COMMISSION OF THE EUROPEAN COMMUNITIES

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Recommendation for a

COUNCIL DECISION

establishing, in accordance with Article 104(8), that the action taken by the Czech Republic in response to the Recommendation of the Council in accordance with Article 104(7) of the Treaty establishing the European Community is proving to be inadequate

(presented by the Commission)

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 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.

2. RECOMMENDATION FOR A COUNCIL DECISION CONCERNING THE LACK OF ADEQUATE ACTION UNDER ARTICLE 104(8)

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 "*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; (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 submission of the update was delayed compared to the 1 December deadline due to the political situation in the Czech Republic in which a government was confirmed by parliament only on 19 January 2007 following the June 2006 general elections. 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 to reduce the general deficit to 3.2% of GDP in 2008 and 2.8% of GDP in 2009 based on a wide range of still to be finalised and approved policy measures.

The Commission services' spring 2007 forecast, which projects that the deficit will reach 3.9% of GDP in 2007 and, on a no-policy change basis, 3.6% of GDP in 2008, confirms that, on current policies, 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 would widen by 1¼ percentage points of GDP in 2007, after deteriorations in both 2005 and 2006.

The Commission services' forecast thus essentially confirms the convergence programme projections, which are inconsistent with a correction of the excessive deficit by the 2008 deadline. In its recommendation for a Council opinion on the update, adopted today, the Commission concludes its assessment of the programme as follows: "in spite of better growth prospects and a lower deficit 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 fiscal stance".

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

Indeed, 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 Council recommendation and is mainly due to increases in social spending decided by the previous parliament and confirmed by the new one inl the adopted budget. 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% for 2006). This was due mainly to better-than-expected growth rather than durable cuts in expenditure.

In sum, based on the 2007 budget and the latest update of the convergence programme, the Czech Republic plans to exceed the target for 2007 (3.3% of GDP) set by the Council in its recommendations under Article 104(7) and the target for 2008 (2.7% of GDP) set in the November 2005 convergence programme which was endorsed by the Council on 24 January 2006. The Commission services' 2007 spring forecast also project outcomes for both years in excess of the endorsed targets. By consequence, the action taken by the Czech authorities is inadequate to correct the excessive deficit by the 2008 deadline as required by the Council. 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.

Table1: 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

		2005	2006	2007	2008	2009
Real GDP (% change)	**CP Mar 2007**	**6.1**	**6.0**	**4.9**	**4.8**	**4.8**
	COM May 2007	6.1	6.1	4.9	4.9	n.a.
	CP Nov 2005	*4.8*	*4.4*	*4.2*	*4.3*	*n.a.*
HICP inflation (%)	**CP Mar 2007**	**1.6**	**2.4**	**2.6**	**2.5**	**2.5**
	COM May 2007	1.6	2.1	2.4	2.9	n.a.
	CP Nov 2005	*1.5*	*2.2*	*2.0*	*2.1*	*n.a.*
Output gap (% of potential GDP)	**CP Mar 2007**[1]	**-0.7**	**0.9**	**1.1**	**1.0**	**1.0**
	COM May 2007[3]	-1.1	0.4	0.5	0.5	n.a.
	CP Nov 2005[1]	*-0.8*	*-0.1*	*0.3*	*0.8*	*n.a.*
General government balance (% of GDP)	**CP Mar 2007**[6]	**-3.6**	**-3.5**	**-4.0**	**-3.5**	**-3.2**
	COM May 2007	-3.5	-2.9	-3.9	-3.6	n.a.
	CP Nov 2005	*-4.8*	*-3.8*	*-3.3*	*-2.7*	*n.a.*
Primary balance (% of GDP)	**CP Mar 2007**	**-2.5**	**-2.4**	**-2.6**	**-2.0**	**-1.6**
	COM May 2007	-2.4	-1.8	-2.8	-2.6	n.a.
	CP Nov 2005	*-4.1*	*-3.0*	*-2.4*	*-1.7*	*n.a.*
Cyclically-adjusted balance (% of GDP)	**CP Mar 2007**[1]	**-3.4**	**-3.9**	**-4.4**	**-3.9**	**-3.5**
	COM May 2007	-3.1	-3.1	-4.1	-3.8	n.a.
	CP Nov 2005[1]	*-4.5*	*-3.8*	*-3.4*	*-3.0*	*n.a.*
Structural balance[2] (% of GDP)	**CP Mar 2007**	**-3.4**	**-3.9**	**-4.4**	**-3.9**	**-3.5**
	COM May 2007[4]	-2.0	-2.8	-4.1	-3.8	n.a.
	CP Nov 2005[5]	*-3.4*	*-3.8*	*-3.4*	*-3.0*	*n.a.*
Government gross debt (% of GDP)	**CP Mar 2007**	**30.4**	**30.6**	**30.5**	**31.3**	**32.2**
	COM May 2007	30.4	30.4	30.6	30.9	n.a.
	CP Nov 2005	*37.4*	*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 (1.1% of GDP in 2005 and 0.2% of GDP in 2006 - both deficit increasing).

[5] One-off and other temporary measures taken from the CP 2005 programme (1.1% of GDP in 2005 - deficit increasing).

[6] Alternative deficit targets based on as yet unapproved measures of the new Czech government: 3.2% of GDP in 2008, 2.8% of GDP in 2009.

Source:

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

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 104(8) 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

[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.

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.

(5) After the expiry of the deadline of 5 November 2004, the Commission concluded, in its Communication to the Council of 14 December 2004[12], that no further steps were necessary under the excessive deficit procedure for the Czech Republic as the Czech government had taken effective action regarding the measures envisaged to achieve the 2005 deficit target. The November 2005 update of the convergence programme indicated a deficit of 2.7% of GDP for 2008 which was endorsed by the Council on 24 January 2006.

(6) The assessment of the action taken by the Czech Republic to correct the excessive deficit by 2008 in response to the Council recommendation under Article 104(7) leads to the following conclusions:

– on 15 March 2007, the Czech Republic submitted the most recent update of the convergence programme, covering the period until 2009. The 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 programme also included an additional “declaration of the new government” aiming to reduce the general deficit to 3.2% of GDP in 2008 and 2.8% of GDP in 2009 based on a wide range of as yet unknown policy measures;

– the Commission services’ spring 2007 forecast, which projects that the deficit will reach 3.9% of GDP and 3.6% of GDP in 2007 and 2008 respectively on a no-policy change basis, confirms that, on current policies, 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 would widen by 1¼ percentage points of GDP in 2007, after deteriorations in both 2005 and 2006;

– the higher 2007 deficit comes against much stronger growth than forecast at the time of the Council recommendation and is mainly due to increases in social spending decided before the 2006 parliamentary elections. 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. This was due mainly to better-than-expected growth rather than durable cuts in expenditure.

(7) This leads to the conclusion that, while the Czech Republic has so far overachieved the budgetary targets for 2004-2006 of the consolidation path set in the Council recommendation of 5 July 2004, 2007 deficit will be well above the target set by the Council and the 2008 deficit will on current policies clearly exceed the 3% of GDP threshold. The Czech authorities’ budgetary targets are not in line with the

[12] 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.

recommendations of the Council for a correction of the excessive deficit by the 2008 deadline. 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.

HAS ADOPTED THIS DECISION:

Article 1

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 fixed by the Recommendation.

Article 2

This Decision is addressed to the Czech Republic.

Done at Brussels,

For the Council
The President