

# **The Impact of the Czech Republic's Accession to the European Union on Consumer Prices in the Czech Republic**

## **Information Material for the Government**

The Czech Republic will probably join the EU in May 2004. The Czech National Bank analyses summarised in this material prove that the one-off price impacts of accession will probably be only slight; in other words they will not take the form of a dramatic price hike as some older estimates suggested.

The experiences of countries that joined the EU in the past (Ireland, Greece, Spain, Portugal) should also alleviate fears of a fundamental price shock. However, it is very difficult to make comparisons with these countries owing to the different circumstances of their accession, such as different rates of inflation, the different structures of the economies of the acceding countries, the different nature of the EU and its regulations at the time etc.

### **1. The need to quell unfounded fears of a massive price shock**

Although the Czech Republic's accession to the EU will evidently have only a slight impact on inflation, some economic subjects continue to fear a pronounced, one-off equalisation of Czech comparable price levels and a massive rise in inflation. These subjects might even see the impact of EU accession in this year's anticipated return of inflation from its current, extremely low levels to levels within the inflation target. This return will chiefly be linked, however, to the end of disinflationary cost shocks and will have nothing to do with joining the EU.

If the expectation of a marked price impact were to become more widespread, it might to some extent be self-fulfilling, i.e. it might of itself lead to additional inflationary pressures. That would subsequently make it necessary to tighten monetary policy, with undesirable impacts on the real economy. The government of the Czech Republic and the CNB, as the key actors of economic policy, can avoid this kind of needless restriction if they succeed in quelling this unfounded expectation by means of intensive, joint communication of the message that joining the EU will not result in fundamental one-off price hikes or a sudden, unusually large-scale increase in inflation. This material is intended to be a document on which this communication can be based.

### **2. Short-term impacts of the Czech Republic's accession to the EU on consumer prices (administrative factors)**

#### **2.1 Summary**

The following can be regarded as fundamental factors that could, in the short term after EU accession, lead to a major, one-off acceleration in the increase of consumer prices: (i) harmonisation of the structure and rates of indirect taxes; (ii) the Czech Republic's joining the Common Agricultural Policy; and (iii) the introduction of the single customs policy of the European Union. By contrast, changes in the prices of production factors cannot be expected to have a significant short-term impact<sup>1</sup>.

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<sup>1</sup> The movement of capital, specifically the purchase of real estate by EU citizens, will continue to be restricted

The impacts of the Czech Republic's accession to the EU can only be estimated relatively accurately in the case of the harmonisation of indirect taxes. If the government proposals for their further harmonisation are approved, this will probably bring an increase in the year-on-year CPI increment of approximately 0.6% in July 2003 for a period of one year and in January 2004 a further contribution to the year-on-year CPI increment of 0.4% (again for a period of one year). In 2004, as of the date of accession to the EU, i.e. in May, there should be a transfer of items between the lower and higher rate of VAT, with an anticipated impact on year-on-year inflation of approx. 1.5% (for a period of one year).

The Czech Republic's joining the Common Agricultural Policy will bring changes in foodstuffs prices, but will not affect the overall absolute level of these prices in the short term. No increases in the price of foodstuffs can be expected from the introduction of the Single Customs Policy of the European Union either. Foodstuffs prices will experience conflicting pressures in connection with the changes in customs and related legislation; the overall direction and scale of the pressure this change will put on foodstuffs prices cannot be accurately predicted, however. Nevertheless, fundamental aggregate impacts on consumer prices cannot be expected.

## **2.2. Detailed evaluation of the impact of short-term factors on prices**

### ***2.2.1 Harmonisation of the structure and rates of indirect taxes (consumer taxes and value added tax)***

**Increasing consumer taxes** to the minimum EU level before accession, with the exception of tobacco products, was a condition of the successful completion of accession talks. That means that consumer tax rises can still be deferred, but the Czech Republic will have to raise consumer taxes by the date of EU entry at the latest if the commitments assumed in respect of the EU are to be fulfilled. Current proposals anticipate raising consumer taxes in two stages; any deferral of the decision would thus result in a pronounced, all-at-once increase.

In the case of **value added tax** the Czech Republic is not obliged to change the rates in connection with EU accession. There does not have to be a change in VAT rates either before EU entry or immediately afterwards.

On the other hand, by the date of EU entry at the latest **certain items must be moved from the lower rate to the basic rate and vice versa** (exemptions from this commitment have only been agreed for certain items). The most marked impact can be estimated with items of public catering and telephone charges.

## Summary of anticipated impacts of tax adjustments on consumer prices

	anticipated validity from:	estimated impact on inflation in %	decision status	comment
<b>changes in consumer taxes</b> - tobacco products, liquor	1.6./1.7.2003	0.6	to be re-submitted to Chamber of Deputies	attainment of minimum EU levels
- tobacco products, petrol, wine	1.1.2004	0.4	submitted to government	excluding cigarettes
<b>VAT changes</b> - transfer to higher/lower rate	as of EU entry (1.5.2004)	1.5	being prepared by Ministry of Finance	excluding heat

In April the Chamber of Deputies of the Parliament of the Czech Republic rejected a draft amendment of the act on consumer taxes which contained the first-stage increase in consumer taxes for tobacco products and liquor.<sup>2</sup> The draft will probably put before Parliament again in May. The overall direct impact in the first stage of proposed consumer tax changes can be estimated at approximately 0.3% to 0.4%. Indirect impacts (price increases outside the consumer tax adjustment) of an estimated 0.2% also need to be reckoned with. Adopting this consumer taxes act amendment would therefore raise year-on-year inflation by 0.6%, probably for a period of 12 months from June or July 2003 (if enacted in May 2003).

Another amendment of the consumer taxes act containing the second stage of harmonisation of consumer taxes with EU rates has already been approved by the government and will also be put before Parliament in May. This consumer taxes increase is likely to start to apply at the start of 2004 (cigarettes, propellants); its overall estimated impact on inflation is an increase of approx. 0.4% (again, just for one year in the year-on-year CPI increment).

The draft **amendment of the act on VAT** has not been submitted yet. As of the EU accession date, there should be a shift in rates between the higher and lower VAT rates according to EU rates, with the exception of household heat and construction work (construction work is not an item in the consumer basket). Most items will be moved to the higher rate; some foodstuffs items, for example, will be shifted down to the lower rate. The biggest impact on inflation will come from the move of catering and accommodation to the higher rate, with an estimated impact on inflation of 1%. The second most significant change is the transfer of telephone charges to the upper rate, estimated to raise inflation by 0.3-0.4%.

### 2.2.2 Common Agricultural Policy

Application of the EU's Common Agricultural Policy (CAP) will bring Czech agriculture higher incomes compared to the existing level of subsidies provided from the state budget of the Czech Republic, state funds and EU pre-accession aid. As "direct payments" are gradually

<sup>2</sup> For cigarettes it is expected that the rate will be raised from the existing CZK 0.36/unit to CZK 0.44/unit and the percentage rate from 22% to 22.5%. VAT will raise the end price by a further 22% of the consumer tax increase. Cigarette prices could rise by approx. CZK 2.50 per box. Consumer tax will be raised for all other tobacco products as well.

For liquor the fixed rate is expected to be raised from the existing CZK 234/litre to CZK 265/litre. VAT will raise the end price by a further 22% of the consumer tax increase. The prices of alcoholic drinks could rise by approx. CZK 8 for a half-litre box of a 40% proof alcoholic drink.

increased, the overall volume of subsidies provided will grow (compared to the level budgeted for 2003) by approximately 60% in 2004 and to approx. 120% in 2006. This will raise substantially the proportion of non-price payments into agriculture, which might partially weaken the pressure from agricultural producers on raising the prices of their produce. The increased costs of agricultural producers on material measures (veterinary, phytosanitary, hygiene standards etc.) and administrative requirements (records of agricultural land, farm animals etc.) already have the opposite effect and will continue to do so.

In recent years, agricultural producers' prices have drawn close to EU prices; this has been caused both by the increase in the domestic prices of certain commodities and by the reduction in intervention (cereal crops) or guideline (milk) prices in the EU. The strengthening Czech koruna has also had some effect. Upon entry to the EU, the prices of agricultural products can be expected to move in both directions; some commodities are expected to rise sharply in price (sugar beet, milk), slaughterhouse pigs and certain types of poultry in particular should become cheaper. Overall, it is possible to estimate that entry to the EU should not have a major impact on the prices of agricultural producers in the Czech Republic. This estimate is based on the conclusions of the Ministry of Agriculture of the Czech Republic and the Agricultural Economics Research Institute. If we take into consideration the fluctuations that have affected these prices to date (as much as 10% year-on-year), the expected rise cannot be regarded as a fundamental risk of accelerated foodstuffs price increases. Seeing that the core agricultural products will be sold for at least the officially fixed prices, one notable effect of joining the CAP will be to reduce the price fluctuations of the main commodities and to stabilise the development of agricultural producers' prices.

### Comparison of agricultural producers' prices (as of 29.9.2002)

<i>Commodity</i>	<i>unit</i>	<i>Czech Republic</i>	<i>Slovak Republic</i>	<i>Germany</i>	<i>UK</i>
Food wheat	CZK/tonne	3280	2996	3010	
Feed wheat	CZK/tonne	2735	2380	2656	2986
Feed barley	CZK/tonne	2590	2551	2610	
Malting barley	CZK/tonne	3392		3610	
Rape	CZK/tonne	6215		6840	
Consumption potatoes	CZK/tonne	3250	3474	1876	3158
Fatted pigs	CZK/tonne of live matter	38220	37120	28529	
Fatted chickens	CZK/tonne of live matter	20.45		21	
Fatted cattle	CZK/tonne of live matter	37360	32874	28727	38926

Source: Agricultural Economics Research Institute, AgraEurope, Czech Statistical Office

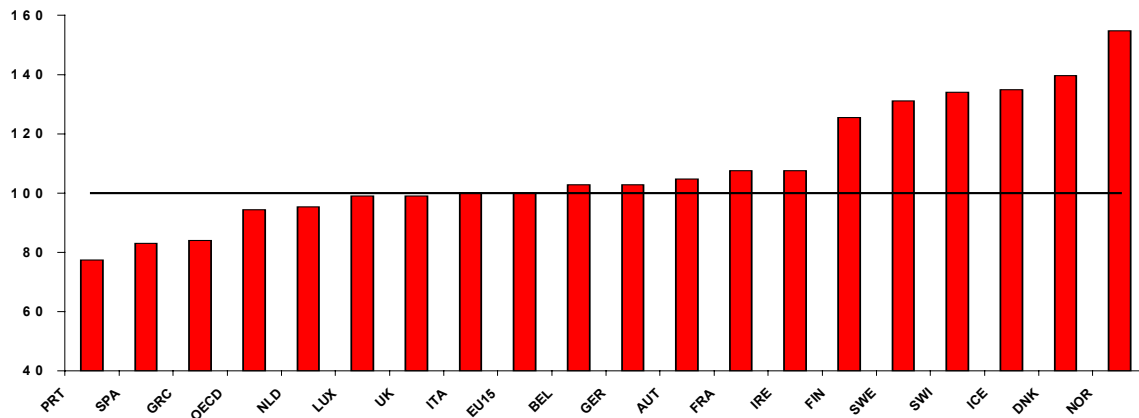
The table shows the prices at which primary producers sell their produce on the market.

These prices do not include non-price payments to agricultural primary producers (e.g. direct payments in the EU).

Joining the CAP will not have a direct influence on the overall **level of consumer foodstuffs prices in the Czech Republic** either. There are relatively large differences in foodstuffs prices from one EU member state to another – these differences go into the tens of percent, even though farmers all sell their produce according to the CAP's rules. The biggest price dispersion is in fresh produce intended for immediate consumption (dependent on local production, transport costs etc.). There will, however, be considerable shifts in the mutual relations between the prices of individual types of foodstuffs and a gradual approximation with prices in neighbouring countries (which will also depend on the Czech koruna exchange rate). Compared to existing EU countries, the Czech Republic has for a long time enjoyed

substantially cheaper sugar, beef, beer and bread, for example. It should be expected that the differences between the prices of individual foodstuffs will increase according to the amount of processing, the degree of preparation by hand etc.

### Comparison of foodstuffs price levels in 1999 (EU 15 = 100), based on exchange rates



Agricultural producers' prices constitute the first link in the vertical production chain and therefore represent merely a part of the final consumer price of most foodstuffs products (the more demanding the processing, the smaller the impact of changes in the prices of the initial raw material on the final consumer price). That applies mainly for the meat production chain, which dominates the foodstuffs consumer basket (approx. 1/3).

Additionally, the current market situation is marked by a causal dependency between individual price sets that is the opposite of what might be expected: agricultural producers are not the primary price determinants. The biggest buyers, particularly international supermarkets, determine the price at which commodities are bought from agricultural produce processors or primary producers. As the foodstuffs industry gets more concentrated and comes under the control of foreign owners, their role in fixing the price of agricultural raw materials also grows (buyer monopolisation). The level of final (consumer) foodstuffs prices is today largely determined by the price policy of these supermarket chains.

At the same time, experience has shown that international supermarket chains fix end prices with an eye to the purchasing power of a given country's population. The consumer prices of foodstuffs are therefore largely dependent on the magnitude of household incomes and the structure of their expenditure.

These factors suggest that concern about a large foodstuffs price hike is inappropriate. In the long term, though, gradual growth of foodstuffs prices can be foreseen as an integral part of the economic convergence with developed EU countries.

### 2.2.3 Introduction of the EU's Single Customs Policy

As far as the movement of goods and services is concerned, prices will be affected by **changes in customs tariffs and other circumstances** (quotas, imports of subsidised goods) related to the introduction of the EU's single customs policy.

Under free trade agreements, preferential customs tariffs are already applied to imports of goods from the European Union, CEFTA countries, EFTA and the Baltic republics. The real customs incidence is currently around just 0.7%. The Czech Republic's accession to the Czech Republic, accompanied by participation in the customs union, will mean that all tariff barriers are eliminated. The Czech Republic's relations with third-party countries (EU non-members) will be governed mainly by GATT. It is reasonable to expect that any pressure to restrict imports from these countries (and from Asia in particular) will be reflected in non-customs measures which should not have any impact on prices. GATT countries account for 95% of the Czech Republic's total foreign trade. The change in customs policy will therefore not lead to any marked increase in the level of import prices.<sup>3</sup>

At the moment of EU accession, the integration of the Czech Republic's foreign trade into the EU's single customs policy (which also means the scrapping of subsidised exports from existing EU countries to the Czech Republic) and into the system of subsidised exports to non-EU countries will take effect. Duty on imports from existing EU countries (e.g. wine) will be abolished, but so will the subsidies that the EU provides solely for exports outside the EU (e.g. cheeses). There will therefore be movements in both directions in the prices of foodstuffs or raw materials for foodstuffs production that are imported to the Czech Republic from EU countries. Czech agricultural output will also find itself in competition with foodstuffs from other countries acceding at the same time. Conversely, the abolition of duty on exports to existing EU states will strengthen Czech producers' position somewhat. The prices of agricultural products and foodstuffs imported to the Czech Republic from third-party countries will rise for the most part (because of the increased customs protection in the EU). Evaluation of the overall effect of these conflicting changes associated with the new duty system leads to the conclusion that no fundamental impact on consumer prices can be expected.

### **3. Productivity growth – a long-term price factor without any strong link to EU accession**

Besides the aforementioned administrative influences, prices will be affected by a number of other long-term factors, i.e. factors not associated with the Czech Republic's accession to the EU. These are mainly the gradual growth in the economy's productivity, the closing of the gap in gross domestic product per inhabitant, the related rising standard of living and the change in the structure of consumption. This growth in the economy's performance is linked to the faster pace of productivity growth in the Czech trade sector (industry) than in the non-trade sector (services). The outcome is a balanced, real appreciation in the foreign exchange rate as an expression of the convergence of the Czech economy with other developed economies.

These processes will cause Czech price levels to gradually draw closer to the price level in developed countries. This is a medium-term to long-term tendency, however, which has already started and will continue when the Czech Republic is a member of the EU and later

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<sup>3</sup> For example, according to calculations by the General Directorate of Customs of the Ministry of Finance of the Czech Republic the value of collected duty should fall by approx. CZK 9 billion (from CZK 10 billion to CZK 1 billion) after EU entry; that should lead to the deduction that the level of import prices will experience a one-off fall.

the Eurozone. There is no reason to expect that EU accession on its own will result in any sudden turbulence in this area, with dramatic price impacts. Moreover, it is reasonable to expect that the influence of these factors will gradually weaken in future. This sober evaluation is partly based on existing empirical research. This shows that the existing development of the said differential in productivity growth has been relatively weak and that the quantitative impacts on prices of the process of economic convergence were limited.