

Methodological Manual of the Fiscal Outlook CR

August 2011 Update

**Methodological Manual
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

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.

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 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 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 adjust-

ments. The government statistics are structured as a sum of individual items of public budgets, where the consolidation of revenues and expenditures is further

applied in order to exclude flows among individual parts of the government sector.

The structure and coverage of the public sector in GFS 2001 methodology is clearly depicted in the Figure 1 in the chapter dedicated to the **institutional coverage**.

Public budgets record revenue and expenditure operations related to the state budget including the Na-

tional 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).

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 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.
- Outlays in implementing high-risk guarantees whose return is uncertain are included in the

- 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.

expenditures as capital transfers. Under the GFS 1986 methodology, these had been clas-

sified 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.

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).

Accrualisation of taxes means basically calculation of tax revenues under the **accrual ESA 95 methodology**. This issue has been treated in detail within a dedicated chapter in the May 2009 Fiscal Outlook from, where adjustments for individual types of taxes may be looked up. 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.

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 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 thematic chapter of the **May 2009 Fiscal Outlook**.

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. 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.

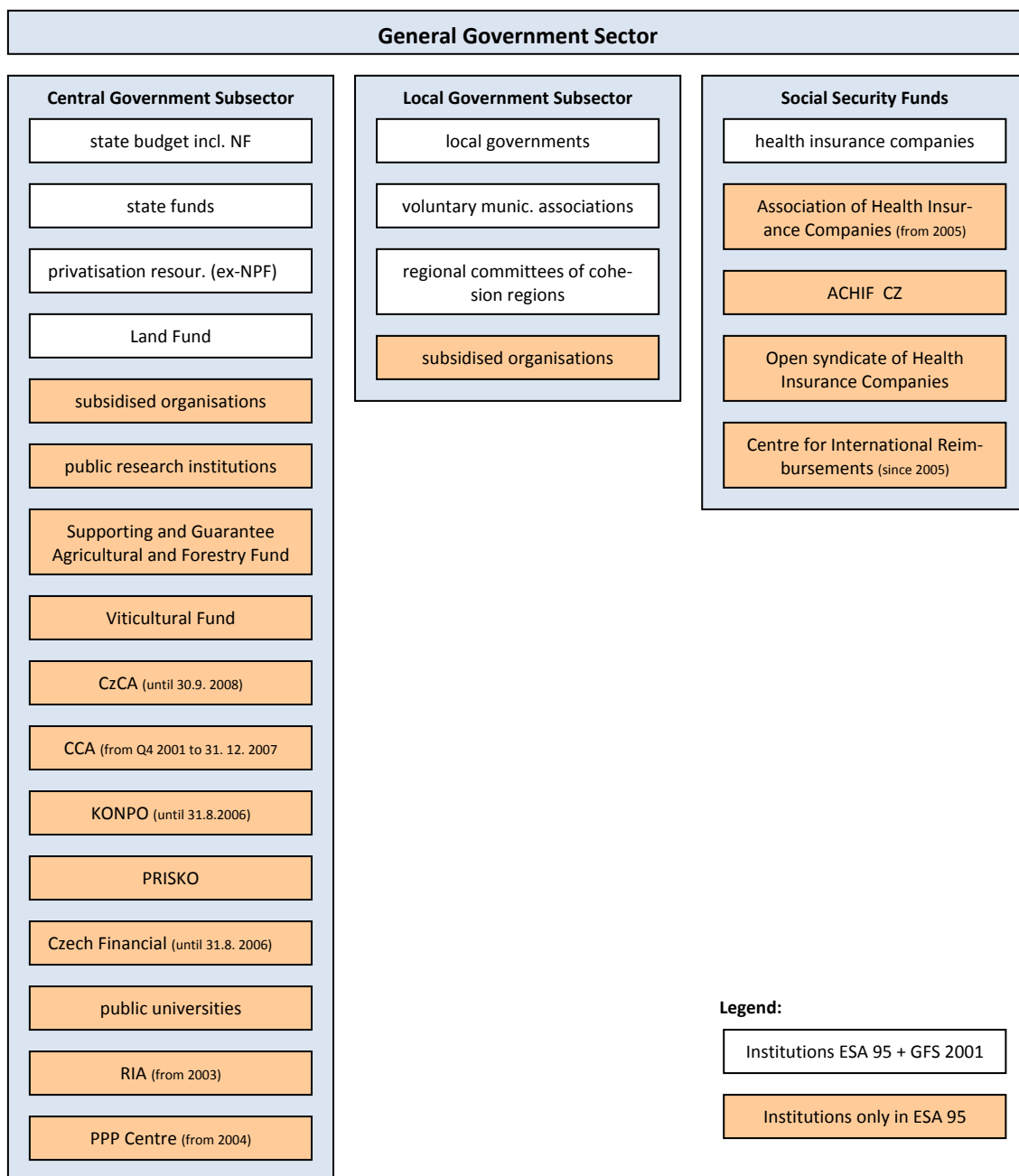
Besides a detailed overview of the government sector institutions, the Figure 1 also provides the definition of the sector of public finances in the GFS 2001 methodology. The Figure thus illustrates a current broader coverage of the ESA 95 methodology in the Czech Republic.

Compared to the general government sector in ESA 95, public budgets in GFS 2001 still do not include:

- Supporting and Guarantee Agricultural and Forestry Fund,
- the Viticultural Fund,
- PRSKO
- public universities,
- Management of Railway Infrastructure,
- PPP Centre,
- public research institutions,
- Association of Health Insurance Companies,
- Open syndicate of Health Insurance Companies
- Centre for International Settlements
- and a part of grant governmental organizations classified under the general government sector.

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, ACHIF CZ = Association of Companies Health Insurance Funds Czech Republic.
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 cre-

ated 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.

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

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 Frameworks

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), 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 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 $\pm 15\%$ fluctuation band (modified in August 1993 from $\pm 2.25\%$ and $\pm 6\%$).

- 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 EU, especially for countries in the euro area, because without a healthy public finances the monetary union cannot in practice work. The Pact has two branches:

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, like 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. The EU 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, the Commission may with the country launch an **Excessive Debt Procedure**.

SGP 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. Long-term projections are made by the EU Commission in a co-operation with member states and the results are published in the **Sustainability Report**. Results of long-term projections also represent a criterion for evaluation of Stability and Convergence Programmes.

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, but 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, 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)

Within its **SGP** 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 structural government balance comes to -1.0% of GDP. 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 espe-

cially 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.

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).

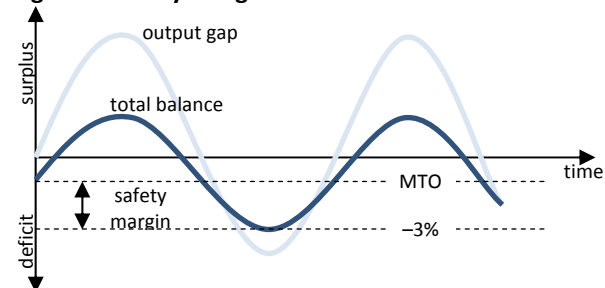
Safety Margin

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 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).

Figure 2: Safety Margin and MTO



Source: EC (2006). Modified by MF CR.

Excessive Deficit Procedure

This Procedure was for the first time launched with the Czech Republic very soon after its accession to the EU in 2004, for the second time in December 2009.

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 that may be after two years tightened. 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.

For the member states outside the euro area, the final stage is different as they are not subjected to the intensified budgetary supervision. The penalty may be “just” decision to suspend transfers and drawing from the Cohesion Fund.

For a successful completion of the Procedure it is important to remove the excessive deficit in a credible and sustainable way. Thus it can not be based on one-off and/or non-systematic measures. Assessed is being also expected future developments and fiscal strategy.

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.

EDP B.9 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

The concept of fiscal sustainability is generally ambiguous, requiring fiscal sustainability to be defined separately. The European Commission uses two main indicators, the so-called **S1 and S2**, for grasping of the concept of fiscal sustainability. Their methodology and values publishes in the **Sustainability Report** regularly. These indicators make use of information from long-term projections in a consistent and comparable methodology and assumptions.

Permanent fiscal consolidation S1 expresses by how many per cent of GDP it is necessary to permanently

(from the given year) raise taxes or cut spending so that the government debt at the end of the projection reaches 60% of GDP.

Permanent fiscal consolidation S2 expresses by how many per cent of GDP it is necessary to permanently (from the given year) raise taxes or cut spending to keep the general government solvent for an indefinite period of time (i.e. intertemporal budget constraint is met).

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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