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COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 7.5.2008
SEC(2008) 571 final

Recommendation for a

COUNCIL DECISION

abrogating Decision 2005/185/EC on the existence of an excessive deficit in the Czech Republic

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. BACKGROUND

Article 104 of the Treaty establishes that Member States should avoid excessive deficits and lays down a procedure for their identification and correction. The excessive deficit procedure (EDP) is further specified in 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. According to Article 104(2) of the Treaty, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the planned or actual government deficit exceeds the reference value of 3% of GDP (unless either the deficit ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value); and (b) whether government debt exceeds the reference value of 60% of GDP (unless the debt ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

In accordance with the Protocol on the excessive deficit procedure annexed to the Treaty, the Commission provides the data for the implementation of the EDP. As part of the application of this Protocol, Member States have to notify data on government deficits and debt and other associated variables twice a year, namely before 1 April and before 1 October, in accordance with Article 4 of Council Regulation (EC) No 3605/93[2,3].

On 12 May 2004, the Commission initiated the EDP for the Czech Republic with the adoption of a report under Article 104(3), based on a general government deficit of 12.9% of GDP in 2003[4] (5.9% of GDP excluding a major one-off operation related to imputed state guarantees). On 5 July 2004, the Council decided, on a recommendation from the Commission, that the Czech Republic was in excessive deficit according to Article 104(6)[5]. At the same time, and also based on a Commission recommendation, the Council addressed recommendations under Article 104(7) to the Czech Republic with a view to bringing the situation of an excessive government deficit to an end, by 2008 at the latest.

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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 332, 31.12.1993, p. 7. Regulation as last amended by Regulation (EC) No 2103/2005 (OJ L 337, 22.12.2005, p. 1).

3 The most recent notification of the Czech Republic can be found at: http://epp.eurostat.ec.europa.eu/portal/page?_pageid=2373,58110711&_dad=portal&_schema=portal.

4 SEC(2004) 575. In the meantime the 2003 deficit outturn has been revised downwards to 6.6% of GDP (no longer including any one-offs).

5 OJ L 62, 9.3.2005, p. 20.

In view of the forecast of a marked budgetary slippage in 2007 and a continuing excess of the deficit over the reference value in 2008, based on budgetary plans proposed before the June 2006 general election, the Council adopted a decision under Article 104(8) on 10 July 2007, based on a recommendation from the Commission, stating that the action being taken by the Czech Republic did not appear to be adequate to correct the excessive deficit by the deadline of 2008. On 10 October 2007, the Council issued a new recommendation under Article 104(7), based on a recommendation from the Commission, recommending the Czech Republic to further contain the budgetary deterioration in 2007 and confirming the original target year of 2008 to put an end to the excessive deficit situation. The Czech authorities had to bring the deficit below the 3% of GDP reference value in a credible and sustainable manner. To this end, on the basis of then available projections the Council recommended the Czech authorities to ensure an improvement in the structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) of at least ¾% of GDP in 2008 compared to 2007. The Council set a deadline of 9 April 2008 for the Czech authorities to take effective action.

In addition, the Council invited 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."

Table 1: Adjustment endorsed by the Council on 10 October 2007

% of GDP, unless indicated otherwise	**2006**	**2007**	**2008**
General government balance	-2.7	better than -3.3	deficit < 3
change in structural balance			*at least ¾*
p.m.: Real GDP growth (%)	6.0	5.0	4.9

Notes: Structural balance = cyclically-adjusted balance excluding one-off and other temporary measures.
Source: Council recommendation under Article 104(7), adopted on 10 October 2007, and Commission services' Spring 2007 forecast

After the expiry of the deadline set by the Council, the Commission habitually makes a formal assessment of the action taken by the authorities in response to the Council's recommendations, taking into account the most recent Commission services' forecasts. This represents an intermediate assessment of whether the country is on track to correct the excessive deficit in time. In the case of the Czech Republic, this intermediate assessment is subsumed under and replaced by the current document. It takes into account the Czech government's note on corrective measures adopted under the EDP of April 2008[6].

According to Article 104(12), a Council decision on the existence of an excessive deficit is to be abrogated, on the basis of a Commission recommendation, when the excessive deficit in the Member State concerned has, in the view of the Council, been corrected.

6 Letter of 10 April 2008 addressed by the Czech Minister of Finance to the Commissioner for Economic and Monetary Affairs.

2. RECENT DEFICIT DEVELOPMENTS

The general government deficit reached a high of 6.6% of GDP in 2003. Thereafter, with the exception of 2005 (3½% of GDP), the general government deficit has not been above 3% of GDP. The nominal deficit developments since 2004 have been better than the recommended (nominal) deficit reduction path in the 104(7) recommendation of 5 July 2004. The improvement in the general government deficit has been due to better-than-expected revenues from higher-than-anticipated growth, which has exceeded 6% annually since 2005, as well as expenditure restraint. General government expenditure has fallen gradually as a percentage of GDP from 45% of GDP in 2004 to 42.4% of GDP in 2007. This is partly due to government consumption which has been lowered by about 2% of GDP and also diminishing costs related to the consolidation of the banking sector[7].

Based on data provided by the Commission (Eurostat), following the reporting by the Czech Republic before April 2008[8,9], the general government deficit stood at 1.6% of GDP in 2007[10] which is significantly below the target of 4% of GDP, set in the March 2007 update of the convergence programme. In the outturn, revenues, as a percentage of GDP, were 0.8% of GDP higher than projected in the March 2007 convergence programme, and government expenditure was 1.8% of GDP lower. The much better-than-expected outturn appears to mainly reflect containment of social expenditure, which was projected to rise by about 1% of GDP. Other elements of public expenditure including compensation of employees and intermediate consumption were also contained. In addition, growth turned out at 6.5% of GDP compared to 4.9% of GDP, as expected in the March 2007 convergence programme, and tax elasticities were better than predicted.

Both revenues and expenditures were positively affected by a stronger than expected rise in employment. Social contributions grew more than anticipated and social transfers only increased marginally, as a percentage of GDP.

Compared to 2006, the headline deficit declined by 1.1% of GDP, of which about one half is due to measures taken, as illustrated by the improvement in the structural balance, and the other half is thanks to stronger growth. Total expenditures decreased by 1.2% of GDP while total revenues decreased by 0.2% of GDP. The improvement in 2007 represents an overachievement of the Council's recommendation to "further contain the budgetary deterioration" that was at the time expected for 2007.

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7 In the context of privatisation of the banking sector, the Czech government bore much of the costs related to non-performing loans, in particular, through the creation of the Czech Consolidation Agency. Over time, the proportion of these assets has declined.

8 Eurostat News Release No 54/2008 of 18 April 2008.

9 In accordance with Article 8g(1) of Regulation (EC) No 3605/93.

10 Deficit ratios are usually revised – upwards or downwards – after the publication of the first outcome in the spring notification. For most EU Member States, the revisions are usually relatively small and on average insignificantly different from zero. For the Czech Republic, in view of the distance between the currently reported deficit for 2007 and the deficit reference value, there is a low probability that any potential future revision in government accounts will raise the 2007 deficit ratio to a level in excess of 3% of GDP.

The overall reduction in government expenditure is reflected in the increase in the size of the reserve funds which are estimated to have expanded to 2¾% of GDP (from about 2% in 2006), of which about ¾% of GDP is non-EU funds related expenditure that is deferred expenditure which may swell future deficits. The other 2% are EU-funds related and backed-up by revenues.

In structural terms, the deficit decreased from 2.9% of GDP in 2006 to 2.3% of GDP in 2007 due to continued government expenditure restraint including public sector wages.

3. DEFICIT PROJECTIONS FOR 2008 AND BEYOND

According to the Commission services' spring 2008 forecast, the general government deficit is projected to decline further, reaching 1.4% of GDP in 2008 and, under a no-policy change assumption, 1.1% of GDP in 2009. This is due to the balance of measures included in the stabilisation package, approved on 19 September 2007, which is estimated to have a positive impact amounting to around 0.3% of GDP for each year (see box I). The level of social transfers is expected to fall, as a percentage of GDP, in 2008 and 2009 as a result of legislative measures in the stabilisation package. In addition to legislative measures, the consolidation also relies on continuing public sector wage restraint and a reduction in public consumption as a percentage of GDP. Revenues are expected to remain stable as a percentage of GDP, although the range of tax measures occurring at the same time makes forecasting difficult. The Commission services' deficit projections in the spring forecast are in line with the planned deficit reported in the spring notification (1.5% of GDP).

Based on the Commission services' spring 2008 forecast, the structural balance is expected to improve from -2¼% of GDP in 2007 to around -2% of GDP in 2008. The improvement is lower than recommended by the Council (at least ¾% of GDP) in light of the much better headline deficit in 2007, underpinned by a structural improvement in 2007, of about ½% of GDP, which was not anticipated at the time of the recommendation.

The medium-term objective (MTO) of the Czech Republic is a structural deficit to 1% of GDP, which according to the most recent convergence programme submitted in November 2007 should be achieved by 2012. The Council opinion of 4 March 2008 on the programme[11] invited the Czech authorities to "exploit the high rate of growth in the economy by strengthening the pace of adjustment so as to build a safety margin against breaching the reference value as soon as possible, and achieve the MTO by 2012 at the latest".

Box I: Summary of measures in the stabilisation package of September 2007

The stabilisation package has shifted the overall tax burden from direct to indirect taxation. From 1 January 2008, a 15% flat rate of personal income tax was introduced, albeit on an expanded base, which is planned to be further reduced to 12.5% in 2009. From 1 January 2008, the corporate income tax rate was reduced from 24% to 21% and will decline further to 19% by 2010. Indirect taxes were increased in January 2008 through an increase in the lower band of VAT from 5 to 9 %, increases to excise taxes, and the introduction of an environmental tax on electricity, natural gas and solid fuels. A ceiling has also been introduced on the maximum base for payment of social contributions which will reduce

[11] OJ C 74, 20.3.2008, p. 24.

revenue.

The stabilisation package introduced new legislation aimed at reducing expenditure in primarily the area of social benefits, including child benefits, social care benefits, parental allowances, maternity benefits, foster care benefits, benefits for school supplies, and funeral benefits. In addition to fixed reductions, most social care benefits have ceased to be indexed to the minimum subsistence level, which in turn has been changed to a discretionary basis by the government. The stabilisation package also introduced service charges for healthcare services from January 2008. This includes charges for medical consultations, prescription medicines, and hospitalisation. These changes are estimated to have a small positive impact on government revenues by generating additional income and reducing expenditure by lowering demand.

The government tabled a proposal on 23 January 2008 to compensate churches for confiscated religious property (see box II). Pursuant to its approval by the Czech parliament, the financial compensation will be registered as a one-off deficit-increasing expenditure amounting to 2.2% of GDP in the year in which the government liability is recognised, though most effective payment will be deferred over a very long period of 60 years. This transaction was not considered in the Commission services' spring 2008 forecasts based on the usual no-policy change assumption, since it was not clear whether and when the government proposal would be adopted by Parliament. This transaction was not considered either in the projections of the convergence programme. In case the proposal became effective in 2008 or 2009, the government deficit (including this transaction) would on current projections be temporarily in excess of 3% of GDP for that year.

Box II: The Czech proposal for compensation for the confiscation of religious property

On 23 January 2008, the Czech Government tabled in parliament a proposal to compensate the church for religious property confiscated during the period 1948-1990. Two ways of compensation are foreseen: restitution in kind and financial compensation when restitution in kind is no longer possible. According to the proposal, as far as the financial compensation is concerned, the churches will receive from the government 60 yearly cash instalments of CZK 4274.9 million (0.1% of the 2008 GDP). Given an annual interest rate of 4.85%, this corresponds to a principal of CZK 83.0 billion (2.2% of the 2008 GDP) and CZK 173.5 billion of interest[12].

The Czech statistical office has required Eurostat to clarify the appropriate accounting implications of the proposal for compensation. Eurostat clarified that the restitutions in kind have no impact on the government deficit. When the returned asset is the same as confiscated in the past, the transaction is recorded in ESA accounts as other changes in volume without any direct impact on the government revenue and expenditure accounts. When the returned good is not the same, the restitution is booked as a capital transfer paid offset by negative investment.

In relation to the financial compensation, Eurostat clarified that, according to its interpretation of ESA accounting rules, the principal to be paid should be booked as government expenditure when the legal act is approved, instead of when cash payments take

[12] According to information provided by the Czech authorities, part of the compensation deal is also that state support to churches (e.g. payment of priests' salaries) will be phased out. This state support amounts to CZK 1406 million (0.04% of GDP in 2008).

place. Interest will be booked as government expenditure over the 60 following years. Eurostat also clarified that the outstanding liability vis-à-vis the churches will be booked as accounts payable[13].

Therefore, in the year the Czech Parliament adopts the law and the latter enters into force, the Czech government accounts will include a very large one-off deficit-increasing transaction amounting to 2.2% of GDP. The fact that the liability vis-à-vis the churches will be booked as accounts payable means that it will not constitute government debt in the sense of Regulation (EC) No 3605/93. At the moment the expenditure is booked, the stock-flow adjustment will include an exceptionally large negative cash-accrual difference, which will be progressively offset over 60 years.

4. DEBT DEVELOPMENTS AND PROJECTIONS

Despite significant general government deficits since 2004, the increase of the level of debt has been largely contained. Due to record growth since 2005, and a substantial reduction in the general government deficit in 2007 compared to 2006, the level of government debt has decreased from 30.4% of GDP in 2004 to 28.7% of GDP in 2007.

On the basis of the Commission services' spring 2008 forecast, the debt ratio is expected to continue on a downward path to below 28% of GDP in 2009, due to continuing fiscal consolidation and sustained macroeconomic growth.

5. CONCLUSIONS

Despite the expectation of a strong fiscal expansion in 2007, the general government balance improved from -2.7% of GDP in 2006 to -1.6% of GDP in 2007. This was due in part to expenditure savings as well as higher growth. The structural balance, i.e. the cyclically-adjusted balance net of one-off and other temporary measures, improved by ½% of GDP in 2007.

The Czech government has introduced a range of legislative measures, effective from 2008, with the aim of consolidating public finances in 2008 and 2009, including through the containment of social spending and the introduction of service charges for healthcare, which will have a net positive impact on public finances. Combined with continuing expenditure restraint, and a close monitoring of the impact on revenues of the wide range of tax measures implemented in 2008, these measures are expected to lead to a further reduction in the general government deficit. According to the Commission services' spring 2008 forecast, the headline deficit is expected to improve further to 1.4% of GDP in 2008 and, on a no-policy change basis, to 1.1% in 2009. This indicates that the deficit has been brought below the 3% of GDP ceiling in a credible and sustainable manner.

General government gross debt declined from 29.4% of GDP in 2006 to 28.7% in 2007, well below the 60% of GDP reference value. According to the Commission services' spring 2008 forecast, the debt ratio is expected to fall further to below 28% of GDP by 2009 (on a no-policy change basis).

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[13] The Eurostat letter of 14 March 2008 providing ex ante advice to the Czech statistical office is available at: http://epp.eurostat.ec.europa.eu/pls/portal/docs/PAGE/PGP_DS_GFS/PGE_DS_GFS_8/ADV%20-%20CZ%20-%202008.1%20-%20CONFISCATED%20PROPERTIES.PDF

From an overall assessment, it follows that the excessive deficit situation in the Czech Republic has been corrected. Accordingly, the Commission recommends to the Council to abrogate its decision on the existence of an excessive deficit in the Czech Republic.

Table 2: Budgetary developments, 2003-2009

	2003	**2004**	**2005**	**2006**	**2007**		**2008**		**2009**	
% of GDP, unless indicated otherwise					**COM**	**CP**[2]	**COM**	**CP**[2]	**COM**[3]	**CP**[2]
General government balance	-6.6	-3.0	-3.6	-2.7	-1.6	-3.4	-1.4	-2.9	-1.1	-2.6
- Total revenues	40.7	42.2	41.4	41.0	40.8	39.8	40.7	39.5	40.7	38.1
- Total expenditure	47.3	45.2	44.9	43.6	42.4	43.3	42.2	42.4	41.8	40.7
Of which : - interest expenditure	1.2	1.2	1.2	1.1	1.2	1.2	1.1	1.3	1.1	1.2
- gross fixed capital formation	4.5	4.8	4.9	5.0	4.8	5.1	4.8	5.3	4.9	5.4
Primary balance	-5.5	-1.8	-2.4	-1.5	-0.4	-2.3	-0.3	-1.7	0.0	-1.3
One-off and temporary measures	0.0	-0.7	-1.1	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Structural balance[1]	-5.5	-1.3	-2.1	-2.9	-2.3	-4.1	-1.9	-3.4	-1.5	-2.8
Structural primary balance[2]	-4.4	-0.1	-1.0	-1.7	-1.2	-2.9	-0.8	-2.2	-0.4	-1.6
Government gross debt	30.1	30.4	29.7	29.4	28.7	30.4	28.1	30.3	27.2	30.2
Pm Real GDP growth (%)	3.6	4.5	6.4	6.4	6.5	5.9	4.7	5.0	5.0	5.1
Pm Output gap	-3.0	-2.6	-0.8	0.8	2.0	1.8	1.4	1.4	1.1	0.7

(1) Cyclically-adjusted (primary) balance excluding one-off and temporary measures.
(2) Cyclically-adjusted and structural balances and output gaps according to the programme as calculated by Commission services on the basis of the information in the programme.
(3) No-policy change assumption.

Sources: Commission services' spring 2008 forecast (COM) and November 2007 update of the convergence programme (CP)

Recommendation for a

COUNCIL DECISION

abrogating Decision 2005/185/EC on the existence of an excessive deficit in the Czech Republic

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 104(12) thereof,

Having regard to the recommendation from the Commission,

Whereas:

(1) By Council Decision 2005/185/EC[14], following a recommendation from the Commission in accordance with Article 104(6) of the Treaty, it was decided that an excessive deficit existed in the Czech Republic. The Council noted that the general government deficit was 12.9% of GDP in 2003 (5.9% of GDP excluding a major one-off operation related to imputed state guarantees), well above the 3% of GDP Treaty reference value.

(2) On 5 July 2004, in accordance with Article 104(7) of the Treaty and Article 3(4) of Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure[15], the Council made, based on a recommendation from the Commission, a recommendation addressed to the Czech Republic with a view to bringing the excessive deficit situation to an end by 2008 at the latest. The recommendation was made public.

(3) In view of the forecast of a marked budgetary slippage in 2007 and a continuing excess of the deficit over the reference value in 2008, the Council adopted a decision under Article 104(8) on 10 July 2007, based on a recommendation from the Commission, stating that the action being taken by the Czech Republic did not appear to be adequate to correct the excessive deficit by the deadline of 2008[16]. On 10 October 2007, the Council issued a new recommendation under Article 104(7), based on a recommendation from the Commission, recommending the Czech Republic to further contain the budgetary deterioration in 2007 and reconfirming the excessive deficit had to be put to an end by 2008 at the latest, with a deadline of 9 April 2008 for the Czech authorities to take effective action. On the basis of then available projections the Council invited the Czech authorities to ensure an improvement in the

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14 OJ L 62, 9.3.2005, p. 20.

15 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).

16 OJ L 260, 5.10.2007, p. 13.

structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) of at least ¾% of GDP in 2008 compared to 2007.

(4) In accordance with Article 104(12) of the Treaty, a Council Decision on the existence of an excessive deficit is to be abrogated when the excessive deficit in the Member State concerned has, in the view of the Council, been corrected.

(5) In accordance with the Protocol on the excessive deficit procedure annexed to the Treaty, the Commission provides the data for the implementation of the procedure. As part of the application of this Protocol, Member States are to notify data on government deficits and debt and other associated variables twice a year, namely before 1 April and before 1 October, in accordance with Article 4 of Council Regulation (EC) No 3605/93 of 22 November 1993 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community[17].

(6) Based on data provided by the Commission (Eurostat) in accordance with Article 8g(1) of Regulation (EC) No 3605/93 following the notification by the Czech Republic before 1 April 2008 and on the Commission services' spring 2008 forecast, the following conclusions are warranted:

- the general government deficit was reduced from 2.7% of GDP in 2006 to 1.6% of GDP in 2007, which is below the 3% of GDP deficit reference value. This compares with a target of 4% of GDP in the March 2007 convergence programme,

- while tax revenues exceeded expectations due to higher-than-projected economic growth, the deficit reduction in 2007 was also the consequence of expenditure restraint, in particular with respect to the compensation of public sector employees and intermediate consumption. Most of the expenditure savings are of a permanent nature. The improvement in the structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) is estimated at just above ½% of GDP in 2007,

- for 2008, the spring 2008 forecast projects the deficit to be reduced further, to 1.4% of GDP, driven by additional expenditure savings measures, legislative measures to reduce social expenditure and the introduction of partial health charges. Revenue as a percentage of GDP is expected to remain broadly constant on the back of a wide range of tax measures implemented in 2008. The spring forecast is in line with the deficit target of 1.5% of GDP in the April fiscal notification. For 2009, the spring forecast projects, on a no-policy change basis, a further decline in the deficit to 1.1% of GDP. This indicates that the deficit has been brought below the 3% of GDP ceiling in a credible and sustainable manner. The structural balance is projected to improve by almost ½ a percentage point of GDP in 2008 and again, on a no-policy change basis, in 2009. This has to be seen against the need to make progress towards the medium-term objective (MTO) for the budgetary position, which for the Czech

[17] OJ L 332, 31.12.1993, p. 7. Regulation as last amended by Regulation (EC) No 2103/2005 (OJ L 337, 22.12.2005, p. 1).

Republic is a structural deficit of 1% of GDP, to be reached by 2012 according to the November 2007 update of the convergence programme.

– government debt remains well below the 60% of GDP reference value. It declined from 29.4% of GDP in 2006 to 28.7% in 2007. According to the spring 2008 forecast, the debt ratio is projected to fall further to below 28% by end-2009 (on a no-policy change basis).

(7) In the view of the Council, the excessive deficit in the Czech Republic has been corrected and Decision 2005/185/EC should therefore be abrogated.

HAS ADOPTED THIS DECISION:

Article 1

From an overall assessment it follows that the excessive deficit situation in the Czech Republic has been corrected.

Article 2

Decision 2005/185/EC is hereby abrogated.

Article 3

This Decision is addressed to the Czech Republic.

Done at ,

For the Council
The President