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Recommendation for a

COUNCIL RECOMMENDATION TO THE CZECH REPUBLIC

with a view to bringing an end to the situation of an excessive government deficit

Application of Article 104(7) of the Treaty

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. BACKGROUND

On the basis of the Commission services' spring 2004 economic forecasts[1], which revealed a deficit of 12.9% of GDP for 2003 (5.9% of GDP excluding a major one-off operation related to imputed state guarantees)[2], the Commission initiated the excessive deficit procedure for the Czech Republic with a report in accordance with Article 104(3)[3]. In May 2004, the Czech Republic submitted its first convergence programme, covering the period 2004-2007, and, based on a Commission recommendation, the Council adopted an opinion on it on 5 July 2004[4]. At the same time, the Council decided, on the basis of a Commission recommendation in conformity with Article 104(6) that the Czech Republic had an excessive deficit[5] and consequently, pursuant to Article 104(7), issued a recommendation to the Czech authorities for its correction, also on the basis of a Commission recommendation[6]. In this recommendation, the Council recommended the Czech authorities "*to put an end to the present excessive deficit situation as rapidly as possible*" and "*to take action in a medium-term framework in order to achieve their objective of bringing the deficit below 3% of GDP by 2008 in a credible and sustainable manner, in accordance with the path for deficit reduction specified in the Council Opinion of 5 July 2004 on the convergence programme submitted in May 2004*" with the following intermediate annual targets: 5.3% of GDP in 2004, 4.7% of GDP in 2005, 3.8% of GDP in 2006 and 3.3% of GDP in 2007.

The Czech authorities were also recommended to "*implement with vigour the measures envisaged in the May 2004 convergence programme, in particular a cut in the wage bill of central government and a reduction in spending of individual ministries*". Further, they were invited to "*allocate higher-than-budgeted revenues to deficit reduction; introduce fiscal targeting based on medium-term expenditure ceilings and to design effective rules to reduce the risk of increasing indebtedness of regions and municipalities; undertake the reform of the pension and healthcare systems to improve the long-term sustainability of the public finances; minimise the negative budgetary impact of the operations of the Czech Consolidation Agency.*"

The Council also established the deadline of 5 November 2004 to take effective action regarding the measures envisaged to achieve the 2005 deficit target. After the expiry of this deadline, the Commission concluded, in its Communication to the Council of 14 December 2004, that the Czech Republic had taken effective action regarding the measures envisaged to achieve the 2005 deficit target and hence no further steps under the EDP were required[7]. In its meeting of 18 January 2005, the Council concurred with this assessment.

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1 The Commission services' spring 2004 economic forecast took into consideration data reported by the Czech Republic in March 2004.

2 In the meantime, the deficit figure for 2003 has been revised, according to the usual procedures. It now stands at 6.6% of GDP.

3 SEC(2004) 575.

4 OJ C 320, 24.12.2004, p. 1.

5 OJ L 62, 9.3.2005, p. 20.

6 See http://register.consilium.eu.int/pdf/en/04/st11/st11215.en04.pdf.

7 Communication from the Commission to the Council: The action taken by the Czech Republic, Cyprus, Malta, Poland and Slovakia in response to the Council recommendations under the excessive deficit procedure, SEC(2004) 1630, 22.12.2004.

The Council recommendation under Article 104(7) specified that the deficit had to be brought below 3% of GDP by 2008 but did not contain a quantified target for 2008. This is because the May 2004 convergence programme, to which the Council made reference in its recommendation, covered the period until 2007. The November 2005 update of the convergence programme, which extended the programme period to 2008, set a deficit target for 2008 of 2.7% of GDP. In its opinion on this programme, the Council noted that the programme followed the deficit adjustment path set by the Council recommendations under Article 104(7)[8]. It invited the Czech Republic to " (i) *strengthen, in the context of possible better budgetary outcome in 2005 as well as strong growth outcome and prospects, the effort in the structural budgetary adjustment, in view of the small margin below the reference value targeted for 2008 (which is the deadline for the correction of the excessive deficit) and in order to speed up the attainment of the MTO* [i.e. the medium-term objective for the budgetary position, defined as a structural deficit of 1% of GDP for the Czech Republic]*; (ii) enhance the quality of budgetary planning, in particular by analysing causes of significant expenditure carryovers and reinforcing the medium-term expenditure ceilings; (iii) improve the long-term sustainability of the public finances, in particular by accelerating the pension reform and undertaking the reform of the healthcare system".*

On 15 March 2007, the Czech Republic submitted the most recent update of the convergence programme, for the period 2006-2009. The March 2007 update of the convergence programme contained the following annual deficit projections: 4.0% of GDP for 2007, 3.5% of GDP for 2008 and 3.2% of GDP for 2009. The deficit targets for 2007-2008 were the same as those contained in the budget for 2007, which was approved by parliament on 13 December 2006. The programme also included an additional "declaration of the new government" aiming at implementing a wide range of revenue and expenditure measures ("stabilisation package") with an estimated deficit-reducing effect of 0.3% of GDP in 2008, thereby reducing the general government deficit to 3.2% of GDP in 2008 (and 2.8% of GDP in 2009). The estimate of the deficit-reducing effect in 2008 seems to be plausible, although considerable uncertainties remain, in particular given the scale of tax reforms. Corresponding measures were approved by the lower house of parliament on 21 August 2007. Their deficit-reducing effect is projected to be expenditure-based and expenditure measures consist mainly of cuts in the social area and reductions in the wage bill. The package also contains corporate and personal income tax cuts (including the introduction of a flat personal income tax rate of 15%). These tax cuts are projected to be fully compensated by VAT increases only in 2008 but deficit-increasing thereafter. Even after the adoption of the stabilisation package, a delay in achieving the medium-term objective (MTO) for the budgetary position, originally targeted for 2012 is implied.

The Commission services' spring 2007 forecast projected that the deficit will reach 3.9% of GDP in 2007 and, on a no-policy change basis, 3.6% of GDP in 2008, indicating that the targets set in the Council recommendation under Article 104(7) for 2007 (3.3% of GDP) and 2008 (below 3% of GDP) will be missed. In structural terms (i.e. in cyclically-adjusted terms net of one-off and other temporary measures), the deficit is likely to widen by 1¼ percentage points of GDP in 2007, after deteriorations in both 2005 and 2006.

[8] OJ C 55, 7.3.2006, p. 5.

The debt to GDP ratio has remained at about 30% of GDP on average since 2000 and is anticipated to increase somewhat through the period covered by the March 2007 convergence programme, reaching 32.2% of GDP by 2009, which is broadly in line with the Commission services' spring 2007 forecasts. In the absence of measures to address the budgetary impact of ageing, the debt ratio is likely to increase significantly over the next decades.

The Commission services' forecast thus essentially concurs with the convergence programme projections, which are inconsistent with a correction of the excessive deficit by the 2008 deadline. In its opinion on the update, adopted on 10 July 2007, the Council concluded its assessment of the programme as follows: *"In spite of better growth prospects, and a lower deficit outcome in 2006 than anticipated, the programme postponed the correction of the excessive deficit until 2010, compared with the 2008 deadline set in the July 2004 Council recommendation under Article 104(7). Given the sustained growth, the postponement, which reflects the higher deficit due primarily to planned increases in social expenditure in 2007, would also result in a pro-cyclical expansionary stance of fiscal policy."*

The increased expenditure in the 2007 budget has resulted in the previously established medium-term expenditure framework being overshot. The higher 2007 deficit comes against much stronger predicted growth than forecast at the time of the July 2004 Council recommendation under Article 104(7) and is mainly due to increases in social spending decided by the previous parliament and confirmed by the new one in the adopted budget, without countervailing revenue or expenditure measures in other areas. The impact of this additional expenditure is estimated at over 1% of GDP in 2007. It also has to be noted that the higher 2007 deficit is projected to occur against the background of much lower deficits in the preceding years than foreseen in the Council recommendation under Article 104(7): deficit outcomes in 2004-2006 were on average more than 1 percentage point of GDP better than foreseen in the Council recommendation (for 2004: deficit outcome of 2.9% of GDP against Council target of 5.3%; for 2005: 3.6% of GDP compared to 4.7%; and for 2006: 2.9% of GDP compared to 3.8%). This was due mainly to better-than-expected growth rather than durable cuts in expenditure.

By consequence, the Council adopted a decision under Article 104(8) on 10 July 2007 stating that "*the action taken by the Czech Republic in response to the Council Recommendation of 5 July 2004 under Article 104(7) of the Treaty is proving to be inadequate to correct the excessive deficit within the deadline [2008] fixed by the Recommendation*". No unexpected adverse economic events with major unfavourable consequences for government finances as meant in Article 3(5) of Council Regulation (EC) No 1467/97 have occurred since the adoption of the recommendation. On the contrary, developments in the economy relevant for public finances have been significantly more favourable than expected.

2. RECOMMENDATION FOR A NEW COUNCIL RECOMMENDATION FOR THE CORRECTION OF THE EXCESSIVE DEFICIT UNDER ARTICLE 104(7)

According to the Treaty and the Stability and Growth Pact, a Council decision under Article 104(8) on inadequate action has to be followed by another Council recommendation under Article 104(7) given that the Czech Republic is not participating in the single currency and is therefore not subject to the next steps of the excessive deficit procedure (Article 104(9) and Article 104(11)).

According to Article 3(4) of Regulation (EC) No 1467/97, a recommendation made in accordance with Article 104(7) has to specify that effective action is to be taken by the Member State concerned within six months at most and that the correction of the excessive deficit should be completed in the year following its identification unless there are special circumstances. Special circumstances – namely, the size of the deficit and the ongoing structural shift in the economy – were considered to exist when the Council issued its July 2004 recommendation to the Czech Republic under Article 104(7), which allowed for a correction in a medium-term framework, namely by 2008. There is no reason to extend the deadline for the correction of the excessive deficit beyond 2008 given the following considerations:

(1) The deficit outturns in the period 2004-2006 were well below the targets underlying the July 2004 Council recommendation under Article 104(7), due mainly to better-than-expected growth. The March 2007 convergence programme was based on an outturn for 2006 substantially worse than the most recent indications (deficit of 3.5% of GDP compared to 2.9%).

(2) The principal reason for the postponement of the correction of the excessive deficit indicated in the March 2007 convergence programme is the expansionary budget of 2007, notably substantial increases in social expenditure without countervailing revenue or expenditure measures in other areas. These increases were approved on 13 December 2006 before the new government was confirmed on 19 January 2007. Without the expansionary budget for 2007, the deficit, which reached 2.9% of GDP in 2006, would remain below the 3% of GDP reference value.

(3) There is ample opportunity to correct the excessive deficit by the original 2008 deadline. In particular, there continues to be buoyant growth in the Czech economy, higher than anticipated at the time of the July 2004 Council recommendation, and the output gap is in positive territory, so that the country is enjoying 'good times'. Fiscal consolidation would thus be not only conducive to the correction of the excessive deficit but also be appropriate in the current cyclical situation. Also, given that the Czech Republic has a record of achieving lower-than-planned expenditure targets (as e.g. in 2006) and the expansionary 2007 budget has not yet been fully executed, better results could still be attained in 2007. Finally, the March 2007 update of the convergence programme contains a “declaration by the new government” stating the intention to implement a stabilisation package with an estimated fiscal impact of 0.3% of GDP, thus reaching an annual deficit target only slightly above the 3% of GDP threshold in 2008, namely 3.2% of GDP. Corresponding measures have in the meantime been approved by the lower house of parliament. This implies that only a slightly greater effort would be necessary to ensure a deficit below the threshold.

Article 3(4) of Regulation (EC) No 1467/97 also specifies that in a recommendation to a Member State to correct an excessive deficit, the Council should request the achievement of a minimum annual improvement in the structural balance of at least 0.5% of GDP as a benchmark. In view of the advanced state of implementation of the expansionary budget for 2007, the structural balance will deteriorate significantly in 2007 rather than improve. The size of this deterioration should be contained as much as still possible. Furthermore, on the basis of the Commission services' spring 2007 forecast, bringing the deficit in 2008 below the 3% of GDP threshold value would require an improvement in the structural balance of at least 1% of GDP compared to 2007.

Table 1: Deficit projections and growth forecasts

Annual deficit projections (% of GDP)	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
Commission services' spring 2007 forecast	2.9	3.6	2.9	3.9	3.6	-
March 2007 Convergence Programme	-	3.6	3.5	4.0	3.5	3.2
March 2007 Convergence Programme (alternative deficit targets in the declaration by the new government)	-	3.6	3.5	4.0	3.2	2.8
November 2005 Convergence Programme	3.0	3.6	3.5	3.3	2.7	-
July 2004 Council Recommendation	5.3	4.7	3.8	3.3	< 3	-
GDP growth forecasts (% y-o-y)	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
Commission services' spring 2007 forecast	4.2	6.1	6.1	4.9	4.9	-
March 2007 Convergence Programme	-	6.0	6.0	4.9	4.8	4.8
November 2005 Convergence Programme	4.4	4.8	4.4	4.2	4.3	-
July 2004 Council Recommendation	2.8	3.1	3.3	3.5	-	-

Table 2: Comparison of key macroeconomic and budgetary projections

		2006	**2007**	**2008**	**2009**
Real GDP (% change)	**CP Mar 2007**	**6.0**	**4.9**	**4.8**	**4.8**
	COM May 2007	6.1	4.9	4.9	n.a.
	CP Nov 2005	*4.4*	*4.2*	*4.3*	*n.a.*
HICP inflation (%)	**CP Mar 2007**	**2.4**	**2.6**	**2.5**	**2.5**
	COM May 2007	2.1	2.4	2.9	n.a.
	CP Nov 2005	*2.2*	*2.0*	*2.1*	*n.a.*
Output gap (% of potential GDP)	**CP Mar 2007**[1]	**0.9**	**1.1**	**1.0**	**1.0**
	COM May 2007[3]	0.4	0.5	0.5	n.a.
	CP Nov 2005[1]	*-0.1*	*0.3*	*0.8*	*n.a.*
General government balance (% of GDP)	**CP Mar 2007**[6]	**-3.5**	**-4.0**	**-3.5**	**-3.2**
	COM May 2007	-2.9	-3.9	-3.6	n.a.
	CP Nov 2005	*-3.8*	*-3.3*	*-2.7*	*n.a.*
Primary balance (% of GDP)	**CP Mar 2007**	**-2.4**	**-2.6**	**-2.0**	**-1.6**
	COM May 2007	-1.8	-2.8	-2.6	n.a.
	CP Nov 2005	*-3.0*	*-2.4*	*-1.7*	*n.a.*
Cyclically-adjusted balance (% of GDP)	**CP Mar 2007**[1]	**-3.9**	**-4.4**	**-3.9**	**-3.5**
	COM May 2007	-3.1	-4.1	-3.8	n.a.
	CP Nov 2005[1]	*-3.8*	*-3.4*	*-3.0*	*n.a.*
Structural balance[2] (% of GDP)	**CP Mar 2007**[5]	**-3.9**	**-4.4**	**-3.9**	**-3.5**
	COM May 2007[4]	-2.8	-4.1	-3.8	n.a.
	CP Nov 2005	*-3.8*	*-3.4*	*-3.0*	*n.a.*
Government gross debt (% of GDP)	**CP Mar 2007**	**30.6**	**30.5**	**31.3**	**32.2**
	COM May 2007	30.4	30.6	30.9	n.a.
	CP Nov 2005	*37.1*	*37.9*	*37.8*	*n.a.*

Notes:

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

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

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

[4] One-off and other temporary measures taken from the Commission services' spring 2007 forecast (0.3% of GDP in 2006 - deficit-increasing)

[5] One-off and other temporary measures taken from the CP 2007 programme.

[6]Alternative deficit targets based on the stabilisation package of the Czech government: 3.2% of GDP in 2008, 2.8% of GDP in 2009.

Source:

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

Recommendation for a

COUNCIL RECOMMENDATION TO THE CZECH REPUBLIC

with a view to bringing an end to the situation of an excessive government deficit

Application of Article 104(7) of the Treaty

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 104(7) thereof,

Having regard to the recommendation from the Commission,

Whereas:

(1) According to Article 104 of the Treaty, Member States are to avoid excessive government deficits.

(2) The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. The Stability and Growth Pact includes Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure (EDP)[9] which was adopted to further the prompt correction of excessive general government deficits.

(3) By Council Decision 2005/185/EC[10] of 5 July 2004, it was decided, following a recommendation from the Commission in accordance with Article 104(6) of the Treaty, that an excessive deficit existed in the Czech Republic.

(4) On 5 July 2004, in accordance with Article 104(7) of the Treaty and Article 3(4) of Regulation (EC) No 1467/97, the Council, based on a recommendation from the Commission, adopted a recommendation to the Czech authorities with a view to bringing the excessive deficit situation to an end as rapidly as possible and to taking action in a medium-term framework to achieve the objective of bringing the deficit below 3% of GDP by 2008 in a credible and sustainable manner, in accordance with the path for deficit reduction specified in the convergence programme submitted by the authorities in May 2004 and endorsed in the Council Opinion of 5 July 2004[11], with the following intermediate annual targets: 5.3% of GDP in 2004, 4.7% of GDP in 2005, 3.8% of GDP in 2006, 3.3% of GDP in 2007. The Council established the deadline of 5 November 2004 to take effective action "regarding the measures envisaged to achieve the 2005 deficit target". The Czech Republic agreed to make the recommendation public[12].

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9 OJ L 209, 2.8.1997, p. 6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p. 5).

10 OJ L 62, 9.3.2005, p. 20.

11 OJ C 320, 24.12.2004, p. 1.

12 See http://register.consilium.eu.int/pdf/en/04/st11/st11215.en04.pdf.

(5) On 10 July 2007, the Council adopted a decision in accordance with Article 104(8) stating that the action taken by the Czech Republic in response to the Council recommendation of 5 July 2004 under Article 104(7) was proving to be inadequate to correct the excessive deficit by 2008[13]. The decision was based on the deficit for 2007 being projected in the Commission services' spring 2007 forecast to be well above the target set in the Council recommendation of 5 July 2004 and the 2008 deficit clearly exceeding on current policies the 3% of GDP reference value, with developments in the economy relevant for public finances having been significantly more favourable than expected since the adoption of the recommendation (in particular, much better-than-expected budgetary outturns for the period 2004-2006 and an upward revision of growth prospects). In its opinion on the March 2007 convergence programme, the Council concluded that the planned postponement of the correction of the excessive deficit reflected the planned expansionary fiscal stance in 2007, primarily due to discretionary increases in social expenditure without countervailing revenue or expenditure measures in other areas[14].

(6) The Czech Republic is currently a Member State with a derogation within the meaning of Article 122(1) of the Treaty, which means that it shall avoid excessive deficits but that Articles 104(9) and Article 104(11) of the Treaty do not apply to it; further recommendations can be addressed to the Czech Republic only on the basis of Article 104(7).

(7) According to Article 3(4) of Regulation (EC) No 1467/97, a recommendation made in accordance with Article 104(7) has to specify that effective action is to be taken by the Member State concerned within six months at most and that the correction of the excessive deficit should be completed in the year following its identification unless there are special circumstances.

(8) Special circumstances – namely, the size of the deficit and the ongoing structural shift in the economy – were considered to exist when the Council issued its July 2004 recommendation to the Czech Republic under Article 104(7), which allowed for a correction in a medium-term framework, namely by 2008. Given that the deficit outturns in the period 2004-2006 were well below the targets underlying the July 2004 Council recommendation under Article 104(7) and the Czech economy continues to enjoy very high growth (higher than anticipated at the time of the recommendation), there is no reason to extend the deadline for the correction of the excessive deficit.

(9) According to the March 2007 update of the convergence programme, covering the period 2006-2009, the deficit is targeted to widen to 4.0% in 2007 owing to discretionary increases in social spending decided by the previous parliament and confirmed by the new one with the 2007 budget. The deficit targets for 2008 and 2009 in the update were 3.5% and 3.2% of GDP. The Commission services' spring 2007 forecast indicated that the deficit would widen to 3.9% of GDP in 2007 and narrow in 2008, on a no-policy change basis, to 3.6% of GDP. In structural terms, the deficit would deteriorate by 1¼ percentage points of GDP in 2007 (after deteriorations in both 2005 and 2006) and improve, on a no-policy change basis, by ¼ percentage point in 2008. In the meantime, a "stabilisation package" has been adopted, which was already indicated in the update of the convergence programme, and is estimated by the Czech authorities to have a deficit-reducing effect of approximately 0.3% of GDP in

[13] Council decision Art. 104.8 adopted on 10.7.2007.
[14] Council opinion adopted on 10.7.2007.

2008, thereby narrowing the deficit to 3.2% of GDP in 2008 (and 2.8% in 2009). The estimated deficit-reducing effect in 2008 seems to be plausible, although considerable uncertainties remain, in particular given the scale of tax reforms. The deficit-reducing effect is projected to be expenditure-based and expenditure measures consist mainly of cuts in the social area and reductions in the wage bill. The package also contains corporate and personal income tax cuts that are projected to be compensated by VAT increases only in 2008 but are deficit-increasing thereafter. Even after the adoption of the "stabilisation package" a delay in achieving the medium-term objective (MTO) for the budgetary position, a structural deficit of 1% of GDP, originally targeted for 2012, is implied.

(10) Article 3(4) of Regulation (EC) No. 1467/97 also specifies that in a recommendation to a Member State to correct an excessive deficit the Council should request the achievement of a minimum annual improvement in the structural balance (i.e. the cyclically-adjusted deficit net of one-off and other temporary measures) of at least 0.5% of GDP as a benchmark. In view of the advanced state of implementation of the expansionary budget for 2007, the structural balance will deteriorate significantly in 2007 rather than improve. The size of this deterioration should be contained as much as still possible. Furthermore, on the basis of the Commission services' spring 2007 forecast, bringing the deficit in 2008 below the 3% of GDP threshold value would require an improvement in the structural balance of at least 1% of GDP compared to 2007.

(11) The debt to GDP ratio has remained at about 30% of GDP on average since 2000 and is anticipated to increase somewhat through the period covered by the March 2007 convergence programme, reaching 32.2% of GDP by 2009, which is broadly in line with the Commission services' spring 2007 forecasts. In the absence of measures to address the budgetary impact of ageing, the debt ratio is likely to increase significantly over the next decades.

(12) In general, budgetary consolidation measures should secure a lasting improvement in the general government balance, while being geared towards enhancing the quality and the long-term sustainability of public finances and reinforcing the growth potential of the economy.

HEREBY RECOMMENDS:

1. The Czech authorities should limit the budgetary deterioration in 2007 and put an end to the excessive deficit situation as rapidly as possible and by 2008 at the latest. The Council establishes the deadline of [9 April 2008] for the Czech authorities to take effective action to this end.

2. The Czech authorities should bring the general government deficit below the 3% of GDP reference value in a credible and sustainable manner. To this end, on the basis of current projections they should ensure an improvement in the structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) of at least 1% of GDP in 2008 compared to 2007.

In addition, the Council invites the Czech Republic to ensure that budgetary consolidation towards its medium-term objective (MTO) for the budgetary position of a structural deficit of 1% of GDP is sustained after the excessive deficit has been corrected and to achieve the MTO by the original deadline of 2012 at the latest.

This recommendation is addressed to the Czech Republic.

Done at Brussels,

For the Council

The President