7 Sustainability of Public Finances

7.1 Introduction

Preparations for the economic consequences of an ageing population have become a priority concern in a number of EU countries, and moreover, this topic is one of the main points on the agenda of the Economic Policy Committee (EPC). The Czech Republic has recognised the urgency of the ageing population issue. Population development in the Czech Republic will be influenced by a strong demographic shock in the form of a growing share of older persons in the total population. An ageing population will not only have an effect on the structure and volume of public expenditures, but it will also affect the labour market and the future development of the standard of living.

The best notion of the extent of demographic changes can be derived from the development of the dependency rate over the next 45 years. Eurostat's population projection (EUROPOP 2004) was used as a source database and is in line with domestic projections from the standpoint of the demographic dependency rate[19].
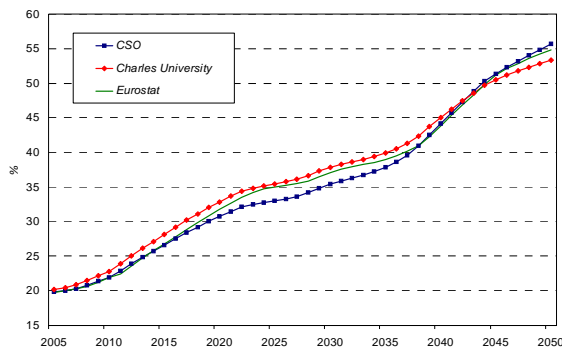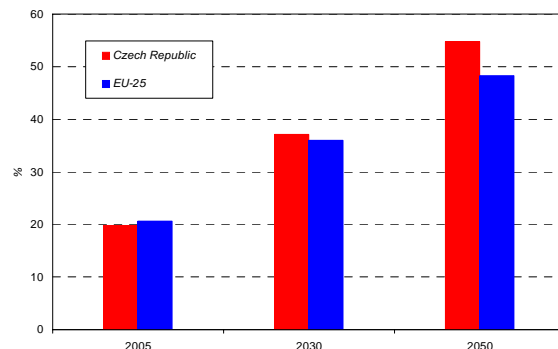
Chart 7.1: Dependency rate   **Chart 7.2: Dependency rate in the CR and the EU**

Note: The dependency rate is defined as the ratio of the population 65 years of age and older to the population 15 to 64 years old in middle variant demographic projection.

Source: Czech Statistical Office, Faculty of Science at Charles University, Eurostat

Within the context of current European demographics, the Czech population is relatively young. However, very dynamic changes in its structure are expected in the upcoming decades. In fact, the Czech population will be among the oldest in Europe within the next 50 years (Chart 7.2). The reason behind these changes is the rapidly increasing life expectancy accompanied by a low aggregate fertility rate. The Eurostat projection assumes that life expectancy at birth will increase between 2004 and 2050 by 7.3 years for men (from 72.4 to 79.7 years) and by 5.3 years for women (from 78.8 to 84.1 years). The aggregate fertility rate will remain far below the level that ensures simple reproduction (an increase from 1.15 to

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[19] *Use of this projection permits comparison with the demographic projections in other EU countries. The European Commission will also use Eurostat's projection to assess the long-term sustainability of public finances in member countries. This projection does not deviate significantly from the domestic projections with respect to the dependency rate (Czech Statistical Office, Faculty of Science at Charles University), which indicates the very robust results of the demographic projections (Chart 7.1).*

1.5). Even significant growth in the active migration balance (from 4,300 to 20,000 annually) will not prevent an overall decline in the population (from 10.2 to 8.8 million people).

The demographic dependency rate will increase from a current rate of ca 20% to ca 55%, i.e. almost triple. In the absence of reform, the dependency rate would be a very good indicator of future deficit tendencies because it measures the ratio of the number of people in their productive age to those in their post-productive age. To confront such a strong demographic shock, the Czech government is preparing a detailed strategy for dealing with the problems of an ageing population.

7.2 Government strategy

The Czech government continues confront long term challenges by continuation of the public finance reform well planned changes to the pension system and the healthcare system and increasing the overall employment rate. By eliminating the excessive deficit and approaching the medium-term objective, a large portion of the existing fiscal gap can be wiped out. Public finance consolidation, is a necessary condition for renewing long-term fiscal sustainability.

In its programme declaration, the government committed itself to submitting a proposal for the pension system reform by the end of its term in office. In April 2004, an expert political team was created to carefully analyse the current state of the pension system and to assess various proposals for pension reform. For this purpose, the government decided to create an independent Executive Team whose job it would be to prepare the materials used in resolving the pension reform issue. The Executive Team finished its work in June 2005, and the results of this work were published in a Final Report containing a detailed analysis of the situation. It was revealed in the report that the current pension system is financially unsustainable and microeconomically ineffective over the long run. The analysis of the implicit tax revealed that the system does not sufficiently motivate citizens to work soon after reaching the statutory retirement age. The pension system also shows a large degree of redistribution, which is effective in combating poverty for pensioners but which could discourage economic activity and/or the payment of premiums.

Independent expert analyses serve as a foundation for negotiations held with the representatives of the political parties. Currently, agreements are being negotiated on gradually increasing the statutory retirement age, expanding the support for voluntary savings in old age and creating a reserve fund from privatisation revenues and from pension system surpluses relating to pension reform. This involves parametric changes that have a positive impact on the long-term sustainability and equivalence of pensions. The creation of a reserve fund helps generate a financial buffer that would curb the costs of the system reform. However, consensus on the principles of the system reform has not yet been reached.

Short-term stabilisation measures have been adopted in healthcare. These measures focus primarily on strengthening the revenue side of the system, concerning in particular the purchase of irrecoverable receivables from health insurance companies, increasing compensation for persons insured under the state system and full redistribution of the revenues of health insurance companies. It also focuses on better regulation of costs through optimising the network of healthcare services, amending regulations on covering medication, introducing healthcare books or the development of instruments for measuring and assessing the quality of provided healthcare services. A reform strategy for healthcare that would

resolve the problem of the system's long-term sustainability is currently in the preparation phase.

As for the participation rate and employment rate, the Czech Republic is one of the more successful countries in the European Union. Nevertheless, it lags behind the leading countries primarily due to its low participation rate for persons between the age of 55 and 64. In recent years, the participation rate has increased in this segment of the population as a result of tightening the conditions for early retirement and a gradual increase in the retirement age. It is anticipated that the pension system reform will be drawn up with respect to an additional rise in the employment of older citizens. Tax changes are intended to support employment in the group of persons with low incomes and qualifications (adjusting the personal income tax parameters).

7.3 The Fiscal Consequences of an Ageing Population – a Long-Term Projection

The European Union devotes a great deal of attention to the long-term fiscal projection and focuses its efforts on the maximum comparability of results between member states. The Czech Republic supports these efforts, and this is why it works as much as possible with the common assumptions and methodology discussed by the EPC's Working Group on Ageing (AWG).

The projections were formed using the following assumptions:

- The population will develop in line with the Eurostat projection (EUROPOP 2004).

- The development of macroeconomic variables up to 2008 is based on national projections. After 2008, the assumptions on labour productivity growth and real GDP growth have been taken from the baseline scenario prepared by the AWG. This assumes gradual convergence to the long-term equilibrium labour productivity growth rate (1.7% per year), a slight increase in the participation rate for men and women and a reduction in the structural unemployment rate to 6.5%.

Table 7.1: Projection assumptions

% of GDP	Year 2000	Year 2005	Year 2010	Year 2020	Year 2030	Year 2040	Year 2050
Labour productivity growth	4,6	3,8	3,4	3,0	2,7	1,9	1,7
Real GDP growth	3,9	4,8	3,6	2,5	1,9	0,4	0,8
Participation rate males (aged 20–64)	86,3	84,3	84,6	87,4	87,1	84,4	85,6
Participation rates females (aged 20–64)	68,9	68,5	70,6	76,4	76,1	72,9	74,0
Total participation rates (aged 20–64)	77,6	76,4	77,6	81,9	81,6	78,7	79,8
Unemployment rate	8,8	7,9	7,3	6,5	6,5	6,5	6,5
Population aged 65+ over total population	13,8	14,0	15,5	20,8	23,6	26,8	31,0

Source: Ministry of Finance

- The pension system projection relies on the national model apparatus. It assumes the validity of current legislative changes, pension valorisation at the level of the mandatory minimum and indexation of the pension model parameters that ensures a stable replacement rate for newly granted pensions.

- The expenditure projection for healthcare and long-term care is based on the assumption of health improvements in the population that fully reflect the increase in life expectancy and the assumption of neutral price development.

- The expenditure projection for education precisely follows the methodology proposed by the AWG. It calculates the expenses per student from the ratio of students to teachers, development of the average wage in the education sphere and the share of other expenditures per student.

- In addition to the above expenditure entries, the development of benefits to families with children and unemployment benefits was also explicitly modelled in order to be consistent with the demographic and macroeconomic scenario.

Age-related expenditures from 2005 to 2050 will increase by about 8% of GDP. The most significant growth factor is expenditures for old-age pensions and healthcare and long-term care. The adverse developments in the pension system and healthcare system will only be reduced to a limited extent by the development of expenditures for education and benefits to families with children.

Table 7.2: Long-term sustainability of public finances

% of GDP	Year 2000	Year 2005	Year 2010	Year 2020	Year 2030	Year 2040	Year 2050
Total expenditure	42,1	45,9	43,0	43,3	45,8	51,2	57,6
of which: **Age-related expenditure**	19,9	20,0	19,0	19,1	21,0	24,5	27,3
Pension Expenditure	8,7	8,3	7,9	8,1	9,2	11,8	13,5
Social security pensions	8,7	8,3	7,9	8,1	9,2	11,8	13,5
Old-age and early pensions	7,7	7,5	7,2	7,4	8,4	11,0	12,8
Other pensions	1,0	0,8	0,7	0,8	0,8	0,8	0,7
Occupational pensions	-	-	-	-	-	-	-
Health care	6,0	6,6	6,5	6,9	7,5	8,3	9,1
Long-term care	0,2	0,3	0,3	0,3	0,4	0,5	0,6
Education expenditure	3,5	3,7	3,2	2,8	2,9	3,0	3,1
Other age-related expenditures	1,4	1,1	1,0	1,0	0,9	1,0	1,1
Interest expenditure	0,9	1,3	1,1	1,3	2,0	3,9	7,5
Total revenue	38,5	41,1	40,9	40,9	40,9	40,9	40,9
of which: **Property income**	0,5	0,5	0,4	0,4	0,4	0,4	0,4
of which: **Pension contributions**	7,9	8,9	8,9	8,9	8,9	8,9	8,9
Pension reserve fund assets	0,0	0,8	4,9	14,2	17,4	3,8	0,0
of which: **Consolidated public pension fund assets**	0,0	0,0	0,0	0,0	0,0	0,0	0,0

Source: Ministry of Finance

A substantial rise in age-related expenditures will cause the primary deficit to worsen, interest rates to increase from the current 1.3% of GDP to 7.4% of GDP and rapid accumulation of government debt. Under these assumptions, Czech public finances would not be compatible with the fiscal criteria defined in the Stability and Growth Pact.
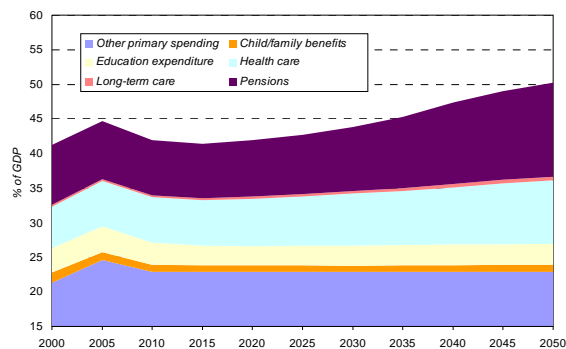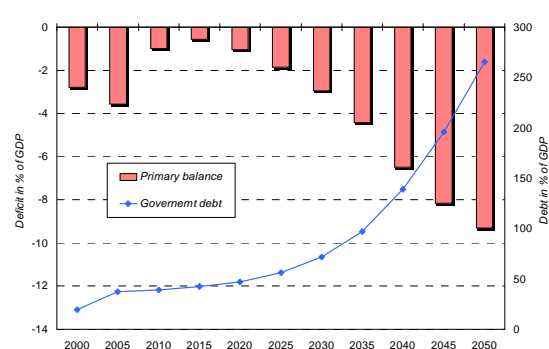
Chart 7.3: Projection of expenditures

Chart 7.4: Primary deficit and debt

Source: Ministry of Finance

When interpreting the results of the projections, it should be remembered that the projections are created on the assumption of existing policies and do not account for any future reform measures. The aim of this approach is to calculate the level of fiscal correction needed to ensure the long-term sustainability of public finances. In order for the Czech Republic to meet the requirements of the fiscal discipline set in the Stability and Growth Pact between 2008 and 2050, it would be necessary to implement measures that would reduce the share of expenditures or increase the share of taxes in GDP by more than three percentage points in 2008 (i.e. the S1 indicator). This means that the overall public finance balance should register a surplus in 2008 of 0.6% of GDP. In order to ensure the long-term solvency of the general government, a fiscal correction of, in fact, 7.0% of GDP would be needed in 2008 (i.e. the S2 indicator).

Table 7.3: Scope of needed fiscal consolidation

% of GDP	Year 2008	Year 2009	Year 2010
1. Revenues	40,9	40,9	40,9
2. Primary expenditures	42,1	42,0	41,9
3. Primary balance (1-2)	-1,2	-1,1	-1,0
4. Sustainability gap S1 [1]	3,3	3,4	3,5
5. Required primary balance (3+4)	2,0	2,2	2,5
6. Required total balance	0,6	1,1	1,3
Memo: Sustainability gap S2 [2]	7,0	7,1	7,2

[1] *Permanent fiscal consolidation (S1) expresses the percentage of GDP needed to permanently increase taxes (from the given year) or reduce expenditures in order to achieve a government debt of 60% of GDP at the end of the projection period.*

[2] *Permanent fiscal consolidation (S2) expresses the percentage of GDP needed to permanently increase taxes (from the given year) or reduce expenditures in order to keep the general government solvent for an indefinite period of time (i.e. meeting the inter-temporal budget restrictions).*

Source: Ministry of Finance