



**COUNCIL OF
THE EUROPEAN UNION**

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LEGISLATIVE ACTS AND OTHER INSTRUMENTS

Subject: 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

**COUNCIL RECOMMENDATION
TO THE CZECH REPUBLIC**

of

**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 procedure¹ which was adopted to further the prompt correction of excessive general government deficits.
- (3) By Council Decision 2005/185/EC² 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.

¹ 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).

² OJ L 62, 9.3.2005, p. 20.

- (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 2004¹, 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.

¹ OJ C 320, 24.12.2004, p. 1.

- (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 2008¹. The decision was based on the deficit for 2007 projected in the Commission services' spring 2007 forecast being 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 areas².
- (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 is to avoid excessive deficits but that Article 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).

¹ OJ L 260, 5.10.2007, p. 13.

² OJ C 204, 1.9.2007, p. 1.

- (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. Recent information based on strong tax receipts suggests that the 2007 deficit is likely to be lower, providing a favourable spill-over for 2008. In structural terms, the deficit would deteriorate by 1,25 percentage points of GDP in 2007 (after deteriorations in both 2005 and 2006). 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 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 to the extent that is still possible. Furthermore, on the basis of the Commission services' current projections taking into account the latest indications for 2007, bringing the deficit in 2008 below the 3 % of GDP threshold value would require an improvement in the structural balance of at least 3/4 % of GDP compared to 2007.
- (11) The debt to GDP ratio has remained at about 30 % of GDP on average since 2000 and is expected 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 coming 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 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. 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 3/4 % of GDP in 2008 compared to 2007.
3. 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 Luxembourg, 9 October 2007

For the Council

The President
