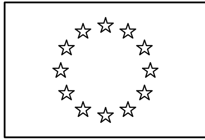

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 7.10.2009
SEC(2009) 1269 final

REPORT FROM THE COMMISSION

Czech Republic

Report prepared in accordance with Article 104(3) of the Treaty

1. THE APPLICATION OF THE STABILITY AND GROWTH PACT IN THE CURRENT CRISIS SITUATION

Many EU countries are presently facing general government deficits above the 3% of GDP reference value set in the Treaty. The often strong deterioration in the deficit as well as the debt positions must be seen in the context of the unprecedented global financial crisis and economic downturn in 2008/09. Several factors are at play. First, the economic downturn has brought about declining tax revenue and rising social benefit expenditure (e.g. unemployment benefits). Second, recognising that budgetary policies have an important role to play in the current extraordinary economic situation, the Commission called for a fiscal stimulus in its November 2008 European Economic Recovery Plan (EERP), endorsed by the European Council in December. The Plan explicated that the stimulus should be differentiated across Member States to reflect their different positions in terms of public finance sustainability and competitiveness and should be reversed when economic conditions improve. Finally, several countries have taken measures to stabilise the financial sector, some of which have impacted on the debt position or constitute a risk of higher deficits and debt in the future, although some of the costs of the government support could be recouped in the future.

The Stability and Growth Pact requires the Commission to prepare a report such as the present one whenever an actual or planned deficit of a Member State exceeds the 3% of GDP reference value. This report, which represents the first step in the "excessive deficit procedure" (EDP), analyses the reasons for the breach of the reference value with due regard to the economic background and all other relevant factors. The amendments to the Stability and Growth Pact in 2005 aimed specifically at ensuring that in particular the economic and budgetary background was fully taken into account in all steps in the EDP. This means for instance that, if an "excessive deficit" is deemed to exist, adequate attention needs to be paid to the economic background and outlook when making recommendations on the pace of the correction. 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.

2. LEGAL BACKGROUND

This report, which assesses recent and current budgetary developments in the Czech Republic and reviews the short- and medium-term prospects in the light of overall economic conditions and policy action taken by the government, is prepared according to Article 104(3) of the Treaty.

Article 104 of the Treaty lays down an excessive deficit procedure (EDP). This procedure 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 ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference

[1] OJ L 209, 2.8.1997, p.6. The report also takes into account the "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, available at http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

value of 3% (unless either the 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 the ratio of government debt to GDP exceeds the reference value of 60% (unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

Article 104(3) stipulates that, if a Member State does not fulfil the requirements under one or both of these criteria, the Commission has to prepare a report. This report also has to "take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State".

Since the start of stage III of economic and monetary union, an EDP for Czech Republic was initiated in May 2004 by the Commission with the adoption of a report under Article 104(3) in view of a deficit of 12.9% of GDP in 2003 (5.9% of GDP excluding a major one-off operation related to imputed state guarantees)[2], i.e. above the reference value. On 9 March 2005, the Council decided that the Czech Republic was in excessive deficit according to Article 104(6) and addressed recommendations under Article 104(7) with a view to bringing this situation to an end by 2008 at the latest. On 10 July 2007, the Council adopted a decision under Article 104(8) 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) recommending the Czech Republic to further contain the budgetary deterioration in 2007 and confirmed the deadline of 2008 to put an end to the excessive deficit. After assessment of the measures taken, on 3 June 2008, the Council issued a decision under Article 104(12), abrogating Decision 2005/185/EC on the existence of an excessive deficit in the Czech Republic[3].

According to the data notified by the authorities in April 2009[4], the general government deficit in the Czech Republic is planned to reach 3.9% of GDP in 2009, thus exceeding the 3% of GDP reference value, while general government gross debt would be 33% of GDP, below the 60% of GDP reference value but on a rising trend. In a letter of 21 August 2009 to the Commission, the authorities of the Czech Republic estimated that the 2009 government deficit could reach 5.5% of GDP, mainly reflecting a further deterioration of the economic outlook.

---

[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] http://ec.europa.eu/economy_finance/sg_pact_fiscal_policy/excessive_deficit9109_en.htm

[4] According to Council Regulation (EC) No 479/2009 (previously Council Regulation (EC) No 3605/93), Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. 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.

<u>Table 1</u>: General government deficit and debt [a]

	2003	2004	2005	2006	2007	2008	2009		2010
							COM	CZ[b]	COM
General government balance	-6,6	-3,0	-3,6	-2,6	-0,6	-1,5	-4,3	-3.9	-4,9
General government gross debt	30,1	30,4	29,8	29,6	28,9	29,8	33,7	33,2	37,9

<u>Note</u>:
[a] In percent of GDP.
[b] Spring 2009 fiscal notification
<u>Source</u>: Eurostat and Commission services' spring 2009 forecasts, Czech Ministry of Finance

The planned figure for the 2009 deficit provides *prima facie* evidence on the existence of an excessive deficit in the Czech Republic in the sense of the Treaty and the Stability and Growth Pact. The Commission has therefore decided to initiate the excessive deficit procedure for the Czech Republic with the adoption of this report. Section 3 of the report examines the deficit criterion and Section 4 the debt criterion. Section 5 deals with public investment and other relevant factors. The document takes into account the Commission services' spring 2009 forecasts, released on 4 May 2009, and their evaluation of subsequent developments.

3. DEFICIT CRITERION

In 2009, the general government deficit is planned to reach 3.9% of GDP, according to the April notification. Based on the draft 2010 budget, the 2009 deficit could however turn out significantly higher.

Well in excess of 3% of GDP, the planned deficit is <u>not close</u> to the Treaty reference value.

The planned excess over the 3% of GDP reference value is <u>exceptional</u>. In particular, it results, among other things, from a severe economic downturn in the sense of the Treaty and the Stability and Growth Pact. The Commission's spring 2009 forecast predicts negative annual real GDP growth of 2.7% in 2009 compared to positive growth of 3.2% in 2008, largely reflecting the impact of the global economic crisis. Since the finalization of this forecast, the economic situation has worsened significantly and in August 2009 the Czech authorities revised their real GDP growth forecast for 2009 to -4.3% of GDP. Furthermore, the structural deterioration started already earlier when the economy was still in good times.

Table 2: Macroeconomic and budgetary developments [a]

	2003	2004	2005	2006	2007	2008	2009		2010	
							COM	CZ[b]	COM	CZ[b]
Real GDP (% change)	3,6	4,5	6,3	6,8	6,0	3,2	-2,7	-4,3	0,3	0,3
Potential GDP (% change)	3,3	3,6	3,7	3,8	3,9	3,8	3,2	N.A.	2,9	N.A.
Output gap (% of potential GDP)	-2,4	-1,6	0,9	3,8	5,9	5,3	-0,7	N.A.	-3,3	N.A.
General government balance	-6,6	-3,0	-3,6	-2,6	-0,6	-1,5	-4,3	-5,5	-4,9	N.A.
Primary balance	-5,5	-1,8	-2,4	-1,5	0,5	-0,3	-3,2	-4,0	-3,7	N.A.
One-off and other temporary measures	-0,4	-0,6	-1,2	-0,2	-0,2	0,0	0,0	N.A.	0,0	N.A.
Gov't gross fixed capital formation	4,5	4,8	4,9	5,0	4,7	4,8	5,4	N.A.	5,8	N.A.
Cyclically-adjusted balance	-5,7	-2,4	-3,9	-4,0	-2,8	-3,4	-4,0	N.A.	-3,7	N.A.
Cyclically-adjusted primary balance	-4,5	-1,2	-2,8	-2,9	-1,6	-2,3	-2,9	N.A.	-2,5	N.A.
Structural balance [c]	-5,3	-1,8	-2,7	-3,9	-2,5	-3,4	-4,0	N.A.	-3,7	N.A.
Structural primary balance	-4,2	-0,6	-1,6	-2,8	-1,4	-2,3	-2,9	N.A.	-2,5	N.A.

Notes:
[a] In percent of GDP unless specified otherwise.
[b] Based on the last forecast of the Ministry of Finance published in July 2009
[c] Cyclically-adjusted balance excluding one-off and other temporary measures.
Source: *Eurostat and Commission services' spring 2009 forecast, Macroeconomic forecast of the Czech Ministry of Finance published in July 2009.*

The planned excess over the 3% of GDP reference value is not temporary in the sense of the Treaty and the Stability and Growth Pact. The Commission services' 2009 spring forecast projects a widening of the general government deficit to 4.9% of GDP in 2010 based on the no-policy change assumption. This assumption takes into account that, according to government plans, only part of the measures of extraordinary nature linked to the crisis will be maintained in 2010. The stimulus measures include temporary increases in government spending and reductions in revenues, with an overall fiscal impact of about 2¼% of GDP. Two measures accounting for approximately 0.7% of GDP (reductions of the social security contributions paid by employees and reduction of the corporate income tax) are permanent.

In sum, the planned deficit is not close to the 3% of GDP reference value and, while the planned excess over the reference value can be regarded as exceptional, it is not temporary in the sense of the Treaty and the Stability and Growth Pact. This analysis suggests that the deficit criterion in the Treaty is not fulfilled.

4. DEBT CRITERION

The general government debt ratio has remained broadly stable since 2003 around 30% of GDP. In 2008, it stood at 29.8% of GDP, well below the 60% of GDP reference value. However, according to the Commission services' spring 2009 forecast, this ratio is set to increase rapidly in 2009 and 2010, reaching 37.9% of GDP in 2010. This increase would reflect the higher headline deficit, some recapitalization costs (0.1 percent of GDP), and the sharp decline in economic activity. In view of the worse fiscal and economic situation relative to the Commission's spring 2009 forecast, under unchanged policies, debt developments are likely to be less favourable than indicated in Table 1.

5. RELEVANT FACTORS

Article 104(3) of the Treaty provides that the Commission report "shall also take into account whether the government deficit exceeds government investment expenditure and take into account other relevant factors including the medium-term economic and budgetary position of

the Member State". These factors are further clarified in Article 2(3) of Council Regulation (EC) No 1467/97, which also specifies that "any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess in qualitative terms the excess over the reference value and which the Member State has put forward to the Commission and to the Council" need to be given due consideration.

In view of the above provisions, the following four subsections consider in turn (1) the medium-term economic position; (2) the medium-term budgetary position (including public investment); (3) other factors put forward by the Member State; and (4) other factors considered relevant by the Commission.

5.1. Medium-term economic position

Cyclical conditions and potential growth. Over the past five years the Czech economy has grown on average by 5.4% per year, well above the estimated potential growth rate. The strong growth has been driven by strong external demand and rising inward investment. The labour market improved markedly over the period, with the unemployment rate falling below five per cent which, together with a pronounced expansion of credit, has supported private consumption growth. From the second half of 2008, the Czech Republic has been severely affected by the global financial crisis and the associated sharp slowdown of external demand. For the first time since 2002, real GDP growth was below potential in 2008 and, in 2009, it is forecast to be clearly negative. The economy is expected to experience a gradual recovery in 2010 and the following years. Potential output growth is expected to slow, at least temporarily, from 3.4% in 2008 to 2¼ % in 2009 and 2010, reflecting slower capital accumulation after the large drop of capital expenditure during the crisis. According to Commission services' calculations, the sharp recession would bring the economy at a level close to its potential level in 2009, and the output gap would turn strongly negative in 2010.

Recent structural reforms. The government has implemented several structural reforms with the aim of stimulating economic growth and limiting public expenditure. Pension, healthcare, labour market and tax policy reforms have been initiated. 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, which will contribute to both higher labour participation and lower pension expenditure. First steps of a healthcare reform program included the introduction of fees for basic medical services. With respect to the labour market, reforms have focused on increasing labour market participation and flexibility while lowering the tax burden on labour for businesses. The amended Employment Act introduced tighter conditions for unemployment benefits. The tax policy reforms carried out in 2007 and 2008 introduced a flat personal income tax rate and a lower corporate income tax rate. In 2009, social security contributions were lowered as part of the recovery package.

5.2. Medium-term budgetary position

Structural deficit and fiscal consolidation in good times. Based on the output gap estimates in the Commission services' spring 2009 forecast according to the commonly-agreed methodology, the fiscal stance appears to have been expansionary from 2004 to 2006 and again in 2008, but restrictive in 2007. Overall fiscal policy has provided some pro-cyclical stimulus to economic activity over the period, with the structural deficit (cyclically adjusted deficit net of one-offs) increasing from 1.8% of GDP in 2004 to 3.4% of GDP in 2008, during good times. Good economic times were thus not exploited to make progress with fiscal consolidation. Looking forward, under unchanged policies, the Commission services' 2009

spring forecast projects that the structural balance will continue to deteriorate by 0.6 percentage point of GDP in 2009 and narrow slightly by 0.3 percentage point in 2010. There is significant distance between the projected structural deficit in 2010 (-3.7% of GDP), and the medium-term objective (MTO) of -1% of GDP.

Public investment. The government investment-to-GDP ratio has consistently exceeded the government deficit ratio since 2004. Government investment has remained close to 5% of GDP over the last four years, while the deficit decreased from 3.6% of GDP in 2005 to 1.5% in 2008. The government investment-to-GDP ratio was also persistently higher than the structural deficit, which increased from 2.7% of GDP in 2005 to 3.4% of GDP in 2008. According to the Commission services' spring 2009 forecast, public investment will continue to exceed the general government deficit in 2009 and 2010.

Quality of public finances. General government expenditure has declined steadily from 45.1% of GDP in 2004 to 42.4% of GDP in 2008. Compared to the average of other EU countries, the Czech Republic spends a relatively high proportion of expenditure on infrastructure (2.1% of GDP against an EU average of 1.2%), economic affairs (6.9% of GDP against an EU average of 3.8%) and health care (7.1% of GDP against an EU average of 6.6%). By contrast, spending on social protection is significantly lower than the EU average (12.9% of GDP against an EU average of 18%). The Czech Republic has also embarked on reforms of research, development and innovation systems with the aim of ensuring more efficient use of public resources for R&D, and making better use of the R&D results in business. Public funding for R&D has been steadily increased in recent years, but no further increase is planned for the period 2010-2012 due to the economic downturn. Revenue as a percentage of GDP has declined since 2004 from 42.2% of GDP to below 41% of GDP in 2008. In the most recent update of the convergence programme the Czech authorities announced plans aimed at improving budgetary management and enhancing tax collection. Output and target orientated budgeting was introduced in January 2009 and there will be increased integration and simplification of the tax system from January 2010. These measures will help to improve budgetary implementation. 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 are not binding and they have been breached since 2006 compared to the originally planned ceiling.

Long-term sustainability of public finances. In its opinion of 10 March 2009 on the update of the November 2008 convergence programme, the Council assessed the long-term sustainability of the Czech Republic's public finances. In particular, the Council was of the opinion that the long-term budgetary impact of ageing is above the EU average according to the projections made in 2005, which are based on the common methodology[5]. Initial phases of pension and health care reforms have been introduced which will reduce expenditure. However, the Council invited the authorities to make further progress in both areas, taking into account the principles of equity accessibility and sustainability. While the budgetary position in 2008, as estimated in the programme, was considered to have markedly improved, this was largely due to a better starting position in 2007 rather than discretionary measures, and still compounded the impact of population ageing. Achieving primary surpluses over the

[5] Since the submission of the convergence programme, risks to the long-term sustainability may have changed in view of the worsened economic and budgetary situation. The new assessment will be published in the upcoming report on the long-term sustainability of public finances in the European Union.

medium term and implementing further structural measures aimed at curbing age-related expenditures would reduce the high risks to the long-term sustainability of public finances.

5.3. Other factors put forward by the Member State

In a letter of 21 August 2009, the authorities of the Czech Republic listed some relevant factors in accordance with Article 2(3) of Council Regulation (EC) No 1467/97. The analysis presented above already covers most of the items put forward by the authorities (macroeconomic developments, current and projected revenues, impact of the stimulus packages). The remaining items on their list, and their relevance for the purpose of this report, are as follows.

The Czech Ministry of Finance's most recent projection of the general government deficit for 2009 is 5.5% of GDP, compared to the planned deficit of 3.9% GDP reported in the spring 2009 fiscal notification. This reflects deterioration in the economic outlook, including a sizeable slump in tax revenue and higher growth in social benefits, as well as increased debt servicing costs. The Czech authorities also note that the countercyclical character of the medium-term budgetary framework will lead to a higher deficit in the context of the current strong economic downturn.

Moreover, the Czech authorities estimate that the fiscal impact of stimulus measures taken so far to tackle the impact of the economic crisis is 2.2% of GDP in 2009[6] and that the majority of stimulus measures (with the exception of cuts in social contributions for employees) will expire by 2011.

5.4. Other factors considered relevant by the Commission

In response to the crisis, the Czech Republic has implemented a range of stimulus measures primarily to support the labour market and boost private consumption and investment. The stimulus measures taken by the Czech authorities can be regarded as in line with the EERP in that they are timely and targeted. In fiscal terms the measures are broadly balanced between revenue and expenditure items. On the revenue side, the main measures are a permanent reduction in social security contributions for employees of 1.5 percentage points and a reduction in the rate paid by employers by the same amount over the period 2009-2011. On the expenditure side, the main measure has been a substantial increase in infrastructure investment. In addition to the fiscal impact of stimulus measures, the impact of automatic stabilisers on the deterioration of the budget balance is estimated at around 2% of GDP based on the Commission services' spring 2009 forecast.

In response to the financial crisis, the Czech Republic took a number of measures, including a slight increase in capital of the Czech Export Bank, the Export Guarantee and Insurance Corporation, and the Czech-Moravian Guarantee and Development Bank. These measures amount to less than 0.1% of GDP and have no impact on the deficit. The bolstering of the capital of these institutions will help exporting firms, especially SMEs. In addition, the Czech government increased the coverage of the deposit guarantee scheme to €50 000.

---

[6] This estimation is based on stimulus measures adopted up to 25 June 2009.

In its opinion on the most recent update of the convergence programme, the Council considered that the budgetary outcomes are subject to downside risks. The Council invited the Czech Republic to "implement the 2009 fiscal plans, including stimulus measures, in line with the EERP and within the framework of the SGP; carry out significant structural consolidation in 2010 and beyond towards the MTO, and back-up the budgetary strategy with specific measures for reducing expenditure in 2010-2011; continue with the necessary pension and health care reforms, given the projected increase in age-related expenditures, in order to improve the long-term sustainability of public finances".

6. CONCLUSIONS

The general government deficit in the Czech Republic is planned to reach 3.9% of GDP in 2009, above and not close to the 3% of GDP reference value. In the light of more recent information, the 2009 deficit could however turn out significantly higher. The planned excess over the reference value can be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact but can not be considered as temporary. These elements suggest that the deficit criterion in the Treaty is not fulfilled.

General government gross debt remains well below the 60% of GDP reference value.

In line with the Treaty, this report has also examined "relevant factors", which, according to the Stability and Growth Pact, can only be taken into account in the steps leading to the decision on the existence of an excessive deficit if the double condition - that the deficit remains close to the reference value and that its excess over the reference value is temporary - is fully met. Considered on their own merit, the relevant factors in the current case on balance seem to present a mixed picture.

The existence of a severe economic downturn, with public finance implications, increases the need to undertake enhanced surveillance under the EDP.