Ministry of Finance
Department for Financial Policy

Methodological Manual
of the Fiscal Outlook CR

May 2012 Update

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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:

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Introduction

In the May 2012, the Ministry of Finance has updated the Methodological Manual of its semi-annual publication Fiscal Outlook of the Czech Republic. The aim of this document is 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. Chapters which deal with economic issues governance in EU in connection with the so-called "Six-Pack", which is a collection of six law acts adopted at the end of 2 011, were modified thoroughly. Procedures of tax accrualisation and notification are described in more detail.

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 (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.

Figure 1 in the chapter dedicated to the **institutional coverage.**

Public budgets record revenue and expenditure operations related to the state budget including the National Fund and since 2006 the resources from privatisation (the former National Property Fund, abolished by Act No. 178/2005 Coll.), extra-budgetary funds (state funds and the Land Fund of the Czech Republic), public health insurance and local government units (municipalities, regions, voluntary associations of municipalities, and regional councils of cohesion regions).

The structure and coverage of the public sector in GFS 2001 methodology is clearly depicted in the

From GFS 1986 to GFS 2001 Methodology

The International Monetary Fund (IMF) prepared a new methodology 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 derived 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. The institutional coverage is thus defined in accordance with the methodology of the **European System of National and Regional Accounts** (ESA 95). Since 2003, and at the recommendation of the IMF, the Ministry of Finance commenced gradual implementation of government financial statistics for public budgets using the new GFS 2001 methodology. During 2001 to 2004, the data from the GFS 1986 format were transformed according to established adjustments to the statement of sources and uses of cash, statement of government operations, and other related statements from GFS 2001 without any changes in the institutional definition. Since 2005, these statements have been processed on the basis of primary data.

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:

- 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. Nevertheless, outside the GFS 2001 methodology framework, tables in this material also contain total values for revenues and expenditures including sales and acquisition of non-financial assets.
- 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 including purchase of shares and ownership interests minus their sale) 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, the following balance categories are defined in the given phase of implementation:

- Net cash deficit/surplus is a balance involving cash flows from operating activities and net acquisition of non-financial assets. Due to its character, it can be compared to the GFS 1986 deficit net of net loans.

This balance can be further analysed by means of the following indicators:

- Net cash inflow 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 outflow from investments in NFAs, which represents the value of newly acquired non-financial assets decreased by the revenues from the sale of non-financial assets.

You can find more about methodologies' differences in the Box 1 of the **October 2010 Fiscal Outlook**.

European System of Accounts 1995 (ESA 95)

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

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 a half of their output is financed by the government and less than a half is financed from receipts. General government in the Czech Republic is divided into three subsectors: central government, local government and social security funds. The rules for defining the general government sector are harmonised internationally and its composition is updated regularly.

The conventional sectoral 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 revenue consists 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 expenditure can be also regarded from several points of view. In the Fiscal Outlook, they are presented according to final consumption and directly linked to GDP presentation according to the expenditure method. From this point of view, the general government expenditure consists of: final consumption expenditure, social benefits other than social 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 social 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 financial instruments: currency and deposits, securities issued other than shares, exclusive of financial derivatives and loans. According to the current European standards other claims (for example, commercial loans) are not included in the government debt.

Moreover, the ESA 95 methodology is used to determine the **Stability and Growth Pact** and so-called **Maastricht Criteria** in relation to the deficit and of government debt. **The deficit is adjusted** for interest derivatives.

Description of conversion from the cash-based balance to the balance under the ESA 95 accrual 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 government 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 Czech Republic.

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 there 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 special 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 Czech Republic's 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 sale of the company Arcelor Mittal (decrease of a receivable), payments received from the sale of emission permits and unit amounts assigned to emission permits (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** included in the WB and which are not part of the balance (EDP B.9).

The working cash balance does not include **transactions of sources and uses** for which there are no accompanying 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 to it. (For more details see also 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. Simply put, this is in the amount of the value of the acquired property. On the other hand, lease-payment expenditures in the ensuing years are eliminated from the working cash balance of revenues and expenses again as financial operations.

The ESA 95 methodology specifically requires that 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 of Taxes

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 benefits,
- 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 + origination of new related receivables;

b) use transactions = expenditures – decrease of related payables + origination of new related payables.

However, an alternative, so-called time-adjustment method approved by Eurostat is used for taxes.

Accrualisation of taxes means basically calculation of tax revenues under the **accrual ESA 95 methodology**. Calculation of taxes based on the ESA 95 methodology can be carried out via two methods: 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 ESA 95 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.

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	except tobacco	10 working days (in case of imports of goods)
	except tobacco	2 months (in case of passing goods into free circulation)
	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		-

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.

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 (**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 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.

You can find more about the tax accrualisation in the topic chapter of the **May 2009 Fiscal Outlook**.

Notification of the government deficit and debt

In accordance with European Council Regulation No. 479/2009, the Czech Republic, as represented by the Czech Statistical Office, twice annually 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 their Notifications, the individual countries are operatively responsible to answer Eurostat's follow-up questions concerning the data sent. During this period of 2–3 weeks, Eurostat may order that changes be made in the sent data. The final act, then, is to issue a Eurostat report on the current Notification and publication of the final data for years *t*-4 to *t*-1. In case serious deficiencies are found which could not be resolved before the deadline, Eurostat may publish the figures for the relevant 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*. The 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**, a method of calculating the government deficit and demonstrating the connection between the amount of the deficit balance and the change in the debt balance.

Notification tables (briefly stated in Table 2 as to their contents) are compiled for units belonging to the **general government sector.**

Table 2: Structure of Notification Tables

Table	Content		Coverage	Period t-4 to t-1	Period t
Table 1	Reporting of government deficit/surplus (EDP B.9) for each subsector; total debt levels for S.13, sorted by instruments; gross fixed capital formation; interest payments (both D.41 and EPD D.41); nominal gross domestic product		S.13; S.1	yes	yes
Table 2	Transition from cash-balance to ESA 95 balance (EDP B.9)	2A	S.1311	yes	yes
		2B	S.1312	yes	no
		2C	S.1313	no	no
	Transition from balance of income and expenses to ESA 95 balance (EDP B.9)	2D	S.1314	yes	no
Table 3	Stock-flow adjustment	3A	S.13	yes	no
		3B	S.1311	yes	no
		3C	S.1312	no	no
		3D	S.1313	yes	no
		3E	S.1314	yes	no
Table 4	Liabilities from trade credits and advances; gross national income		S.13; S.1	yes	yes

Source: MF CR.

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, to be included into the calculation of GDP.

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 subsector. The social security funds participate in this output to an utterly minor extent. This 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. The output is therefore created elsewhere. The gross value added of the general government represents approximately two thirds of the total general government's 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 (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 value added (about two thirds) is assigned to the employees. The fixed capital consumption then represents approximately one third of gross added value.

The net operating surplus of the central government may thus easily 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 consequently paid from other revenues, in particular from taxes and social contributions. This confirms the function of the general government sector which, as was already mentioned, consists particularly in redistribution of wealth.

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 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 on average. 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 the part of individual consumption that corresponds to the payments to health care 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 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.

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

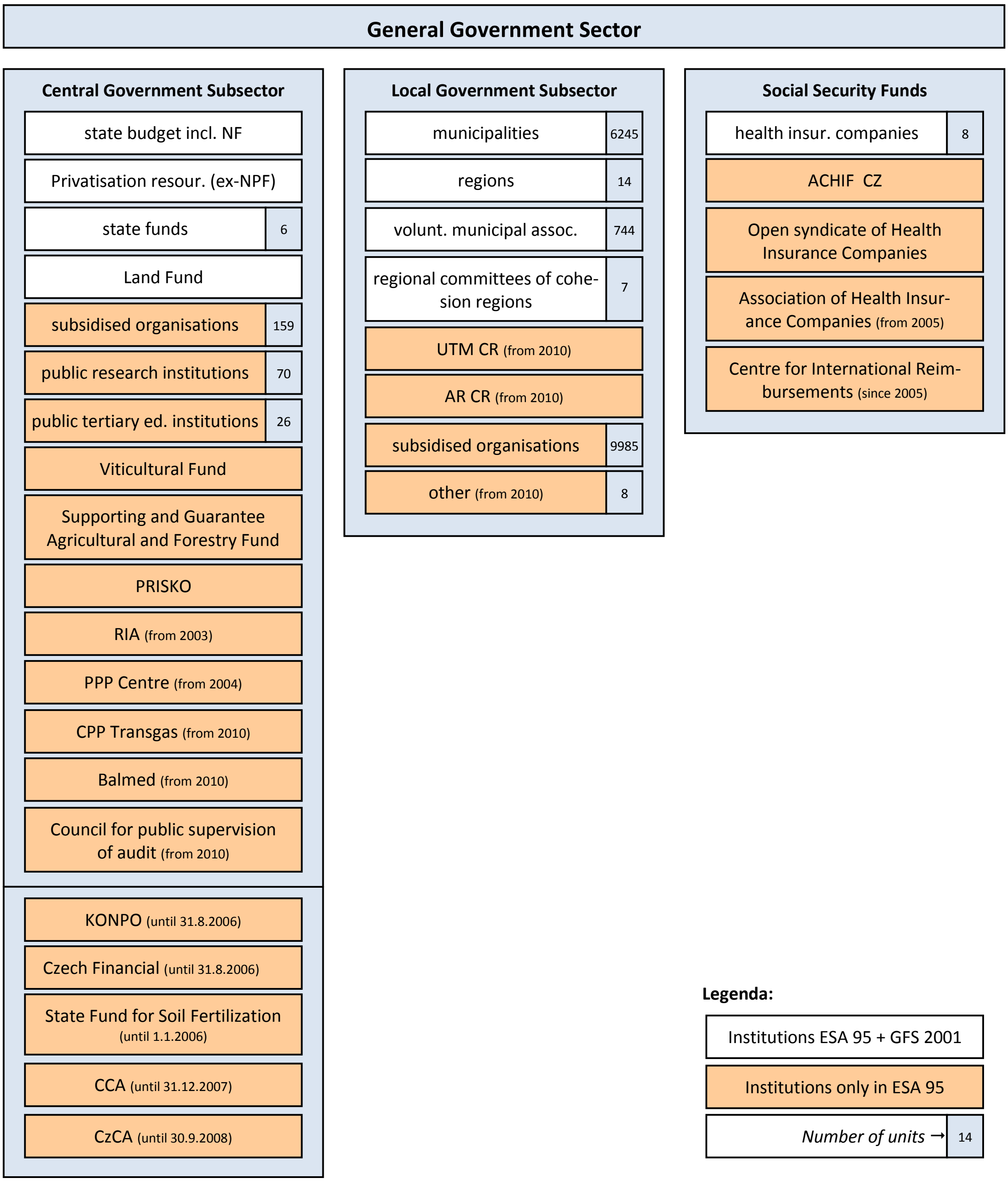
The rules for the institutional coverage of general government sector are internationally harmonised and its composition is continuously actualised by the Czech Statistical Office in the Business Register (RES). The coverage in ESA 95 encompasses four basic institutions: central government subsector, 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 1 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 1: General Government Sector in the CR (ESA 95 and GFS 2001)



Note: CCA = Czech Consolidation Agency, CzCA = Czech Collection Agency, NF = National Fund, RIA = Railway Infrastructure Administration, NPF = National Property Fund, UTM CR = Union of Towns and Municipalities of the Czech Republic, AR CR = Association of Regions of the Czech Republic, ACHIF CZ = Association of Companies Health Insurance Funds Czech Republic.

Numbers in pale blue boxes indicate the number of those institutions.

Among the "other" subjects of the local government sub-sector stand: Culture for Kladno, Senior Centre of the town Svitavy, Technical Services Bystrice p/H, Southern Centre Brno, Prague 10 – Proprietary, Elementary school and Kindergarten of the Valley of Desna, Elementary school and Kindergarten of the Carlsbad Rural Region, Research institute for Balneology.

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 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 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

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 an 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.

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:

1. 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.
2. 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 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 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 deficit 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).

Structural vs. Cyclically Adjusted Balance

In a number of economic texts, these two terms 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 transactions (i.e. such that are by their nature rare and "unsystematic") results in a so-called structural balance. An example of non-recurring, one-off items represents income from the sale of UMTS licenses (state-issued 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.

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-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).

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.

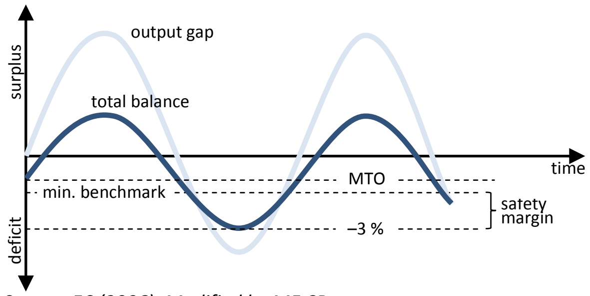
An **excessive deficit procedure** is not initiated with a specific state in a case that the insufficient pace of debt reduction is due to significant decline in economic output.

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 2: 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 sanctions 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 EDP Balance

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 (2009) uses two main indicators – so-called **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.

Permanent fiscal consolidation, S1, expresses by how many percentage points of GDP taxes need to be permanently (from the given year) increased or expenditures decreased so that the government debt at the end of the projection horizon reaches 60% of GDP.

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

If t is the current year, t_0 the year preceding the long-term projection, D_t the ratio of debt to GDP, PB the primary structural balance and T any selected year, then the indicator S1 (and S2 below) may be calculated according to the following equations:

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).

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

whereby the change in the primary balance is divided into the change of the primary balance due to population ageing (PB ageing) and that due to change in property income (PI):

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

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 individual 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 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 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.

National Fund

The National Fund has been established at the Ministry of Finance of the Czech Republic since 1st January 1999. The National Fund is a central place of public administration to transfer funds from the European Union in order to finance its programmes and projects. The Fund's accounts are kept by the Czech National Bank and are treated as state financial assets. Draw and use of the funds as well as their budgetary control is governed by the rules of the Czech Republic and the relevant regulations.

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