

**Czech Republic: Report on the Observance of Standards and Codes—  
Fiscal Transparency Module—Update**

This update to Report on the Observance of Standards and Codes—Fiscal Transparency Module for the **Czech Republic** was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on **August 2, 2004**. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of the **Czech Republic** or the Executive Board of the IMF.

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**Report on the Observance of Standards and Codes  
Czech Republic—Fiscal Transparency Module: An Update  
August 2, 2004**

The Report on the Observance of Standards and Codes (ROSC) in fiscal transparency in the Czech Republic was first issued in September 1999. Annual factual updates of the original report were prepared and issued subsequently in the context of the Article IV consultations.<sup>1</sup> This note reports on key developments in fiscal transparency since the last update in August 2003. It also reports on the intentions of the previous government—most of which are expected to be endorsed by the new government—and those reflected in the *Convergence Program of the Czech Republic* submitted to the European Commission and publicly disseminated in May 2004. For a full description of institutions and practices, and IMF staff recommendations, it should be read in conjunction with the original ROSC and its updates.

The original ROSC concluded that the Czech Republic meets many of the requirements of the IMF *Code of Good Practices on Fiscal Transparency* and the annual updates have reported steady improvements in addressing the remaining transparency issues. Most of the ROSC recommendations have been addressed, but there are still areas where transparency could be improved.

The Czech Republic acceded to the European Union (EU) on May 1, 2004 and a number of changes in fiscal coverage, reporting, and procedures were prompted by the harmonization of national practices with the EU standards. The Convergence Program outlines many of these changes and describes the government's medium-term institutional reform intentions, many of which have a bearing on fiscal transparency.

**A. Clarity of Roles and Responsibilities**

*The original ROSC expressed concern about the growing share of expenditure outside the State Budget, and therefore beyond the scope of fiscal policy formulation. In fact, the share of state expenditure in total general government spending steadily declined from 63.0 percent in 2000 to 54.4 percent in 2003, reflecting both the establishment of new extrabudgetary funds (EBFs) and the shift of expenditures to subnational levels following the 2001 public administration reforms.<sup>2</sup>*

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<sup>1</sup> The original report “*Experimental Report on the Observance of Standards and Codes—Czech Republic*” and its annual updates are available on the IMF website: [www.imf.org/external/np/rosoc.asp](http://www.imf.org/external/np/rosoc.asp).

<sup>2</sup> During 2000–03, the share of EBFs in total general government expenditure increased from 2.7 percent to 6.8 percent, and that of local governments from 21.2 percent to 26 percent.

Since the last update, the fiscal coverage of the general government has been broadened—on the basis of the European System of Accounts 1995 (ESA95)—by including the financial subsidiaries of the Czech Consolidation Agency (CKA), including Ceska inkasni, and the Viticulture Fund. However, the impact on the general government’s fiscal balance and debt was fairly small.

In order to broaden the scope of the State Budget and improve expenditure management, the government has established a timeframe, as a part of its medium-term fiscal reform program, for liquidating some EBFs, integrating others in the State Budget, and applying stricter expenditure control on the rest. Specifically:

- The government is planning to terminate the operations of CKA (currently outside the general government on the national definition) by end-2007 and the State Budget is to assume CKA’s accumulated losses (of about CZK 63 billion) through a special bond issue spread over 2005–07. In the meantime, CKA will only be able to assume impaired assets up to the end of 2005, with transactions in excess of CZK 1 billion requiring parliamentary approval.
- Ceska inkasni (also currently outside the general government on the national definition) is planned to be terminated by March 2005.
- A draft law is under discussion to close the National Property Fund (NPF)—the main privatization fund, which is currently included in the national definition of general government—by end-2005. NPF liabilities, projected at about CZK 95 billion by that date, would be transferred to its legal successor, most likely the Ministry of Finance (MoF). However, the NPF accounts are not expected to be integrated with the State Budget. The government also intends to liquidate the Czech Land Fund—a smaller privatization fund—by end-2009.
- Liquidation of the State Fund for Soil Fertilization—a state EBF—by end-2005 is planned.
- Finally, the remaining state EBFs will become subject to the same rules and procedures as the State Budget. Most importantly, their expenditure will be brought within the medium-term expenditure framework (see below) and will become subject to the same controls as state budget expenditure.

## **B. Public Availability of Information**

*The original ROSC and its updates acknowledged the comprehensiveness of data on the State Budget, but suggested more frequent availability of data on the rest of the general government. Fiscal information continues to exceed the IMF’s Special Data Dissemination Standards (SDDS). Following accession, ESA95-based fiscal data have moved to the center stage for policy discussions with the EU, while the national definition continues to serve budgeting purposes.*

The MoF web site provides, with a short-time lag, monthly information on the performance of the State Budget and on major revenue and expenditure categories. However, data on the rest of the general government—the state EBFs, the privatization funds, local governments, and the social security funds—are available with a long time lag and only on an annual basis, although updated quarterly.

In compliance with ESA95 reporting requirements, the Czech Statistical Office (CSO) has been providing annual nonfinancial data and the financial accounts for the general government to Eurostat since 1993.<sup>3</sup> Beginning in 2004, the CSO has started providing quarterly data to Eurostat.

As regards the fiscal data provided to the IMF, progress continues to be made in migrating from the 1986 cash-based *Manual on Government Finance Statistics 1986 (GFSM 1986)*—which is consistent with the national definition—to the 2001 accrual-based *Government Finance Statistics Manual (GFSM 2001)*—which is compatible with ESA95 standards. Beginning with the 2004 annual data, the presentation will be shifted to that of GFSM 2001 and the data will be reported initially on a mixed cash-accrual basis, gradually moving to accrual reporting according to bridge tables already in place.

The differences in the coverage of “general” government under the national GFSM 1986 methodology and the ESA95 and GFSM 2001 methodologies, the use of cash (the national definition and GFSM 1986) versus accrual accounting (ESA95 and GFSM 2001), and the uneven frequency and timeliness of data have contributed to difficulties in interpreting and assessing fiscal developments and targets.

### **C. Open Budget Preparation, Execution and Reporting**

*The original ROSC recognized the transparent budget preparation and execution process and the updates reported on the progress made over the years. The concerns expressed by the ROSC related to fiscal risks associated with the recognition of contingent liabilities have been largely addressed. The Convergence Program also provides a sensitivity analysis (although more of a macro, than of a fiscal, nature) and an assessment of the long-term sustainability of public finances in view of projected demographic changes in the Czech Republic.*

Important legislative changes have been initiated to strengthen fiscal planning, execution and control. Specifically:

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<sup>3</sup> Preliminary data on the main aggregates are provided on a t+3 (months) basis and a t+8 basis. More detailed revenue and expenditure data are provided on a t+12 basis. Annual data provided to Eurostat are publicly available, including those published in the Czech Republic’s Pre-Accession Economic Programs and the post-accession Convergence Program.

- The Amendments to the Law on Budgetary Rules propose to introduce a rolling three-year fiscal targeting framework, hinged on multi-year binding expenditure ceilings, starting with the 2005–07 period.<sup>4</sup> The expenditures of the State Budget and state EBFs (but not the NPF) will be brought under the ceiling, with subceilings on all budgetary chapters. The framework, which has already been implemented on an experimental basis in the context of the 2004 budget, will be formalized by the Amendments, and the 2005 budget will be cast within this framework. The expenditure ceilings may be exceeded only with parliamentary approval and under certain exceptional circumstances, or in response to legislative changes.<sup>5</sup> Also, certain EBFs may exceed their annual spending limits by shifting/postponing spending. The ceilings will be protected from cyclical and one-off revenue shortfalls, while revenue over-performance will be reflected in a lower deficit.
- Further institutional changes are envisaged to enhance the scope of performance budgeting beyond indicators of performance already required for capital expenditure.

There were also developments, with transparency implications, regarding the rules and procedures for extending state guarantees:

- The policy on issuing state guarantees was significantly tightened in 2001 when guarantees were made subject to parliamentary approval on a case-by-case basis. As a result, only three guarantees were issued in 2001–02, and two (for the Czech Railways) in 2003. However, in 2003 a general (open) guarantee (Act 77/2002) was granted to the Railway Transport Infrastructure Administration (SZDC), a spin-off of the Czech Railways. As a result, SZDC may take out loans automatically covered by the statutory guarantee. Because of legal ambiguities regarding the authority for setting the borrowing limits, as of mid-2004 no loans had been extended under this general cover. Following clarifications, effective July 1, 2004, the annual limits will be set by the government based on submissions from the Ministry of Transport.
- Consistent with ESA95 guidelines, beginning in 2003 and retroactive to 1994, some outstanding state guarantees were classified as “high risk” and their full amounts were reflected in general government expenditure (as a capital transfer) in the year in which they were exercised for the first time, even if the payment was only for interest

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<sup>4</sup> These amendments have been approved by the lower house of parliament and are currently before the senate.

<sup>5</sup> The ceilings could be exceeded if the inflation outcome “significantly” deviates from the framework assumptions or in the case of changes in the tax structure and revenue-sharing arrangements with the local governments which involve expenditure shifts. However, commitments arising from the existing state guarantees (for example, the financing of the accumulated losses of CKA mentioned earlier) and the State Budget’s cofinancing of EU projects will not be covered by the ceilings.

or for part of the guarantee.<sup>6</sup> They therefore also added to ESA95-measured debt. This classification change increased the ESA95 general government deficit and debt by CZK 185 billion (7.7 percent of GDP) in 2003, largely reflecting two guarantees related to financial sector restructuring.

- For national budgeting purposes, the Amendments to the Law on Budgetary Rules propose to establish, from 2005, a “reserve fund” for state guarantees covering existing as well as all new issues. The provisions for the reserve fund will be provided (on a risk-weighted basis) from the State Budget. The establishment of the reserve fund is intended to serve two primary purposes: (i) to hold the issuing government accountable; and (ii) to provide more flexibility in expenditure management in the year of guarantee call-in. The reserve fund will operate as a special account, administered outside the State Budget.

Measures were also put in place to control the indebtedness of local governments:

- The Act on Local Government Debentures (190/2004), effective May 1, 2004, requires MoF approval of bond issues before local governments can approach the Securities Commission for approval.
- A government resolution on “Regulation of Municipalities’ and Regions’ Indebtedness” (resolution 346 of April 2004) requires the MoF to calculate annually “debt service limit indicators” defined as 30 percent of tax and nontax revenues for each municipality and region. Should the actual debt service of a local government exceed its 30 percent indicative limit, the MoF will seek an explanation and will discuss with the local government its plans to reduce its indebtedness.<sup>7</sup>

Coinciding with the transfer of greater expenditure responsibility to local governments, the 2002 amendment of the Act on Municipalities and the Act on Regions stated explicitly that, in order to avoid moral hazard problems, the State Budget is not liable for their debt. However, some recent developments may indicate a weakening resolve. In particular, in 2003–04, the State Budget provided CZK 3.5 billion to the regional governments to cover the arrears of hospitals (which are under the regions’ jurisdiction) to their suppliers. With the aim of cutting expenses and preventing a recurrence of arrears, some regions have started financial restructuring of hospitals.

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<sup>6</sup> Guarantees not classified as “high risk” are included in government expenditure and debt when they are called in.

<sup>7</sup> Calculated on a pilot basis, 211 of around 6,250 municipalities exceeded their 30 percent limits in 2003. The debt service indicator might be taken into account, on a case-by-case basis, when discussing the level of subsidies to municipalities for new projects.

Consistent with EU practices, in 2004 the approval authority for granting access to investment incentives was shifted from the Office of Protection of Competition to the Ministry of Trade and Industry. The European Commission has the authority to determine whether incentives conform with EU limits on public support. The system for extending investment incentives was modified in May 2000 from one based on direct (and explicit) budget subsidies to one based on corporate tax concessions for firms in manufacturing. The investors under the direct subsidy system were grandfathered until 2012. The MoF calculates the tax expenditure arising from the investment incentives for internal purposes. There have been no recent estimates of tax expenditures in the Czech Republic, but the MoF is preparing a case study estimating tax expenditures associated with social support programs.

#### **D. Independent Assurances of Integrity**

*The original ROSC recognized the independence and competence of the Supreme Audit Office (SAO) in conducting high-quality and transparent audits of the State Budget and the state EBFs. The SAO also audits all public institutions that receive funds from the State Budget, use foreign loans and grants, and receive state guarantees and public tenders. As for the local governments, there were procedural changes in 2003 and 2004 for auditing their accounts.*

The SAO is strengthening its capacity to perform financial and “value-for-money” audits. Since 2003, the approved annual audit plans contain performance-based audits of expenditure programs and projects in the area of transportation, transport infrastructure and construction. Audit guidelines and manuals have already been issued in these areas, and are being finalized for other areas of activity. The SAO is also providing training for auditors to undertake financial and performance audits and is hiring specialized staff.

The responsibility for auditing the accounts of local governments (14 regions and 6,250 municipalities) rested with district offices of the MoF until these offices were abolished at end-2002. As a transitional arrangement for 2003, municipalities with populations of less than 5,000 were audited by the regions and those with more than 5,000 used external auditors. The regions were audited by external auditors.

With effect from August 1, 2004, a new act establishes the authority, scope, and procedures for auditing the accounts of local governments.<sup>8</sup> Accordingly, the regions will be audited by the MoF, while the municipalities will have the option of being audited by the regions (free of charge) or by external auditors (at their own expense). Those municipalities that access bank credit (some 200 in number) are already being audited, and will continue to be audited, by external auditors. All audit reports will have to be submitted to the MoF. The MoF will review the audit reports, scrutinizing closely the report of those municipalities which are recipients of EU funds and other external resources, or are on the MoF’s watch list for high debt indicators.

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<sup>8</sup> The act on “Examination of Financial Management of Self-Governing Territorial Units and Voluntary Unions of Municipalities” (Act 420/2004).



### **E. IMF Staff Commentary**

The proposed Amendments to the Law on Budgetary Rules include a number of changes in the institutional framework with important implications for fiscal transparency. Importantly, with firm commitment to its underlying principles, the medium term fiscal targeting framework with multi-year expenditure ceilings should significantly strengthen budget planning and execution. At the same time, the intended elimination and/or transformation of a number of key extrabudgetary funds should broaden the coverage on the State Budget, and strengthen fiscal control by closing loopholes that the existence of some of these funds might have created. In this regard, it is important to ensure that the transfer of functions and accounts of the EBFs to successor entities will improve transparency and strengthen fiscal discipline. The operation of the reserve fund should also help internalize costs of guarantees to the issuing government.

Important steps have also been taken or are in train to bring more transparency and accountability to the extension of state guarantees, notwithstanding the provision of the open guarantee to SZDC which was a departure from the rule-based system in place since 2001.

Efforts to contain the indebtedness of local governments and monitor more closely their borrowing activity are encouraging, and should be pursued rigorously to ensure that local governments do not thwart efforts of the center to reduce the general government deficit. Legislating rules and procedures for auditing the accounts of local governments—yet to be tested—is also welcome.

In the area of auditing, the SAO is correctly placing more emphasis on its financial and performance-based audit capacity.

As regards data coverage and reporting, progress is being made simultaneously to comply with Eurostat definitions and standards, and to shift to GFSM 2001 for reporting to the IMF.

With their early and full implementation, these measures should help improve fiscal transparency. There are still other areas where transparency could be improved:

- Focusing on the broadest measure of the deficit and improving the timeliness and frequency of data will help improve the assessment of fiscal developments, projections, and targets. Medium-term budget planning could also benefit from a deeper assessment of fiscal risks. The shift to ESA95 standards should be expedited and the CSO should consider releasing ESA95-based quarterly data to the general public at an early date. In the meantime, provision of reconciliation tables to explain the differences between presentations would be helpful.
- Greater effort should be made to estimate and publish information on tax expenditures, including those associated with investment incentives.