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(Resolutions, recommendations and opinions)

OPINIONS

COUNCIL

COUNCIL OPINION

on the updated convergence programme of the Czech Republic, 2009-2012

(2010/C 138/01)

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union,

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 ⁽¹⁾, 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 26 April 2010 the Council examined the updated convergence programme of the Czech Republic, which covers the period 2009 to 2012.
- (2) The global crisis had a strong impact on the Czech economy. Following a three-year period of growth above 6 %, real GDP grew by only 2,5 % in 2008 and declined by 4 % in 2009, according to the updated convergence programme. The economy was mainly affected through the trade channel, but also through confidence effects, a tightening of credit conditions, and shrinking foreign investment inflows. The authorities reacted determinedly to the crisis.

The Czech National Bank reduced its key policy interest rate from 3,75 % in mid-2008 to 1 % currently, and the government designed and implemented a sizeable fiscal stimulus package in line with the European Economic Recovery Plan (EERP), amounting to 2,2 % of GDP in 2009. The Czech koruna depreciated by about one fifth against the euro between mid-July 2008 and mid-February 2009 (it then appreciated by some 14 % by mid-February 2010). In the current immediate post-crisis period, the Czech economy does not suffer from important macro-economic vulnerabilities. The main challenge is to reduce the high structural government deficit, estimated at around 6 % of GDP in 2009, to a sustainable level. Furthermore, it is also important to ensure a rapid adjustment of the labour market to the downturn and progress towards long-lasting convergence. On 2 December 2009, in view of the planned deficit for 2009, the Council decided on the existence of an excessive deficit and issued recommendations to bring the deficit below the 3 % of GDP threshold by 2013.

- (3) Although much of the observed decline in actual GDP in the context of the crisis is cyclical, the level of potential output has also been negatively affected. In addition, the crisis may also affect potential growth in the medium term through lower investment and increasing structural unemployment. Moreover, the impact of the economic crisis compounds the negative effects of demographic ageing on potential output and the sustainability of public finances. Against this background it will be essential to accelerate the pace of structural reforms with the aim of supporting potential growth. In particular, for the Czech Republic it is important to undertake reforms aimed at raising productivity (enhancing R&D and innovation, business environment and competition) as well as labour supply and skills.
- (4) The macroeconomic scenario underlying the programme projects real GDP growth at 1,3 % in 2010, 2,6 % in 2011 and 3,8 % in 2012. Assessed against currently available

⁽¹⁾ OJ L 209, 2.8.1997, p. 1. The documents referred to in this text can be found at the following website: http://ec.europa.eu/economy_finance/sgp/index_en.htm

information, this scenario appears to be plausible until 2011 and it is consistent with monetary and exchange rate assumptions.

The programme real GDP growth projection for 2012, which envisages an increase of growth to a level above its potential, seems to be on the favourable side. Inflation is expected to increase moderately in 2010, mainly due to increases in indirect taxes, and to remain moderate throughout the programme period. The programme foresees a further deterioration of the situation on the labour market in 2010. Overall, the inflation and labour market projections seem plausible and consistent with real GDP growth projections.

(5) The programme estimates the general government deficit in 2009 at 6,6 % of GDP. The significant deterioration from a deficit of 2,1 % of GDP in 2008 reflects to a large extent the impact of the crisis on government finances, but was also brought about by significant stimulus measures amounting to 2,2 % of GDP in 2009 adopted by the government in line with the EERP. The main measures included cuts in social contributions, increases in public infrastructure investment, and financial support to businesses and to employment. Remarkably, in 2009, general government expenditure increased less than planned in the previous update of the convergence programme. The structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures calculated according to the commonly agreed methodology on the basis of the data in the programme) deteriorated by some 2 percentage points of GDP in 2009. According to the programme, the Czech authorities plan a frontloaded consolidation starting in 2010, which in view of the Czech Republic's large structural deficit and the projected improvement in economic conditions is in line with the exit strategy advocated by the Council.

(6) The programme projects the general government deficit at 5,3 % of GDP in 2010. This would imply an improvement in the structural balance by 2 percentage points of GDP, which is more than recommended by the Council in December 2009 — the recommendation was to achieve an average annual structural effort of 1 % of GDP over 2010-2013. In 2010, consolidation will be based on an increase in the revenue ratio by 1,5 percentage point of GDP.

The underlying measures include increases in VAT, excise duties and real estate taxes (around 0,8 % of GDP). It also reflects the early withdrawal of temporary cuts of social contributions and an increase of social security ceilings. Measures on the expenditure side include cuts in social benefits covering sickness and maternity leave (around 0,1 % of GDP) and unused possibility of pension indexation (around 0,2 % of GDP).

(7) The main goal of the medium-term budgetary strategy is to continue consolidation after 2010 and reduce the

government deficit below 3 % of GDP by 2013, in line with the December Council Recommendation. According to the programme, the deficit will decrease from 5,3 % of GDP in 2010 to 4,8 % and 4,2 % of GDP in 2011 and 2012 respectively. Despite the expected economic recovery, the improvement in the structural balance would slow markedly compared to 2010, and would not exceed 0,6 percentage point of GDP over 2011-2012. Most of the adjustment would be made on the expenditure side. The programme indicates that half of the spending cuts would involve operational expenditure and the other half mandatory spending, but does not provide sufficient details on how to achieve these reductions. Revenue side measures are small but better specified and include higher social security contributions and higher personal income tax. For the year 2013, the programme provides the target for the government deficit (3 % of GDP) but no details on how to reach it (including the underlying growth assumptions), for which reason it is not possible to determine the annual average fiscal effort for the period 2010-2013. As communicated by the authorities, the MTO of the Czech Republic is a government balance of - 1,0 % of GDP in structural terms. Given the most recent projections and debt level, the MTO reflects the objectives of the Pact. However, the programme does not envisage achieving it within the programme period.

(8) The budgetary outcomes in 2010 could turn out somewhat below than projected in the programme. Revenue from VAT and excise duties may turn slightly lower than expected due to possibly weaker private consumption.

On the expenditure side, spending may increase due to spending pressures before the parliamentary elections. Uncertainties to fiscal targets are larger for the outer years. The expenditure targets set in the current update for 2011 and 2012 are not supported by concrete measures, making their attainment uncertain, and the revenue projections for 2012 are based on a favourable real GDP growth assumption. Finally, the programme does not provide any information on how to bring the deficit from 4,2 % in 2012 to below 3 % of GDP in 2013.

(9) Government gross debt is estimated at 35 % of GDP in 2009, up from 30 % in the year before. The debt ratio is projected to increase by further 7 percentage points over the programme period, reaching 42 % of GDP in 2012, mainly driven by still relatively high government deficits. The evolution of the debt ratio is likely to be less favourable than projected in the programme, especially after 2010, in view of the risks identified for budgetary consolidation compounded by the possibility of less favourable real GDP growth in 2012 than assumed in the programme. The government debt ratio will however remain well below the 60 % of GDP threshold over the whole programme period.

(10) Medium-term debt projections that assume GDP growth rates to gradually recover to the values projected before the crisis, tax ratios to return to pre-crisis levels and include the projected increase in age-related expenditure show that the budgetary strategy envisaged in the programme, taken at face value and with no further policy change, would not be enough to stabilise the debt-to-GDP ratio by 2020.

(11) The long-term budgetary impact of ageing is clearly above the EU average, mainly as a result of a relatively high increase in pension expenditure as a share of GDP over the coming decades. The budgetary position in 2009, as estimated in the programme, compounds the budgetary impact of population ageing on the sustainability gap.

Achieving primary surpluses over the medium term and undertaking reforms of pension and health care systems with a view of containing the future increase in these expenditures would contribute to reducing the risks to the sustainability of public finances which were assessed in the Commission 2009 Sustainability Report as high. An expert advisory group of the Minister of Finance and the Minister of Labour and Social Affairs was established in January 2010 with the aim of preparing alternative proposals for pension reform. These will be finalised by the end of May 2010 and conveyed to the new government.

(12) With respect to budgetary procedures, preparation of the budget is rather decentralised but at the same time not governed by strong fiscal rules. In 2004, the Czech Republic introduced a medium-term budgetary framework which sets ceilings for nominal expenditure for the state budget over three years. Experience however shows that ceilings have been revised upwards several times in the past beyond the revisions permitted by the budgetary rules. The main weaknesses of the current set-up include low enforceability, limited ex-post monitoring, operational complexity and limited public scrutiny of the process. On 2 December 2009, the Council recommended the Czech Republic to 'enforce rigorously its medium-term budgetary framework and improve the monitoring of the budget execution throughout the year to avoid expenditure overruns compared to budget and multiannual plans'. The programme does not include sufficient proposals in this direction. Some progress is however being made to improve fiscal governance. The ongoing implementation of significant changes in tax collection and tax management as well as a rapid shift to a treasury system of budgetary management will contribute to more efficient management of public finances.

(13) There is some scope to improve the quality of public spending in the Czech Republic. In particular, spending

on R&D is lower than the EU average and efficiency of public expenditure in areas such as healthcare, education and public procurement could be improved.

By contrast, the level of government investment is high relative to the EU average and regional peers (close to 5 % of GDP over the last four years). On the revenue side, the Czech authorities implemented several reforms since 2007 aiming at a gradual shift from direct to indirect taxation. However, further reforms of the tax and benefits system would be needed to increase work incentives and reduce inactivity traps. Furthermore, the system of direct taxation and tax collection is complex and would benefit from further simplification.

(14) Overall, in 2010 the budgetary strategy set out in the programme is consistent with the Council recommendations under Article 126(7). The deficit target appears appropriate and is underpinned by specific consolidation measures. From 2011 on, taking into account the risks mentioned above, the budgetary strategy may not be fully consistent with the Council recommendations under Article 126(7). In particular, the consolidation plans for the years 2011 and 2012 are not ambitious enough, with an average fiscal adjustment of 0,3 % of GDP per year, and subject to risks. The expenditure targets are not backed up by specific measures, the revenue projections for 2012 are based on favourable macro-economic assumptions, and no detail is provided on how the deficit will be reduced from 4,2 % of GDP in 2012 to below 3 % of GDP in 2013. Information on budgetary strategy for 2013 is missing. The annual fiscal effort over the programme period (2010-2012) amounts to 0,8 % on average, which is close to but below the 1 % average annual fiscal effort recommended by the Council. Meeting the recommendation will require implementation of further consolidation measures during the period 2011-2013 to ensure the recommended fiscal effort of 1 % on average.

(15) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme has some gaps in the required data ⁽¹⁾. In its recommendations under Article 126(7) of 2 December 2009 with a view to bring the excessive deficit situation to an end, the Council also invited the Czech Republic to report on progress made in the implementation of the Council's recommendations in a separate chapter in the updates of the convergence programmes. The Czech Republic partly complied with this recommendation.

⁽¹⁾ In particular, the data on general government expenditure by function and on liquid financial assets and net financial debt are not provided.

The overall conclusion is that the budgetary strategy of the Czech Republic for 2010 is appropriate and in line with the Council Recommendation under Article 126(7) TFEU. The fiscal strategy for the following years lacks ambition and fiscal targets are subject to risks both on the revenue and expenditure side. In particular, the expenditure targets are not backed up by specific measures from 2011 on and the favourable macro-economic assumptions put some doubt on the revenue projections for 2012. Moreover, while the target date for bringing the government deficit below 3 % of GDP (2013) is in line with the Council Recommendation, it is not possible to fully assess the budgetary strategy as the programme does not provide details on the consolidation measures that are necessary to achieve the planned significant adjustment in that year. Therefore, more information on the broad strategy underpinning the correction of the excessive deficit, including in particular 2013, would be welcome. With respect to the fiscal framework, there are noticeable weaknesses in several areas, in particular in budgetary procedures, enforcement of the medium-term budgetary framework. Furthermore, the long-term budgetary impact of ageing is clearly above the EU average which remains a concern for long-term sustainability of public finances and points to the need for reforms in the areas of pensions and healthcare.

In view of the above assessment and also in the light of the recommendation under Article 126 TFEU of 2 December 2009 and also given the need to ensure sustainable convergence the Czech Republic is invited to:

- (i) implement the 2010 budget rigorously and avoid expenditure slippages; in line with the Council Recommendation under Article 126(7), target, in the context of the 2011 and 2012 budgets, a larger budgetary adjustment than the one planned in the programme and specify in more detail the measures that are necessary to correct the excessive deficit by 2013 at the latest;
- (ii) take action to improve budgetary procedures and to enforce and monitor more rigorously the medium-term budgetary targets; in particular, avoid upward revisions of expenditure ceilings beyond the revisions permitted by the budgetary rules;
- (iii) implement the necessary reforms in order to improve the long-term sustainability of public finances.

The Czech Republic is also invited to add in its next update of the convergence programme more substantial information in the separate chapter on progress made to bring the excessive deficit situation to an end, as requested by the Council in its recommendations under Article 126(7) of 2 December 2009.

Comparison of key macroeconomic and budgetary projections

		2008	2009	2010	2011	2012
Real GDP (% change)	CP Feb 2010	2,5	- 4,0	1,3	2,6	3,8
	COM Nov 2009	2,5	- 4,8	0,8	2,3	n.a.
	CP Oct 2008	4,4	3,7	4,4	5,2	n.a.
HICP inflation (%)	CP Feb 2010	6,3	0,6	1,8	1,5	1,8
	COM Nov 2009	6,3	0,6	1,5	1,8	n.a.
	CP Oct 2008	6,4	2,9	3,0	2,5	n.a.
Output gap ⁽¹⁾ (% of potential GDP)	CP Feb 2010	4,8	- 2,0	- 2,9	- 2,6	- 1,1
	COM Nov 2009 ⁽²⁾	5,6	- 1,8	- 2,9	- 2,5	n.a.
	CP Oct 2008	1,9	0,4	- 0,4	- 0,2	n.a.
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	CP Feb 2010	- 2,4	- 0,2	1,0	0,2	0,6
	COM Nov 2009	- 2,2	- 1,5	- 0,7	- 0,4	n.a.
	CP Oct 2008	- 1,0	- 0,5	0,4	1,2	n.a.
General government revenue (% of GDP)	CP Feb 2010	40,9	39,0	40,5	40,8	40,5
	COM Nov 2009	40,9	40,3	41,0	40,9	n.a.
	CP Oct 2008	41,0	40,6	39,6	39,0	n.a.

		2008	2009	2010	2011	2012
General government expenditure (% of GDP)	CP Feb 2010	43,0	45,5	45,8	45,6	44,7
	COM Nov 2009	43,0	46,9	46,5	46,6	n.a.
	CP Oct 2008	42,2	42,2	41,1	40,2	n.a.
General government balance (% of GDP)	CP Feb 2010	- 2,1	- 6,6	- 5,3	- 4,8	- 4,2
	COM Nov 2009	- 2,1	- 6,6	- 5,5	- 5,7	n.a.
	CP Oct 2008	- 1,2	- 1,6	- 1,5	- 1,2	n.a.
Primary balance (% of GDP)	CP Feb 2010	- 1,0	- 5,3	- 3,5	- 2,8	- 2,0
	COM Nov 2009	- 1,0	- 5,2	- 3,9	- 4,1	n.a.
	CP Oct 2008	0,0	- 0,4	- 0,4	- 0,1	n.a.
Cyclically-adjusted balance ⁽¹⁾ (% of GDP)	CP Feb 2010	- 3,8	- 5,9	- 4,2	- 3,8	- 3,8
	COM Nov 2009	- 4,1	- 6,0	- 4,5	- 4,8	n.a.
	CP Oct 2008	- 2,0	- 1,7	- 1,4	- 1,1	n.a.
Structural balance ⁽²⁾ (% of GDP)	CP Feb 2010	- 3,7	- 6,1	- 4,1	- 3,7	- 3,5
	COM Nov 2009	- 4,1	- 6,3	- 4,7	- 4,9	n.a.
	CP Oct 2008	- 1,9	- 1,7	- 1,3	- 1,1	n.a.
Government gross debt (% of GDP)	CP Feb 2010	30,0	35,2	38,6	40,8	42,0
	COM Nov 2009	30,0	36,5	40,6	44,0	n.a.
	CP Oct 2008	28,8	27,9	26,8	25,5	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 2,4 %, 2,0 %, 2,0 % and 2,2 % respectively in the period 2009-2012.

⁽³⁾ Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0,2 % of GDP in 2009 (deficit reducing) and - 0,1 % in 2010 and 2011 (deficit-increasing) according to the most recent programme and 0,3 % of GDP in 2009, 0,2 % of GDP in 2010 and 0,1 % of GDP in 2011 (all deficit-reducing) in the Commission services' autumn 2009 forecast.

Source:

Convergence programme (CP); Commission services' autumn 2009 forecasts (COM); Commission services' calculations.