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ECFIN/2008/50266

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, XX.XX.Year
Number

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Art. 9 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the updated convergence programme of the Czech Republic, 2007-2010

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

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 2005 reform of the Pact acknowledged its usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Stability and Growth Pact, stipulates that each Member State has to submit, to the Council and the Commission, a stability or convergence programme and annual updates thereof. Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes. The first convergence programme of the Czech Republic was submitted in May 2004. In accordance with the Regulation, the Council delivered an opinion on it on 5 July 2004 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. As regards updated stability and convergence programmes, the regulation foresees that these are assessed by the Commission and examined by the Committee and, if necessary and following the same procedure as set out above, the updated programmes may be examined by the Council.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the convergence programme of the Czech Republic, submitted on 30 November 2007, and is recommending a Council opinion on it (see box for the main points covered by the assessment).

In order to set the scene against which the budgetary strategy in the updated convergence programme is assessed, the following paragraphs summarise:

(1) the country's position under the corrective arm of the Stability and Growth Pact (excessive deficit procedure)

(2) the most recent assessment of the country's position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the previous update of the convergence programme)

(3) the March 2007 update of the country-specific broad economic policy guidelines in the area of budgetary policies

(4) the Commission's assessment of the October 2007 implementation report of the national reform programme.

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1 OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

2.1. The excessive deficit procedure for the Czech Republic

On 5th July 2004 the Council adopted a decision stating that the Czech Republic had an excessive deficit in accordance with Article 104(6). At the same time, the Council addressed a recommendation under Article 104(7) specifying that the excessive deficit had to be corrected by 2008.

In view of the expectation of a marked budgetary slippage in 2007, based on budgetary plans proposed before the June 2006 general election, the Council adopted a decision under Article 104(8) on 10 March 2007, stating that the action being taken by the Czech Republic did not appear to be sufficient to correct the excessive deficit by the deadline of 2008. On 10 October 2007, the Council issued a new recommendation under Article 104(9) recommending the Czech Republic to further contain the budgetary deterioration in 2007 and put an end to the excessive deficit situation as rapidly as possible and by 2008 at the latest, with a deadline of 9 April 2008 for the Czech authorities to take effective action. On the basis of then available 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 ¾% of GDP in 2008 compared to 2007.

In addition, the Council invited 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."

2.2. The assessment in the Council opinion on the previous update

In its opinion of 10 July 2007, the Council summarised its assessment of the previous update of the convergence programme, covering the period 2006-2009, as follows. "The overall conclusion is that, in spite of better growth prospects and a lower deficit outcome in 2006 than anticipated, the programme postpones the correction of the excessive deficit 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 adoption and implementation of the fiscal consolidation included in the Law on Stabilization of Public Finances currently debated in the Parliament would be a step in the right direction."

Also in the light of the recommendation under Article 104(7) of 5 July 2004, the Council invited the Czech Republic to: "(i) limit the budgetary deterioration in 2007 and ensure the correction of the excessive deficit in a credible and sustainable manner by 2008 at the latest; (ii) adjust the composition of expenditure in order to reduce the share of mandatory expenditure; (iii) in view of the projected increase in age-related expenditures, improve the long-term sustainability of public finances by implementing the necessary pension and health care reforms."

2.3. March 2007 update of the country-specific broad economic policy guidelines in the area of budgetary policies

On 27 March 2007, the Council adopted a recommendation on the 2007 update of the broad guidelines for the economic policies of the Member States and the Community and on the implementation of Member States' employment policies[2]. With a view to improving the long-term sustainability of public finances, the Czech Republic was recommended to "take steps to implement reforms of the pension and health care systems, in particular on the basis of the 2005 all-party pensions report, and fix a timetable for their implementation."

2.4. The Commission assessment of the October 2007 implementation report of the national reform programme

On 11 December 2007, the Commission adopted its Strategic Report on the renewed Lisbon strategy for growth and jobs, which includes an assessment of the October 2007 implementation report of the Czech Republic’s national reform programme[3]. This can be summarised as follows.

The Czech Republic’s national reform programme identifies as key challenges/priorities: the long-term sustainability of public finances in the context of an ageing population, fulfilling the commitments for public R&D expenditure and further increasing its effectiveness, improving security and flexibility in the labour market, improving the efficiency and equity in education and training and increasing participation in life-long learning. The Commission’s assessment is that the Czech Republic has made some progress in implementing its national reform programme over the period 2005-2007.

Against the background of strengths and weaknesses identified, the Commission recommended that the Czech Republic is recommended to take action in the areas of: pension and health care system reform; research by increasing expenditure and building human capacity; employment and education in order to introduce a flexicurity approach.

In addition the Commission recommended that the Czech Republic should focus on the following areas: improving the protection of intellectual property rights; speeding up progress in the ICT area; improving access to finance for innovative companies; increasing the coverage of entrepreneurship education; better integrating disadvantaged groups into the labour market; reducing regional disparities; reconciling work and family life; tackling the gender pay gap and implementing the active ageing strategy.

Box: Main points covered by the assessment

As required by Article 5(1) (for stability programmes) and Article 9(1) (for convergence programmes) of Council Regulation (EC) No 1466/97, the assessment covers the following points:

- whether the economic assumptions on which the programme is based are plausible;
- the medium-term budgetary objective (MTO) presented by the Member State and whether the adjustment path towards it is appropriate;
- whether measures being taken and/or proposed to respect that adjustment path are sufficient to achieve the MTO over the cycle;
- when assessing the adjustment path towards the MTO, whether a higher adjustment effort is made in economic good times, whereas the effort may be more limited in economic bad times, and, for euro-area and ERM II Member States, whether the Member State pursues an annual improvement of the cyclically-adjusted balance, net of one-off and other temporary measures, of 0.5% of GDP as

2 OJ L 92, 3.4.2007, p. 23.

3 Communication from the Commission to the European Council, “Strategic report on the renewed Lisbon strategy for growth and jobs: launching the new cycle (2008-2010)”, 11.12.2007, COM(2007)803.

a benchmark to meet its MTO;

- when defining the adjustment path to the MTO (for Member States that have not yet reached it) or allowing a temporary deviation from the MTO (for Member States that have), the implementation of major structural reforms which have direct long-term cost-saving effects (including by raising potential growth) and therefore a verifiable impact on the long-term sustainability of public finances (subject to the condition that an appropriate safety margin with respect to the 3% of GDP reference value is preserved and that the budgetary position is expected to return to the MTO within the programme period), with special attention for pension reforms introducing a multi-pillar system that includes a mandatory, fully-funded pillar;
- whether the economic policies of the Member State are consistent with the broad economic policy guidelines.

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2007 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability[4];
- the degree of integration with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs, and its October 2007 implementation report. In its cover note of 7 June 2005 to the European Council on the broad economic policy guidelines for the period 2005-2008, the ECOFIN Council stated that the national reform programmes should be consistent with the stability and convergence programmes;
- compliance with the code of conduct[5], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

4 Communication from the Commission to the Council and the European Parliament, "The long-term sustainability of public finances in the EU", 12.10.2006, COM (2006) 574 final and European Commission, Directorate-General for Economic and Financial Affairs (2006), "The long-term sustainability of public finances in the European Union", European Economy No 4/2006.

5 "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005.

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On the updated convergence programme of the Czech Republic, 2007-2010

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[6], and in particular Article 9(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [4 March 2008] the Council examined the updated convergence programme of the Czech Republic, which covers the period 2007 to 2010.

(2) The Czech Republic is experiencing a period of high growth which is expected to moderate in the medium term. The recent sharp fall in unemployment can be mainly accounted for by cyclical factors. Structural rigidities still appear to remain in the labour market, indicated by a high level of vacancies, evidence of skills-mismatches, and regional disparities in unemployment, which will need to be addressed by future employment policy. The stabilisation programme adopted in 2007 appears to be a step in the right direction while further measures will be necessary to continue fiscal consolidation. Notably, risks remain with respect to long-term sustainability of public finances, given the ageing population and current state of pension and health care systems. A well devised pension reform could also have a positive impact on potential growth. While taking into consideration the good track record of the Czech Republic, inflationary pressures are set to increase due to rises in indirect taxation and rising international commodity prices.

(3) The convergence programme estimates GDP growth to be about 6% in 2007 and moderate to about 5% over the rest of the programme period. Assessed against

6 OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text can be found at the following website: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

currently available information[7], this scenario appears to be based on plausible assumptions. The Commission services' autumn 2007 forecast expects private consumption growth to remain strong on the back of high wage increases in the private sector and rising employment, while moderating from the high level in 2007 linked to the government's planned fiscal consolidation. Both the convergence programme and the Commission services' autumn forecast predict a steep rise in inflation in 2008 due to increases in indirect taxation and rising commodity prices, which may weigh on nominal convergence.

(4) For 2007, the Commission services' autumn forecast and the convergence programme estimate a general government deficit of 3.4% of GDP, which is 0.6 percentage points below the target set in the previous update. However, recent information on budgetary implementation indicates that the 2007 outturn could be significantly better than envisaged in the current programme: the most recent preliminary estimate from the Czech authorities is a general deficit in 2007 of 1.9% of GDP. The lower estimated fiscal outcome is mainly due to the base effect of a higher revenue-to-GDP ratio in 2006 than anticipated in the previous convergence programme, as well as some expenditure restraint in 2007 and dynamic revenue growth thanks to stronger nominal GDP growth than anticipated. A lower 2007 deficit compared to the 2006 budgetary outcome is in line with the invitation in the Council opinion of 10 July 2007 on the previous update of the convergence programme[8] to limit the budgetary deterioration in 2007.

(5) The main goal of the budgetary strategy in the programme is to correct the excessive deficit in 2008 and thereafter to continue consolidation towards the achievement of the medium-term objective (MTO), which is a structural deficit of 1% of GDP, in 2012. The general government deficit is projected to decrease from 3.4% of GDP in 2007 to 2.9% of GDP in 2008, 2.6% of GDP in 2009 and 2.3% of GDP in 2010. The primary deficit follows a similar path, narrowing from 2.3% of GDP in 2007 to 1.1% of GDP in 2010. The consolidation will be mainly expenditure-driven. In particular, the expected fall in the revenue-to-GDP ratio (partly attributable to the introduction of a flat tax in 2008 will be more than offset by a cut in the expenditure-to-GDP ratio. The latter is relatively broad-based but affects social and welfare benefits most significantly; public investment is the only spending category that is planned to increase as a share of GDP. Building on the better-than-expected outturn in 2006, the targets for public finances have been improved compared to those in the previous convergence programme. The most recent estimate of a lower general deficit in 2007 implies that these targets should be comfortably within reach.

(6) The outcome for 2008 could be better than expected while the balance of risks is neutral with respect to budgetary outcomes from 2009 onwards. On one hand, the Czech Republic has a history of achieving lower-than-planned deficits and the latest estimate for 2007 is significantly better than foreseen in the programme, which may have a favourable base effect on expenditure in 2008. While there are a large amount of tax changes occurring, which makes forecasting difficult, the programme's tax estimates appear cautious. On the other hand, the targeted consolidation requires significant expenditure restraint, including public sector wage restraint and cut backs

7 The assessment takes notably into account the Commission services' autumn forecast and the Commission assessment of the July 2007 national reform programme.

8 OJ C 204, 1.9.2007, p.1.

in the number of public employees, while expenditure ceilings have been breached in previous years. After 2008, there is a lack of information on the public finance measures needed to underpin the targeted consolidation.

(7) In view of this risk assessment, namely in the light of the better-than-expected outturn in 2007, the budgetary stance in the programme seems consistent with a durable correction of the excessive deficit by 2008, as recommended by the Council. This is conditional on continuing expenditure restraint and a close monitoring of the fiscal impact of the tax reforms in the stabilisation programme. However, sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations would not be achieved within the programme period. In the years following the correction of the excessive deficit, the pace of adjustment towards the MTO implied by the programme should be strengthened and backed up with measures to be in line with the Stability and Growth Pact. In particular, while the Czech Republic has experienced a period of strong growth, the programme target for 2010 implies that a significant adjustment will have to be made in 2011-2012 to achieve the MTO by 2012.

(8) The Czech Republic appears to be at high risk with regard to the sustainability of public finances. The initial budgetary position in the programme is not sufficiently high to stabilize the debt ratio over the long-term. The long-term budgetary impact of ageing is well above the EU average, influenced notably by a substantial increase in pension expenditure as a share of GDP as well as a significant increase in health care expenditure. Implementation of structural reform measures notably in the field of pensions and health care aimed at containing the significant increase in age-related expenditures would contribute to reducing risks to the sustainability of public finances. While initial steps have been made to reform the health care system, reform of the pension system still lacks implementation against a definite timetable.

(9) The convergence programme seems to be consistent to some extent with the October 2007 implementation report of the national reform programme. The national reform programme includes a number of actions taken with the objective of improving the long-term sustainability of public finances; increasing the amount and quality of education and research; and increasing the motivation to take up employment. While the convergence programme does not provide systematic information on the direct budgetary costs associated with the main reforms envisaged in the national reform programme, the programme's budgetary projections seemingly take into account the public finance implications of the reforms envisaged in the implementation report of the NRP.

(10) The budgetary strategy in the programme is partly consistent with the country-specific broad economic policy guidelines, including in the integrated guidelines, in the area of budgetary policies issued in the context of the Lisbon strategy given the limited actions on pension and health care reform.

(11) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme provides nearly all required data and most of the optional data.[9]

The overall conclusion is that the programme is consistent with a correction of the excessive deficit in 2008, conditional on continuing expenditure restraint and close monitoring of the impact of the fiscal impact of the tax measures in the stabilisation package. Owing to the positive macroeconomic outlook and a likely better 2007 budgetary outturn than expected in the programme, there could be ample opportunity to bring the 2008 deficit below the 3% of GDP reference value by a larger margin, and to achieve stronger-than-targeted fiscal consolidation afterwards. The main risks are in the reliance on reductions to public sector employment and relate to the fact that appropriate consolidation measures remain to be spelled out after 2008. The Czech Republic remains at high risk with respect to the sustainability of public finances, while first steps have been made on health care reform.

In view of the above assessment and also in the light of the recommendation under Article 104(7) of 10 October 2007, and given the need to achieve sustainable convergence, the Czech Republic is invited to:

(i) exploit the likely better-than-expected 2007 budgetary outcome to bring the 2008 deficit below the 3% of GDP reference value by a larger margin by continuing to exercise expenditure restraint;

(ii) exploit the high rate of growth in the economy by strengthening the pace of adjustment so as to build a safety margin against breaching the reference value as soon as possible, and achieve the MTO by 2012 at the latest;

(iii) in view of the projected increase in age-related expenditures, improve the long-term sustainability of public finances through the necessary pension and health care reforms.

9 In particular, specific CZK / euro exchange rate data is not provided for the whole programme period and the data on COFOG for 2010 is not provided.

Comparison of key macro-economic and budgetary projections

		2006	2007	2008	2009	2010
Real GDP (% change)	**CP Nov 2007**	**6.4**	**5.9**	**5.0**	**5.1**	**5.3**
	COM Nov 2007	6.4	5.8	5.0	4.9	n.a.
	CP March 2007	*6.0*	*4.9*	*4.8*	*4.8*	*n.a.*
HICP inflation (%)	**CP Nov 2007**	**2.1**	**2.4**	**3.9**	**2.3**	**2.1**
	COM Nov 2007	2.1	3.0	3.8	3.2	n.a.
	CP March 2007	*2.4*	*2.6*	*2.5*	*2.5*	*n.a.*
Output gap[1] (% of potential GDP)	**CP Nov 2007**	**0.9**	**1.8**	**1.4**	**0.7**	**0.5**
	COM Nov 2007[2]	1.1	2.1	2.1	1.4	n.a.
	CP March 2007	*0.9*	*1.1*	*1.0*	*1.0*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**CP Nov 2007**	**-2.7**	**-2.4**	**-1.6**	**-0.4**	**1.5**
	COM Nov 2007	-2.7	-2.5	-2.1	-1.9	n.a.
	CP March 2007	*-2.8*	*-1.4*	*0.2*	*1.1*	*n.a.*
General government balance (% of GDP)	**CP Nov 2007**	**-2.9**	**-3.4**	**-2.9**	**-2.6**	**-2.3**
	COM Nov 2007	-2.9	-3.4	-2.8	-2.7	n.a.
	CP March 2007	*-3.5*	*-4.0*	*-3.5*	*-3.2*	*n.a.*
Primary balance (% of GDP)	**CP Nov 2007**	**-1.8**	**-2.3**	**-1.7**	**-1.3**	**-1.1**
	COM Nov 2007	-1.8	-2.3	-1.8	-1.7	n.a.
	CP March 2007	*-2.4*	*-2.6*	*-2.0*	*-1.6*	*n.a.*
Cyclically-adjusted balance[2] (% of GDP)	**CP Nov 2007**	**-3.3**	**-4.1**	**-3.4**	**-2.8**	**-2.5**
	COM Nov 2007	-3.3	-4.1	-3.6	-3.2	n.a.
	CP March 2007	*-3.9*	*-4.4*	*-3.9*	*-3.5*	*n.a.*
Structural balance[3] (% of GDP)	**CP Nov 2007**	**-3.1**	**-4.1**	**-3.4**	**-2.8**	**-2.5**
	COM Nov 2007	-3.3	-4.1	-3.6	-3.2	n.a.
	CP March 2007	*-3.9*	*-4.4*	*-3.9*	*-3.5*	*n.a.*
Government gross debt (% of GDP)	**CP Nov 2007**	**30.1**	**30.4**	**30.3**	**30.2**	**30.0**
	COM Nov 2007	30.1	30.2	30.3	30.5	n.a.
	CP March 2007	*30.6*	*30.5*	*31.3*	*32.2*	*n.a.*

Notes:

[1]Output gaps and cyclically-adjusted balances according to the programmes as recalculated by Commission services on the basis of the information in the programmes.

[2]Based on estimated potential growth of 4.5%, 4.7%, 5.0% and 5.6% respectively in the period 2006-2009.

[3]Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures in the convergence programme of November 2007 are -0.2% of GDP in year 2006; deficit-increasing. There are no one-offs in the Commission services' autumn forecast.

Source:

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