Ministry of Finance
Department for Financial Policies

Methodological Annex

to Fiscal Outlook

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Contents

The document *Methodological Annex to Fiscal Outlook* has been prepared by the Ministry of Finance’s Financial Polices Department with the aim of explaining in more detail selected terms used in the periodical semi-annual publication Fiscal Outlook. It is continuously updated for selected terms from the filed of public finances and fiscal policy.

1 Introduction

The Ministry of Finance has prepared a permanent methodological annex to its periodical semi-annual publication Fiscal Outlook of the Czech Republic. Its aim of this document is to explain in a simplified way key principles of main methodologies used for recording performance of public finances and to interpret selected terms used in the publication Fiscal Outlook.

The Annex will be continuously updated for new terms and concepts used in the Fiscal Outlook.

The main aim of the Annex is an 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 Annex 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. List of selected information sources is given in the last section.

2 Cash flow methodology

The cash flow methodology records revenues and expenditures at the time when individual subjects of public budgets realise the related cash flows. It is used especially in the 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 revenues and expenditures. It represents the financing need (in case of a deficit) or financing ability (in case of a surplus). The balance of public budgets is in the publication 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 (without the influence of *financial operations*) net of subsidies for transformation institutions and other costs of transformation processes. Excluded are also 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 and the respective instalments. 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, as well as the impacts of operations related to reserve funds. 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 that has been issued the guarantee. 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 the 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.

Institutional coverage of public budgets:

- **state budget**, including settlement of losses of the Czech Consolidation Agency according to the bond programme, less the net influence of transfers into reserve funds,
- **National Fund**,
- privatisation proceeds (former National Property Fund),
- **extra-budgetary funds** – state funds, Land Fund of the Czech Republic,
- **public health insurance** – General Health Insurance Company (VZP), occupational health insurance companies, and
- **municipal governments** – local and regional governments, voluntary associations of local governments, regional committees of cohesion regions.

The term **"public budgets"** as used in the publication Fiscal Outlook has, as to its institutional coverage, a **narrower** meaning than the general government sector. **Compared to the institutional coverage of the general government sector,** public budgets **do not include:** Czech Consolidation Agency and its subsidiary companies, Czech Collection Company, Supporting and Guarantee Agricultural and Forestry Fund, Viticultural Fund, public universities, Railway Infrastructure Administration, PPP Centre, Association of Health Insurance Companies, Centre of Inter-governmental Settlements, public research institutions and a part of semi-budgetary organisations classified in the governmental sector. These subjects are included in the public budgets only by transfers between these subjects and the respective components of public budgets.

3 National accounts methodology ESA 95

Data under the national accounts methodology covers the entire general government and its operations are recorded on the accrual principle (i.e. 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).

Generally speaking, the general government in the national accounting system represents all institutional units that are controlled by the government and are non-market producers, i.e. more than half of their output is financed by the government and less than a half is financed from receipts. General government of the Czech Republic is divided into three subsectors: **central government**, **local government** and **social security funds** (for details, see below). From the perspective of institutional coverage, the rules for defining the general government sector are harmonised internationally and its composition is updated regularly.

The conventional sector accounts in the national accounting system show various stages of the economic process: production, formation, distribution, redistribution and use of income, and accumulation. Nevertheless, 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 sector are presented in a classification as revenues and expenditures.

General government revenues consist of the following transactions: current taxes on income, wealth and others, taxes on production and imports, capital taxes, social contributions, sales, subsidies on production, property income, other current and capital subsidies and transfers.

General government expenditures can be regarded from several points of view. In the publication Fiscal Outlook, they are presented according to final consumption and directly linked to GDP presentation according to the expenditure method.

General government expenditures after considering expenditures for a government final consumption in turn consist of the following items: government final consumption expenditure, social benefits other than social transfers in kind, interest, subsidies, gross fixed capital formation and other expenditures.

General government expenditures by transactions consist of the following items: 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 social transfers in kind, social benefits in kind, other current transfers, capital transfers, and net acquisition of non-financial, non-produced assets.

The general government balance is the difference between total revenues and total expenditures.

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 financial instruments: currency and deposits, securities issued other than shares, exclusive of financial derivatives and loans. According to the current European standards other receivables (for example, commercial loans) are not included in the government debt.

Moreover, the ESA 95 methodology is used to determine the so-called Maastricht criteria in relation to the deficit (reference value 3% of GDP) and of government debt (reference value 60% of GDP).

Institutional coverage of the general government sector in the Czech Republic:

- **Central government subsector:** state budget, including operations of the National Fund and operations with proceeds from privatisation, state funds, semi-budgetary organisations controlled and predominantly financed by the central government, public research institutions, Land Fund, Supporting and Guarantee Agricultural and Forestry Fund, Viticultural Fund, Czech Collection Company, Czech Consolidation Agency (since the last quarter of 2001), including its subsidiary companies (since 2002), public universities, Railway Infrastructure Administration (since 2003), PPP Centre (since 2004).

- **Local government subsector:** local governments (regions, municipalities), voluntary associations of local governments, semi-budgetary organisations controlled and predominantly financed by local government, and regional committees of cohesion regions.

- **Social security funds subsector:** health insurance companies, Association of Health Insurance Companies (since 2005) and Centre for International Reimbursements (since 2005).

4 Differences between the fiscal targeting and the national accounts (ESA 95) methodologies

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), and then to exclude one-off transactions (e.g. settlement of past transformation costs) and, finally, to bring the results closer to the ESA 95 international methodology.

The international **ESA 95 methodology** is based on the accrual recording of the entire general government as defined by the national accounts. The balance does not represent the difference between the cash revenues and expenditures but a change in financial assets and liabilities of the sector due to revenue and expenditure transactions. Along with other factors representing changes in assets and liabilities (revaluation, etc.), it constitutes the change in net wealth of the general government. A balance under the ESA 95 methodology, in the case of zero revaluation and other volume changes, directly expresses the decrease of the sector's net wealth. On the other hand, a balance under the cash methodology expresses (only) the increase or decrease of cash sources.

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 an accrual expenditure but not a cash expenditure, etc.).

This raises the question as to why the fiscal targets are established as a specifically defined balance of public budgets if the most frequently used indicator for evaluating the general government balance is the balance under the ESA 95 methodology. The main reason is 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 fulfilling or not fulfilling targets (as a result of the state budget and state funds that are under its direct control) and to what extent the fulfilment or non fulfilment was caused by inaccurate estimates of other components of public budgets or by non fulfilment of the revenue forecast.

5 Output of the general government sector

The general government sector contributes quite substantially to the growth of gross domestic product. Although this sector's main task is to redistribute national wealth, it also creates the second-greatest added value, after the sector of non-financial enterprises, to be included into the calculation of GDP.

Output of this sector represents approximately one fifth of the gross domestic product.. Obviously, the dominant part consists of non-market output which, in the long term, 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 subsector. The social security funds participate in this output to an utterly minor extent, which is caused particularly by the fact that the entities to which the health insurance companies pay for health services provided to the household sector are not part of this subsector, and the output is therefore created elsewhere. The intermediate consumption of the general government sector represents approximately one third and the gross added value approximately two thirds of the total general government sector's output.

As the majority of this sector's output is non-market, it is not possible reliably to determine its value in a market. The valuation is made on the basis of internal costs (fixed capital consumption, compensation of employees, intermediate consumption, other net taxes on output), among which the biggest items are compensation of employees and fixed capital consumption. The majority of this sector's added value is assigned to the employees. This value represents approximately two thirds of gross added value and the fixed capital consumption then represents approximately one third of gross added value. The net operating surplus of this sector may thus easily reach even negative values, which in turn means that the output of this sector alone cannot cover the costs related to the fixed capital amortisation and employees' salaries. These costs must be consequently paid from other revenues available to this sector (in particular, taxes and social contributions). This confirms the function of the general government sector which, as was already mentioned, consists particularly in redistribution of wealth.

The sum of the added values of the individual sectors of the national economy can be described as the economy's total production, usually represented by gross domestic product.

6 Expenditures on general government final consumption

Besides summing up the added values, it is possible to calculate the general government's contribution to GDP growth using the expenditures of individual entities. Government spending may be presented within the national accounts as individual transactions in their sequence of national accounts. This sequence may also be shown in the concept of government final consumption expenditure that is directly linked to gross domestic product. Government final consumption expenditures make up some

50% of total government expenditure in the long term. Their main components are collective consumption expenditures (i.e. goods and services of collective consumption, such as defence) and individual consumption (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).

The subsector of social security funds finances that part of individual consumption that corresponds to the payments to health care institutions for providing services to households, and 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 subsector. 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 also by local governments, while the central government participates only very little in this financing.

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.

7 Relation between the deficit and 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 whose amount determines the increase or decrease of debt during the period under review.

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 transactions (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 receivables and liabilities due to transactions which express the difference in profit/loss values calculated using the so-called cash basis and accrual principle, which represent the main pillar of the ESA 95 – or national accounts – methodology.

Then the debt liabilities must be adjusted by the influence of revaluation and other changes that were not accounted for in the financial account, and, 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 growth in nominal GDP on the indicator as to the share of total debt in GDP.

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.

8 Recording the guarantees in the national accounts system ESA 95

Excluded from the general regulation contained in the ESA 95 Manual on government deficit and debt are two cases that, in terms of the national accounts, automatically do not represent a guarantee for a public company debt:

- A case where the company's shareholder and, therefore, a creditor of last resort is the state.
- A case where the state borrows directly on the market in its own name with the intention to provide funds to a certain public company.

In most cases the guarantee, whether concerning a particular borrowing or the entire debt, is recognised only in the company's balance sheet. The specific guarantee is then recognised depending on whether the company, when experiencing 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 accounts and is recognised off the balance sheet.

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 (interest, principal) for the company, the situation may occur that the obligation is recognised in the balance sheets of both the company and the government.

If the company does not request the government to fulfil the guarantee, it is the debtor's guaranteed obligation. The obligation is recognised in the national accounts only in the company's balance sheet. The government records only the contingent liability. Therefore, the obligation is not taken into account when calculating the government debt.

In this regard, it is good to recognise that the so-called Excessive Deficit Procedure considers only the deficit and debt of the general government and not the public debt that would probably be influenced by this operation.

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 recognised in the government's financial accounts (as a change in loans F.4) and will be reflected in the balance sheet (AF.4).

The net borrowings/loans balances are influenced as follows:

- The assumption of an obligation must be recognised through expenditure capital transfer (D.99) on behalf of the public company, and the corresponding record made in the system of national accounts is an increase in a liability (loan). Both records have the value of the total amount of the guaranteed principal.
- After the debt is assumed, the accrued interest is recognised each year on an accrual basis on account D.41, the primary distribution of income account.

The annuity payments of principal then constitute a mere financial transaction (i.e., decrease in cash F.2 and in loans F.4) recognised on the government's financial account. In this way, the government's debt is reduced.

However, settlement of part of the guaranteed obligation does not mean that the general government balance and debt are affected automatically. In practice, a situation may occur that in order to execute its economic policy, the government decides to pay off a certain borrowing of a public company or its part without this borrowing being utilised (without its being “exercised”). In such case, the debt is not assumed and remains recognised only on the balance sheet of the company, which remains the sole legal debtor. The payments of this nature are recognised as capital transfers on behalf of the company (matched by the expended cash flow). This affects the general government balance, but not the debt.

On the other hand, another situation may occur, where provided that certain conditions are met, the company’s obligation is automatically considered as the government’s obligation. This may occur, for example, if there exists 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. Upon its origin, an obligation of such nature must be recognised 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 paid subsequently is recognised each year on an accrual basis as a utilisation on the distribution of primary income account.

As soon as the funds from issue of the company’s debt (increase in cash F.2) are available, the capital transfer must be recognised on the capital account (D.99) on behalf of the company, by means of which the general government balance is affected.

9 Other terms

Medium-term expenditure frameworks

Medium-term expenditure frameworks represent ceilings for the volume of the state budget and state funds expenditures. Expenditure frameworks form a part of the medium-term outlook of the state budget and they are determined for three years ahead as a difference between expected revenues and the targeted balances for those years. Already approved expenditure frameworks for the corresponding year represent a ceiling for the volume of the state budget and state funds expenditures in this year.

Approved expenditure frameworks may subsequently be modified only in cases explicitly defined by the Act on Budgetary Rules. These include 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 these 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.).

In the context of the Czech republic, therefore, the firm fiscal rule is not observance of a fiscal target in the form of public budgets’ balance, but sticking to the approved expenditure frameworks. The reason for this is twofold. First, there is the fact that 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. The second reason is an economic one. 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 revenues due to better than predicted 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.

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[1] may occur even in a period of economic decline. For the Czech Republic, this margin is calculated as 1.4% of GDP. This means that the minimum limit of the budget balance (the minimum benchmark) is -1.6% 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).

The parts of the Pact described thus far are referred to as the preventive portion. The other branch includes the so-called sanctions parts and deals with the progress of the Excessive Deficit Procedure (i.e. for the situation in which the concerned country has exceeded or will exceed the reference 3% limit of the government deficit or the 60% limit of the government debt).

Minimum fiscal effort

The Pact also determines that until the member states achieve their medium-term targets, they must consolidate their public budgets and improve their fiscal positions at least by a half percent of GDP each year (less the economic cycle influence and excluding one-off and extraordinary measures). In economically good times, the member states, then, 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 point of 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).

Excessive deficit procedure

This Procedure was launched with the Czech Republic very soon after its accession to the EU in 2004, and, regarding its special circumstances (as a transforming country), it was given a four-year term to correct the excessive deficits. However, the standard procedure is different. An excessive deficit must usually be corrected within one year after it is identified.

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[1] In determining the safety margin, no extraordinary circumstances are considered that would lead to a significant decline in the economic output.

Upon the Procedure's initiation, the Council issues a recommendation first, and the member state has a six-month period for submitting measures that will lead to correcting of this deficit. If such measures are ineffective or implemented insufficiently, the Council may issue another call in which specific measures are established for the concerned country to adopt to correct the situation. At the same time, so-called intensified budget supervision can occur, wherein the member state is obliged to provide regular information according to a schedule agreed in advance. If even then the member state does not meet the recommendation, the Council may impose sanctions that may become stricter after two years.

The final stage is different for those member states outside the eurozone, 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.

Medium-term objective (MTO)

Within its Pact review, each country has laid down its individual medium-term fiscal target reflecting both the growth potential of the country and its indebtedness level. For the Czech Republic, this target for the government balance comes to -1.0% of GDP, which should be achieved in 2013 according to the latest update of the Czech Convergence Programme. At present, there is a discussion in the EU on how to include in this target the so-called implicit liabilities, i.e. long-term obligations of public finances, and especially in the form of the future old-age pensions and other expenditures depending on the age structure of the population. This will mean even stricter targets particularly for those countries – such as the Czech Republic – which have a problem with the population's ageing and the long-term non-sustainability of public finances.

10 References

[1] European system of Accounts 1995. Eurostat, Luxembourg 1996.

[2] ESA 95 Manual on government deficit and debt. Eurostat, Luxembourg 2002.

[3] Government finance statistics manual 2001. IMF, Washington 2001.

[4] A Manual on government finance statistics. IMF, Washington 1986.

[5] System of national accounts 1993. OECD, European Commission, UN, IMF, New York 1994.

[6] Act on Budgetary Rules No. 218/2000 Coll.