COMMISSION OF THE EUROPEAN COMMUNITIES

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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

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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 shall 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.

(3) The 2005 reform of the Stability and Growth Pact sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run. It aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation.

(4) The Council has decided on [2 December 2009], in accordance with Article 104(6), that an excessive deficit exists in the Czech Republic.

(5) In accordance with Article 104(7) of the Treaty and Article 3 of Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure[1] (which is part of the Stability and Growth Pact), the Council is also required to make recommendations to the Member State concerned with a view to bringing the situation of excessive deficit to an end within a given period. The recommendation has to establish a deadline of six months at the most for effective action to be taken by the Member State concerned to correct the excessive deficit as well as a deadline for the correction of the excessive deficit, which should be completed in the year following its identification unless there are special circumstances. In deciding whether special circumstances exist, “relevant factors” as clarified in Article 2(3) of Regulation (EC) No 1467/97 should be taken into account. Furthermore, in a recommendation to correct an excessive deficit the Council should

[1] OJ L 209, 2.8.1997, p. 6.

request the achievement of a minimum annual improvement in the structural balance, i.e. the cyclically-adjusted balance excluding one-off and other temporary measures, of at least 0.5% of GDP as a benchmark.

(6) Special circumstances, which are relevant for the greater flexibility in the application of the EDP introduced with the 2005 reform of the Stability and Growth Pact, are deemed to exist in the case of the Czech Republic. In particular, the global economic and financial crisis has caused a very severe recession in the Czech Republic. The economic environment deteriorated sharply already in the last quarter of 2008. The deterioration continued in the first half of 2009 when real GDP contracted by 5% year-on-year. The collapse of external demand, which has been the main channel through which the global crisis has impacted on the Czech economy, has triggered a double-digit contraction of Czech exports and industrial production in the first half of 2009 . In parallel, tighter credit conditions coupled with worsening output prospects have dragged down investment, which fell by more than 7% in the first half of 2009. According to the Commission services' 2009 autumn forecast, real GDP is projected to contract by 4.8% in 2009. A sluggish recovery is expected in 2010 with real GDP growth reaching 0.8%. The existence of special circumstances authorises the Council to allow the correction of the excessive deficit in a medium-term framework.

(7) The Commission services’ autumn 2009 forecast projects that the government deficit reaches 6.6% of GDP in 2009 and 5.5% of GDP in 2010. In response to the global crisis and in line with the EERP, the Czech authorities adopted stimulus measures amounting to approximately 2.1% of GDP in 2009 which have helped stabilise the economy but which together with tax shortfalls and rising social expenditure are expected to raise the government deficit to 6.6% of GDP, also according to the latest notification. The worsening budgetary situation prompted the Czech authorities to adopt in October 2009 a fiscal consolidation package in the context of the budget for 2010. According to the Commission services' autumn 2009 forecast, the consolidation package, estimated at approximately 1½% of GDP, will reduce the general government deficit to around 5.5% of GDP in 2010. The main measures include an increase in VAT, excise duties and real estate tax, and withdrawal of some previously adopted anti-crisis measures, such as higher unemployment benefits, higher child allowances and temporary reductions in social security contributions. Under the no policy change assumption, the general government deficit is projected to reach 5.7% of GDP in 2011 as some consolidation measures on the expenditure side will expire at the end of 2010.

(8) Considering the special circumstances and the EERP framework, an average annual structural budgetary adjustment is recommended. The required adjustment should take into account the fiscal room for manoeuvre which is assessed on the basis of all factors relevant for achieving the fiscal policy objectives, starting with the level of the general government deficit and gross debt as well as other indicators, such as the current account position, the level of contingent liabilities of the financial sector, interest payments, risk premia and the expected change in age-related expenditure in the medium term. In calculating the average annual adjustment, the 2011 deficit in the Commission services' autumn 2009 forecast is taken as the starting point. The total structural adjustment needed to reach the nominal deficit target of 3% by the deadline is then calculated by assuming a gradual closure of the output gap by 2015.

(9) Against this background, it is appropriate to consider the correction of the excessive deficit for the Czech Republic in a medium-term framework with a deadline for the correction of 2013. In particular, in view of the size of the 2009 deficit, and of the economic outlook for the Czech Republic, a credible and sustainable adjustment path would require the Czech authorities to implement the deficit reducing measures in 2010 as planned in the draft budget law for 2010. In order to bring the deficit below 3% of GDP in 2013, an average annual structural budgetary adjustment of 1% of GDP over the period 2010-2013 has to be ensured. The Czech authorities should specify the measures that are necessary to achieve the correction of the excessive deficit by 2013 cyclical conditions permitting and accelerate the reduction of the deficit if economic or budgetary conditions turn out better than currently expected.

(10) According to data notified by the Czech authorities in October 2009, the general government gross debt remains well below the 60% of GDP reference value and is planned to stand at 35.5% of GDP in 2009. According to the Commission services' autumn 2009 forecast, the debt ratio is set to increase rapidly, reaching 44% of GDP in 2011 under the no policy change assumption.

(11) In 2004, the Czech Republic introduced a medium-term budgetary framework which sets annual ceilings for nominal expenditure for the state budget over three years; however, under the current set-up, the expenditure ceilings have been breached since 2006 compared to the originally planned ceiling. In light of this track record, it is important to enforce more rigorously the medium-term budgetary framework and improve the monitoring of the budget execution throughout the year to avoid expenditure overruns compared to budget and multi-annual plans.

(12) As regards the long-term sustainability of public finances, the budgetary impact of ageing in the Czech Republic is above the EU average, mainly as a result of unfavourable demographic developments. Initial phases of pension and health care reforms have been introduced which will reduce expenditure. In 2008 parametric changes to the pay-as-you-go pension system were introduced, in particular an increase in retirement age from 62 to 65. First steps of a healthcare reform program included the introduction of fees for basic medical services. However, further progress in both areas is necessary to reduce the risk as defined by the Commission Communication[2] on 'Long-term sustainability of public finances for a recovering economy' and endorsed by the ECOFIN Council[3] on 10 November 2009.

(13) Enhanced surveillance under the EDP, which seems necessary in view of the deadline for the correction of the excessive deficit, will require regular and timely monitoring of the progress made in the implementation of the fiscal consolidation strategy. In this context, a separate chapter in the updates of the Czech Republic's convergence programme which will be prepared between 2010 and 2013 could usefully be devoted to this issue.

(14) In general, budgetary consolidation measures should secure a lasting improvement in the general government balance, while being geared towards enhancing the quality of the public finances and reinforcing the growth potential of the economy. In particular, the Czech Republic should improve the efficiency and effectiveness of public

[2] Available at: http://ec.europa.eu/economy_finance/publications/publication15996_en.pdf
[3] Available at: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/111025.pdf

spending. Moreover, the Czech authorities should continue with the necessary pension and healthcare reforms, with reforms aimed at labour supply and skill levels, as well as with reforms increasing the amount and effectiveness of public R&D.

(15) In addition, in view of the importance of achieving its medium-term objective (MTO) to provide an adequate safety margin against cyclical downturns and to ensure convergence of the debt ratio towards a prudent level, also taking into account implicit liabilities related to ageing, the Czech Republic should also ensure that budgetary consolidation towards the MTO is sustained after the excessive deficit will have been corrected.

HEREBY RECOMMENDS:

(1) Recognising that the Czech Republic's budgetary position in 2009 resulted from the free play of automatic stabilisers and from measures (amounting to 2.1% of GDP), which are an adequate response to the downturn and broadly in line with the European Economic Recovery Plan principles, the Czech authorities should put an end to the present excessive deficit situation by 2013.

(2) The Czech authorities should bring the general government deficit below 3% of GDP in a credible and sustainable manner by taking action in a medium-term framework. Specifically, to this end, the Czech authorities should:

   (a) implement the deficit reducing measures in 2010 as planned in the draft budget law for 2010;

   (b) ensure an average annual structural budgetary adjustment of 1% of GDP over the period 2010-2013;

   (c) specify the measures that are necessary to achieve the correction of the excessive deficit by 2013 cyclical conditions permitting and accelerate the reduction of the deficit if economic or budgetary conditions turn out better than currently expected.

(3) To limit the risks to the adjustment, the Czech Republic should 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 multi-annual plans.

(4) The Council establishes the deadline of [2 June 2010] for the Czech government to take effective action to implement the deficit reducing measures in 2010 as planned in the draft budget law for 2010 and to outline the measures that will be necessary to progress towards the correction of the excessive deficit. The assessment of effective action will take into account economic developments compared to the economic outlook in the Commission services' autumn 2009 forecast.

The Czech authorities should report on progress made in the implementation of these recommendations in a separate chapter in the updates of the convergence programmes which will be prepared between 2010 and 2013.

Furthermore, the Council invites the Czech authorities to implement reforms with a view to raising potential GDP growth. This includes reforms conducive to enhancing the quality of public finances, in particular reforms improving the efficiency and effectiveness of public spending. In addition, the Council invites the Czech authorities to continue with the necessary pension and healthcare reforms, with reforms aimed at raising labour supply and skill levels, as well as with reforms increasing the amount and effectiveness of public R&D.

This recommendation is addressed to the Czech Republic.

Done at Brussels,

For the Council
The President