Methodological Manual

of the Fiscal Outlook CR

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of the Fiscal Outlook of the Czech Republic

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The Methodological Manual stands as an integral part of the Fiscal Outlook of the CR. The Manual defines and explains terms, methods and statistics used in the Fiscal Outlook.

The Fiscal Outlook is published by the Department for Financial Policy of the Ministry of finance of the CR with a semi-annual periodicity (published generally at the end of May and October). It contains forecast of the current and next year and also the outlook for the following 2 years. The Outlook is available on the internet:

http://www.mfcr.cz/FiscalOutlook

Relevant comments and ideas helping to improve the quality of the publication are welcomed at:

Fiscal.Outlook@mfcr.cz

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List of Abbreviations

CR...Czech Republic
CZSO..Czech Statistical Office
EC...European Commission
EDP...Excessive Deficit Procedure
EDP B.9...net lending/borrowing of the general government applied under EDP
ESA 95 ....European System of National and Regional Accounts (1995)
ESA 2010 ....European System of National and Regional Accounts (2010)
ESCB ....European System of Central Banks
EU, EU28 ....European Union (EU28 coverage)
GFS 1986 ....Government Finance Statistics 1986
GFS 2001 ....Government Finance Statistics 2001
GDP ....gross domestic product
MF CR..Ministry of Finance of the Czech Republic
OECD ....Organisation for Economic Co-operation and Development

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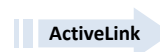
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Words highlighted **this way** are active links leading to another term in the publication or external document dealing with the term. The alphabet list of references is to be found at the end of the Manual.

Introduction

The Methodological Manual of the Ministry of Finance's semi-annual publication Fiscal Outlook of the Czech Republic aims to explain key principles of main methodologies used for recording in the public finances and to interpret selected terms used in the publications Fiscal Outlook, Convergence Programme and Macroeconomic Forecast. The main focus of the Manual is on easy comprehensibility of interpretation. Presented information were put together with an intent of selecting only key aspects necessary for understanding of the given terms while preserving factual correctness. Because of the significant extent of information summarised in the Manual it was not possible to avoid a certain degree of simplification. Accurate and detailed information can be looked up in relevant methodological manuals and other related documents, whose short list is given at the end of the document.

Cash Flow Methodology

The **cash flow methodology** records revenue and expenditure at time the cash flow is realised. It is used especially in budgetary documents, and it is directly linked to the state budget, budgets of state funds and other subjects of public budgets that are in the approval process.

The **cash principle** records revenues and expenditures on the basis of payments made, not on the basis of the origination of a receivable or a payable. The main analytical elements are revenue/expenditure, deficit/surplus and financing (including loans provided and their respective repayment instalments).

Balance of public budgets is the difference between the revenue and expenditure. It represents the financing need (in case of a deficit) or financing ability (in case of a surplus). The balance is in the Fiscal Outlook shown without the influence of financial operations, thus representing the balance of revenues and expenditures less privatisation revenues and other financial operations.

The **balance for fiscal targeting** is the public budgets balance (till the end of year 2013 without the influence of financial operations) net of subsidies for transformation institutions and other costs of transformation processes. Excluded is also an impact of EU resources (incl. financial operations of the **National Fund**) which would distort results of the given year by time inconsistency between accepted payments from EU and their drawing by end acceptors.

Financing is identical with the balance and represents changes in received governmental loans and bonds, changes in cash and active liquidity management operations, including the change in receivables resulting from the provided loans, their respective instalments and other financial operations. It is used to evaluate the budgetary policy with focus on its impacts and effects on the financial markets and their stability.

Financial operations mean transactions that create or extinguish a financial receivable and therefore are not primary expenditures. These are only changes within financial assets, and include, for example, repayable financial assistance provided, purchase and sale of state ownership interests (stock), i.e. operations where one financial asset (e.g. money) is exchanged for another financial asset (e.g. an account receivable). Similarly, payment for an exercised guarantee represents the creation of a receivable of the state from the entity to which the guarantee has been issued. In case that the exercised guarantee is not returnable, it is classified as a capital spending transfer.

Debt represents in the presented concept the volume of debt instruments (foreign loans, bank loans, state bonds and bonds issued by municipal governments).

State debt, defined in the **Act on Budgetary Rules No. 218/2000 Coll.**, consists of the sum of financial liabilities. State financial liabilities are obligations arisen from foreign loans and bank loans received by the state, as well as from state bonds issued, and other state obligations. It does not include any obligations of extra-budgetary funds, health insurance and municipalities systems, state guarantees or any other conditional obligations of the general government sector.

Government Finance Statistics 2001 (GFS 2001)

The data is reported on the basis of a cash flow methodology **Government Finance Statistics 2001** that is reflected in grouping of revenue and expenditure operations and necessary methodological adjustments. The government statistics are structured as a sum of individual items of public budgets, where the consolidation of revenues and expenditures is further applied in order to exclude flows among individual parts of the government sector.

The structure and coverage of the public sector in GFS 2001 methodology is depicted in **Figure 2** in the chapter dedicated to the **institutional coverage.**

From GFS 1986 to GFS 2001 Methodology

The Ministry of Finance since 2010 started using a new methodology prepared by the International Monetary Fund (IMF) for reporting government finance statistics, which is defined in the publication **Government Finance Statistics Manual 2001** (hereinafter referred to as "GFS 2001").

Based on this manual, both public budgets transactions (revenues, expenditures and financing) carried out on a cash basis and those from stock variables regarding debt that were reported in compliance with the **Government finance Statistics 1986 methodology** are monitored, as well as operations associated with the origin, extinguishment or conversion of accounts receivable and payable and with other economic flows, such as gains and losses from holding assets and liabilities. In addition to the flow operations, a balance sheet is also compiled. The institutional definition of the sector under the GFS 1986 methodology had de-rived from a functional concept for defining the government sector, while GFS 2001 includes institutions in the government sector on the basis of an institutional concept defined in accordance with the methodology of the **European System of National and Regional Accounts** (ESA 95).

In the current phase of implementation the financial flows are followed and the GFS 1986 and GFS 2001 institutional coverage is of the same extent. The aim is to achieve consistent institutional coverage under the GFS 2001 methodology with the definition of the government institutions sector in the ESA 95 methodology. In coming years, extension of the institutional coverage of public budgets to additional subjects (such as selected centrally and locally managed semi-budgetary organisations, public universities and the Railway Infrastructure Administration) is anticipated.

Differences between GFS 1986 and GFS 2001

Items in the categories of revenues and expenditures have undergone partial changes. Among the main changes are the following (**MF CR, 2010**):

- Total capital revenues and capital expenditures are not reported separately. Operations relating to purchase and sale of non-financial assets have been excluded from the revenues and expenditures. In this connection, the category of cash flows from investments into non-financial assets is newly monitored. Another part of capital expenditures related to revenue and expenditure from subsidies and transfers was included into operating revenues and expenditures.
- Payments of social contributions made from public budgets for their employees that were consolidated under the GFS 1986 methodology remain as components of the revenues and expenditures from relevant categories.
- In tax revenues, the value added tax is decreased by tax payments of the EC's own sources into the EU budget in relation to VAT.
- The category of net loans (i.e. loans provided minus their repayments) is not part of expenditures in the GFS 2001 methodology, i.e. these operations do not affect the public budgets deficit but are part of the accounts receivable recorded within financing.
- Outlays in implementing high-risk guarantees whose return is uncertain are included in the expenditures as capital transfers. Under the GFS 1986 methodology, these had been classified as loans. Their potential payments are part of public budgets revenues (not repayments of previously granted loans as under GFS 1986).

In the GFS 2001 methodology is the **total balance** in the given phase of implementation defined as a net cash deficit/surplus. Due to its character, it can be compared to the GFS 1986 deficit net of net loans.

This balance can be further decomposed to:
- **Net cash flow from operating activities**, which represents the difference between revenues and expenditures from operating activities. Compared to the previously reported current balance deficit, this balance includes capital revenue and expenditure from subsidies and transfers.
- **Net cash flow from investments in non-financial assets**, which represents the value of newly acquired non-financial assets decreased by the revenues from the sale of non-financial assets.

European System of National and Regional Accounts 1995 (ESA 95)

Data under the national accounts methodology cover the entire **general government** and its operations are recorded on the **accrual principle**.

The general government in the national accounting represents all institutional units that are controlled by the government and are non-market producers, i.e. more than a half of their output is financed by the government and less than a half from receipts. Conventional sectoral accounts in the national accounting show various stages of the economic process: production, formation, distribution, redistribution and use of income, and accumulation.

For the purposes of using data for the general government sector, particularly in evaluating the fiscal discipline and formulating fiscal policy, data for the general government are presented in a classification as revenues and expenditures.

General government revenue consists of the following transactions:
– current taxes on income, wealth and others,
– taxes on production and imports,
– capital taxes,
– social security contributions (contributions on social insurance, state employment policy insurance and health insurance),
– sales,
– subsidies on production,
– property income,
– other current and capital subsidies, and
– transfers.

General government expenditure can be also regarded from several points of view. Considering the **final consumption**, the general government expenditure consists of:
– final consumption expenditure,
– social benefits other than transfers in kind,
– interest, subsidies,
– gross fixed capital formation, and
– other expenditures.

On the other hand, the **general government expenditure by transactions** consists of:

– intermediate consumption,
– gross fixed capital formation,
– compensation of employees,
– other taxes paid on production,
– subsidies paid,
– property income,
– current taxes on income, wealth and others,
– social benefits other than transfers in kind,
– social benefits in kind,
– other current transfers,
– capital transfers, and
– net acquisition of non-financial, non-produced assets.

A **general government balance** is the difference between total revenue and total expenditure.

General government debt means total gross debt in its nominal value at the end of the respective year (i.e. consolidated after excluding debt held by various government institutions). Government debt is defined as the following instruments: currency and deposits, securities issued other than shares, exclusive of financial derivatives and loans. According to the current European standards other claims (e.g. commercial loans) are not included in the government debt.

Moreover, the ESA 95 methodology is used for deficit and debt definition under the **Stability and Growth Pact** and so-called **Maastricht Criteria**. **The deficit is adjusted** for interest derivatives.

European System of National and Regional Accounts 2010 (ESA 2010)

The National Account data will be published in the CR according to the European System of Accounts 2010 standard since the second half of 2014. The ESA 2010 is methodically based on its predecessor (**ESA 95**); however, some methodical modifications are present to better record all stages of economic process in modern economies with regard to growing globalisation and the rise of the financial sector.

General changes in ESA 2010 contain:
– recording R&D as capital formation,
– definition of expenditures on weapons systems included in assets as fixed capital formation, not in intermediate consumption,
– introducing analytical concept of capital services in terms of market production,
– broadening of financial assets definition particularly regarding financial derivatives,
– creation of new rules for recording the obligations of pension schemes,

– modification of accounting rules for goods and products intended for further processing (recorded net, not gross values),
– more detailed accounts of financial corporations and especially of Special Purpose Entity including their foreign loans footage,
– clearing up the definition of super dividends paid out by public corporations: regarded as exceptional payments and drawings of own capital,
– defining rules for PPP accounting including agencies for restructuring,
– specify recording of transactions between a government, public corporations and securitization agencies with possible impact on public debt,
– recording credit guarantees and appropriate financial assets and obligations ready to repay.

Conversion from Cash-based to Accrual ESA 95 Methodology

The cash-based balance of revenues and expenditures for the state budget, state funds and local budgets

constitutes the starting point for calculating the balance (EDP B.9) of the central and local general gov-

ernment subsector. This is compiled from official cash-based data of the Ministry of Finance, and, in the case of the state budget and state funds, the balance is approved by the Chamber of Deputies of the CR.

Operations needing to be performed upon this so-called working balance (WB) can be summarised as follows:
a) elimination of financial operations,
b) elimination of valuation operations,
c) **accrualisation**,
d) adding changes in accounts receivable and payable accompanied by sources and uses transactions,
e) special methodological adjustments,
f) adding the balances (EDP B.9) of other institutional units within the given subsector, and
g) other adjustments.

From the working cash balance of revenues and expenditures, we need to eliminate those amounts characterised as **financial transactions** (with an increase or decrease of cash occurs a simultaneous addition or reduction of a financial asset or liability), as these operations do not influence the balance (EDP B.9) and therefore cannot be left in it. These include in particular revenues from sales of ownership interests and loan repayments received, as well as expenditures for purchase of ownership interests and providing loans, i.e. categories which can be found in dedicated items of the budget structure. Certain other revenue and expenditure items also include revenues and expenditures related to changes in accounts receivable and payable which need to be identified and eliminated. Examples include payments for the CR participation in international organisations (decrease in accounts payable), payments for military hardware acquired in the past (decrease in accounts payable), payments received against accounts receivable for the former Czech Consolidation Agency (decrease of a receivable), payments received from the sale of emission permits and unit amounts assigned (decrease of a receivable), and advances provided (giving rise to a receivable).

Also eliminated from the working cash balance of revenues and expenditures are r**ealised exchange rate gains and losses** which are not part of the balance (EDP B.9).

The working cash balance does not include **transactions of sources and uses** which are no accompanied by cash flows (revenue and expenditure) but which give rise to or reduce accounts receivable or payable and do influence the resulting balance (EDP B.9). As such, these must be added to the WB. These include, for example, crediting of interest for unpaid foreign receivables (increase of an account receivable vs. interest on the sources side) and taking deliveries of military hardware for which advance payments had previously been made (decrease of a receivable vs.

intermediate consumption and acquisition of non-financial assets on the uses side).

Subsequently, the result from **operations of other institutional units** in a given subsector must be added to the adjusted cash balance of revenues and expenditures. This is calculated already from the accrual expenses and revenues using the relevant items from the profit and loss statement and subsequent information from statistical determinations.

Let us merely highlight that, among others, the following are added:
– the balance (EDP B.9) for secondary activities of state organisational units and local administrations,
– the balance (EDP B.9) of the National Fund relating exclusively to Czech funds (given in particular by a transfer from the General Treasury Administration chapter for offsetting of the realised exchange rate losses),
– the balance (EDP B.9) of the Sources from Privatisation (formerly the National Property Fund), and
– the balance (EDP B.9) of other extra-budgetary funds and accounts (in particular, extra-budgetary creation of reserve funds of the state organisational units).

Special methodological adjustments
All bilaterally agreed forgiveness of borrowers' obligations to settle their liabilities and the providing of other non-monetary benefits (e.g. wages in kind and free transfer of assets) represent use transactions (expenditure by capital transfer) under the ESA 95 methodology, which worsens the balance (EDP B.9). As these circumstances have no accompanying cash flows, they also are not part of the WB and must be added. (Similarly revenue capital transfers.)

In case a government institutional unit which has provided a guarantee is called upon to pay compensation (whether principal or interest), it is necessary to add to the working balance the capital expenditure transfer of this unit in favour of the debtor. Thus, there is a one-time deterioration of the balance (EDP B.9) in the amount of the entire guaranteed principal (so-called imputation of the guarantee). On the other hand, payments made against guarantees already imputed are eliminated from the working balance as financial operations.

Similarly, when acquiring property by means of financial and long-term operating lease (as in the case of Grippen airplanes), at the time of acquisition the expenditure capital transfer of the acquiring unit is again added to the working cash balance, with a one-time deteriorating effect on the resulting balance in the amount of the value of the acquired property. On the other hand, lease-payment expenditures in the ensu-

ing years are eliminated from the working cash balance again as financial operations.

The ESA 95 methodology specifically requires the time discrepancies between the expenditures from EU funds (including pre-financing from national funds) and revenues from the EU in the working cash balance not affect the resulting balance (EDP B.9). Therefore, the WB is also corrected to this effect.

Accrual Principle and Accrualisation

The accrual principle means that transactions are recorded at the time when the economic value is created, transformed or ceases to exist or when receivables and liabilities increase or decrease regardless of the moment when the realised transaction will be settled in money terms.

The following are accrued:
− **taxes**,
− social security contributions,
− toll and highway fees,
− national share in customs and sugar duties collected for the EU budget,
− interest revenues and expenditures,
− pensions paid, and
− net acquisition of non-financial assets.

In general, the accrual principle can be summarised as follows:
a)   source transactions = revenues − decrease of related receivables + new related receivables;
b)   use transactions = expenditures − decrease of related payables + new related payables.

However, accrualisation of cash data in the Czech Republic has several forms. An alternative, so-called time-adjustment method approved by Eurostat is used for **taxes and social security contributions**.

Highway fees and toll are accrued with one-month-adjustment when an encashment for t−1 year's December is added to t year's encashment subtracted for the t year's December encashment.

Interest revenues and expenditures are accrued in the way to spread them evenly throughout the whole duration of bonds.

Pensions paid are accrued in the way that the funds transferred from the Ministry of Labour and Social Affairs to be paid out by the Czech Post in January next year are added to expenditures of the next year, i.e. in the year when the funds are really paid out.

Net acquisition of non-financial assets is recorded at the moment of net acquisition of an asset (e.g. purchasing of a building) in legal terms, not when the transaction is settled in money terms.

National share in customs and sugar duties collected for the EU budget is not accrued in the Czech Republic.

Accrualisation of Taxes including the Social Security Contributions

Accrualisation of taxes means basically calculation of tax revenues under the **accrual ESA 95 and ESA 2010 methodology**. Calculation of taxes based on the both methodologies can be carried out via two methods (see **Regulation No. 2516/2000 of the European Parliament and of the Council**): based on the tax returns and by using time-adjusted cash.

The **method based on tax returns** uses data published in tax returns of those subjected to the assumed tax. Such recorded data, however, need to be adjusted for a part of the tax liability that will never be paid. The

Table 1) is based on the effective legislation and empirical knowledge on the delay between the movement of funds on the governmental accounts and the economic reality whose existence generates the emergence of a certain tax obligation. In the case of ESA 95 or ESA 2010 methodology provides governments with a possibility to decide whether this amount should reduce the volume of tax revenues or whether to maintain the volume unchanged and record the amount of uncollected taxes in national accounts as a capital transfer, i.e. an increase in total government expenditures.

The time-adjusted cash method is based on the shift of the recorded cash movements into the period to which their economic character belongs. The length of the time shift (
tax prepayments, overpayments or underpayments of the tax are usually transferred to the corresponding year. For other taxes, adjustments are made for payments from the turn of the year. For more information see **May 2009 Fiscal Outlook**.

Table 1: Accrualisation of Taxes in the Czech Republic – The Time-adjusted Cash Method

Tax	Specification	Time adjustment
Value Added Tax	tax liability	1 month
	tax refunds	2 months
	customs debt	10 working days
Excises	excises except tobacco	10 working days (in case of imports of goods)
	excises except tobacco	2 months (in case of intra-community transactions)
	tobacco	2 months
	energy taxes	1 month
Corporate Income Tax	withholding	1 month
	tax return	8 months (just a tax settlement)
Personal Income Tax	dependent activity	1 month (8 months for a tax settlement)
	tax return	8 months (just a tax settlement)
	withholding	1 month
Road Tax		2 months
Taxes on capital transfers	real estate transfers	3 months
	inheritance and gift tax	12 months
Real Property Tax	-	No time adjustment
Social Security Contributions	social insurance	1 month
	health insurance	1 month

Note: The time adjustment is done by subtraction of the relevant part of tax collection in the current year t and by addition of the relevant part of tax collection in year t+1.
Source: MF CR.

Accrualisation of Interest

Principal purpose of interest accrualisation is the adjustment in obligations' cash flow in the way corresponding to factual and time context. **Coupons** of bonds, which are paid out for a time span exceeding a calendar year may be mentioned as an example. Cash flows just in one particular year, but in terms of ESA 95 and ESA 2010 it is necessary to split the sum into two years in appropriate share. The same case concerns the **premium** (bond sold for more than its nominal value) or **discount** (bond sold for less than its nominal value).

The main and most frequented method of accrualisation is the linear one, when the sum is linearly split into all periods.

In terms of this method it is necessary to take into account the arithmetic standard set at the bond issue, i.e. how many days has a month or a year. For example, convention 30E/360, where the nominator says all months have 30 days and the denominator says the year has 360 days. The last day in February, however, is the exception and February is not prolonged to 30 days. There is a variety of such conventions (e.g. act/360, act/365, act/act etc.). Accrualisation takes into account each convention used at the issue of every individual bond. Taking the bond with coupons issued in the middle of a year and sold for higher than its nominal value, it is necessary to accrue the premium as well as the coupons. The premium will be linearly split into all periods of the bond's duration (despite the cash flows in the middle of the year) and

lower the interest expenditures. In case of discount, the interest expenditures would be higher. The similar way is valid for the coupons when each exceeding to other calendar years is linearly split according to the convention used (i.e. in case of annual coupon, half of the coupon value would be relevant for a year t and the other half of the value for a year t+1). In case of the bonds with discount, the discount is linearly split in the same way as in case of the bonds with coupons up to the date of maturity.

Issued bond may be purchased by the issuer (in this case, the public sector is the issuer) before the maturity date. Accrualisation has to take this into account. Purchased bond and corresponding accrual transaction are not cancelling each other, but the government becomes an investor by purchasing the bond and coupons as well as premium/discount are accrued. Total accrual interests for this instrument are the sum of accrued revenue and expenditure positions.

So called **retailed bonds**, i.e. bonds sold to small investors, are, however, the exception to above mentioned method. These are accrued through the computed bond yield until the maturity date. There is used such an interest rate that by discounting given bond's cash flows (particularly principal and coupon) equalizes these flows with the purchase price of the bond. The interest rate calculated in this way is used for setting the annual costs of the bond.

Drawing the EU Cohesion Policy Funds

EU policy for economic, social and territorial cohesion is financed from the EU structural funds (European fund for regional development and European social fund) and cohesion fund (thereinafter EU funds). The policy is aimed at "…reducing disparities between the levels of development of the various regions and the backwardness of the least favoured regions…" (Article 174, The Treaty on the Functioning of the European Union), whereby should contribute to the single market development.

Resources are drawn from EU funds within the cycles lasting several years, so called programming periods, on account of clearly defined targets and priorities. Drawing from the cohesion fund is conditioned by certain level of gross national income per capita compared to EU average. EU finances up to 85 % of the total costs and the rest is financed from national sources (without any further special treatment).

It is appropriate, for better understanding the impact of EU funds concerning various methods of computing the general government deficit, to describe briefly the stages of drawing. First step is the announcement to submitting calls for financial support within single areas. Consequently, the calls which are monitored in terms of their compatibility with the function and targets of each operational program are presented. Based on various criteria, the calls are evaluated and projects to be subsidised are chosen. This stage can be ended up by subscribing the contracts and providing the subsidy. Each payment is realized on the basis of the request for payments, which the receiver submits to appropriate managing authority (some ministries, Regional councils etc. – in charge of an operation). According to the decision of managing authority, the payments can be:

–   *ex post* – funds paid out after the realization,
–   *ex ante* – funds paid out before the realization.

After pre-funding from the state budget, these sources are afterwards refunded back to the appropriate chapter of the state budget from the account of a Certifying Authority (National Fund department at the MF CR). Consequently the call for payment is submitted to the European Commission, which transfers the means to National Fund's account.
The time between realizing the expenditures and receiving funds from the EU is the methodical problem.

In terms of national methodics, which is set in the law of budgetary rules no. 218/2000, just cash flows are recorded and the EU funds are treated in the same way. Revenue is thus recorded at the moment of arriving of the cash on account and an expenditure at the moment of paying out (either as the subsidy in case the ultimate receiver is from outside the general government or appropriate expenditure item (e.g. in-

vestment) in case the ultimate receiver is within the general government). If the above mentioned process exceeds in length one calendar year, the revenues from the EU funds represent the expenditures realized in the past and have no connection with the expenditures of the given year. The budget balances in individual years are thus affected.[1]

The IMF methodics GFS 2001 treats the means from the EU funds similarly. However, the balance may be shown with or without the National Fund operations. Operations of the National Fund are contained in the budget balance in the CR and thus biased by the balance of revenues from the EU and expenditures.

Another methodics that is based on GFS 2001 is the methodics Fiscal targeting. The balance is calculated according to the IMF methodics and adjusted by the impact of flows from the EU funds and the subsidies to the transition institutions. In terms of EU funds, all relevant revenues and expenditures are subtracted. Zero financial flows concerning EU are simulated and the budget balance is affected just by national financing of the co-financed projects. Thus the budget balance is not biased.

Accrual methodics ESA 95 (and ESA 2010) treats the EU flows most elaborately. General government balance is not biased by unequal revenues and expenditures concerning the EU funds in the same way like the sources and uses are not biased through pure mediation (when the ultimate receiver is outside the general government). Realizing of the expenditure by the ultimate receiver is the moment to which the occurrence of claim is connected. As regards the EU flows treatment, it is necessary to distinguish the cases ultimate receiver being within or outside the general government. At first, the revenues of the general government are adjusted for all cash revenues from the EU funds (or National fund) in both cases. Secondly, the subsidies from the mediator to receivers outside the general government are subtracted and so these do not bias the subsidy relations.
If the ultimate receiver is within the general government, the part of the expenditure to be refunded from the EU is added to the general government revenues. This means that the revenues from the EU are in ESA equal to expenditures of the EU funds allocation and the budget balance is not biased.

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[1] In terms of this methodics, the beginning and the end of the programming period are problematic. In the former case, it is probable that cash revenues fall short of the expenditures on the approved projects; in the latter case the case is reversed and the budget balance is improved. If, for instance, the revenues from the EU funds would be equal to the expenditures on the co-financed projects at the end of programming period, it would mean spending once more already spent money.

Notification of the Government Deficit and Debt

In accordance with European Council Regulation No. 479/2009, the Czech Republic, represented by the Czech Statistical Office, semiannually presents the European Commission, represented by Eurostat, with its so-called **Notification of the government deficit and debt** (hereinafter referred to as the "Notification"), always no later than at 1 April and 1 October of the current year. After sending Notifications, countries are operatively answering Eurostat's follow-up questions concerning the data. During those 2–3 weeks, Eurostat may order changes to be made in the data. The final act is to issue a Eurostat report on the current Notification and publication of the final data for years $t-4$ to $t-1$. If serious deficiencies are found which could not be resolved in time, Eurostat may publish the figures for the country with a reservation.

The Czech Statistical Office processes data for the past four years, $t-4$ to $t-1$, while the Ministry of Finance supplies a forecast pertaining to the current year, t. Czech Statistical Office is responsible that the **ESA 95 methodology** be applied in accordance with the valid **manual** and also is responsible for defining the general government sector for which the data is presented.

The notification contains especially data on the amount of the **government deficit (EDP B.9)** and debt for the needs of the **excessive deficit procedure**, further a method of calculating the government deficit and a connection between the amount of the deficit balance and the change in the debt balance. Notification tables are compiled for units belonging to the **general government sector**.

Output of the General Government

The general government sector contributes to the growth of gross domestic product (GDP). It creates the second-greatest added value, after the sector of non-financial enterprises.

Output of this sector represents approximately one fifth of GDP in the Czech Republic. Obviously, the dominant part consists of non-market output, which represents more than 90% of this sector's output. A smaller part of output is included in revenues as sales. The biggest part of output is created in the local government subsector, very closely followed by the central government. Social security funds participate in this output negligibly, which is caused particularly by the fact that the entities to which the health insurance companies pay for health services provided to the households are not a part of this subsector, so the output is created elsewhere. The gross value added of

the general government represents approximately two thirds of the total general government output.

As the majority of this sector's output is non-market, it is not possible to determine its market value reliably. The valuation is made on the basis of internal costs, among which the major are compensation of employees and fixed capital consumption. The majority of this sector's value added (about two thirds) is assigned to the employees. The fixed capital consumption represents approximately one third of gross added value. The net operating surplus of the central government may thus reach negative values, which in turn means that the output itself cannot cover the costs related to the fixed capital amortisation and employees' salaries. These costs must be paid from other revenues, in particular from taxes and social contributions. This is given by the specific role of the general government.

General Government Final Consumption Expenditure

It is possible to calculate the general government's contribution to GDP growth using the expenditures of individual entities. Government final consumption expenditures make up some 50% of total government expenditure on average. Their main components are

- **collective consumption expenditure** (i.e. goods and services of collective consumption, such as defence), and
- **individual consumption expenditure** (i.e. payments for goods and services that are provided to households and have the character of individual consumption, such as education or public health).

Social security funds finances the part of individual consumption that corresponds to the payments to healthcare institutions for providing services to households. This item regularly constitutes about one-

quarter of government final consumption spending. Collective consumption expenditures are paid especially by the central government subsector and, to a smaller extent, by the local government. The participation of social security funds in collective consumption expenditures is absolutely insignificant; their final consumption expenditures consist mainly of individual consumption. A relatively large part of individual consumption is financed by local governments, while the central government participates only very little.

Government final consumption expenditure forms approximately one-fifth of nominal GDP. In addition to government consumption, the GDP calculation using the consumption method involves also the formation of general government gross capital.

Public Sector

National economy could be divided in private and public sector (see **Figure 1**). Public sector includes such institutions, which are resident units controlled by the government. Public sector is thus comprised of general government and public corporations. **Public corporations** represent sub-sectors of market producers, which are operated by government institution and are either wholly owned or controlled by government sector unit.

Public corporations comprise of
- Non-financial corporations (Czech Railways, Municipal transport companies, Czech Post, CEZ, etc.)
- Financial corporations
  - Central bank
  - Other public financial corporations (Czech Export Bank, Export Guarantee and Insurance Corporation, Czech-Moravian Guarantee and Development Bank, etc.)

Public sector is therefore broader concept then government sector and these terms should not be interchanged. Unless otherwise specified, in publications of Fiscal Outlook of the CR, Convergence Programme of the CR and Macroeconomic Forecast of the CR, it is only spoken about the government sector.

More information on results of public sector could be found in the public sector satellite account published by the Czech Statistical Office.

Figure 1: Private and Public Sector
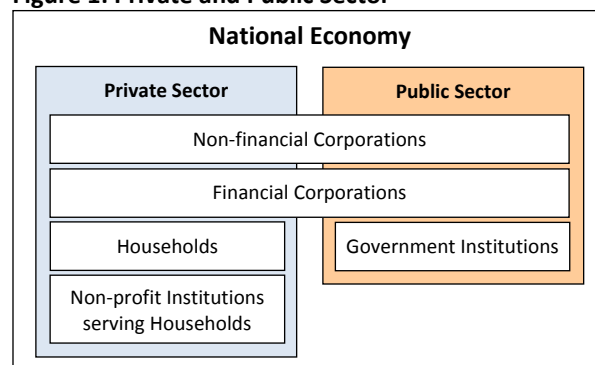
Source: EU Council (2011) and MF CR.

Institutions of the General Government Sector in the CR (GFS 2001 and ESA 95)

The rules for the **institutional coverage of general government sector** are internationally harmonised and its composition is continuously actualised by the Czech Statistical Office in the Business Register (RES). The coverage in ESA 95 encompasses four basic institutions: central government subsector, state government subsector, local government subsector and social security funds. As the Czech Republic is not a federative country the state government subsector do not exist here and the general government sector has only three subcategories.

Besides a detailed overview of the government sector institutions, the **Figure 2** also provides the definition of the sector of public finances in the GFS 2001 methodology. The Figure thus illustrates a current broader coverage of the ESA 95 methodology in the Czech Republic.

The GFS 2001 classification does not include secondary economic activities of and any economic activities of institutions. On the other hand, it includes the EU resources of the National Fund contrary to ESA 95.

To be obvious that general government sector in GFS 2001 methodology is used in the Fiscal Outlook, we often simplify the term to "**public budgets**".

Figure 2: General Government Sector in the CR (ESA 95 and GFS 2001)

General Government Sector

Central Government Subsector	**Local Government Subsector**	**Social Security Funds**
State budget	Municipalities — 6245	Health insurance companies — 8
Privatisation resour. (ex-NPF)	Regions — 14	Association of Companies Health Insurance Funds CR
State funds — 6	Municipal associations — 744	Open syndicate of Health Insurance Companies
Subsidised organisations — 159	Regional committees of cohesion regions — 7	Association of Health Insurance Companies (from 2005)
Public research institutions — 70	Union of Towns and Municipalities of the CR (from 2010)	Centre for International Reimbursements (since 2005)
Public tertiary ed. institutions — 26	Association of Regions of the CR (from 2010)	
Viticultural Fund	Subsidised organisations — 9985	
Supporting and Guarantee Agricultural and Forestry Fund	Other (from 2010) — 8	
PRISKO		
Railway Infrastructure Administration (from 2003)		
PPP Centre (from 2004)		
CPP Transgas (from 2010)		
Balmed (from 2010)		
Council for Public Supervision of Audit (from 2010)		

Land Fund (until 31.12.2012)
KONPO (until 31.8.2006)
Czech Financial (until 31.8.2006)
State Fund for Soil Fertilization (until 1.1.2006)
Czech Consolidation Agency (until 31.12.2007)
Czech Collection Agency (until 30.9.2008)

Legenda:

Institutions ESA 95 + GFS 2001
Institutions only in ESA 95
Number of units → 14

Note: NF = National Fund,
NPF = National Property Fund
*   Numbers in pale blue boxes indicate the number of those institutions.*
Source: CZSO (2012). Adjustment and GFS 2001 classification MF CR.

From Deficit to Debt (Stock-Flow Adjustment)

The **government deficit** (so-called "**net borrowing**" in the terminology of national accounts) or surplus (so-called "net lending") is not the only factor that increases or decreases a debt.

Let's begin from the fact that net lending/borrowing is the balance of the financial account that records only changes in financial assets and liabilities due to trans-

actions (i.e. not due to revaluation and other volume changes), and moreover does so at market value. The relation between this balance and the change in debt liabilities due to transactions involves also net change in financial assets and other "non-debt" liabilities due to transactions.

These include, among others, **net change in volume of claims and liabilities** due to transactions which express the difference in profit/loss values calculated using the cash basis and accrual principle.

Then the debt liabilities must be adjusted by the influence of **revaluation** and other changes that were not accounted for in the financial account. Due to the fact that government debt is presented at its nominal value, any differences between its market and nominal values must be taken into account. If the data are presented as a percentage of GDP, it is necessary to account for the influence of nominal GDP growth.

Last but not least, as to the relation between the amount of the government deficit and the change of government debt, an important role is played by revenues from **privatisation**. The privatisation itself does not lead to a net change in financial assets because one financial asset (investments in privatised companies) is exchanged for another (currency). However, the funds received may be used to finance the deficit without the need to issue bonds or take new loans, i.e. without increasing the debt.

Guarantees in ESA 95 Methodology

Guarantees in ESA 95 Methodology might be provided one-off (e.g. to guarantee specific loan or for better borrowing conditions) as well as cover all liabilities. However, two cases are excluded from the regulation. In terms of the national accounts, a **public enterprise** debt does not represent a guarantee automatically if the general government:
− is the company's shareholder (and, therefore, a last creditor),
− borrows directly on the market in its own name with the intention to provide funds to a certain public enterprise.

In most cases the guarantee, whether concerning a particular borrowing or the entire debt, is recorded only in the company's off-balance sheet. The guarantee is then used only if the company, experiencing e.g. financial difficulties or restructuring, requests the guarantee to be fulfilled. If the guarantee is not an exercised guarantee, then it represents a contingent liability for the general government without an impact on balance or debt. Nevertheless, if upon the entry of a company into a contractual relationship it is generally known (based on the law, for example) that the government is obliged to repay a debt for the company, the obligation could be recorded in the balance sheets of both the company and the government.

Upon **the utilisation of a guarantee**, the obligation is transferred to the government. This utilisation may concern the entire guaranteed debt or only its part. The amount to which the guarantee applies is recorded in the government's financial accounts (as a change in loans) and in the balance sheet. Also the government balance is worsened through:
− **expenditure capital transfer**, and the corresponding record is made increase in a liability (loan),

− **accrued interest payments** that are spread equally over the horizon of the debt maturity.

The annuity payments of principal then constitute a mere financial transaction (i.e., decrease in cash and in loans) recorded on the government's financial account, without any further impacts on balance. By the principal payments, the general government debt is reduced.

However, in order to execute its economic policy, the government may decide to pay off a certain borrowing of a public enterprise or its part without this borrowing being utilised. In such case, the debt is not assumed and remains recorded only on the balance sheet of the company, remaining the only legal debtor. The payments of this nature are capital transfers for government that affect the balance, but not the debt.

On the other hand, another situation may occur, where the company's obligation is automatically considered as the government's one. This may occur, for example, in case of a statutory authorisation to issue a debt that imposes an obligation on the government to pay it, if the state budget for each year contains explicitly expressed payments, or if the company's debt is systematically paid by the state. An obligation of such nature must be recorded on the financial account and balance sheet of the government, and not on the accounts of the company. The amount of the obligation is included in the government debt, the interest payment is accrued. As soon as the funds from issue of the company's debt (increase in cash) are available, the capital transfer must be recorded on the capital account on behalf of the company, by means of which the general government balance is affected.

Budgetary Process of the State Budget

The sequence of activities in the preparation, approval and subsequently also administration, monitoring and control of the state budget is referred to as the budg-etary process. This process is regulated primarily by Act No. 218/2000 Coll. on budgetary rules and by Act

No. 90/1995 on rules on procedure of the Chamber of Deputies.

The draft state budget for the upcoming year is always proposed together with a draft medium-term outlook for the next two years. The government discusses the proposed amounts of **Medium term expenditure framework** (MTEF) by 30 April of the current year. Based on the amounts, preliminary draft of revenues and expenditures broken down by individual budgetary chapters is prepared by the Ministry of finance and submitted to government by 31 May. After government approval, individual chapter administrators elaborate detailed budget proposals for the upcoming year and revenue and expenditure draft for the purpose of medium-term outlook. The deadline for the processing of these documents is 31 July. The finalized draft state budget for the upcoming year and draft medium-term outlook is presented to government by the Ministry of finance by 31 August. Law on state budget is subsequently discussed and approved only by the Chamber of Deputies, in which is the government proposal submitted no later than on 30 August. Act on state budged passes three readings in the Chamber of Deputies. In the first, the basic parameters of the budget (revenues, expenditures, balance and methods of its financing and the relationship of the state budget to local government's budgets) are discussed. After their approval, these parameters become binding and cannot be changed during next readings anymore. The second reading is opened for amendatory proposals, the third reading serves primarily for legislative and technical corrections. If approved by the Chamber of Deputies, chapter administrators follow the budget parameters in the upcoming year. The budgetary process is completed by the approval of the Year-End Report, which contains processed data about the budget management in the past year. The draft Year-End Report is submitted by the Ministry of finance by 30 April and is discussed again just in the Chamber of Deputies. Each budgetary process lasts more than two years from the beginning to the end.

Figure 3: The Budgetary Process of State Budget in the Czech Republic
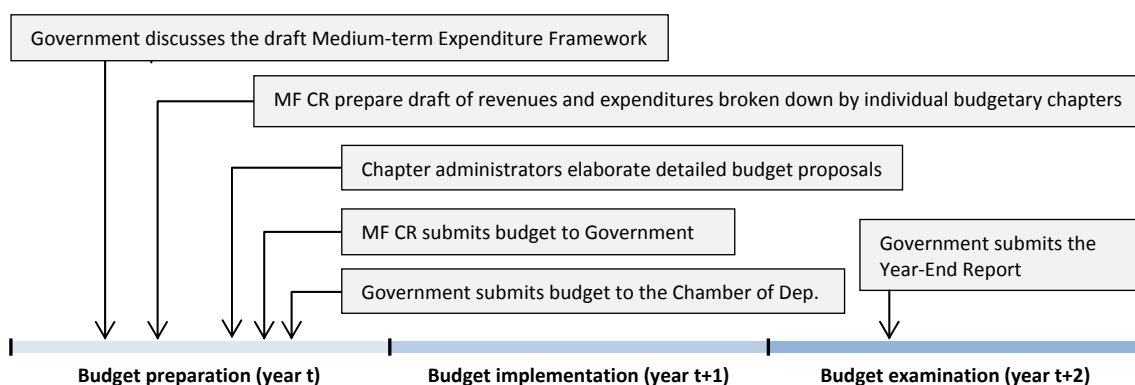
Source: MF CR.

Medium-term Expenditure Framework

Medium-term expenditure framework represents ceilings of the nominal values of the state budget and state funds expenditures. The expenditure framework forms a part of the medium-term outlook of the state budget. The Framework is determined for three years ahead as a difference between expected revenues and the targeted general government balances for those years. The figures of the expenditure framework are stated in the national **fiscal targeting methodology**.

Approved expenditure framework may be modified only in cases explicitly defined in the **Act on Budgetary Rules No. 218/2000 Coll.**:
– a change in the budgetary designation of tax revenues (redistribution of revenues between the state budget and municipal budgets also affects the volume of expenditures),

– a change in the expected volume of expenditures financed from EU funds (ceilings should not limit the possibility to draw from EU funds),
– a change in subsidy relationships between the state budget and state funds (frameworks are approved as unconsolidated and a change in subsidy relationships changes their size without influencing volume of expenditures after consolidation, which is decisive for the balance of the public budgets)
– and other extraordinary events (e.g. exceptionally inaccurate macroeconomic forecasts, natural disasters, etc.).

Thus, in the context of the Czech Republic, the fiscal rule is not a meeting the fiscal targets in the form of general government balance in per cent of GDP, but sticking to the approved expenditure framework.

The reason for this is twofold. First, in contrast to revenues and consequently also the balance, the government exercises a direct control over the size of expenditures of the state budget and state funds. Subsequently it is directly responsible for fulfilment or divergence from this rule. Second, determination of fixed volumes of expenditures is in line with operation of automatic fiscal stabilisers and anti-cyclical influence of fiscal policy. In case of higher than expected revenue due to better than forecasted economic development there comes to a decrease in the balance and a fiscal restriction, and *vice versa*. On the other hand, targeting a pre-determined volume of the balance implies pro-cyclical impacts of fiscal policy.

Fiscal Targeting Methodology and ESA 95

The **national fiscal targeting methodology** begins from recording the balances of selected public budgets on a cash basis. For the purpose of fiscal targeting, these balances are adjusted for operations of a financial nature (lending and repayments), and for revenues from privatisation and subsidies to transformation institutions (for example, settlement of losses of the Czech Consolidation Agency). The goal is:

– to net out the balance by financial operations that are cash revenues or expenditures but that nevertheless, from the economic point of view, do not represent changes in assets of public finances (e.g. privatisation),
– then to exclude one-off transactions (e.g. settlement of past transformation costs)
– finally, to bring the results closer to the ESA 95 international methodology.

The main differences between the fiscal target in the fiscal targeting methodology and the balance under ESA 95 are the following:

– differences between the cash and accrual principles (time shift between the origin of the payable or receivable and the corresponding cash flow),

– differences from unlike coverage (national fiscal target includes only balances of selected parts of general government), and
– other differences in classification (e.g. remission of uncollectible receivables that represent accrual expenditure but not a cash expenditure, etc.).

This raises the question as to why the fiscal targeting methodology has been established if the most frequently used indicators for assessing the general government balance are in the ESA 95 terms. The main reason has been to ensure the direct relation between the fiscal targeting methodology and the methodology for compiling the state budget, first in the phase when the state budget parameters and its outlook are derived from the fiscal target (expenditure limits of the budget and state funds) and then in the phase of evaluating the fulfilment of the targets. In setting a target using the fiscal targeting methodology, it is possible unambiguously to evaluate to what extent the government policy contributes to meet the targets (as a result of the state budget and state funds that are under its direct control) and to what extent the fulfilment was caused by estimates of other components of general government or by revenue forecast.

Maastricht Convergence Criteria

Joining the European Union, member states undertake to enter in the future the Economic and Monetary Union, i.e. to give up their national currencies and national monetary policy and to adopt the euro. For the member state to adopt euro, five "nominal" conditions have to be met, known as the Maastricht Convergence Criteria. These criteria are:

1) **Inflation criterion**: the annual inflation rate must not exceed by more than 1.5 percentage points the average rate of inflation in the three most successful countries.
2) **Exchange rate criterion**: the exchange rate may not deviate from the ±15% fluctuation band (modified in August 1993 from ±2.25% and ±6%).

3) **Interest rate criterion**: the average annual long-term interest rate must not exceed by more than 2 p.p. rates in the three most stable countries.
4) **Debt criterion**: general government debt-to-GDP ratio must be less than the reference threshold of 60% of GDP, or sufficiently close to this limit.
5) **Deficit criterion**: The ratio of planned or actual government deficit must not exceed a reference value of 3% of GDP, or it must sufficiently approach that value or breach it only in exceptional circumstances.

The definitions of the general government deficit and general government debt are the same as in the **Stability and Growth Pact**. (I.e. net borrows of the government sector incl. interest derivatives.

Stability and Growth Pact (SGP)

The Stability and Growth Pact is a binding framework for the co-ordination of national fiscal policies within the European Union, especially for countries in the euro area.

The reason for its implementation was to secure healthy public finance as a key component for the functioning monetary union. Its coordination and monitoring function was reinforced more in the new millennium. The Pact has two branches, a preventive one and a penalty one:

Prevention Branch
Member states are required to submit stability and convergence programmes. The first ones are submitted by members of the EMU, the second ones by EU member states with derogation i.e. EU member states with an obligation to adopt the euro in the future (as the CR). These are strategic documents that describe the objectives and means of economic policy in the horizon of 3–5 years within the macroeconomic area, fiscal area and structural policies. Member counties are especially required to achieve the minimal fiscal effort and to obey expenditure, balance and debt rule (see further chapters). The European Commission evaluates these programs and the EU Council adopts an opinion on them. If there is a risk of a failure of the adopted targets, the Commission may recommend to the EU Council an issuance of a warning and later also a proposal of recommendations.

Penalty Branch
Should a member state still fail to meet its targets and exceed the threshold of the general government defi-

cit of 3% of GDP or should it have an excessive debt, the Economic and Financial Council (ECOFIN) may, on the proposal of the European Commission, launch an **Excessive Deficit Procedure** with the state**.**

Stability and Growth Pact Reform
Since the reform of the SGP in 2005, an increased emphasis on the evaluation of long-term **sustainability of public finances** is being placed as the result of the population aging. Results of long-term projections of the European Commission which are made in collaboration with the member states also represent a criterion for evaluation of Stability and Convergence Programmes. In 2011 an important reform aiming to strengthen the monitoring of the fulfilment of medium-term objectives of the member states of the EU has been implemented in response to the world financial and economic crisis and the debt crisis of the EU member states. For that purpose, the expenditure rule was approved and the role of the debt rule was strengthened.

In summary, under assessment is the short-term development of public finances (overshooting the 3% of GDP), **Medium-Term Objective** including the Minimum Fiscal Effort (see separate headings) and long-term objectives, including sustainability indicators (see separate heading).

Cyclically Adjusted Balance

For estimation of the position of domestic economy in the economic cycle and subsequent adjustment of fiscal policy, cyclical adjusting of the general government balance is used. The overall balance net of the cyclical component is called cyclically adjusted balance.

Technique used for estimation of the cyclical component at the Ministry of finance of the CR is based on the methodology developed by the OECD (Girouard and André, 2005). The overall balance is adjusted from the cyclical component in two steps. First, the potential output is estimated, using the two-factor Cobb-Douglas production function with constant returns to scale. Potential output is specified on the basis of the labour force development (smoothed over six quarters using moving average), actual (unsmoothed) stock of physical capital in the economy and trend factor productivity smoothed using Hodrick-Prescott filter. The output gap, which determines the cyclical position of the economy, is the difference between actual and potential output. The second step is the computation of cyclical components of the items, which are sensitive to the cyclical development of the economy. We consider as sensitive to the cyclical development of GDP the following:

− personal income tax,

− corporate income tax,
− social security contributions,
− value added tax,
− excise taxes,
− import duties, and
− only expenditure item – unemployment benefits.

Cyclically sensitive items are then adjusted for the cycle using respective elasticities. The elasticity of respected revenue or expenditure item with respect to GDP is estimated in two steps. First, the elasticity of cyclical sensitive item with respect to relevant macroeconomic basis is calculated, subsequently, elasticities of these basis with respect to GDP are calculated. Estimation results are shown in Table 2.

Elasticities are set as fixed and are taken from the aforementioned study Girouard and André (2005), except for personal income tax elasticity after 2007, when the statutory progressivity of this tax was limited. Since that time, unit elasticity is used by the Ministry of Finance (see MF CR, 2009). The cyclical component of listed items is calculated as a product of the output gap, elasticities of individual items with respect to GDP and share of these items in GDP. The cyclical adjusted balance is then the difference of overall government balance and the cyclical component.

An alternative way of cyclical adjustment is using the ESCB method (Bouthevillain *et al.*, 2001). The ESCB method models the behaviour of cyclical sensitive revenues and expenditures with respect to their relevant macroeconomic bases. These bases are household consumption for value added tax and excise taxes, wage bill in the private sector for personal income tax and social security contributions, net operating surplus for corporate income tax, and unemployment for unemployment benefits.

Elasticities of these items with respect to selected bases (see Table 2) are estimated using simple linear regression, while the items are net of discretionary measures impact. The exceptions are the elasticity of excise taxes with respect to household consumption and corporate income tax with respect to net operating surplus, which are determined by expert estimation.

Using ESCB method, it is necessary to determine the cyclical behaviour of macroeconomic bases for calculating the cyclical components of individual budgetary aggregates. Cyclical component of macroeconomic base is defined as the difference between the actual level and trend value, which is calculated by smoothing the corresponding time series using the Hodrick-Prescott filter. Cyclical component of the sensitive items is calculated as a product of cyclical component of the base, elasticity of individual item with respect to relevant base and share of the item on GDP.

Table 2: Elasticities – the OECD and ESCB Methods

Cyclically Sensitive Variable	OECD Method Elasticity to output gap	ESCB Method Macroeconomic base	Elasticity to macroec. base
Value Added Tax	1,0	Households consumption	1,2
Excises	1,0	Households consumption	1,0
Corporate Income Tax	1,4	Net operating surplus	1,0
Personal Income Tax	1,0 [*)]	Wage bill	1,2
Social Security Contributions	0,8	Wage bill	0,6
Unemployment Benefits	-3,3	Unemployment	0,8

*Note: *) The personal income tax elasticity to output gap up to 2008 was 1.2%.*
Source: OECD elasticities: Girouard and André (2005). Personal income tax elasticity with respect to the output gap after 2007: MF CR. Elasticities with respect to macroeconomic bases in ESCB method: MF CR.

Structural Balance

In a number of economic texts, terms **cyclically-adjusted balance** and **structural balance** are treated as synonyms. Such a concept is rather simplistic. If the actual general government sector balance is adjusted solely for the impact of an economic cycle, we obtain the cyclically adjusted balance. Taking the cyclically adjusted balance and subtracting the items that have a character of **one-off measures** (i.e. such that are by their nature "unsystematic") results in a so-called structural balance. An example of non-recurring, one-off items represents income from the sale of UMTS licenses (licenses for mobile providers) carried in most European countries. Change in the structural balance in between two time periods is called **fiscal effort** assessing the size of discretionary measures. Carried is

also adjustment of the structural balance for interest expenses (primary structural balance). Fiscal effort from structural balances calculated in such a way then better reflects the size of active government measures since it is not burdened with expenditure items that are in a short-term difficult to influence.

In order to evaluate measures taken during the **Excessive Deficit Procedure** the EC has developed the adjusted fiscal effort (EC, 2013). The fiscal effort is in this case adjusted for the impact of the change in potential growth, for the impact of the change in the structure of the growth and for other influences on public sector revenues.

One-off and Temporary Measures

One-off and temporary measures are such measures that have only temporary impact on public budgets. These measures thus do not change the future structure of public revenues and expenditures and are not taken into account when the assessment of fiscal policy setting is made. That is why these measures are subtracted when the structural balance is calculated. Besides temporary impact on overall balance these measures are usually of nonrecurring nature and very

often result of the events that are beyond direct power of a government. No complete list is possible to make as these measures are very heterogeneous.

Changes in revenues or expenditures resulting from judicial decisions (or arbitration board decisions), sales of non-financial assets (most noted in this respect are probably the sale of frequency domains to mobile operators or the sale of emission allowances) or costs

on eliminating consequences of natural disasters can be mentioned as examples. Another example is financial compensation to churches and religious societies (amounting to 1.5 % of GDP).

The Treaty on Stability, Coordination and Governance in the EMU

Treaty on Stability, Coordination and Governance in the Economic and Monetary Union extend coordination of economic policies within the Eurozone. The crucial part of the Treaty is so called **Fiscal Compact**, which aims to further strengthening of budgetary discipline. Whereas the Stability and Growth Pact strengthen fiscal surveillance at EU´s secondary legislation, the Fiscal Compact is founded on the requirement that the contracting parties incorporate into their internal bodies of law rules, which already have been largely embodied in EU legislation. The contracting parties' bodies of law should reflect (preferably on the level of constitutional provisions) these two crucial rules:

- A duty to achieve balanced or surplus budgets. Compliance with this rule will be regarded as having a structural balance conforming to that defined by the MTO and simultaneously having a structural deficit that does not exceed 0.5% of GDP. If a state achieves a general government debt significantly lower than 60% and risks to the long-term sustainability of its public finance are low, then the structural deficit may be higher but still may not exceed 1% of GDP.

- An automatic corrective mechanism which activates in case a contracting party diverges from the MTO or from the path to its gradual attainment. The mechanism is based upon implementing pre-defined corrective measures. The aim is that initiation of these corrective measures should not be dependent upon politicians' ad hoc decisions, but, rather that, if possible, they would have an automated and binding character, thus creating a distinct pressure when the budgets are compiled.

The Fiscal Compact thus partially shifts responsibility to the individual member states for the monitoring of fiscal policy and upholding the common limits, whereas to date that has been only at the EU level. In contrast to the "six-pack", this treaty is part of the EU legal framework, but it is an international treaty joined by 25 EU states up to date. Moreover, the obligations arising under the Treaty are binding for all members of the Eurozone. Other signatory countries will be bound only if they adopt the common currency, or voluntarily accede to selected provisions of the Treaty.

Medium-Term Objective (MTO)

According to the **SGP**, each country has laid down its medium-term fiscal target (Medium-Term Objective, MTO). The target is set in terms of the **structural balance** and reflects both the growth potential of the country and its indebtedness level. Fulfilment of the medium-term objectives should provide the member states with a sufficient margin to the reference value of the deficit of 3% of GDP, secure progressive steps to the sustainability and provide a space for eventual necessary budgetary operations. The medium-term objective is set every three years or in case of a structural reform with considerable fiscal impact. The procedure of calculation of the MTO is specified by the **(Code of Conduct (EC, 2012a)**.

The euro area member countries and the countries in ERM II are obliged to maintain their MTO between −1% of GDP and a balanced or a surplus balance state.

In the countries, where the debt exceeds 60% of GDP, is the medium-term objective set such as is fulfilment simultaneously contributes to a reasonable debt-reduction effort. MTO of individual countries also has to take into account so-called implicit obligations, i.e. long-term public finance obligations especially in the form of the future old-age pensions and other expenditures depending on the changing age structure of the population. For the Czech Republic, the MTO currently comes to −1% of GDP.

Minimum Fiscal Effort

The **SGP** also determines that until the member states achieve their **MTO**, they must consolidate their public budgets and improve their fiscal stances at least by 0.5% of GDP each year (less the **economic cycle influence** and excluding one-offs). In economically good times, the member states have to try to consolidate more and so create a reserve for worse times. Any revenues beyond the expectations should be used to reduce the deficit. Deviation from this path to the medium-term fiscal target is only possible if the principal structural reforms (e.g. pension reform) are carried out, bringing immediate negative impacts but, from a long-term view, improving the state of public finances. The countries that have achieved their medium-term targets already should let automatic stabilisers act and avoid pro-cyclical policies (i.e. in particular, reducing taxes and increasing government expenditures at a time of cyclical growth).

Expenditure Rule of the Stability and Growth Pact

The expenditure rule is based on an annual comparison of the year-on-year growth rate for real spending in the government sector (which expenditures are netted against outlays for payment of interest, for European Union programmes fully compensated by revenues from EU funds, and for non-discretionary changes in outlays for unemployment benefits) and the medium-term growth rate for potential product. The medium-term growth in potential product is used as a point of reference. The potential GDP growth rate is determined by the European Commission for each member state, and always for three years ahead. All member states must conform to the obligation that the expenditure growth rate in individual years does not surpass the reference medium-term growth rate of potential GDP unless this excess is fully compensated by discretionary measures which would increase revenues.

For any country not having reached its **medium-term budgetary objective**, the reference value for permitted growth in expenditures is decreased by such amount as to ensure it is gradually being reached.

Debt Rule of the Stability and Growth Pact

For countries whose government debt relative to GDP surpasses the level of 60%, the **Stability and Growth Pact** specifies the obligation to decrease their indebtedness at a satisfactory pace. This pace depends on the debt level and its development over the past three years, while the maximum acceptable debt level in the current year is defined by the following equation:

$$dd_t = 60\% + \frac{1}{3}\sum_{i=1}^{3}\left(d_{t-i} - 60\%\right)\cdot 0{,}95^i$$

where d_t is the ratio of debt to GDP and dd_t is its maximum level permitted in year t.

The debt criterion requirement is considered fulfilled also in such case that in the current year the ratio of debt to GDP exceeds the permitted level dd_t but that according to the forecasts of the Commission this permitted value will be reached within the ensuing two years.

An **excessive deficit procedure** is not initiated with a specific state in a case that the insufficient pace of debt reduction is due to significant decline in economic output.

Safety Margin

For cases of unfavourable economic development, the member states have determined a so-called safety margin from the reference 3% limit. It represents a certain margin, respecting which will ensure that no deficits over 3% of GDP may occur even in a period of economic decline. For the Czech Republic, this margin is calculated (EC, 2012b) as 1.5% of GDP. This means that the maximum limit of the budget deficit (the minimum benchmark) is 1.5% of GDP, ensuring that the Czech Republic will not fall beneath 3% of GDP again (i.e. into the **excessive deficit procedure**).

If any of the member states does not meet these rules or if a significant deviation from the medium-term target or from the path to its achievement has been identified, the Council may, in its annual evaluation, recommend upon what the concerned country should focus (a so-called early warning).

Figure 4: Safety Margin and MTO

Source: EC (2006). Modified by MF CR.
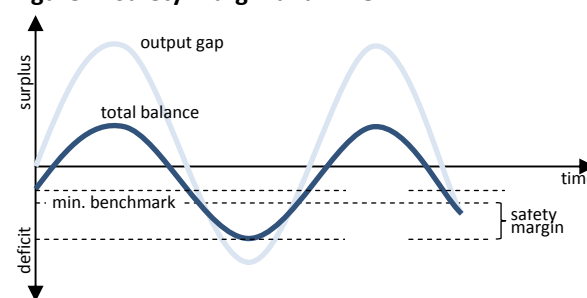
Excessive Deficit Procedure

If a member country of the EU exceeds the value of the government sector deficit of 3% of GDP or it does not achieve sufficient rate of decreasing the public debt higher than 60% of GDP, the **excessive deficit procedure** is launched. Excepted are cases of temporary excesses in deficit or debt values caused by unfavourable cyclical economic development. The unfavourable cyclical development is defined as y-o-y decrease of GDP or cumulated loss of economic output during a long period of extraordinary slow growth of GDP relative to its potential.

The EDP was for the first time launched with the Czech Republic very soon after its accession to the EU in 2004 and due to special circumstances (transition country) the timeframe for the excessive deficit correction was set as four years. The EDP was terminated in July 2008 but in 2 December 2009, after the slump in balance, it was launched again. The CR should remove the excessive deficit to 2013. The standard procedure is different – the excessive deficit has to be removed in the year following to its determination.

The penalty for a given country varies depending on whether the country is in the EMU or not. When the Procedure is initiated, the Council first issues recommendations and the member state has six months to submit measures leading to the elimination of the deficit. If such measures are not effective or not sufficiently implemented, the Council may issue another proclamation specifying concrete steps that the country should take in order to remedy the situation. Introduced may also be **intensified budget supervision**, where a member state is obliged to provide regular information in accordance with previously agreed schedule. If even then the member state fails to fulfil the recommendations, the Council may impose sanc-

tions. These sanctions are every following year revised according to the member state compliance with the EU Council recommendations. These sanctions are for the members of the EMU as follows:
−   financial penalties from 0.2 to 0.5% of GDP of the given member state depending on the violation of the Pact;
−   the Council may require a refundable deposit;
−   the member state may be required, before issuing bonds, to publish all information on this issue;
−   European Investment Bank may be asked to amend its lending policy towards the country.

The final stage is different for those member states outside the euro area, because they are not subject to the intensified budget supervision. "Only" a decision on suspending drawing funds from the Cohesion Fund may be imposed as a sanction.

To complete the Procedure successfully, it is important to remove the excessive deficit in a credible and sustainable manner. Therefore the measures cannot be one-off or non-systematic ones. The expected future development and the fiscal strategy are evaluated as well.

The Balance for Excessive Deficit Procedure Purposes

In the national accounts system there is a **net lending/net borrowing** (i.e. surplus/deficit) with a code B.9. On the other hand the balance for EDP procedure (code EDP B.9) adjusts the B.9 for expenditures connected with the interest derivatives.

The EDP balance is in some sense the basic balance, because it involves the interest expenditures that would be incurred without using the interest derivatives (swaps, Forward Rate Agreement).

Indicators of Fiscal Sustainability

Inasmuch as the **fiscal sustainability concept** is generally ambiguous, it was necessary to define fiscal sustainability itself. The European Commission (2012b) uses three main indicators – so-called **S0**, **S1** and **S2** – for defining the fiscal sustainability concept. Their results, including the methodology, are published in the regular **Sustainability Report**. These indicators make use of information from long-term projections in a consistent and comparable methodology and assumptions. The long-term projections are based on demographic and macroeconomic assumptions created by the European Commission, and the projections pertain to outlays on pensions, health care, long-term care, education and unemployment benefits.

The **S0** indicator is an "**early-detection indicator**", designed to highlight shorter-term (one-year horizon) risks for fiscal stress stemming from the fiscal as well as financial and competitiveness sides of the economy.

Permanent fiscal consolidation, S1, expresses by how many percentage points of GDP taxes need to be permanently (from the given year) increased or expendi-

tures decreased so that the government debt reaches 60% of GDP in 2030.

If t is the current year, t_0 the year preceding the long-term projection, r_t is differential between the nominal interest rate and the nominal GDP growth rate, D_t the ratio of debt to GDP, PB_t the primary structural balance, PI_t property income and T any selected year, then the indicator S1 (and S2 below) may be calculated according to the following equations:

$$S1 = r_t D_{t0} - PB_{t0} - \frac{\sum_{i=t0+1}^{T} \frac{\Delta PIi}{(1+r_t)^{i-t0}}}{\sum_{i=t0+1}^{T} \frac{1}{(1+r_t)^{i-t0}}} + \frac{r_t(D_{t0} - D_T)}{(1+r_t)^{T-t0} - 1} - \frac{\sum_{i=t0+1}^{T} \frac{\Delta PB(ageing)i}{(1+r_t)^{i-t0}}}{\sum_{i=t0+1}^{T} \frac{1}{(1+r_t)^{i-t0}}}$$

Permanent fiscal consolidation, S2, expresses by how many percentage points of GDP taxes need to be permanently (from the given year) increased or expenditures decreased so that the general government remains solvent in an infinite time horizon (i.e. the intertemporal budget constraint has been fulfilled).

$$S2 = r_t D_{t0} - PB_{t0} - r_t \sum_{t=t0+1}^{\infty} \frac{\Delta PI_t}{(1+r_t)^{t-t0}} - r_t \sum_{t=t0+1}^{\infty} \frac{\Delta PB(ageing)_t}{(1+r_t)^{t-t0}}$$

The change in the primary balance is divided into the change of the balance due to ageing ($PB(ageing)_t$) and that due to change in property income (PI_t):

$$\Delta PB_t = \Delta PB(ageing)_t + \Delta PI_t$$

European Semester

The European Semester was created in response to a substantial rise in budget instabilities within EU member countries. Its aim is to ensure closer coordination in the economic and fiscal policies of the indi- Figure 5) begins in January, when the European Commission presents growth assumptions and possible potential risks for the member countries.

These are then reflected in preparing the convergence programmes and stability programmes, which the member states are obliged to present before the end of April. The European Commission evaluates those

vidual countries and thereby contribute to maintaining the rules of the Stability and Growth Pact **and the assumptions of the Europe 2020 strategy. The cycle of the European Semester (see**

programmes and issues recommendations to the member states, and those recommendations should be incorporated into the national budgets for the following year. A crucial change brought about by the European Semester is the actual employment of these programmes at the start of the budget processes.

Figure 5: Scheme of European Semester
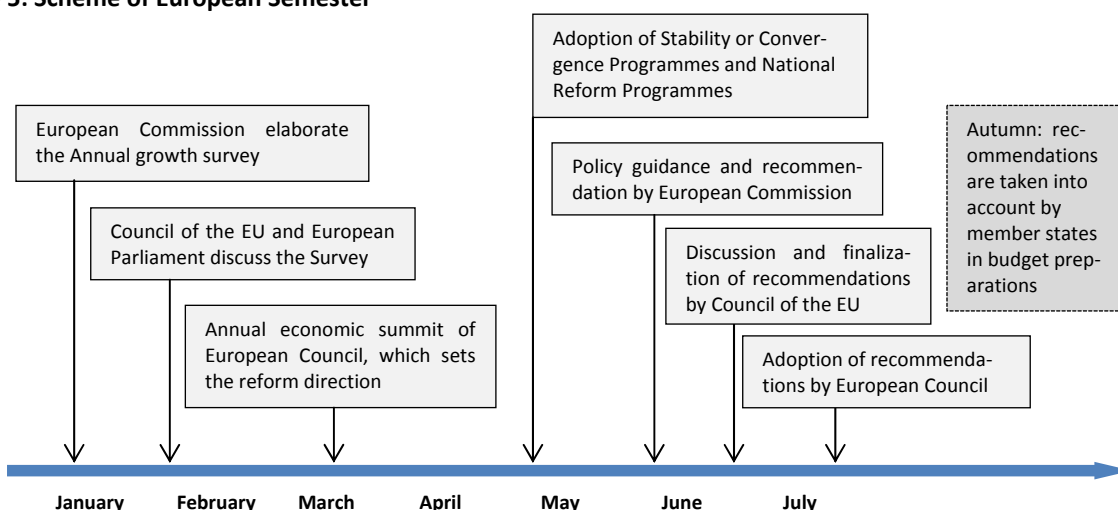
Source: MF CR.

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