COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 30.5.2007
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Recommendation for a

COUNCIL OPINION

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

on the updated convergence programme of the Czech Republic, 2006-2009

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

The Stability and Growth Pact, which entered into force on 1 July 1998, 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 Member States have to submit, to the Council and the Commission, stability or convergence programmes 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. In accordance with the same procedure, updated stability and convergence programmes are assessed by the Commission and examined by the Committee mentioned above, while the Council may examine them.

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 15 March 2007, and has adopted a recommendation for 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 economic and budgetary performance over the last ten years

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

(3) 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), and

(4) the Commission's assessment of the November 2006 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). All the documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

2.1. Recent economic and budgetary performance

The Czech economy has enjoyed firm growth over the last six years after coming out of a recession in the late nineties. In the last two years, the economy has registered record annual growth of 6% of GDP. The labour market has steadily improved since 2004 with unemployment falling to about 7% in 2006. GDP per capita is currently 76.2% of the EU average. HICP was just over 2% in 2006.

Since 2004, the annual budget has registered lower deficits than targeted due mainly to higher-than anticipated growth and the carry-over of unspent budgetary allocations into a reserve fund while expenditure ceilings set in the medium-term budgetary framework have nevertheless been exceeded.

2.2. The excessive deficit procedure for the Czech Republic

On 5 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 particular, the Czech Republic was recommended to put an end to the excessive deficit as rapidly as possible by taking 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 and 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. The Czech Republic was 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, and to take effective action by 5 November 2004 regarding the measures envisaged to achieve the 2005 deficit target.

On 22 December 2004, the Commission concluded that the Czech government had taken effective action regarding the measures envisaged to achieve the 2005 deficit target, by the deadline of 5 November, in response to the Council recommendation, and that no further steps were necessary under the excessive deficit procedure.

2.3. The assessment in the Council opinion on the previous programme

On 24 January 2006, the Council adopted its opinion on the previous update of the convergence programme, covering the period 2005-2008. The Council was of the opinion that "he programme follows the deficit adjustment path set by the Council recommendations under Article 104(7)". The Council invited the Czech Republic to: "(i) 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 reinforce 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".

2.4. The Commission assessment of the November 2006 national reform programme

The implementation report of the National Reform Programme of the Czech Republic, provided in the context of the renewed Lisbon strategy for growth and jobs, was submitted on 21 November 2006. The Czech Republic's national reform programme identifies as key challenges/priorities: to continue public finance reform; to strengthen and increase industrial competitiveness while respecting the need for sustainable resources; and to increase labour market flexibility.

The Commission's assessment of this report (adopted as part of its December 2006 Annual Progress Report[2]), showed that the Czech Republic is making limited progress in the implementation of its National Reform Programme. Progress in several areas is not clearly spelled out; some reforms have been postponed, while others have not been set in motion. Yet the strong economic growth should facilitate reforms. There are certain risks in the macro-economic area, particularly for medium-term budgetary consolidation and the long-term sustainability of public finances in the context of an ageing population. Although the Czech Republic is generally moving ahead relatively well in the microeconomic field, progress on R&D is moderate. In the employment area more efforts are required to respond to the key challenge of improving labour market flexibility.

Against the background of strengths and weaknesses identified, the Czech Republic was recommended to take action in the areas of: (i) reforms of the pension and healthcare systems; (ii) collaboration between business and public R&D institutions; and (iii) employment protection, and education and training systems.

[2] Communication from the Commission to the Spring European Council, "Implementing the renewed Lisbon strategy for growth and jobs - A year of delivery" - COM(2006) 816, 12.12.2006.

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 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' spring 2007 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances. The assessment of consistency with the broad economic policy guidelines is made against the broad economic policy guidelines in the area of public finances as included in the integrated guidelines for the period 2005-2008.

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[3];
- the degree of integration with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs. 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[4], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

[3] Communication from the Commission to the Council and the European Parliament, "The long-term sustainability of public finances in the EU" - COM(2006) 574, 12.10.2006 - 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.

[4] "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, 2006-2009

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[5], 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 [10 July 2007] the Council examined the updated convergence programme of the Czech Republic, which covers the period 2006 to 2009. The submission of the update was delayed to 15 March 2007, compared to the 1 December deadline in the code of conduct due to the political situation in the Czech Republic, where a permanent government was approved by parliament on 19 January 2007 following general elections in June 2006.

(2) The macroeconomic scenario underlying the programme envisages that real GDP growth will decrease from 6.1% in 2006 to 4.9% in 2007 and broadly stabilise thereafter. Assessed against currently available information, this scenario appears to be based on plausible growth assumptions. The programme's projections for inflation also appear realistic.

(3) For 2006, the general government deficit is estimated at 2.9% of GDP in the Commission services' spring 2007 forecast, against a target of 3.8% of GDP set in the previous update of the convergence programme. Stronger GDP and employment growth as well as the roll-over of a marked proportion of unspent budgetary allocations contributed to the lower-than-targeted deficit.

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5 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://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

(4) The main goal of the programme's medium-term budgetary strategy is to achieve long-term sustainability of public finances, notably by making progress towards the medium-term objective (MTO) for the budgetary position of a structural balance (i.e. cyclically-adjusted balance net of one-off and other temporary measures) of 1% of GDP. According to the programme, the headline deficit should widen to 4.0% of GDP in 2007 mainly as a result of discretionary increases in social expenditure and then gradually decline, to 3.5% of GDP in 2008 and 3.2% of GDP in 2009. The primary deficit is projected to narrow from 2.4% of GDP in 2006 to 1.6% of GDP in 2009. The envisaged fiscal consolidation, after 2007, relies on increased revenue by 0.4 percentage point of GDP over the programme period, in particular 'other revenues' (without specifying the actual measures, but which presumably concern EU transfers), which will more than compensate for a decline in taxes and social contributions. On substance, however, the consolidation is expenditure driven with a consistent decline in public consumption mainly due to government sector wage restraint, which will more than offset the increase in public investment and interest expenditure. Compared with the previous update, the new programme postpones the planned reduction of the deficit below the 3% of GDP reference value by at least two years against a more favourable macroeconomic scenario. It has to be noted that the programme also presents an alternative considered by the government which presents lower deficit targets of 3.2% of GDP in 2008 and 2.8% of GDP in 2009. This relies on a range of policy measures as well as introducing greater flexibility into public finances by reducing the proportion of mandatory expenditures. However, these are based on still to be finalised and approved policy measures and the programme offers a coherent and sufficiently quantified medium-term fiscal framework only for the higher deficit targets mentioned above.

(5) The structural deficit calculated according to the commonly agreed methodology is planned to deteriorate from around 3½% of GDP in 2006 to some 4½% of GDP in 2007 before gradually improving to 3½% of GDP in 2009. As in the previous update, the medium-term objective (MTO) for the budgetary position presented in the programme is a structural deficit of 1% of GDP. In comparison with previous update the achievement of the MTO has been postponed by one year, until 2013. As the MTO is more demanding than the minimum benchmark (estimated at a deficit of around 1½% of GDP), achieving it should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The MTO adequately reflects the debt ratio and average potential output growth in the long term.

(6) The risks to the budgetary projections in the programme appear broadly balanced. The risks from the macroeconomic scenario are broadly neutral, while tax projections seem on the whole based on prudent assumptions. The envisaged fiscal consolidation in the programme relies heavily on public consumption expenditure restraint, but the programme does not provide sufficient supporting information on how this will be achieved. On the other hand, the Czech Republic has built up a good track-record in recent years, although achieving its budgetary targets has been facilitated by higher-than-expected growth. There is also a political risk associated with the finely balanced parliamentary situation.

(7) In view of this risk assessment, the budgetary stance in the programme is inconsistent with a correction of the excessive deficit by 2008 as recommended by the Council on 5 July 2004. Given that the economy is currently enjoying "good times" and that growth is higher than anticipated at the time of the July 2004 Council

Recommendation, there is ample opportunity to strengthen the consolidation effort and achieve a steeper reduction than projected in the programme.

(8) Government gross debt is estimated to be at 30.4% of GDP in 2006, well below the 60% of GDP Treaty reference value. The programme projects the debt ratio to increase by almost 2 percentage points over the programme period.

(9) The long-term budgetary impact of ageing in the Czech Republic 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. The budgetary position expected at the end of the programme period, which has worsened compared with previous exercises, constitutes a risk to sustainable public finances even before the long-term budgetary impact of an ageing population is considered. Consolidating public finances further than currently planned would contribute to reducing risks to the sustainability of public finances. Overall, the Czech Republic appears to be at high risk with regard to the sustainability of public finances.

(10) The convergence programme does not contain a qualitative assessment of the overall impact of the November 2006 implementation report of the National Reform Programme within the medium-term fiscal strategy. In addition, it provides no systematic information on the direct budgetary costs (or savings) associated with the main reforms envisaged in the National Reform Programme with the exception of the increase in research and development expenditure in the 2007 budget, but the budgetary projections in the programme seemingly take into account the public finance implications of the actions envisaged in the National Reform Programme. The measures in the area of public finances envisaged in the convergence programme seem consistent with those foreseen in the National Reform Programme. In particular, the shift in the tax burden from direct to indirect taxation and additional support for research and development.

(11) The budgetary strategy in the programme is not consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008 given, in particular, the deviation from the adjustment path set by the Council in July 2004 for the correction of the excessive deficit and the lack of progress on pension and health care reform.

(12) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme provides all required and most of the optional data[6].

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

6 In particular, the data on general government expenditure by function for 2009 are not provided.

deficit due primarily to planned increases in social expenditure in 2007, would also result in a pro-cyclical expansionary stance of fiscal policy.

In view of the above assessment, the Council invites 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) review 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.

Comparison of key macro economic 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