



Ministry of Finance
CZECH REPUBLIC

Expenditure Rule in the Czech Republic

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1 Implementation



Inspirations and Recommendations

– Recommendations of the EPC peer review (2011)

- *Consider introducing an independent fiscal council to support the preparation, evaluation and monitoring of fiscal policies.*
- *Improve enforceability of the expenditure rule by establishing a system by which good performance is rewarded and failings are clearly sanctioned. Enhance transparency by making a clear link between annual expenditure ceilings and state budget expenditure.*
- *Improve coordination between all levels of government in the budgetary process and involve sub-national governments in medium-term budgetary planning. Consider introducing some form of a fiscal debt rule for the local and regional levels.*

– Recommendations from OECD Economic Survey (2011)

- *... medium-term expenditure ceilings broken down to individual ministries' targets.*
- *Establish an independent fiscal institution to assess the budget in light of the cyclical position and medium-term objectives.*
- *Improve transparency of budgetary documentation ... Consider the introduction of an 'internal stability pact' that sets borrowing limits on budgets constitutionally independent municipalities.*

– The Slovak fiscal framework reform



Process of Expenditure Rule Development

or as the time went by from the theoretical conception to the effectiveness of the Act

- **2012:**
 - **MoF working group established, subsequently created political/parliamentary group (representing all parties of Parliament's Chamber of Deputies) – round tables on particular approaches, models and parameters**
 - **MoF proposed a rule alike the “Expenditure benchmark”, but:**
 - The government wished for a rule in accord with the Treaty on Stability, Coordination and Governance in the EMU, but disagreed with Head III and IV stipulations
 - On top of that, the “Expenditure benchmark” was just a supplementary rule at the time
 - **It was decided the rule shall be focused on the structural balance**



Process of Expenditure Rule Development

or as the time went by from the theoretical conception to the effectiveness of the Act

- **Swiss federal rule used as the final concept:**
 - Simple deduction of expenditure frameworks
 - Automatically handles the situation, when ex-post expenditure > MTO expenditure (correction account established for that case)
 - Based on internal simulations, the correction account limit was set to 2% of the GDP, for the rule to be flexible and for automatic stabilizers to act
 - Internal stress-tests made
 - Research paper of the Charles University (*Baxa, Paulus (2016): New Fiscal Rules for the Czech Republic: Analysis of the Proposal* (<http://ies.fsv.cuni.cz/sci/publication/show/id/5475>))



Process of Expenditure Rule Development

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- **2013:**
 - **End of the Nečas Government**
 - **Chamber of Deputies dissolved**
 - the dissolution means all not-approved laws have to be submitted again (but the deadline for Council Directive No. 2011/85/EU transposition was the end of 2013)
 - early elections
- **2014 February:**
 - **The same concept of “legislative package” was submitted by MoF to the government, but in absence of broad political consensus, the rules were softened (MTO added, debt brake narrowed)**
 - **Most discussions on the debt brake and on the legislative anchoring of the rule in the constitutional act form**



Process of Expenditure Rule Development

or as the time went by from the theoretical conception to the effectiveness of the Act

- **Government did not have the constitutional majority, and thus from the original proposal of**
 - 1 Constitutional Act
 - 1 Implementing Act
 - 1 Amending Act**was developed 1 new Act (merging the Constitutional and Implementing acts) and 1 Amending Act**
- **The debt brake rule was also simplified** (originally inspired by Slovakia, the final form ultimately simplified from 4 to 2 thresholds: 55% of GDP of general gov. debt net of cash reserves, 2nd at 60% of Maastricht debt criterion)
- **Least problematic was, paradoxically, the expenditure rule**



Process of Expenditure Rule Development

or as the time went by from the theoretical conception to the effectiveness of the Act

– **2016:**

- **November: Senate rejected the Act No. 23/2017 Coll. and returned it on the grounds that it was unconstitutional in relation to local governments; the same situation also with Amendment Act No. 24/2017 Coll.**

– **2017:**

- **January: Senate veto was overruled by deputies for both Acts**
- **February: Acts took effect** (State Budget for 2018 was designed with respect to the expenditure rule for the first time)
- **March: 59 Senators filed a motion for annulment by the Constitutional Court of the statutory regulations concerning the development of local governments**

– **2018:**

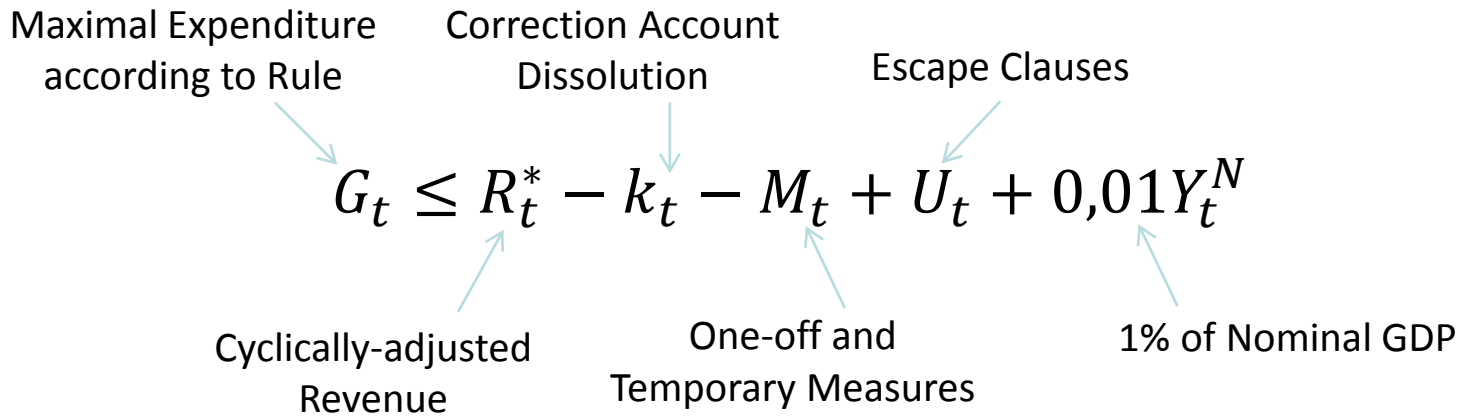
- **the Constitutional Court (Resolution No. 99/2018 Coll.) dismissed the Senators' proposal in full**



2 Expenditure Rule of the State Budget and State Funds



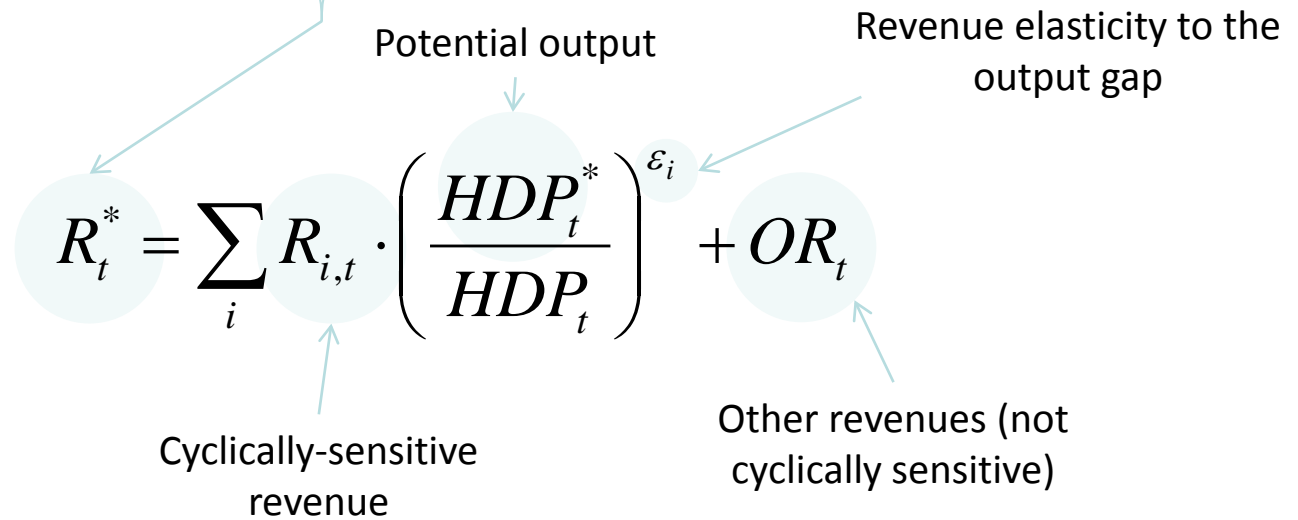
Structure of the expenditure rule of the state budget and state funds



- Expenditure according to the rule shall not exceed the value of cyclically-adjusted revenue
- Decreased further by the dissolution of the correction account
- Decreased further by net one-off and temporary measures
- Increased further by escape clauses as stated in the law
- Increased further by 1% of nominal GDP (corresponding to the MTO)



Cyclically-adjusted Revenues



- **General use of the cyclical adjustment** = determination of the fiscal policy character (expansive/restrictive),
- **Cyclical adjustment done by MF,**
- **The Fiscal council can make a statement on the adjustment of the particular revenue;**



One-off and Temporary Measures

- **One-off measure is an exceptional measure that is not of a structural nature and is:**
 - temporary – the measure only has a limited duration,
 - unrepeatable – limited frequency or likelihood of occurrence of measures,
 - transitional – after the end of its validity, the measure does not lead to a permanent change in the level of income or expenditure
- **Examples:**
 - Property settlement with churches; Flood recovery, etc.
- **Methodology created by MoF in co-operation with the Fiscal council** (<https://www.mfcr.cz/assets/en/media/Methodology-of-Deriving-Expenditure-Frameworks-of-the-State-Budget-and-State-Funds.pdf>), **also described in Information paper** (https://www.mfcr.cz/assets/cs/media/Odborne-vyzkumy_Studie_2018-12_Jednorazove-a-prechodne-operace.pdf), **in Czech only**



Escape Clauses

- Public sector expenditures incurred as a result of the deterioration of the state security situation associated with the government-announced extraordinary measures to increase its defensive capacity, on the basis of an emergency situation, a state threat situation or a state of war,
- the total public sector expenditure related to disaster relief and public sector expenditure arising from the implementation of international treaties and other international commitments of the Czech Republic if, according to the ministry forecast, it exceeds 3% of the nominal gross domestic product forecast by the Ministry for this period,
- additional expenditure related to the projected significant deterioration in economic development if the ministry forecasts a quarterly year-on-year decline of at least 3% of gross domestic product adjusted for price effects.



Correction account and its dissolution

$$A_t = A_{t-1} + (G_{t-1} - \hat{G}_{t-1}) - k_{t-1}$$

Actual expenditure of the previous year

“dissolution” of 1/3 of the accumulated surplus over 2% of GDP

Correction account of the previous year

Rule applied on actual data of the previous year

- **Automatic correction,**
- **Systematic overshooting of actual expenditures is penalised,**
- **Correction Account helps to absorb one-off fluctuations;**



Expenditure framework for the SB and SF

or the Transition from the accrual methodology of the general government to the state budget and state funds' expenditure in the cash flow methodology

Structural balance of the General Government

– **Structural balance of the Local Government**

Accrual

– **Structural balance of the Social Security,**

– **(Structural) balance of other Central Government Units except SB and SF**

+ Cyclical balance and one-offs for SB and SF

– **Accrualisation and Other Operations**

Cash

= Balance of SB and SF

→ Revenue of SB and SF – Balance of SB and SF

= Expenditure Framework of SB and SF

- **The Fiscal council shall co-operate on the transition methodology with the MoF,**
- **The Fiscal council shall always publish its statement on the calculation (application of the methodology)**



3 Changes and Problems Related to the Adoption of the Expenditure Rule



Changes in the budgetary process due to the implementation of the expenditure rule

- **Structure of the expenditure rule is part of Act No. 23/2017 Coll.**
- **Budgetary process starts with the new document: Budgetary strategy of the public institution in the CR**
- **Only total limit for the state budget and state funds' expenditures is set by the Act**
 - **This expenditure limit is not divided by any other rule**
 - **In the past, efforts were made to address this for certain expenditure groups (education, social affairs, healthcare, science and research, etc.), but political support was not found**



Changes in the budgetary process due to the implementation of the expenditure rule

- **§12:** *“MoF together with the Fiscal council elaborate and publish a description of the procedure for setting the state budget and state funds expenditure framework from total expenditure of the public institutions sector”*
- **MoF in co-operation with the Fiscal council created “Methodology of Deriving Expenditure Frameworks of the State Budget and State Funds”**
 - it has the form of an extra-legal implementing act - it does not have the power of law, but it has the power of a regulation approved by the Fiscal council (<https://www.mfcr.cz/assets/en/media/Methodology-of-Deriving-Expenditure-Frameworks-of-the-State-Budget-and-State-Funds.pdf>)
 - contains:
 - method of calculating the output gap similar to EC,
 - adjustment from accrual (ESA 2010) to cash methodology, from general government to state budget and state fund expenditures,
 - methodology on one-off and other temporary measures,
 - the Fiscal council assesses the implementation of the agreed methodology;



Changes in the budgetary process due to the implementation of the expenditure rule

- **MoF has long-term tradition in the assessing macro forecasts:**
 - semi-annual forecast comparison since 1996,
 - however not institutionally anchored,
- **Budgetary Forecasts Committee**
 - inspired by Slovakia, we have institutionalised colloquium on macroeconomic forecasts and added revenue forecasts,
 - independent group of experts (chief economists of commercial banks, academia, representatives of the Chamber of Commerce, trade unions, Czech National Bank),



Compliance of the expenditure rule with EU rules

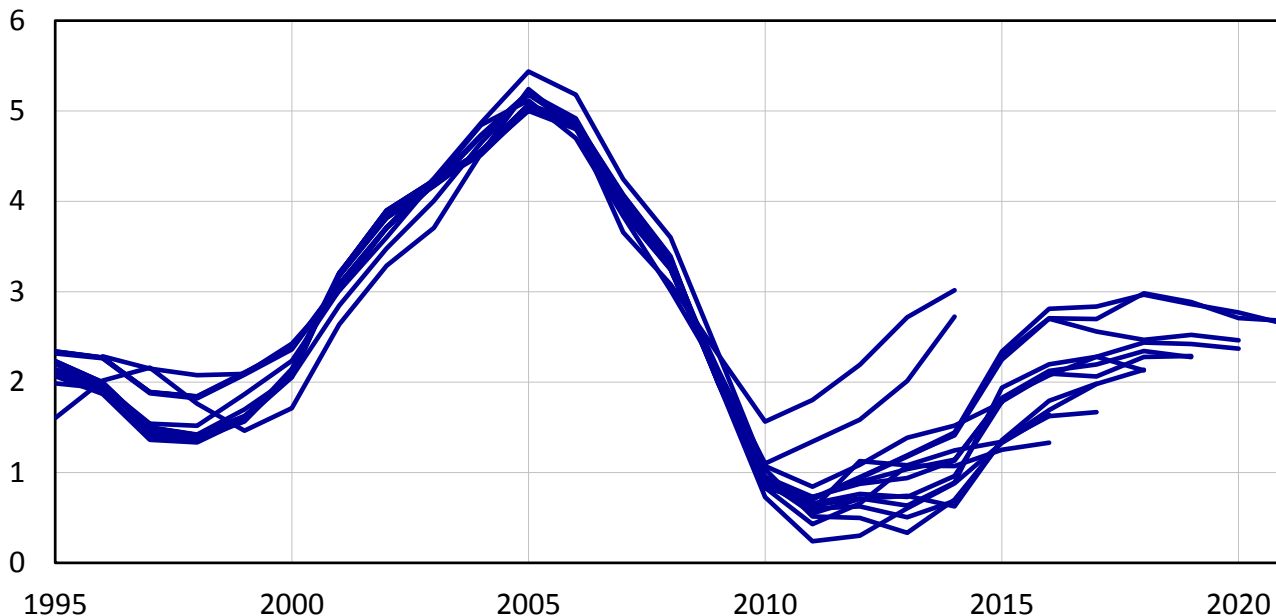
- **Derived from the compliance with the MTO** (Revised Stability and Growth Pact 2011, Directive 2011/85/EU)
- **Both the Pact and the national expenditure rule take into account an expenditure on unusual event without government influence**
- **Activation of the correction mechanism**
 - **a similar term but conceptually different**
 - **EU legislation** enables ex-ante worse balance than MTO and sets a return in the following budget period or thereafter, i.e. a correction back to the MTO of a maximum of 2 years, discretionary
 - **the national rule** enables ex-ante MTO at worst, counts with the correction back in the following year, fully automatic



Problems of the expenditure rule

1) Based on the structural balance

- Structural balance is a theoretical concept, rather complicated from a practical point of view (temporal instability in the potential product calculation – see the graph below, long-term elasticities)
- Marked instability in ca. 2011–2012 (start of 2nd wave of recession)





Problems of the expenditure rule

2) From recent experience, we would recommend that the rule should deal with the structural balance referencing it just loosely in order to adjust it on the basis of

- Minimum benchmark
- Excessive debt
- Population ageing risk

CR as an Euro area non-member could have had MTO at $-1,5\%$ of GDP, currently the recommended value is $-0,75\%$ of GDP due to aggravated impacts related to population ageing

3) Rule based on the estimates of future values and potential product can indicate different fiscal stance ex-ante vs. ex-post and can be over-calculated in time, which can lead to expenditure volatility



Thank you for your attention.

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