroeconomic forecast and the forecast of public finances revenue were assessed by the Committee on Budgetary Forecasts in terms of the probability of their fulfilment. The Committee assessed both the macroeconomic and revenue forecasts as realistic (CBF, 2024a, 2024b).

Table 4.1: Change in the Indicators of the Scenario

		April 2023 CP				April 2024 CP			
		2023	2024	2025	2026	2023	2024	2025	2026
External Assumptions									
Real GDP in EU	*change in %*	**0.7**	**1.5**	**1.5**	**1.3**	**0.5**	**0.7**	**1.6**	**1.6**
Prices of oil (Brent)	*USD/barrel*	**77.0**	**72.9**	**70.7**	**69.0**	**82.4**	**83.8**	**78.4**	**74.7**
Exchange rate USD/EUR	*USD/EUR*	**1.08**	**1.10**	**1.11**	**1.12**	**1.08**	**1.09**	**1.11**	**1.13**
Exchange rate CZK/EUR	*CZK/EUR*	**23.8**	**23.8**	**23.7**	**23.7**	**24.0**	**25.1**	**24.7**	**24.3**
Real Values									
GDP	*change in %*	**0.1**	**3.0**	**2.9**	**2.5**	**-0.3**	**1.4**	**2.6**	**2.4**
Households consumption	*change in %*	-2.7	3.9	4.0	3.0	-3.1	2.7	3.5	2.9
Government consumption	*change in %*	1.6	1.3	1.6	1.8	3.5	1.6	2.2	2.0
Gross fixed capital formation	*change in %*	2.8	0.5	2.2	2.4	4.0	2.2	2.4	2.6
Contribution of final domestic demand	*p.p.*	-0.1	2.2	2.7	2.4	0.3	2.1	2.7	2.4
Contribution of foreign trade	*p.p.*	0.8	1.4	1.0	0.8	2.6	0.2	0.4	0.2
Output gap	*%*	**-1.8**	**-1.2**	**-0.4**	**-0.1**	**-1.3**	**-1.6**	**-0.4**	**0.5**
Others									
Nominal GDP	*CZK bn.*	**7475**	**7989**	**8451**	**8856**	**7344**	**7657**	**8032**	**8391**
Harmonised index of consumer prices	*change in %*	**12.2**	**2.6**	**2.2**	**2.0**	**12.0**	**2.7**	**2.4**	**2.0**
Employment	*change in %*	**-0.4**	**0.5**	**0.2**	**0.1**	**0.8**	**0.4**	**0.2**	**0.1**
Unemployment rate	*%*	**3.0**	**2.8**	**2.7**	**2.7**	**2.6**	**2.8**	**2.7**	**2.6**
Wages and salaries	*change in %*	**7.5**	**5.8**	**4.4**	**4.5**	**7.9**	**6.8**	**5.5**	**4.7**
General Government									
Revenue	*% of GDP*	**41.1**	**39.6**	**39.0**	**38.5**	**41.7**	**42.0**	**41.8**	**41.6**
Value-added tax	*change in %*	8.1	5.5	5.9	4.9	6.7	4.2	5.8	4.4
Excise taxes	*change in %*	0.8	6.3	0.3	0.0	-0.3	6.4	1.9	1.3
Personal income tax	*change in %*	6.9	5.8	3.9	4.6	14.9	7.1	4.1	4.9
Corporate income tax	*change in %*	25.2	1.2	5.6	0.5	19.1	-1.1	-0.2	0.1
Social security contributions	*change in %*	7.4	6.2	4.0	4.2	7.8	8.9	5.3	4.7
Expenditure	*% of GDP*	**44.7**	**42.6**	**41.4**	**40.6**	**45.4**	**44.3**	**43.9**	**43.2**
Compensation of employees	*change in %*	7.1	4.5	3.5	3.5	7.0	3.5	4.5	4.0
Intermediate consumption	*change in %*	10.0	3.5	4.0	4.5	10.0	4.8	5.0	3.5
Social transfers in kind	*change in %*	8.7	5.5	3.0	2.6	12.1	6.5	4.0	3.8
Social benefits other than in kind	*change in %*	12.5	3.2	2.3	2.0	10.5	5.1	2.4	2.7
Gross fixed capital formation	*change in %*	15.8	-2.7	1.9	1.5	16.9	1.8	8.2	1.2
General government balance	*% of GDP*	**-3.5**	**-2.9**	**-2.4**	**-2.2**	**-3.7**	**-2.3**	**-2.1**	**-1.6**
Structural balance	*% of GDP*	**-1.6**	**-2.6**	**-2.3**	**-2.2**	**-2.4**	**-2.0**	**-2.0**	**-1.7**
General government debt	*% of GDP*	**43.5**	**44.0**	**44.4**	**45.0**	**44.0**	**45.5**	**46.4**	**47.1**

Source: CNB (2024a), CZSO (2024a), EIA (2024), Eurostat (2024), MF CR (2023a).

Table 4.2: Basic Macroeconomic Indicators – Sensitivity Scenarios

		2024	2025	2026	2027
Baseline Scenario					
Gross domestic product	*Y-o-Y in %*	**1.4**	**2.6**	**2.4**	**2.5**
Private consumption	*Y-o-Y in %*	2.7	3.5	2.9	2.5
Gross fixed capital formation	*Y-o-Y in %*	2.2	2.4	2.6	2.2
Exports of goods and services	*Y-o-Y in %*	1.5	3.7	3.2	3.1
Imports of goods and services	*Y-o-Y in %*	1.2	3.4	3.2	2.9
Harmonised index of consumer prices	*Y-o-Y in %*	**2.7**	**2.4**	**2.0**	**2.0**
Unemployment rate	*in %*	**2.8**	**2.7**	**2.6**	**2.6**
General government balance	*% of GDP*	**-2.3**	**-2.1**	**-1.6**	**-1.2**
Gross government debt	*% of GDP*	**45.5**	**46.4**	**47.1**	**47.0**
Alternative Scenario I - Lower GDP Growth in EU in 2025					
Gross domestic product	*Y-o-Y in %*	**1.4**	**2.0**	**2.5**	**2.5**
Private consumption	*Y-o-Y in %*	2.7	3.2	2.8	2.5
Gross fixed capital formation	*Y-o-Y in %*	2.2	1.9	2.4	2.2
Exports of goods and services	*Y-o-Y in %*	1.5	2.1	3.1	3.1
Imports of goods and services	*Y-o-Y in %*	1.2	2.2	2.9	2.8
Harmonised index of consumer prices	*Y-o-Y in %*	**2.7**	**2.3**	**2.0**	**1.9**
Unemployment rate	*in %*	**2.8**	**3.2**	**2.6**	**2.6**
General government balance	*% of GDP*	**-2.3**	**-2.3**	**-1.7**	**-1.3**
Gross government debt	*% of GDP*	**45.5**	**46.6**	**47.4**	**47.4**
Alternative Scenario II - Higher Interest Rates					
Gross domestic product	*Y-o-Y in %*	**1.4**	**2.3**	**2.4**	**2.4**
Private consumption	*Y-o-Y in %*	2.7	3.3	2.8	2.5
Gross fixed capital formation	*Y-o-Y in %*	2.2	2.3	2.8	2.3
Exports of goods and services	*Y-o-Y in %*	1.5	3.4	3.1	3.1
Imports of goods and services	*Y-o-Y in %*	1.2	3.3	3.2	2.8
Harmonised index of consumer prices	*Y-o-Y in %*	**2.7**	**2.0**	**1.9**	**1.9**
Unemployment rate	*in %*	**2.8**	**3.0**	**2.6**	**2.6**
General government balance	*% of GDP*	**-2.3**	**-2.2**	**-1.6**	**-1.3**
Gross government debt	*% of GDP*	**45.5**	**46.5**	**47.2**	**47.2**

Note: Different values in the text and in the table are caused by the rounding of values to one decimal place.
Source: CZSO (2024a), EIA (2024), Eurostat (2024), MF CR calculations and forecast.

5 Sustainability of Public Finance

The public finances of the Czech Republic are presently rated as medium-risk in terms of long-term sustainability. By far, the most important factor is the expected demographic developments, which are likely to significantly increase the ratio of pensioners to the economically active population over the next few decades. However, the process of population ageing is already evident today. This underscores the urgent need to reform social systems. The government has implemented the first set of changes in the area of indexation and the criteria for granting early pensions. The second part of the pension reform includes measures to link retirement age to life expectancy or adjust the calculation of pension benefits. However, the phenomenon of population ageing affects not only old-age pensions but also other parts of public finances, such as healthcare, long-term care or education.

5.1 Government Strategy and Implemented Reforms

5.1.1 Current State of the Public Pension System

The pay-as-you-go pension system, regulated by Act No. 155/1995 Coll., has undergone many changes since it entered into force, mainly concerning the retirement age, the calculation of pensions and the method or amount of indexation. The system for calculating pensions is based on the individual's previous earnings but adjusts them by means of reduction thresholds. The amount of income relevant for the calculation of pensions is included in full up to 44% of the average wage and only 26% above that level up to 400% of the average wage. Earnings above 400% of the average wage do not affect the assessment base for pension calculation, which is fully in line with the relevant social security contribution ceiling at the same level.

The general regulation of the pension system in terms of retirement age applies with effect from 1 January 2018 (Act No. 203/2017 Coll.). The retirement age for both men and women is increasing until it is unified at 65 after 2030. The Ministry of Labour and Social Affairs is also required by law to submit a report on the pension system to the Government at five-year intervals (the first report was considered by the last Government in September 2019). The reports aim to assess the current retirement age and, if necessary, propose adjustments to the retirement age so that insured persons can spend, on average, a quarter of their lives in retirement. In addition, the changes to the pension age setting do not affect people who are over 55 at the time of the revision. However, the revision mechanism does not oblige the Government but only recommends submitting the change in the retirement age to the Czech Parliament for approval. As part of the 2019 review, the previous Government took advantage of this arrangement and decided not to change the retirement age setting. The statutory retirement age also affects the conditions of permanent widow's and widower's pensions, where the age limit is linked to old-age pensions. For early retirement pensions, the threshold is gradually shifting so that it is always no more than three years lower than the threshold for the ordinary retirement pension.

With effect from 1 January 2023, two changes have been made to the amount of pensions and the retirement age by Act No. 323/2021 Coll. The first change concerns the adjustment of the earnings-related part of the pension benefit depending on the number of children raised. For each such child, an amount of CZK 500 is added to the pension of one of the parents, which will be further indexed according to the rules in force. The second change is that the early pension for Integrated Rescue System workers will not be reduced if the individual has worked in the system for at least 20 years.

In the area of early retirement pensions, there are generally penalty rates that reduce the resulting benefit throughout the period over which the pension is paid out. A reduction of 1.5% of the calculation base is applied for each 90 days before retirement age. For the award of an early retirement pension, the maximum permissible period between entry into early retirement and reaching the statutory retirement age is three years. This amendment came into force on 1 October 2023 as a result of the adoption of Act No. 270/2023 Coll. In the area of early retirement pensions, however, two additional significant changes have been introduced by this act. The first one is an increase in the minimum period of insurance for the award of a pension to 40 years. The second one is the abolition of indexation of early retirement pensions in their earnings-related part until the statutory age for a regular retirement pension is reached.

In addition, there is a system of pre-retirement pensions that allows participants in supplementary pension savings (Pillar III) to withdraw their funds without penalty up to 5 years before reaching the statutory retirement age. However, a condition for pre-retirement is the amount of accumulated funds in the private Pillar III, which should ensure a monthly pension of at least 30% of the average wage. The old-age pension benefit is not reduced for the years in which the pre-retirement pension is taken. At the end of 2023, only 6,171 individuals with an average benefit of CZK 14,218 took advantage of the pre-retirement scheme.

In the Czech Republic, there are three groups of disability pensions, categorized based on the degree of disability. A person may be eligible for a disability pension if their working capacity is decreased by at least 35% due to a long-term adverse health condition. The first degree of disability applies to a decrease in working capacity of 35% to 49%, the second degree of 50% to 69% and the third degree of 70% and above.

The indexation of pensions paid from the pay-as-you-go system is determined by the sum of the increase in the pensioners' cost-of-living index (Act No. 270/2023 Coll. abolished the choice between this index and the consumer price index, whichever was higher) and one-third (instead of the previous one-half) of the increase in real wages. The indexation is normally carried out once a year on 1 January, except for exceptional indexation when price increases reach at least 5% since the end of the previous reference period. Conversely, in the case of periods of low inflation and/or low real wage growth, the Government has the option to adjust the indexation amount. If the increase in the average pension, as per the standard indexation formula, falls short of 2.7%, the Government is authorized to raise pensions to that level through regulation. Furthermore, for individuals aged 85 and over, the earnings-related part of the pension benefit increases by CZK 1,000 per month, and for those aged 100 and over, it further increases by an additional CZK 1,000).

The Government is fulfilling its announced intentions to strengthen the long-term sustainability of the pension system **through several parametric adjustments**. In addition to the already approved Act No. 270/2023 Coll., the Ministry of Labour and Social Affairs has submitted a set of other measures for comment. Crucially, linking the retirement age to life expectancy and adjusting the calculation of pensions ensures long-term financial sustainability. Linking the age to life expectancy should result in an average retirement duration of around 21.5 years. As regards the calculation of pensions, the income taken into account should be considered in the first reduction threshold at 90% rather than 100%. Additionally, the accrual rate should amount to 1.45% for each year of insurance, replacing the current rate of 1.5%. The changes to pension calculations will be implemented gradually until 2035. Other measures include mitigating the decrease in early retirement pensions by half if the claimant has at least 45 years of insurance, sharing assessment bases between spouses, and introducing a notional assessment base for the care of the first and second child or the care of a dependent person. Childcare allowance will apply only to women who raise more than two children.

5.1.2 Development in the Health care System

From 2015 until the outbreak of the coronavirus pandemic in 2020, the healthcare system was running a surplus every year, which led to a gradual increase in the **cash balances of health insurance companies in the bank accounts**. The Ministry of Health considers the optimal level of cash balances to be 15% of total annual health care expenditure. By the end of 2023, these cash balances will amount to CZK 55.5 billion (0.7% of GDP), which will cover about 10.9% of the total planned annual health care expenditure for this year. Over the course of the year, according to the health insurance plans, cash balances are expected to fall to CZK 47.9 billion (0.6% of GDP), which would finance only 9.1% of the total health care expenditure planned by health insurance companies for 2025. In addition to the overall level of cash balances, there was also a significant inequality between the General Health Insurance Company (over 70% of the total cash balances of the health insurance companies in the bank accounts) and other employee insurance companies, both in absolute terms and per insured person. This is mainly due to the fact that the General Health Insurance Company has in the past had higher reimbursements to hospitals and that the cost of hospital care is rising more rapidly for employee insurance companies in the context of the convergence of base rates. The uneven distribution of cash balances will therefore have to be addressed by some change in the redistribution system, and several possible adjustments are currently being considered. The medium-term outlook for the health insurance companies should then lead to a further reduction in the system's cash balances in the years ahead. In the medium and long term, the healthcare sector will face significant pressures for further health care expenditure growth, mainly due to an ageing population, a gradual increase in high-cost healthcare services, the inclusion of new and very costly drugs in reimbursed care, the introduction of innovative treatments and cost increases for medicines reimbursed to healthcare providers in specialised centres. It is thus clear that changes will have to be made in the public health insurance system in terms of its financing, and above all, measures will have to be implemented to increase efficiency and economy in health care expenditure.

In the area of health care financing resources, with effect from 1 January this year, an **automatic indexation mechanism** was introduced to determine the assessment base for the insurance contributions **for the state-insured person** (Act No. 260/2022 Coll.). The assessment base is now adjusted by the sum of price increases and one half of the increase in real wages, provided that the conditions laid down by law are met. According to the Regulation of the Government No. 288/2023 Coll., the assessment base for 2024 is CZK 15,440 per calendar month, which will strengthen the resources of the public health insurance system by approximately CZK 13.6 billion YoY. The introduction of this mechanism strengthens the transparency of the revenue part of the system and improves the planning of total revenue and related health care expenditure. According to the Policy Statement of the Government, it is also envisaged to introduce **voluntary supplementary insurance for care** that is not reimbursed. Thus, an amendment to Act No. 48/1997 Coll., on public health insurance, is currently being prepared, which should create a legal and clearly defined space for payment for this care and allow health insurance companies to offer this product. This systemic change would slightly diversify the resources of financing, and its introduction is estimated to increase the revenue of the public health insurance system by 2–3%.

Several measures are currently contributing to improving the **efficiency of spending**. A large part of this is the long-term DRG Restart project. Under this project, the **CZ-DRG** (*Diagnosis Related Groups*) **system**, which is a patient classification system based on a finite number of mutually disjunctive classification groups for classifying hospitalised patients according to certain parameters, was developed and implemented across the board **in the acute inpatient care segment.** The CZ-DRG system is thus based on a hierarchical classification of classification units, which are hospital cases, into the resulting system units (DRG groups) in which individual hospital cases are clinically and economically similar to each other. Thus, there will be a significant reduction in the volume of acute inpatient hospital cases covered by lump sum reimbursement (from 92.5% of all cases in 2019 to 46.2% in 2024) and their replacement by reimbursement using an individual base rate (the share is planned to increase from 7.1% in 2019 to 35.8% in 2024) or a lump sum case reimbursement (the share will increase to 15.4% in 2024). In the following years, an increase in the volume of care covered by the lump sum case is planned in the framework of health care reimbursement, but it will be necessary to take into account the heterogeneity of healthcare providers by means of cost modifiers linked to the structural characteristics of hospitals (this applies in particular to care provided by specialised institutes). However, these compensations should only be partial in order to incentivise these providers to make savings and increase efficiency in their health care expenditure. The CZ-DRG system is also increasingly reflected in the reimbursement of day care, with a further increase in specialties and procedures this year. **Greater use of day care** leads to lower unit costs for surgical procedures, reduced need for staff, increased productivity in terms of more efficient use of hospital capacity, reduced waiting times and faster, more comfortable patient recovery in the home environment. In addition, the **role of preventive care is being strengthened** in line with the Policy Statement of the Government. A proposal is currently being prepared to introduce bonuses for citizens who take care of their health in a certain way. They could thus be motivated to use preventive care (e.g. by participating in preventive examinations or screening programmes) by means of a financial reward, for which health insurance companies will be able to allocate up to 3% of the collected health insurance contributions as part of the prevention fund. Emphasising preventive care will both save on subsequent health care expenditure and increase life expectancy.

The overall **digitalisation of healthcare** is also having an impact on the greater efficiency of spending on the provision of healthcare services and their reimbursement. Two pieces of legislation play a key role in this. At the national level, Act No. 325/2021 Coll., on the Electronicisation of Health Care, which is expected to establish the basic elements of e-health. However, in contrast to the original plan, the **core health registers** (of health services, health staff and patients), which should be a source of unambiguous, real-time and correct data for the identification of subjects, have not yet been created. The core registers will also be part of an integrated data interface that will ensure safe sharing of data and medical records and the management of authorised communication between the entities involved in eHealth. Core registries are essential for the further development of the electronicisation of health care and the secure sharing of medical records. However, due to the significant delay in their construction, the obligation for health care providers to use these core data has been postponed until 2026 (Act No. 409/2023 Coll.). On the other hand, this law postpones by 1 year (to 2025) the obligation for providers who have electronic services to comply with the ehealth standards issued by the Ministry of Health. These define the structure, content and format of data files and data messages, interfaces for maintaining and transmitting health records in electronic form and their security, classification, nomenclature and terminology for their use. However, so far only the standard for the patient summary has been issued. In the next phases of digitisation, the introduction of a medical documentation index is planned, beyond the scope of the Act on the electronicisation of health care, as an information system describing the basic typology of existing medical documentation (only for exhaustively defined parts) and bringing together metadata about the documentation.

The second pillar of the digitalisation of healthcare is the **European Health Data Space** (EHDS) **Regulation**, which was presented to the EC in 2022. The European Parliament gave its consent to the proposal in December 2023, and the final form of the legislation will be prepared with the Member States. The aim of this regulation is to establish a single space for the safe and trusted exchange of health data in the EU, while improving individuals' access to their health data, including strengthening control over its use. The Regulation should set the legal framework and support the construction of two cross-border infrastructures for the exchange of health data, for primary and secondary use. Primary use of electronic health data supports its use for healthcare at national and cross-border level. It will not only allow citizens to access their health data in electronic form, but also to make their data available to health staff. Secondary uses of electronic health data are the processing of health data for evaluation and public health policy-making or for research, development and innovation.

5.2 Fiscal Impacts of Population Ageing

The estimates of the impact of population ageing are based on long-term projections conducted in cooperation with the Working Group on Ageing and Sustainability of the Economic Policy Committee established by the Council of the EU. The analyses are based on demographic assumptions and a methodologically consistent macroeconomic framework for EU countries and Norway (EC, 2023b). The projections therefore do not reflect the current macroeconomic forecast or the medium-term macroeconomic and fiscal outlook for the Czech Republic. The projections are made under the constant-policy assumptions. They are therefore indicative of a system that is legislatively anchored at the time of the projections, considering existing practices where legal discretion is permitted. Long-term analyses are not intended to predict specific values, but to show trends and dynamics over the long term. The current update of the long-term projections occurred in autumn 2023 in the context of preparing the 2024 Ageing Report, and it covers the period up to 2070.

The current results of the long-term projections are based on the Eurostat population projection (2023). For comparison, the previous Eurostat projection (2019) and the medium scenario of the CSZO's latest projection (2023) can be used. The latter is used to assess the relationship between the current retirement age and life expectancy. It assumes significantly lower total fertility than the Eurostat baseline scenario and is thus more comparable to the low fertility sensitivity scenario.

Even a basic comparison of Eurostat population projections shows that a decline in the Czech population can be expected in the long term. The current Eurostat projection (2023) is more optimistic in this respect, mainly due to a higher migration balance (see Graph 5.2). This is strongly influenced, especially in the short and medium term, by the immigration of people from Ukraine and their expected partial return. In the longer term (from 2034), the new projection assumes a positive migration balance of around 26,000 persons per year (compared to 17,000 in the previous projection). In general, however, this indicator is considered the most difficult one to predict in the projections.

However, the age structure of the population is particularly important for projections of social and health system expenditure. The dependency ratio, measured as the ratio of the number of people aged 65 and over to the number of people of working age (15–64), follows a similar pattern for both projections. By 2060, it should increase by more than half even in the more favourable (new) projection, reaching more than 50% (see Graph 5.3).

Of course, this is not only a consequence of the decline in the number of working age individuals, but also of the increase in average life expectancy. The share of people aged 85 and over in the number of people aged 65 and over is projected to more than double over the projection horizon. Only a temporary reduction in the dependency ratio is then expected in the later decades of the projections. The strong growth after 2035 and the peak in the 2060s is mainly due to the demographic bulge of those born in the 1970s. After 2060, their influence is expected to diminish, but in the following period, the dependency ratio will be influenced by the ageing of the stronger population cohorts born more recently.

For the purposes of the projection's macroeconomic assumptions, the average exit age from the labour market to retirement increases until 2036 in line with the extension of the statutory retirement age. After 2036, it remains constant, reflecting the current institutional set-up of the pension system. Although the revision mechanism is part of the pension system, it does not oblige the Government but only recommends submitting a change in the retirement age to the Czech Parliament for approval. For this reason, the EC rejected the application of the revision mechanism in the long-term projections. The projection therefore works with the retirement age as a fixed ceiling of 65 years from the 2030s.

From a public finance perspective, pension expenditure relative to GDP evolved more favourably than projected in the pre-crisis period, mainly due to the influence of the macroeconomic environment. The initial value of expenditure in the previous projections was 9.0% of GDP in 2013, while pension expenditure was 1.0 percentage point lower in 2019. In addition, higher growth in wages and salaries, employment and participation rates led to dynamic growth on the revenue side of the system. This had a positive impact on its balance, which stood at 0.3% of GDP in 2019 (MF CR, 2021a). The pandemic and the measures taken on the revenue side then led to a deterioration of the system's balance to −0.7% of GDP in 2020 (MF CR, 2021b). Although the pension account was broadly balanced in 2021, high inflation and the resulting two extraordinary indexations caused a deficit of 0.3% of GDP in 2022, widening further to 1.0% of GDP in 2023 (MF CR, 2024b).

The trend in pension projections is primarily determined by demographic developments and retirement age. Although **pension expenditure** is expected to gradually decline to 8% of GDP by 2030, it will start to increase significantly thereafter, as a result of halting the increase in the retirement age and the retirement of the strong cohorts of the 1970s. They should peak at 11.1% of GDP just before 2060. This is followed by a slight decline in spending to 10.4% of GDP by the end of the projection horizon in 2070. The decline in the expenditure-to-GDP ratio is again driven by demographic factors. This is because individuals born in the demographic trough in the 1990s and early 2000s will retire and replace those born during the demographic bulge.

The projection assumes constant **pension revenues** relative to GDP over the entire horizon. This follows from the assumption that the wage bill in the economy should evolve in line with labour productivity over the longer term. As a result, the share of labour production in GDP is kept fixed, on which a constant pension rate of 28% of gross wage or salary is applied. The system's revenues are thus at the 2023 level of 7.7% of GDP over the entire horizon.

With revenue in relative terms kept constant, the resulting **pension system balance** follows the path of pension expenditure (Graph 5.4). We expect a relatively stable balance until 2030, while it deteriorates thereafter to −3.4% of GDP just before 2060. It will improve again in the last decade, reaching −2.8% of GDP in 2070.

In the area of **health and long-term care**, the situation is similar to previous projections in terms of growth momentum of expenditure net of one-off pandemic-related payments. In the baseline scenario, health care expenditure increases by less than one seventh (from 5.8% of GDP in 2023 to 6.6% of GDP in 2070) and long-term care expenditure almost doubles (from 1.5% of GDP in 2023 to 2.9% of GDP in 2070).

In addition to the baseline projection scenario, a risk scenario was also developed that differs in the following respects. In the case of health care, it is a higher income elasticity, with demand for health care services initially growing one half faster than the standard of living (measured as GDP per capita). This is an expression of health care as a luxury good, for which spending grows relatively faster as the wealth of society increases. For long-term care, the risk scenario assumes higher growth in unit costs and wider population coverage with formal care as real living standards converge towards the EU average. This scenario therefore demonstrates the impact of non-demographic factors.

On the contrary, demographic effects can be observed in the sensitivity scenario of low fertility, which is among Eurostat's demographic scenarios the closest to the current projection of the CZSO (2023). The low fertility scenario significantly affects pension expenditure, resulting in an increase of up to 0.6 percentage points compared to the baseline scenario by the end of the projection horizon. However, health and long-term care expenditure is noticeably more profoundly impacted by the risk scenario (see Graph 5.5 and Graph 5.6).

While lower fertility increases health care spending by 0.5 percentage points at the end of the horizon, higher income elasticity leads to an increase of up to 1 percentage point. In the case of long-term care, the impact of lower fertility is quantified at 0.2 percentage points, while higher unit costs and wider population coverage with formal care contribute to a significant effect of 1.6 percentage points.

Finally, the last major long-term expenditure item, **education**, is expected to grow from 4.1% of GDP in 2022 to 4.4% of GDP in 2070. While this represents a slight decrease compared to the last round of projections, it is still the second-highest increase across the entire EU. This growth is primarily driven by higher compensation of employees in the education sector, outpacing the projected economic growth.

Total expenditure growth between 2022 and 2070 amounts to 3.7 percentage points (Graph 5.7). When considering health care, long-term care and education together, they contribute to a 1.9 percentage point's increase in the baseline scenario. However, especially for health and long-term care, most of the alternative (sensitivity) scenarios tracked in the Ageing Reports exhibit higher growth. The main exceptions are the scenarios that include the impact of a healthier lifestyle.

5.3 Sustainability Analysis

The long-term projections are followed by a sustainability analysis, which identifies the scope of required fiscal consolidation to ensure the stability of public finances. So-called sustainability indicators are calculated to demonstrate the extent of measures needed to either reduce the expenditure ratio or increase the revenue-to-GDP ratio accordingly.

The EC routinely publishes three sustainability indicators (see EC, 2024d). **Indicator S1** generally expresses the percentage of GDP by which the primary structural balance of the general government sector needs to be adjusted in order for the general government debt to be 60% of GDP at the end of the horizon (in 2070). For the Czech Republic, this indicator currently stands at 3.0% of GDP, indicating medium risk. A key determinant is the cost of ageing, which has an impact of 2.9 percentage points.

Indicator S2 measures the level of fiscal effort required to achieve equality of discounted revenues and expenditures over an infinite horizon. According to the latest published calculations, it stands at 4.8% of GDP. The value of this indicator is significantly influenced by the cost of ageing, which amounts to 4.0% of GDP, while the impact of the initial budgetary position accounts for the remaining 0.8% of GDP. The value of the S2 indicator also falls into the medium risk category.

The S0 indicator reveals potential fiscal or financial risks in the short term. It is thus different in nature from indicators S1 and S2, as S0 quantifies the degree of risk.

For the Czech Republic, the current value of the S0 indicator is 0.24, which falls within the low-risk range and is below the critical threshold of 0.46.

The Czech Republic is currently assessed as a medium-risk country in terms of the long-term sustainability of public finances. In order to return to the low-risk zone, it is therefore necessary to address future pressures on public finances arising from demographic changes in particular. This applies to all components of long-term projections, i.e. pensions, healthcare, long-term care, and education. Additionally, gradual consolidation of public finances is necessary to reduce indebtedness and put it back on a downward trajectory.

5.4 General Government Guarantees

The issue of **guarantees** provided by the general government sector to other entities complements the view on the sustainability of public finances. Guarantees represent an increase in general government expenditure when the borrower is unable to repay the obligations for which the guarantee is provided. Before the pandemic, the volume of guarantees provided in the Czech Republic was completely negligible.

Currently, the **Guarantee Programme 2015–2023** (approved by Government Resolution No. 1053/2014), respectively its 4th call, is expiring, which allows small and medium-sized enterprises to obtain a guarantee for a bank loan of an investment or operational nature. The effective guarantee amounted to CZK 4.13 billion as of 31 December 2023. Other current programmes for which the National Development Bank provides so-called M-guarantees (a type of preferential loan guarantee provided in a simplified procedure, supported under the *de minimis* rule) include, for example, the **INOSTART Programme**, which enables innovative small and medium-sized start-ups to obtain a loan for the implementation of innovative projects (the value of exposure at the end of 2023 was CZK 38.4 million).

In 2024, a new guarantee programme **ELECTROMOBILITY** should be launched with an expected allocation of CZK 2 billion. Under this programme, it will be possible to purchase new electric vehicles and their charging stations. The support will be provided in the form of a portfolio bank guarantee for a commercial loan from cooperating partners who will have an agreement with the National Development Bank on the terms and conditions for providing portfolio guarantees in the Electromobility Guarantee programme, and it will also be possible to obtain a financial contribution (subsidy component). The guarantee can be granted up to 70% of the principal amount of the guaranteed loan and the duration of the guarantee cannot exceed 5 years.

Under the **EXPANZE Programme**, which is now closed for applications, the guarantee part supported larger projects outside Prague. The guarantee was provided up to 80% of the principal amount of the guaranteed loan, which ranged from CZK 1 to 60 million and the duration of the guarantee did not exceed 10 years. The effective guarantees of this programme as of 31 December 2023 were around CZK 3 billion, of which CZK 10.5 million related to the Energy Guarantee programme. M-guarantees were also provided through the Operational Programme Enterprise and Innovations for Competitiveness, but by the end of 2023 the effective guarantees were only around CZK 11 million.

As part of the response to the crisis caused by the pandemic, the **COVID II Guarantee** Programme was approved by the Government in March 2020 (Government Resolution No. 260/2020) with indirect support for affected companies in the form of state guarantees with a guarantee capacity of CZK 20 billion. As of 31.12.2023, the limit for performance under the guarantee provided was CZK 186.3 million. On 20 April 2020, the **COVID PRAGUE** programme was announced as a complement to the COVID II programme under similar conditions. The effective guarantees of this programme amounted to CZK 1.4 million at the end of 2023. Both programmes were exhausted relatively quickly and ended already during 2020.

The adoption of Act No. 228/2020 Coll. enabled the implementation of the **COVID III Guarantee** Programme. The provision of loans under this programme was terminated on 31 December 2021. The performance limit as at 31 December 2023 was CZK 11.9 billion.

In addition to these programmes, the National Development Bank provided guarantees under the **COVID Sport Guarantee** (Government Resolution No. 46/2021) and **COVID CK Guarantee** for small and medium-sized travel agencies (Government Resolution No. 51/2021). This was followed by the CK Guarantee scheme from January 2022 (Government Resolution No. 982/2021). The effective guarantees at the end of 2023 were CZK 41.2 million for the COVID Sport Guarantee and CZK 14.3 million for the COVID CK Guarantee.

The effective guarantees for the provided concessional loan guarantees, where the amount of the guarantee for the lending bank is graded into 3 performance bands and the business risk and creditworthiness of the client are assessed, the so-called S-guarantee, at the end of 2023 amounted to approximately CZK 45 million for Operational Programme Enterprise and Innovations for Competitiveness guarantees and CZK 791.3 million for others.

Act No. 214/2020 Coll. enabled the Export Guarantee and Insurance Corporation (EGAP) to expand its portfolio of activities to include the provision of guarantees under the **COVID Plus** programme. The programme was terminated at the end of 2021. The amount of effective guarantees of this programme was CZK 5.1 billion at the end of 2023.

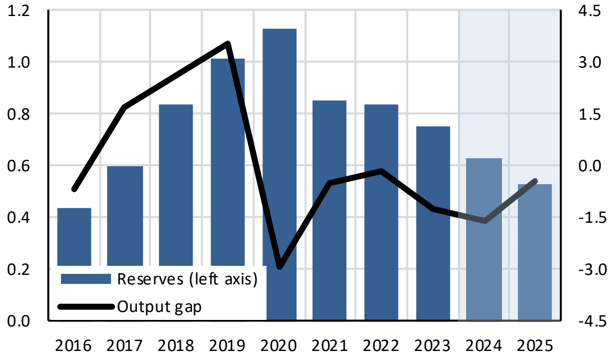
On 3 November 2022, in response to the situation caused by Russia's aggression in Ukraine, Act No. 363/2022 Coll. was approved, which allowed EGAP to provide guarantees to mitigate the economic and social consequences also under other emergency support measures. The new legislation has thus opened up space for supporting export production companies affected by high energy prices or, for example, sanctions against Russia. The guarantees for operating and investment loans were intended for enterprises whose share of exports in annual sales in the last accounting period was at least 25% and which had more than 100 employees in that period. The loan was to amount to a maximum of 15% of total annual sales (on average over the last three closed accounting periods) and was to be between CZK 5 million and CZK 1.2 billion (in total per group). As with the COVID plus programme, the amount of the guarantee varied based on an assessment of the rating. In the case of a rating of 'B or better', it was 90% of the loan principal, while in the case of EGAP's internal rating of 'B−', it was 80%. The maximum duration of the guarantee was 6 years. For the **EGAP Plus programme,** CZK 500 million was allocated from the state budget for the initial deposit into the fund to cover the liabilities from the guarantees provided. In 2023, an additional CZK 239 million was made available to increase EGAP's authorised capital in order to extend export support (Government Resolution No. 525/2023). The programme was set to expire on 31 December 2023. The effective guarantee amounted to CZK 6 billion as of 31 December 2023.

Guarantees provided by local governments also account for a share of general government sector guarantees (outside covid programmes). The most significant of these is to the Prague City Transport Company for deferred payments for the purchase of trams in the amount of CZK 0.8 billion. Others are guarantees provided by local governments for loans related to housing needs (CZK 0.1 billion).

In 2018, a **state guarantee** was provided **to secure the CNB's loan to the International Monetary Fund** from its foreign exchange reserves (Act No. 179/2018 Coll.). The pledged credit framework is up to EUR 1.5 billion, but the reported amount of the guarantee is dependent on the status of the loan drawn down. The guaranteed loan has not yet been drawn down.

Graph 5.1: Health Insurance Companies' Reserves

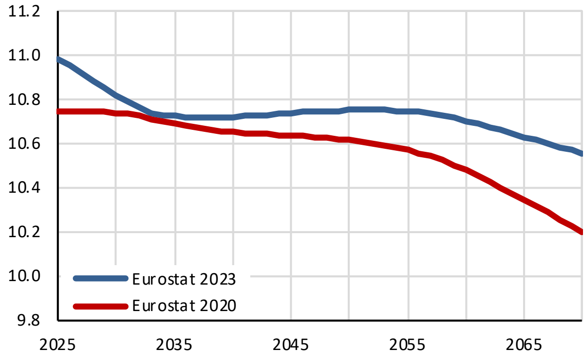
left axis: in % of GDP, right axis: in % of potential product



Note: "Reserves" on health insurance companies' accounts.
Source: Statements of Health insurance Companies, MF CR.

Graph 5.2: Czech Population in Different Projections

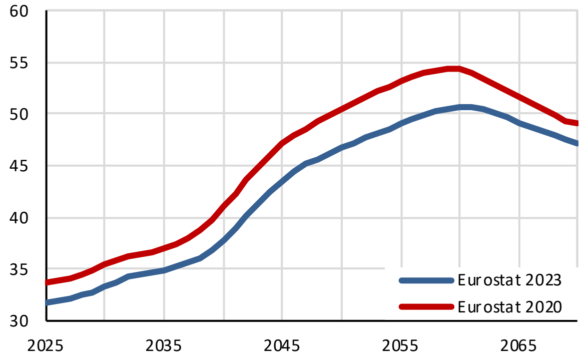
millions of persons



Source: Eurostat (2019), Eurostat (2023).

Graph 5.3: Old-age Dependency Ratio

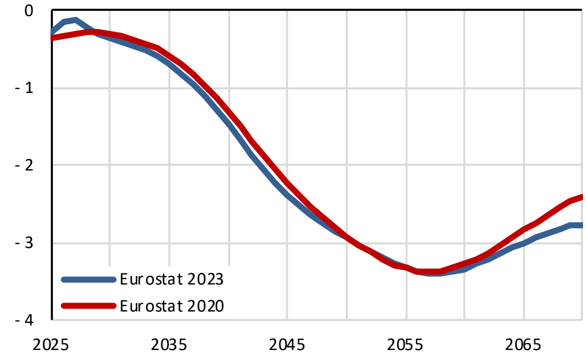
in %, ratio of persons aged 65+ to persons aged 15–64 years



Source: Eurostat (2019), Eurostat (2023).

Graph 5.4: Pension Account Balances

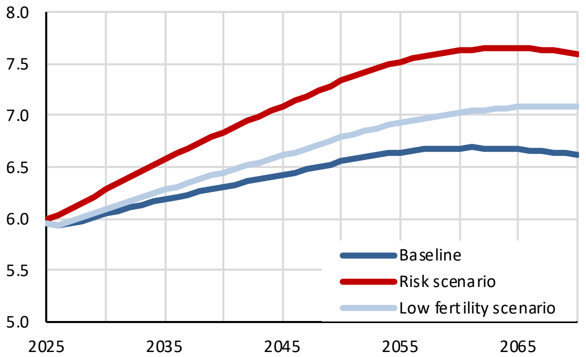
in % of GDP



Source: MF CR calculations and forecast

Graph 5.5: Health Care Scenarios

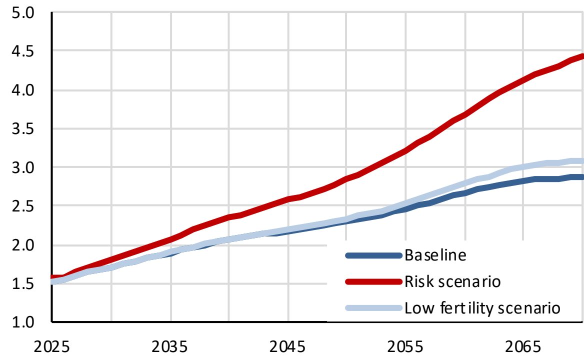
in % of GDP



Source: EC (2024e). MF CR calculations.

Graph 5.6: Long-term Care Scenarios

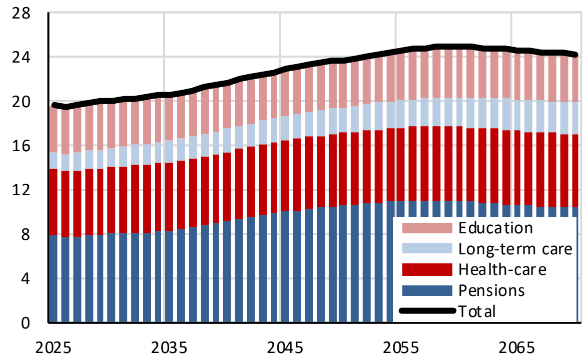
in % of GDP



Source: EC (2024e). MF CR calculations.

Graph 5.7: Expenditure Projections

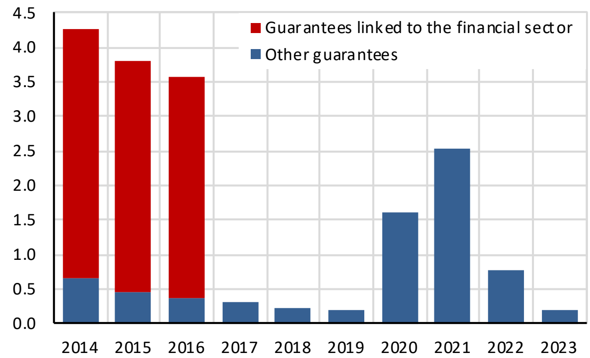
in % of GDP, age-related expenditure



Source: EC (2024e). MF CR calculations.

Graph 5.8: General Government Guarantees

in % of GDP



Source: MF CR.

Table 5.1: Long-term Sustainability of Public Finances

expenditure and revenue in % of GDP, change and rates in %

	2023	2025	2030	2040	2050	2060	2070
Total expenditure	**45.4**	**43.9**	**42.7**	**44.6**	**47.7**	**50.2**	**51.0**
of which: Age-related expenditures	20.3	19.6	20.1	21.7	23.8	24.9	24.3
Pension expenditure	8.8	7.9	8.0	9.2	10.6	11.0	10.4
Social security pensions	8.8	7.9	8.0	9.2	10.6	11.0	10.4
Old-age and early pensions	7.4	6.7	6.8	7.9	9.4	9.7	9.2
Other pensions	1.4	1.3	1.3	1.3	1.2	1.3	1.3
Occupational pensions	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Health care	5.8	5.9	6.0	6.3	6.6	6.7	6.6
Long-term care	1.5	1.5	1.7	2.1	2.3	2.7	2.9
Education expenditure	4.2	4.2	4.3	4.2	4.3	4.5	4.4
Other age-related expenditures	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Interest expenditure	1.3	1.5	1.5	1.6	2.4	3.8	5.2
Total revenue	**42.1**	**41.8**	**41.6**	**41.6**	**41.6**	**41.6**	**41.6**
of which: Property income	1.7	0.7	0.6	0.6	0.6	0.6	0.6
of which: Pension contributions	7.7	7.7	7.7	7.7	7.7	7.7	7.7
Pension reserve fund assets	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
of which: Consolidated public pension fund assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Assumptions							
Labour productivity growth	**0.7**	**1.0**	**1.6**	**2.3**	**2.0**	**1.6**	**1.2**
Real GDP growth	**0.2**	**2.2**	**1.3**	**1.6**	**1.6**	**1.6**	**1.2**
Total participation rate (aged 20–64)	**82.6**	**82.0**	**81.9**	**81.0**	**81.4**	**82.1**	**81.5**
Participation rate of males (aged 20–64)	89.7	88.7	88.1	87.2	87.9	88.4	87.7
Participation rate of females (aged 20–64)	75.4	75.1	75.4	74.3	74.3	75.3	74.8
Unemployment rate	**2.6**	**2.5**	**2.6**	**2.7**	**2.7**	**2.6**	**2.6**
Population aged 65+ over total population	**20.2**	**20.4**	**21.5**	**24.3**	**27.3**	**28.6**	**27.4**

Note: Macroeconomic assumptions are based on long-term projections of the EC and can differ from the medium-term macroeconomic scenario presented in Chapter 2. Total revenue and the age-unrelated expenditure in relative terms are kept constant to their 2027 level to mitigate distortion in impacts of ageing on public finance. On the other hand, total revenue and expenditure in the long run are thus distorted by the medium term budgetary position and the development after 2027, when the autonomous development of the projection is not corrected by the statutory trajectory of public finance consolidation and subsequent adherence to the medium-term budgetary objective.

Source: EC (2023b), EC (2024e). MF CR calculations.

Table 5.2: Sustainability Indicators S1 and S2

in % of GDP

	S1	S2
Cost of Ageing	2.9	4.0
Budgetary position	0.4	0.8
Debt requirement	-0.3	-
Total	**3.0**	**4.8**

Source: EC (2024d).

Table 5.3: Contingent Liabilities
in % of GDP

Measures		Date of adoption	Maximum cont. liabilities *% of GDP*	Estimated take-up *% of GDP*
In response to COVID-19	"COVID II" Guarantee	2020	0.05	0.00
	"COVID Prague" Guarantee	2020	0.01	0.00
	"COVID III" Guarantee	2020	0.19	0.16
	"COVID Sport" Guarantee	2021	0.00	0.00
	"COVID Travel Agency" Guarantee	2021	0.00	0.00
	"COVID Plus" Guarantee	2020	0.18	0.07
	"SURE" Programme Guarantee	2020	0.13	0.13
	Subtotal		**0.56**	**0.36**
Others	Guarantees provided by central government			
	- Macro-financial Assistance (MFA) to Ukraine	2022	0.02	0.02
	- other central government guarantees		0.19	0.08
	Guarantees provided by local governments			
	- for loans related to the housing needs	2014	0.00	0.00
	- for purchase of trams by Prague Transport Company	2012	0.02	0.01
	- other guarantees of the general government sector	2014	0.01	0.01
	Subtotal		**0.24**	**0.12**
	Total		**0.79**	**0.49**

Note: Amount of guarantees is calculated to the end of 2023.
Source: MF CR.

6 Quality of Public Finance Revenue and Expenditure

The main objectives of the tax policy are to increase the efficiency of tax collection, abolish unsystematic tax exemptions, deepen the client-centric approach, develop and expand electronic services for communication with tax subjects, reduce the bureaucratic burden in tax administration and prevent illegal optimisation practices and tax evasion.

On the expenditure side, a number of changes or improvements have been made to the existing framework to promote rationalisation and efficiency gains. First of all, the Public Procurement Act amendment and the expenditure rationalisation as a result of the consolidation package should be mentioned, followed by efforts to save energy and the continued development of the joint gas purchasing system, while other measures concern the management of state property and the continued digitisation of public administration.

6.1 Tax Policy Outlook

The year 2024 is the first year of effect of the measures associated with Act No. 349/2023 Coll., Amending Certain Acts in Connection with the Consolidation of Public Budgets.

The consolidation measures affected almost all tax titles. These included not only rate adjustments, but also the abolition of non-systemic exemptions, adjustments in tax sharing, or the taxation of new products to remove their tax advantages. In the case of the tax assignment, changes have been made both on the basis of the measures themselves (e.g. change in the tax assignment of road tax, different sharing for gambling tax), but also in order to target additional revenue to the state budget (adjustments in income taxes).

Tax changes include, for example, a reduction in the number of value added tax rates to a basic 21% and a reduced 12% rate (unification of the original reduced rates of 15% and 10%) and a shift of selected goods and services from the reduced to the basic value added tax rate. The measure will lead to greater efficiency and transparency. As regards personal income tax, most of the changes concern the reduction or abolition of tax exemptions with the aim of simplifying and straightening the current situation. For corporate income tax, the most significant change is the increase in the tax rate from 19% to 21%, bringing the Czech Republic closer to the European average. In the case of excise duties, there is a multi-year plan to increase the rates on alcohol and tobacco products, for which, in addition, taxation of alternative products not yet taxed (e-cigarette refills, nicotine sachets) has been introduced. In addition, exemptions on mineral oil excise duties and energy taxes were modified or abolished, with the most fiscally significant measure being the abolition of the exemption on solid fuels and natural gas and the refund of tax on mineral oils consumed in metallurgical processes and mineralogical processes. For the gambling tax, the second rate has been increased from 23% to 30% and the tax revenue from all internet games now belongs to entirely to the state budget. The real estate tax has also undergone a major change, with an average increase of 80% in tax rates. The revenue remains with the municipalities, but the tax assignment has reduced the municipalities' revenue from shared taxes accordingly.

Although these measures are introduced in 2024, many of them are expected to overlap into the following years in the form of increased efficiency of the tax system and its simplification, which will ultimately bring potential for savings not only on the part of the state, but also of natural and juridical persons.

The adoption of Council Directive (EU) 2022/2523 of 14 December 2022 on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union continues the EU's efforts to end tax practices of multinational enterprises that allow them to shift profits to jurisdictions where they are subject to no or very low taxation. The reform aims to stop competition on corporate tax rates by introducing a global minimum level of taxation. By removing much of the benefit of shifting profits to jurisdictions with zero or very low taxation, the reform introducing a global minimum tax will level the playing field for businesses around the world and allow jurisdictions to better protect their tax bases. The issue is linked to the Organisation for Economic Co-operation and Development's "Tax Challenges arising from the Digitalisation of Economies" project under the Base Erosion and Profit Shifting (BEPS) initiative. The Directive only applies to EU-based entities that are members of multinational enterprise groups or large domestic groups that reach an annual consolidated revenue threshold of at least €750 million. The minimum effective level of taxation is 15%. The Directive has been transposed into Czech law by Act No. 416/2023 Coll. at the end of 2023. During 2024, additional inputs from the Organisation for Economic Co-operation and Development arising after the adoption of Council Directive (EU) 2022/2523, which do not have a separate transposition deadline but which are expected to be implemented by the Czech Republic by the end of 2024, will be incorporated.

The MF CR has prepared a new Act on Accounting, which is to completely recodify the legal regulation of accounting, adapt it to new requirements and respond to trends in the field of accounting. The proposed amendment reduces the administrative burden for the accounting units concerned, for example by making the bookkeeping voluntary for entrepreneurial natural persons and some non-governmental non-profit organisations, or the obligation to use international financial reporting standards for the preparation of financial statements will be extended. The accompanying law will also propose amendments to the Income Tax Act aimed at ensuring better continuity with the accounting of taxpayers who are accounting entities (namely changes in the area of tax depreciation of assets – reduction of the number of depreciation groups, switch to monthly depreciation), conceptual change in the valuation of assets, etc. The new Accounting Act was submitted to the Government during January 2024 and a companion law will be submitted to the Government in the first half of 2024.

The Excise Act, the Prices Act, the Valuation of Assets Act and the Public Budgets Stabilisation Act will also be amended in the following years. The main objective is to reduce unnecessary administrative burden and remove legal uncertainties related to the handling of selected products subject to excise duties, while the amendment will contribute to streamlining the process of excise duty collection and administration.

An amendment to the Act on International Cooperation in Tax Administration is currently under discussion, which primarily concerns the automatic exchange of information reported by crypto-assets service providers and other partial measures to strengthen international cooperation in tax administration, which represents an important pillar of the fight against tax evasion. The new framework will enter into force in 2026.

Last year, an analysis on the possibilities of siphoning off illegally acquired assets was completed by the Ministry of Justice, the Financial Analytical Office, the General Financial Directorate, the General Directorate of Customs, the Ministry of the Interior, the National Centre against Organised Crime, the Prosecutor General's Office and the Criminal Police and Investigation Service, which aims, among other things, to address the issue of transit accounts. This analysis has resulted in three possible ways of dealing with the situation in the Czech Republic, namely civil, administrative and criminal options. The Government decided (Government Resolution No. 621/2023) to develop a criminal solution. The Minister of Justice is to submit a relevant bill to the Government by 31 December 2024. The amendment should significantly contribute to the reduction of money laundering through the territory of the Czech Republic.

The Cobra method of cooperation will continue and will be further developed. Among the essential facts that need to be taken into account in the future are the changes to the Criminal Code (linking the change in the limit of damage for the offence in Section 240 of the Criminal Code and the jurisdictions of police departments) and the expected change in the structure of the Customs Administration of the Czech Republic, which will affect the mutual cooperation of the cooperating authorities in the fight against tax evasion.

6.2 Rationalisation of General Government Expenditure

6.2.1 Medium-term Joint Procurement in the EU for Gas

In February 2024, under AggregateEU, the platform for joint gas purchasing, the EC launched the first medium-term tender for joint gas purchasing. Buyers can request it for multiple six-month periods between April 2024 and October 2029. The platform is intended to aggregate demand and coordinate gas purchases at European level. The purpose is to ensure greater diversification, security and coordination of energy supply in the EU and, as a consequence, minimise costs (EC, 2024a).

The first gas tender, which closed on 28 February 2024, attracted bids for a total volume of 97.4 billion m^3 of gas. Through the mechanism described above, the EC accumulated 34 billion m^3 of gas in the penultimate week of February, i.e. at almost three times the demand level (EC, 2024b).

6.2.2 Public Procurement

The area of public procurement has undergone major changes with effect from 16 July 2023. The new **Act No. 166/2023 Coll.,** reduces the transaction costs of the whole process by reducing the administrative burden for both parties to the procedure. Contracting authorities are no longer obliged to comply with the principles of socially and environmentally responsible procurement and innovation unles this is appropriate given the nature and purpose of the contract. Previous legislation provided for this obligation in all cases where this was possible. This obligation does not apply to small-scale contracts. The rules on public procurement procedures concerning the requirements for documents proving qualification or guarantee documents which previously had to be submitted in original form, have also been relaxed. In the case of simplified sub-limited contracts, it is possible to prove the supplier's basic competence by means of an affidavit. The law allows, in the event of failure to send the notice of selection of the supplier in time within the tendering period, for the termination of the tendering procedure at the end of three months from the end of that period. In cases where the contracting authority is legally obliged to send the documentation for the procurement procedure or design contest to the Office for the Protection of Competition, this obligation is fulfilled in relation to documents and information even if the contracting authority provides the Office with access to them. The amendment also strengthens the rights of the participants in the procurement procedure. A participant in a procurement procedure may request in writing from the contracting authority the provision of anonymised numerical data from tenders after the deadline for submission of tenders. Despite the increase in the thresholds used to determine an above-the-limit public contract at EU level, the Czech Republic has seen a reduction in the thresholds from 1 January 2024 due to the impact of the strong koruna (see Communication from the Commission C/2023/902). The national limits for small-scale public procurement of supplies and services (CZK 2 million) and construction works (CZK 6 million) remain unchanged for the time being under the current legal regulation (MMR, 2024), but the Ministry of Regional Development is already preparing new national limits as part of the next forthcoming amendment to the Public Procurement Act.

6.2.3 State Property Control

Management of the state property is carried out through the Office for Government Representation in Property Affairs. The Office sells or leases state property, optimises the occupancy of administrative buildings to which state institutions paying elsewhere are moved. In addition, on 1 January 2024, i.e. the expiry of the 10-year period within which the owners or their heirs could claim their properties, the abandoned properties were transferred to the State on the basis of the provisions of the Civil Code.

The Office thus legally acquires a significant amount of real estate, estimated to be as many as 150,000 (UZSVM, 2023).

In 2023, the MF CR prepared a draft act amending Act No. 219/2000 Coll., on the Property of the Czech Republic and its Representation in Legal Relations, as amended, and some other acts. Among other things, the amendment aims to facilitate the process of transferring selected unnecessary immovable property of the state to local governments and to enable the transfer of selected unnecessary immovable property in a reciprocal direction. The amendment proposes the information obligation of the state on the forthcoming transfers of immovable property on the territory of the concerned local governments. In order to simplify and streamline the existing practice, the approval competence of transfers of tangible immovable property of the state is established exclusively with the MF CR. This does not apply, for example, to transfers of cultural monuments and other transfers of property subject to protection under special regulations, where the approval competence will continue to belong to the relevant department (the Ministry of Culture or the Ministry of the Environment). The Act is due to enter into force on 1 January 2025 (OVA No. 86/24).

6.2.4 State Ownership Policy and Strategic Companies

In 2020, the Government approved (Government Resolution No. 115/2020) the State Ownership Policy Strategy (MF CR, 2020), which is based on the Organisation for Economic Cooperation and Development Methodological Guidelines (2015). It defines the principles of the state's behaviour as an owner or co-owner of commercial companies or state-owned enterprises and ensures transparent and effective exercise of ownership rights. Following the adoption of the Strategy, a Report on the implementation of measures resulting from the State Ownership Strategy for the previous year is submitted to the Government by the end of May each year.

The report for 2022 (MF CR, 2023b) states that there has been a change in the division of the portfolio of companies with partial state ownership and state-owned enterprises. There are a total of 107 state-owned or co-owned entities, of which 58 are state-owned enterprises. In addition to the Report on the activities and results of strategic companies with partial state ownership, state-owned enterprises and national enterprises for the previous year is submitted by the end of October of the same year. The Report for 2022 (MF CR, 2023c) contains basic information (including the number of employees) and a set of financial indicators on 36 entities in which the State exercises ownership and founder rights through 7 ministries, namely the MF CR, the Ministry of Interior, the Ministry of Industry and Trade, the Ministry of Transport, the Ministry of Defence, the Ministry of Agriculture and the Ministry of Regional Development. In terms of legal form, there are 17 joint stock companies, 17 state-owned enterprises, one national enterprise and one state organisation. These entities, through their respective ministries, managed assets totalling CZK 1,603.12 billion and reported an aggregate profit after tax of CZK 67.22 billion. These strategic entities paid CZK 26.63 billion to the state budget in the particular year.

6.2.5 Digitalisation of Public Administration

Digital copies of the cards

In accordance with the Programme Declaration of the Government of the Czech Republic (Government Office, 2023), the **Act on the Right to Digital Services** (Act No. 1/2024 Coll.) was amended in January 2024, introducing the possibility of obtaining a digital copy of the identification card, which will serve the same purposes as a physical one. Every citizen is given the choice of using the former or the latter to prove the identity. The digital counterpart is intended for face-to-face, not remote, proof of identity. The law also aims to unify the treatment of different types of public documents which has been fragmented, illogical and consequently inefficient. The compulsory acceptance of proof of identity by means of a digital counterpart has a gradual onset according to the type of entity against which the identity is proven. As of 1 January 2024, it is possible to prove identity with a digital copy of the identification card only to central administrative authorities, with the exception of embassies. As of 1 July 2024 at the latest, it will be also possible to prove identity by means of this instrument to other public authorities and regions and municipalities with extended competence. Finally, as of 1 January 2025, all other entities that are required by law to verify identity by presenting an identification card must be able to verify identity by a digital copy of the cards. The legislation is necessary to deepen the digitalisation of public administration and to further rationalise and streamline its operation.

Digital transformation in the field of Czech legislation
In December 2023, the Ministry of the Interior introduced the **eSeL project**, which consists of the so-called eCollection and e-Legislation. The first component is the electronic Collection of Laws and International Treaties, which was launched on 1 January 2024. At the same time, the obligation for municipal and regional authorities to make the Collection of Laws available to the public in printed form was abolished, which could result in partial savings. Subsequently, from July 2024, the system for automated drafting of legislation (e-Legislation) will be gradually launched. Initially, e-Legislation will be available only for selected legal acts such as international treaties, decisions, communications, followed by a module for implementing legislation as of 1 October of the same year and finally, as of 1 January 2025, e-Legislation will also be available for laws, constitutional laws, legal measures of the Senate and findings of the Constitutional Court. In addition to financial savings, the new system aims to increase the accessibility, clarity and comprehensibility of the legislation in force, as well as to improve the quality, efficiency and transparency and automate the processes of its drafting. The eSeL project will link existing systems of institutions involved in the legislative process. These are primarily the information systems of the Government Office oDok and eKLEP, the system of the Chamber of Deputies and the Senate (MI CR, 2023).

6.2.6 Consolidation of Czech Public Expenditure

In an effort to reduce the general government deficits and thus slow down the rise of indebtedness, the government introduced a set of measures called the **"consolidation package"** in spring 2023. The legislative basis for the package is Act No. 349/2023 Coll., Amending Certain Acts in Connection with the Consolidation of Public Budgets, which was published in the Collection of Laws on 12 December 2023. The package brings a number of measures on the expenditure and revenue side with an aggregate accrual impact on public budgets of over CZK 137 billion, primarily spread over the years 2024 and 2025. On the expenditure side, the most significant contribution to overall savings will come from a reduction in the volume of funds paid out in the system of national subsidies, including the adjustment of national financing of EU projects to reduce the share of co-financing by the state budget by increasing the co-financing share of final beneficiaries. There will also be savings within the public administration itself, which include a 2% reduction in the volume of public administration salaries, slower growth in salaries of constitutional officials, but also a reduction in operational expenditure in ministries or a more efficient enforcement of judicial claims, reduction of physical offices of the financial and customs administration, etc. Compensation for temporary incapacity for work is also being tightened, the conditions for unemployment benefits are being changed due to the low unemployment rate, and support for housing savings account is being halved due to the loss of the original purpose of this instrument.

6.3 Composition of General Government Expenditure

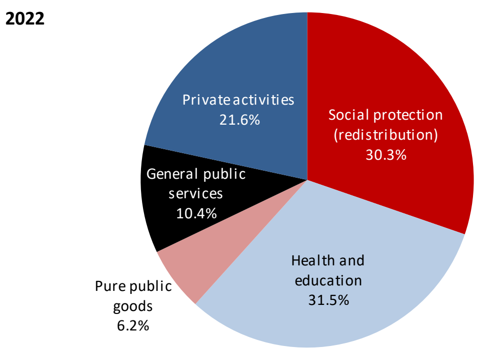
After the highest-ever annual growth of total general government expenditure in 2020 (by CZK 318.1 billion), the growth dynamics more than halved in the following year, and expenditure fell by 0.7 percentage points YoY in relation to GDP. The decline in the relative level of total expenditure continued in **2022** (by 1.9 percentage points YoY), but was driven by faster nominal GDP growth. In absolute terms, total expenditure increased by CZK 185.2 billion YoY and it was the **third largest increase in general government expenditure since 1995**. The increase was mainly driven by expenditure growth in three sections. The largest contribution to growth was in the Social Protection section (annual growth of CZK 82.2 billion), which accounted for almost 45% of the growth in total general government expenditure. Expenditure growth in this section was mainly due to an increase in cash social benefits in the OldAge group (by CZK 47.4 billion) as a result of pension indexation. The other major contributor to expenditure growth was General Public Services, driven by a YoY increase of C27.8 billion in interest expenditure on general government debt management. The third section was Education, in which the increase in expenditure was driven mainly by increases in compensation of employees in regional education (by CZK 7.9 billion) and intermediate consumption (by CZK 8.3 billion). Tertiary Education group also recorded a relatively large YoY increase in expenditure within this section (by CZK 5.1 billion), mainly due to an increase in compensation of employees (by CZK 1.9 billion). In contrast, there was an absolute YoY decrease in expenditure in the Economic Affairs section, mainly due to a decrease in subsidies (by around CZK 50 billion), especially non-investment transfers to business entities.

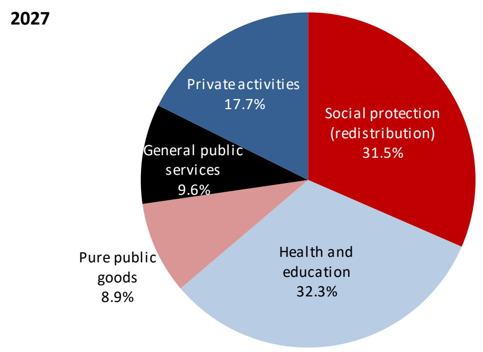
Over the outlook horizon, the downward trajectory of the total general government expenditure is projected, which should be 2.5 percentage points lower in 2027 compared to 2022. . The reduction in total expenditure is largely driven by a decline in expenditure in the Economic Affairs section, which will see a reduction in subsidies and other current and capital transfers. The expected increase in investment expenditure, primarily in the Transport group, will have the opposite effect over the outlook horizon. Despite the projected decline in total general government expenditure, there will be a significant increase in expenditure in the Defence section, by 1 percentage point, due to the approval of Act No. 177/2023 Coll., on the Financing of the Defence of the Czech Republic. The act requires the government to set defence expenditure at a level of at least 2% of nominal GDP for a given budget year in the draft act on state budget each year. Thus, total expenditure on pure public goods in the form of defence and public order and safety expenditure will amount to about 3.8% of GDP at the end of the forecast horizon. We also expect an increase in expenditure in the Education section, especially in the Primary and Secondary Education groups, due to the increase in compensation of employees in connection with the adoption of Act No. 183/2023 Coll. On the basis of this act, the total amount of funds earmarked for teachers' salaries in regional education is to correspond to at least 130% of the average gross monthly nominal wage per full-time equivalent teacher in the national economy.

The forecast also includes expenditure on science and research spent cross-sectionally in individual sections, taking into account the government's intentions according to the approved Innovation Strategy of the Czech Republic 2019–2030 (Government Resolution No. 104/2019). Graph 6.1 and Table 6.1 show the structure of general government expenditure by function in 2022 and its projected composition in 2027. We estimate that in 2027, more than half (51.8%) of total general government expenditure will be allocated on social security and provision of health care to the population (i.e. 21.8% of GDP).

Graph 6.1: Structure of General Government Expenditure, Divided by Function

in % of total expenditure





Note: The category "Pure public goods" includes "Defence" and "Public Order and Safety". The category "Private activities" is a sum of "Economic Affairs", "Environmental Protection", "Housing and Community Amenities", and "Recreation, Culture and Religion". For details see ECB (2009).
Source: CZSO (2024d). MF CR calculations and forecast.

Table 6.1: General Government Expenditure by Function

in % of GDP

	Code	2022	2027
General public services	1	4.7	4.1
Defence	2	1.0	2.0
Public order and safety	3	1.8	1.8
Economic affairs	4	6.8	5.2
Environmental protection	5	0.9	0.9
Housing and community amenities	6	0.7	0.4
Health	7	9.1	8.5
Recreation, culture and religion	8	1.4	1.0
Education	9	4.9	5.0
Social protection	10	13.5	13.3
Total expenditure	TE	44.6	42.1

Note: Year 2027 outlook.
Source: CZSO (2024d), MF CR (2024a). MF CR calculations and outlook.

7 Changes in the Institutional Framework of Fiscal Policy

In the medium and long term, the Czech Republic will make significant investments in view of its obligation to meet the EU's climate targets. In this context, the Government has approved several measures to support the development of strategic investments.

In order to strengthen the efficiency and transparency of public finances, a factual intention of the law on the management and control of public finances was approved. In the area of fiscal policy, the preparation of the new fiscal rules of the EU is being finalised.

7.1 Changes Related to Investment and the Capital Market

7.1.1 Recovery and Resilience Facility

The **Recovery and Resilience Facility**, which forms the core of the NextGenerationEU Instrument, contributes to the implementation of measures leading to the digital transformation of the economy and to the achievement of the EU's climate goals. The original allocation for the Czech Republic in the form of grants of CZK 176.3 billion has been increased by CZK 15.3 billion in 2023 in connection with the refinement of the allocation key based on the economic performance of the Czech Republic. In addition, the grant part was increased by CZK 17.4 billion by including the new EU REPower plan (including the so-called Brexit reserve of CZK 1.3 billion) to enhance energy savings, develop renewable energy sources and reduce dependence on fossil fuels from Russia. Last year, the government also decided (Government Resolution No. 613/2023) to use the loan part of the Recovery and Resilience Facility, approving the adoption of a loan of CZK 19.4 billion. The loan has a maturity of 30 years from the date of the tranche, with interest-only repayments for the first 10 years. The loan will finance investments in affordable housing (CZK 8.4 billion), digitisation (CZK 8 billion) and chip development (CZK 3 billion). The Czech Republic can draw on the Recovery and Resilience Facility in nine tranches, having so far received EUR 1.1 billion in 13% pre-financing and two tranches totalling EUR 1.6 billion.

7.1.2 EU ETS 2 and the Social Climate Fund

With a view to achieving climate neutrality in 2050, an amendment to Directive 2003/87/EC of the European Parliament and of the Council (EU) was approved last year, introducing, among other things, the so-called EU ETS 2, which extends the emissions trading system to the buildings and road transport sectors. The aim of this amendment is to reduce emissions in the newly included sectors by 43% by 2030 compared to 2005 levels. The phasing out of allowances through ETS 2 will start in 2028 for emissions from 2027. A **Social Climate Fund** (Regulation (EU) 2023/955 of the European Parliament and of the Council) **has been established** to address the socio-economic impacts on households, micro-enterprises and transport users related to the inclusion of the new sectors in the emissions trading system, which will be financed from the proceeds of emission allowances (ETS 1 proceeds will be used for pre-financing, and in subsequent years only ETS 2 proceeds). The total allocation of the fund is EUR 65 billion, with **CZK 50 billion reserved for the Czech Republic**. The fund can support investments in the renovation and decarbonisation of buildings, incentives for the use of public, sustainable, low- or zero-emission transport or information, education and advisory services in the field of energy in the period 2026–2032. Individual measures and investments will have to be set out in a so-called Social Climate Plan, which Member States will be required to prepare and submit to the EC by the end of June 2025.

7.1.3 Modernisation Fund Revision

In connection with the update of Directive 2003/87/EC of the European Parliament and of the Council (EU) regarding the trading of emission allowances, the need to increase the share of renewable sources and the level of energy savings on the basis of the revised National Energy and Climate Plan of the Czech Republic (Government Resolution No. 784/2023) or the change in the economic and geopolitical situation in Europe, the Government approved last year (Government Resolution No. 981/2023) **an update of** the programme document of the **Modernisation Fund**, which provides for a revised **total allocation of the Fund of CZK 500 billion**. Within the total allocation, the allocation structure of individual programmes has been changed. In the coming years, more funds will be directed to the modernisation of power plants and heating plants (the allocation of the HEAT programme has increased to CZK 100 billion), modernisation of energy-intensive industry (the allocation of the ENERG ETS sub-programme has increased to CZK 80 billion), energy savings of households and public buildings (in total, the allocation has increased to CZK 90 billion), building renewable energy sources for municipalities and companies (the allocation of the RES+ programme has increased to CZK 100 billion) and community energy (CZK 14 billion). There will also be increased support for public and commercial transport (CZK 50 billion), new support for the modernisation of public networks through the ELEGRID sub-programme (CZK 20 billion) under the SMARTNET programme (CZK 27 billion), green gases (CZK 15 billion) and, under the new I+ programme, projects supported by the Innovation Fund and projects that go beyond the individual Modernisation Fund programmes (CZK 10 billion).

7.1.4 Strategic Investments Support

In order to **accelerate the construction of strategic investments in the field of nuclear energy and transport infrastructure** or to facilitate the opening of deposits and the extraction of critical raw materials, Act No. 465/2023 Coll. was approved, which, among other things, amends Act No. 416/2009 Coll. (so-called Line Act). The amendment, effective from 1 January 2024, creates conditions for faster processing of appeals for constructions within the scope of the Line Act. In the area of transport infrastructure, for example, the construction of high-speed lines is facilitated by anchoring them in the Subdivisional Territorial Development Plan in the territory of the whole country, thus avoiding possible conflicts with other constructions or interests across the country, while the rights of local governments are not compromised in any way. It also simplifies and speeds up the preparation and permitting of the construction of refuelling infrastructure in line with developments in the field of clean mobility. In the field of nuclear energy, the authorisation procedure is simplified to speed up the construction of nuclear power plants by removing unjustified time extensions. Furthermore, it is possible to finance the construction of nuclear units through a *Contract for Difference* (a form of compensation between the State and the investor) or to introduce a safety net to prevent the conclusion of a contract with a supplier from a geopolitically unstable environment.

Due to the lack of systematic support for the development of investment locations and the disproportionately long time it takes to prepare and build a larger industrial complex to a state of infrastructure readiness, the government approved this year (Government Resolution No. 64) the establishment of a joint stock company, the State Investment and Development Company, of which the state, exercising its rights through the Ministry of Industry and Trade, is a 100% shareholder. The main objective of the new company is the maximum coordinated preparation of areas and initiation of selected locations to a condition of basic technical and design readiness for the construction of production units according to modern sustainable parameters, which would lead to the activation of private capital and shorten the time of implementation of strategic investments. This will significantly strengthen the competitiveness of the Czech Republic in the cross-border competition for the type of differential investments with higher value added. The company's activities will focus on larger development areas and systematically remove obstacles to their development, proactively seek consensus over land use with the affected municipalities and regions, and intensively prepare the area so that the negative state of the permitting process and the lack of surrounding infrastructure will be eliminated as much as possible in the event of the arrival of a strategic investor. Together with other instruments (e.g. the Just Transition Fund), it should also contribute to the faster development of "coal" regions or sites undergoing a revitalisation process after the removal of historical burdens.

In order to support significant **investments in transport infrastructure**, last year the Government (Government Resolution No. 577/2023) approved the involvement of a private entity **in the form of a PPP project** in two investments for the modernisation and construction of railway lines (Prague-Veleslavín – Prague-Václav Havel Airport (– Kladno) and Nemanice I – Ševětín) with total investment costs in current prices amounting to almost CZK 50 billion. Feasibility studies for both projects confirmed the advantage of their implementation in this form of financing. In addition, preparation of feasibility studies for other PPP projects on the motorway and railway network will be launched. These include the completion of the Central Bohemian D3, the southern part of the D55, the northern parts of the Prague ring road and some sections of high-speed railway lines.

7.1.5 Investments from the European Investment Bank

In October 2023, a loan **agreement** was signed between the Czech Republic (represented by the MF CR) and the European Investment Bank in the amount of EUR 992 million (approx. CZK 24 billion) **to finance the modernisation of the railway network.** Through the Railway Administration Company, investments totalling CZK 97.5 billion will be supported for the modernisation and retrofitting of the railway lines of the Trans-European Networks (TEN-T) in the Czech Republic and the introduction of the European Rail Traffic Management System (ERTMS). The terms of this financing method are more favourable in terms of interest expenses (an annual saving of CZK 100 million is estimated) than standard debt financing by issuing government bonds.

The European Investment Bank will also participate in **affordable rental housing projects** that meet quality, energy efficiency and affordability criteria, based on a cooperation agreement signed in February 2024 between the MF CR, the Ministry of Regional Development and the European Investment Bank. In the first phase, the agreement will provide a detailed analysis of the housing market in the Czech Republic and help prepare a strategy for the development of its affordable segment. It will also identify potential housing construction and reconstruction projects. Following this, it will prepare suitable financing options, including possible contributions from other international partners and private sources.

7.1.6 Investment Incentives Changes

With effect from 13 January 2024, applications for investment incentives are newly approved (Act No. 426/2023 Coll.) by the Ministry of Industry and Trade. The Ministry, in cooperation with other relevant ministries, assesses compliance with the conditions and obligations set out in the Act and other legislation and issues a decision based on this information. The initial approval of each project by the government led to delays and unpredictability of the whole process for investors. In the case of so-called strategic investment projects, where part of the investment incentives are drawn in the form of material support, the approval of applications is left to the government. The amendment also allows for the use of different EU regulations for the approval of large projects above EUR 110 million than was the case before. This gives the possibility to use special rules, for example, to support key investments important for the transformation of the European economy, just within the framework of the Investment Incentives Act. In connection with the change in European legislation, the Government Regulation on the permissible level of public support in the regions in the sense of cohesion policy (Government Regulation No. 335/2023 Coll.) was also amended. As a result of inflation, the threshold for notifying projects to the EC increased by 10% to EUR 110 million as of 1 January 2024. The threshold for large investment projects has also increased by the same amount, to EUR 55 million. There is also a new explicit maximum amount of public aid in relation to a cohesion region and a regional aid rate to be applied when eligible costs exceed EUR 110 million. Projects whose investment exceeds the EUR 110 million threshold are thus subject to individual approval by the EC.

7.1.7 Development of Czech Capital Markets

In accordance with the Concept of Capital Market Development in the Czech Republic 2019–2023 (MF CR, 2019), Act No. 462/2023 Coll. was approved, which amends several laws in the area of the financial market and old-age support. Its aim is to increase the motivation of the population to build up savings for old age and at the same time to involve their savings in investments on the capital market. Thus, with effect from 1 January 2024, a so-called long-term investment product (amendment to Act No. 256/2004 Coll., on Capital Market Business) was introduced, which is a comprehensive term for investment or savings products that help provide security for old age. The provider of this product is, for example, a bank, credit union or securities dealer, and must be registered in the list of long-term investment product providers maintained by the CNB. The long-term investment product may contain cash (in the form of savings accounts or fixed-term deposits), shares and bonds, unit-linked certificates and interest rate or currency derivatives. A tax deduction of up to an aggregate amount of CZK 48,000 can be claimed for the amount invested. The withdrawal of funds does not take place earlier than 10 years after the long-term investment product was created and before the taxpayer reaches the age of 60. Furthermore, the possibility for employers to contribute up to CZK 50,000 to investments in a long-term investment product or to life insurance and retirement savings has been introduced. The contribution is exempt from social security contributions. The aggregate tax deduction (CZK 48,000) can now also be used in combination with both existing old-age products (life insurance with a savings component or supplementary pension savings) and long-term care insurance. Thanks to the amendment to Act No. 586/1992 Coll., on Income Taxes, the client is able to arrange this tax-supported product in the event of an insured event in the form of his/her dependence (or that of a close person) on the assistance of another natural person in managing the basic needs of life due to a long-term adverse health condition (III or IV degree of dependence according to Act No. 108/2006 Coll., on Social Services).

Thanks to the amendment to Act No. 427/2011 Coll., on Supplementary Pension Savings (Act No. 462/2023 Coll.), the **motivation of persons to make higher contributions to pension funds** will **be strengthened**. With effect from 1 July 2024, the lower limit of a participant's monthly contribution will be increased to CZK 500 to reach the lowest state contribution (CZK 100). The amount of the state contribution will be linear at 20% of the participant's contribution, with the maximum state contribution increasing to CZK 340. The maximum state contribution corresponds to a monthly contribution of CZK 1,700 by the participant; from this amount tax deductions can also be claimed. The amendment also introduces an **alternative participatory fund** in Pillar III as an alternative to the existing participatory funds with a dynamic investment strategy. The fee policy and investment strategy of this fund are more freely set. This allows for more dynamic investments in riskier products with the potential for higher yield (e.g. securities, commodity derivatives, real estate, intellectual property rights, public infrastructure under the Building Act, etc.).

7.2 Increasing Efficiency and Transparency of Public Finances

7.2.1 Open Public Administration Data

The basic legal framework for open data in the Czech Republic is Act No. 106/1999 Coll., on free access to information. Based on its amendment by Act No. 241/2022 Coll. in order to increase the transparency of public finances, with effect from 1 January 2024, the Central Register of Annual Reports in the area of information provision was established. The register, which is administered by the Ministry of the Interior, is publicly accessible free of charge and without restriction in a manner allowing remote access. It serves entities that are obliged to publish annual reports on their activities as an alternative to the current method of processing and publishing the annual report (usually by placing it on the entity's website).

7.2.2 Public Finance Management and Control

In February 2024, the Government approved the **Substantive Intention of the Law on the Management and Control of Public Finances**, which aims to legislate a greater degree of protection of public funds (Government Resolution No. 115/2024). The intention of the law focuses on setting more explicit rights and enforceable obligations in financial control and streamlining existing procedures. This includes, for example, more clearly defined duties and responsibilities of the head of the public administration authorities and officials within the framework of management control, adjusting the requirements for establishing an internal audit unit and defining its position within the organisation, setting procedural processes, or specifying the activities of public audit and the scope of its use. At the same time, it makes recommendations to improve coordination and cooperation between control authorities by imposing a legal obligation to coordinate control plans through the information system managed by the MF CR for all control authorities carrying out control of public financial support (including local governments, The Office for the Protection of Competition and financial administration authorities) and enshrining the principle of a unified audit directly in the Act on Management and Control of Public Finances. In order to improve the quality of the annual reports on the results of financial audits submitted by the MF CR to the Government in accordance with Section 22 of the Act on Financial Control, it proposes to streamline data collection by reducing marginal reports. It also recommends that the annual report on the results of financial audits should be submitted only by organisations where internal audit will be compulsorily established by law.

7.2.3 Single Portal for Recording Controls

In September 2023, the Government approved the project of the Unified Portal of Inspection Records – Calendar of Planned Inspections (Government Resolution No. 709/2023) in order to streamline the activities of the control authorities. Its aim is to create an application that will enable the sharing of dates and results of inspections between the control authorities carrying out inspection activities in relation to business entities (45 control authorities are expected to be involved). At the same time, it will be possible to provide basic information on planned inspections to businesses in a transparent and individualised manner, without compromising the purpose of the inspection. The application should be linked to the Entrepreneur Portal, which is also gradually being developed. The implementation of the project is financially supported by the National Recovery Plan.

7.2.4 Legal Regulation of Lobbying

In March 2024, the Government approved (Chamber of Deputies Print No. 649 and 650) the Lobbying Regulation Bill and the related amendment bill. The aim of the laws is to establish transparent rules for lobbying activities and reduce the threat of clientelism, conflict of interest or corruption. The new law would establish a lobbying register, laying the basis for establishing lobbying as a legitimate activity. The register would record both lobbyists and those being lobbied, and would also record information on changes to draft legislation based on lobbyists' proposals or requests. The legal environment for lobbying is linked to the reforms contained in the National Recovery Plan.

7.3 Budgetary Policy

7.3.1 EU Fiscal Framework Reform

In the context of new insights gained from recent economic crises, and also in the context of higher levels of national debt, the EC issued a proposal in April 2023 for a set of measures with the primary objective of strengthening debt sustainability and promoting sustainable, inclusive growth through reforms and investment. The reform is based on a medium-term approach and aims at a gradual and credible debt reduction through prudent fiscal policy supported by growth-enhancing investment as well as reforms implemented in line with EU priorities, reinforced principles of national ownership based on common EU rules, and improved enforceability, which should also be achieved through simpler rules reflecting different fiscal challenges. The package consists of three proposals for regulations. These are a proposal for a new regulation on effective economic policy coordination and multilateral budgetary surveillance, which will repeal the original Council Regulation (EC) No. 1466/97, an amendment to Regulation (EC) No. 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure and an amendment to Directive 2011/85/EU on Requirements for Budgetary Frameworks of the Member States (EC, 2024c). The cornerstone of the reform package are medium-term national fiscal and structural plans, of which the so-called adjusted net expenditure path is an essential component.

Over a specified period (four to seven years), the debt should credibly decline, or at least remain at a prudent level. Deviations from the country-specific net expenditure path will be recorded in the control account. The target maximum level for the general government deficit-to-GDP ratio is 3% of GDP and for the general government debt ratio remains 60%. The duration of the fiscal adjustment will be extendable to a maximum of seven years, provided that this period is filled with specific reforms and investments. These should support growth and resilience, fiscal sustainability, common EU priorities (e.g. the Green Deal, the Strategic Compass for Security and Defence, the digital transition, etc.) and reflect the country specific recommendations imposed on individual Member States. Similarly, it should ensure that the overall level of nationally financed public investment over the lifetime of the plan is higher than the medium-term level before the plan period. At the same time, Member States should report to the EC on progress in implementing the expenditure rule. In practical terms, the reform under the European Semester will also take the form of replacing the National Reform Programme and the CP with the aforementioned medium-term fiscal and structural plan (EC, 2024c; MF CR and CNB, 2024).

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Annex: Convergence

The economic level of the Czech Republic, expressed in terms of gross domestic product per capita in current purchasing power parity, was 9% lower than in the EU and 21% lower than in Germany in 2023. Although the economic level of the Czech Republic was rapidly approaching the EU average between 2000 and 2008 due to strong economic growth, the convergence process then stalled by 2013 due to recessions and only a moderate recovery. Subsequently, however, the Czech Republic started to slowly converge towards the EU average again until 2020, when the world was paralysed by the coronavirus pandemic, a synchronised decline in economic activity occurred and convergence stopped again (see Graph A.1). In the context of the lingering effects of the pandemic and the Russian aggression against Ukraine, which led to a sharp increase in prices and tighter monetary policy, we expect that the convergence process could resume only after 2024.

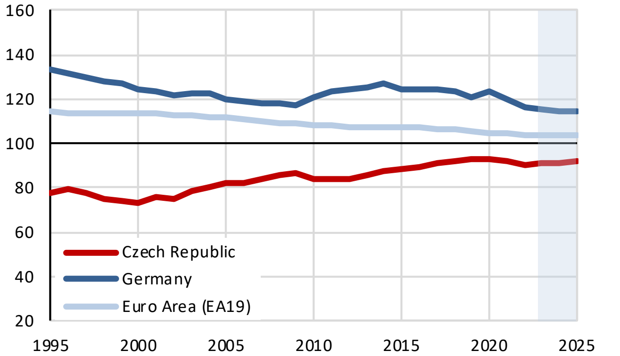
The comparative price level of the Czech Republic has been exhibiting an increasing trend since 1995. During 2013 and 2014, the CNB's exchange rate commitment and the related depreciation of the koruna against the euro resulted in its decline, and in 2014 it even fell to the 2006 level. Since 2015, however, it has gradually risen again (see Graph A.2). In 2022 and 2023, due to faster price growth in the Czech Republic and the appreciation of the koruna, the comparative price level increased more significantly to 84% of the EU average. This year, with a small inflation differential, it could fall to 80% of the EU average due to the koruna depreciation.

Owing to the depreciation of the Czech currency and a slight decline in productivity in the Czech Republic, labour productivity per hour worked (see Graph A.3) in the Czech Republic could fall to 59% of the EU level this year. By contrast, it could rise to 61% of the EU average next year.

Wage convergence came to a temporary halt after 2008. Subsequently, the average wage in the private sector in the Czech Republic averaged around 46% of the EU level. In 2017–2019, due to the economic upturn and the increase in the minimum and guaranteed wages, this ratio started to increase again until 2020, when it decreased slightly. The tight labour market has contributed to an increase in the average nominal wage, which reached 62% of the EU average in 2023, or 74% in purchasing power parity terms.

Graph A.1: Relative Economic Level

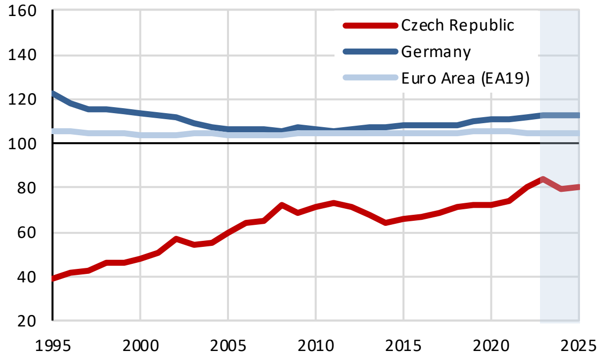
EU27=100, GDP per capita in current purchasing power parities



Source: CZSO (2024a), Eurostat (2024). MF CR calculations and forecast.

Graph A.2: Comparative Price Level

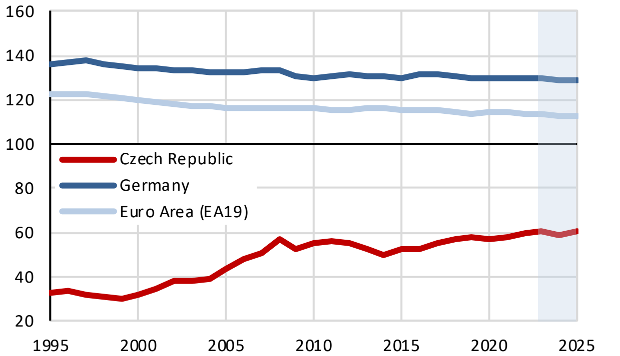
EU27=100



Source: CZSO (2024a), Eurostat (2024). MF CR calculations and forecast.

Graph A.3: Real Labour Productivity

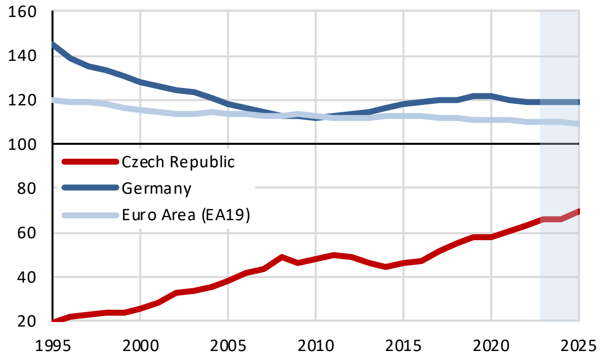
EU27=100, constant prices of 2010, per hour worked



Source: Eurostat (2024). MF CR and AMECO (2024) calculations and forecast.

Graph A.4: Average Compensation of Employee

EU27=100



Source: AMECO (2024), Eurostat (2024). MF CR calculations and forecast.

Glossary

Accrual methodology means that economic transactions are recorded at the time an economic value is created, transformed or cancelled or when receivables and liabilities increase or decrease, regardless of when the transaction will be paid (unlike the cash principle, which is the basis of, for example, the state budget).

Balance of payments captures economic transactions between residents and non-residents for a given territory in a certain period of time. The basic structure of the balance of payments is based on the methodology of the International Monetary Fund and includes the current, capital and financial accounts (including changes in foreign-exchange reserves).

Capital transfers include acquisition or loss of an asset without equivalent consideration. They may be made in cash or in kind. **Capital transfer in cash** is defined as cash transfer without expected consideration from the unit which received the transfer. **Capital transfer in kind** is based on the transfer of ownership of an asset (other than inventory and cash) or decommitment by a creditor for which no consideration, assumption of debt, etc. was received.

Comparative price level is the ratio of the GDP at market exchange rate to the GDP in purchasing power parity.

Consumer price index is one of the indexes measuring the price level. It is constructed on the basis of regular monitoring of the prices of selected goods and services (so-called representatives) in the consumption basket of households. Each representative has a certain weight. The consumption basket is divided into 12 categories (e.g. food and non-alcoholic beverages; alcoholic beverages, tobacco; clothing and footwear; housing, water, electricity and fuel; etc.). **Harmonised index of consumer prices** is calculated in EU countries according to uniform and legally binding procedures, which (unlike national indexes) allows for comparability of this indicator among countries.

Cyclically adjusted balance of the general government sector is used to identify the fiscal policy stance because it does not include the impact of those parts of revenues and expenditures which are generated by the position of the economy in the business cycle.

The **debt rule of the national fiscal framework** activates legally defined measures if the relative government debt ratio (minus the cash reserve of government debt financing) exceeds 55% of GDP. These measures set out the conditions for the preparation of budget drafts for individual segments of the general government sector (state budget, budgets of the state funds, health insurance plans of health insurance companies and budgets of local governments) and other public institutions limit new liabilities leading to an increase in the general government debt with a maturity of more than 1 year.

Dependency rate (demographic) is the ratio of the senior-age population (over 64 years old) to the working-age population – it thus does not reflect retirement age extending. **Dependency rate according to the applicable legislation** is the ratio of the retirement-age population according to the applicable legislation to the number of other inhabitants over 14 years of age. **Effective dependency rate** refers to the ratio of the number of old-age pensions paid to the number of employees.

Discretionary measures represent direct interventions of executive or legislative authorities in general government revenue and expenditure.

The **expenditure rule of the national fiscal framework** serves as the basis for the preparation of the draft of the state budget and the budgets of state funds. The rule derives the maximum amount of government sector expenditure from the structural part of the government sector revenue increased by 1% of GDP. This increase represents the established medium-term budgetary objective of the Czech Republic. The rule is supplemented by an automatic correction mechanism reflecting in retrospective the gap between the actual level of expenditure and the expenditure prescribed by the rule, and is accompanied by precisely defined escape clauses under Act No. 23/2017 Coll., on fiscal responsibility rules.

The **expenditure rule of the Stability and Growth Pact** limits the growth of adjusted real expenditure of general government sector adjusted by discretionary revenue measures (so-called adjusted expenditure), thus the given member state shall reach the medium-term budgetary objective and would follow it henceforward. The adjusted expenditure of countries which meet their medium-term budgetary objective shall grow at most by the average rate of growth of the potential output calculated in 10-year horizon containing 5 past years, the current year and 4 following years. The average rate of the potential output growth is updated annually, based on the Spring European Economic Forecast with the validity period for the following year. For countries which have not yet reached their medium-term budgetary objective, the highest acceptable rate of adjusted expenditure growth is lower than the average growth of the potential output. The difference between the two rates is referred to as the convergence margin, which reflects the fiscal effort required for the gradual achievement of the medium-term budgetary objective.

Fiscal impulse is used to assess the impact of government fiscal policy on economic growth. Unlike the primary fiscal effort, it does not include revenues from EU funds and expenditures to the EU budget, and on the contrary, it includes certain one-off operations (usually government measures with a direct fiscal impact).

Fiscal effort is a year-on-year change in the structural balance indicating expansive of restrictive setting of the fiscal policy in a given year.

Fiscal sustainability indicators, based on long-term projections, characterise the sustainability of public finances and the extent of the changes necessary to attain it. The EC uses three main indicators. **Indicator S0** consists of 28 macro-financial and fiscal indicators and indicates fiscal risks for the coming year. **Indicator S1** indicates by how many percent of GDP the primary structural balance must be improved in the medium term for next 5 years to make the general government sector debt reach 60% of GDP in 2030. **Indicator S2** enumerates by how many percent of GDP the primary structural balance must be permanently improved to make the general government debt remain stable in an infinite time horizon (i.e. the current value of future primary balances to be equal to the current general government debt).

The **general government sector** is defined by internationally harmonised rules of the EU. In the Czech Republic, it includes, in the ESA 2010 methodology, three main subsectors: central government, local government and social security funds.

Government Deficit and Debt Notification is the quantification of fiscal indicators submitted by each EU member state twice a year to the EC under Council Regulation (EC) No. 479/2009 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community, as amended. It is compiled for the general government sector using the accrual methodology. The Czech Statistical Office processes the data for the past four years and MF CR prepares the prediction for the current year. The notification contains both a basic set of notification tables, including key indicators such as balance and debt, with an explanation of the transition from the balance in the national methodology to the accrual balance and contributions to the change in debt, as well as a number of supplementary questionnaires, such as the guarantee table.

Government final consumption expenditure includes government payments which are subsequently used for consumption of individuals in the household sector (mainly reimbursement of health care by health insurance companies for services provided by medical facilities) or are consumed by the entire society (such as expenditure on army, police, judiciary, state administration, etc.). General government services, provided for consumption to the entire society, are usually valued at the level of own costs for a given service because they do not pass through a market which would value them. For the above reasons, consumption consists mainly of intermediate consumption (i.e. goods and services, excluding fixed assets consumed in the production of other goods or services), compensation to employees (wages and salaries including the part of social security contributions paid by employers), social transfers in kind to households (in particular payments by health facilities outside the general government sector) or consumption of the fixed capital. The value calculated is not the entire value of these transactions but only the value associated with the production valued at own costs. The costs associated with the production of activities which pass a market fully or partly and for which the general government sector receives payment are excluded from its consumption.

Gross fixed capital formation represents the investment activities of units. Fixed capital is represented just by assets used in production for more than one year. It also includes for example military equipment, expenditure on research and development, etc.

Gross domestic product (GDP) is the monetary expression of the total value of goods and services newly created in a given period in a given territory. **Real GDP** is the gross domestic product, expressed in the prices of the reference year. This transformation enables, in analysing GDP (or other variables), to eliminate the impact of price changes over time and to focus only on the changes in physical volume. **Gross value added** represents the difference between the value of production and intermediate consumption (production consumed in the production of other goods or services).

Inflation is a sustained growth in the general price level, i.e., internal currency depreciation. The price level is measured using price indices, such as the consumer price index or the harmonised index of consumer prices. The most commonly mentioned **year-on-year inflation rate** is the relative change in the consumer price index compared to the same month of the previous year. The **average inflation rate** is the relative change in the average of the consumer price index in the last 12 months compared to the average of the consumer price index in the previous 12 months. Inflation rates are expressed as a percentage. By **administrative measures on consumer prices** are meant state measures that directly affect the price level. They include the effect of changes in indirect taxes (value-added tax, excise and energy taxes) and regulated prices (e.g. electricity, gas, heat, water and sewerage, public urban transport).

Long-term interest rates are measured on the basis of yields of long-term government bonds or comparable securities until maturity in percent per year. Bonds with residual maturity ranging from 8 to 12 years (the use of these limits is fully based on the conditions of the Czech government bond market, which were set based on the periodicity of Czech government bond issues) are classified as representative. From this set, a combination of bonds whose average residual maturity is closest to the 10-year limit is then generated.

Medium-Term Budgetary Objective is expressed in the structural balance of general government sector and should ensure the sustainability of public finance of the given country. It reflects both the growth potential of the country and its level of indebtedness. Compliance with the medium-term objectives should allow Member States to maintain sufficient reserves of −3% of the GDP against the reference value of the balance of general government sector during common cyclical fluctuations, to secure the progressive steps towards sustainability and ensure space for any necessary budgetary operations. The procedure for its calculation is determined by the Code of Conduct (EFC, 2017). For the Czech Republic it currently corresponds to the level of structural balance of −0.75% of GDP and is revised every three years.

One-off and other temporary measures are revenue or expenditure measures that only have a temporary impact on the general government balance and often stem from events outside the direct control of executive or legislative authorities (e.g. flood relief expenditure).

Output gap is the difference between real and potential output measured in percent of potential output. It serves to identify the position of the economy in the cycle.

Potential output is the level of economic output in the "full" utilisation of available resources. Full utilisation of resources is meant here rather as optimal and balanced, which does not lead to pressures such as changes in the inflation dynamics, etc.

Short-term interest rate is in the Czech Republic represented by PRIBOR 3M, as the reference value for the interest rate indicating the average rate, for which banks can borrow on the market for interbank deposits with a maturity of three months.

Using the **purchasing power parity** method, comparison of the economic performance of individual countries within the EU is carried out in Purchasing Power Standards, which is an artificial currency unit that expresses a quantity of goods that can be purchased on average for 1 euro in the EU after currency conversion for countries using a different currency unit than the euro.

Social benefits in cash are social benefits (e.g., pension insurance benefits, state social security benefits) paid to households from the general government sector.

Structural balance is the difference between cyclically adjusted balance, and one-off and temporary measures (for both components see above). **Primary structural balance** is further adjusted for interest payments.

Unemployment (Labour Force Sample Survey) corresponds to the number of persons who simultaneously met three conditions in the reference period (reference week): they were not employed, actively sought work and were ready to take up work within 14 days at the latest. **Unemployment rate** expresses the ratio of the number of the unemployed and the labour force. A person unemployed for more than 12 months is considered **long-term unemployed**.

Ministry of Finance of the Czech Republic
Letenská 15
118 10 Prague 1

http://www.mfcr.cz

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