

5 Sustainability of Public Finances

Long-term sustainability is one of the weak spots of Czech public finances. The most serious risk is the expected demographic development, which will dramatically increase the ratio of persons of retirement age to the economically active population over the next several decades.

5.1 Fiscal Impacts of an Ageing Population

The results of the impacts of ageing are based upon long-term projections made in cooperation with the Working Group on Ageing Populations (AWG) of the Economic Policy Committee (EPC). The development analyses are based upon the assumptions on demographic development (EUROPOP2008) and the macroeconomic framework consistent for EU countries.

The stated projections do not reflect the current medium-term macroeconomic and fiscal outlooks of the Czech Republic. The projections are made under an assumption of unchanged policies (they correspond to a system which is today legislatively anchored), and therefore the reported numbers in no way reflect the debated but not yet approved reform measures.

The outcomes of the long-term projections are fully in accordance with the analyses carried out by AWG in the latest report on long-term projections (EC, 2009). In this analysis, 2007 is set as the base year. The following years, therefore, show only a trend projection which cannot be directly compared with current data. Long-term analyses do not aim to forecast specific values but only display trends and long-term dynamics.

An update of long-term projections will be made this year in connection with updating the demographic and macroeconomic assumptions, which are currently being prepared.

Table A.7 in the annex confirms that from today's point of view the pension area appears to be the most problematic in terms of the dynamics of expenditure growth. Expenditure will grow from the current level of approximately 7% of GDP to 11% due to changes in the population structure.

The growth of expenditures, among other things those depending on demographic changes, will also be seen in expenditures for health care, which will rise by more than 2 percentage points by the end of the projection horizon. Expenditures on long-term care will also raise rather dramatically, their volume more than tripling.

The sustainability analysis, which proceeds from the long-term projections, identifies the extent of necessary fiscal consolidation to ensure stability of public finances. So-called sustainability indicators are calculated, which show what measures would need to be carried out to decrease expenditures or increase revenues as percent of GDP so that they correspond to the required levels. Currently, the S1 indicator, which expresses by what percent of GDP it is necessary to increase taxes or decrease expenses so that the state debt at the end of the projection horizon (i.e. in 2060) is 60% of GDP comes to 5.3% of GDP. On the other hand, the S2 indicator, which specifies the amount of necessary fiscal effort for reaching equality of discounted revenues and expenditures on an infinite horizon, stands at 7.4% of GDP.

There has occurred a certain improvement in the sustainability analysis, which can be attributed to reform measures carried out in the pension system, in particular increasing the retirement age.

The current fiscal position is a negative factor for long-term development, resulting in higher accumulation of debt due to relatively high deficits. This will lead to significant growth in interest costs.

5.2 The Government's Strategy – Reforms

In connection with the aforementioned results of the long-term projections, reform measures in the pension and health care systems which should lead to overall improvement in long-term sustainability are currently being discussed.

5.2.1 Parametric Adjustments

This primarily concerns a set of measures reacting to a ruling of the Constitutional Court that a part of the

provisions in the act on pension insurance stipulating the calculation of pension entitlement (in particular the section on the amount of reduction thresholds) to be unconstitutional.

The measures currently being discussed by the Chamber of Deputies bring in particular changes in the calculation of pensions. These aim, in accordance with the opinion of the Constitutional Court, to strengthen the relationship between the amount paid in for pen-

sion insurance and the amount of pension paid out from the pension insurance.

The proposed solution changes the design of the pension calculation by moving the second reduction threshold to 400% of the average wage, “binding” the first reduction threshold to the average wage, decreasing the benefit between the first and second reduction thresholds to 26%, decreasing the benefit above the second reduction threshold to 0%,⁵ and gradually extending the decisive period to be lifelong. The stated measures are designed so that they have no effect on the state budget.

It also has been suggested to continue increasing the retirement age of men at the current pace, i.e. by 2 months per year, even after reaching the age limit of 65 years. For women, there should be an increase of the tempo of increasing retirement age for those born in 1956 and after to 6 months per year with the aim to gradually unify the retirement age for both sexes. Complete unification for all insured persons will occur in 2041 for persons born in 1975, for whom the age limit will be 66 years and 8 months. For each subsequent year of birth, the retirement age will increase by 2 more months, without limitation.

The total increase in paid pensions (regular valorisation) will, as it has until now, correspond to the rise in the consumer price index and to one-third of the growth in real wages. However, valorisation will be carried out by a regulation in accordance with specifically set rules. Thus would end the possibility for the government to discretionarily increase pensions, which has occurred repeatedly in the past.

The proposal also includes measures increasing penalisation for early old age retirement. These would decrease the attractiveness of retiring before reaching the legal retirement age.

The stated measures will significantly increase the stability of the pension system. The balance will remain in deficit for the entire period by around 0.5% of GDP compared to the previous approximately 4.5% of GDP over the long term (roughly from 2040 onward). Only in the critical period of years 2046–2066 should the pension system deficit fluctuate around 2% of GDP.

5.2.2 Pension Reform

Reform of the pension system comprises planned introduction of the second pillar of additional pension insurance. Currently, there is agreement within the

⁵ Thus, the system is in fact limited to the already mentioned level of four times the average wage. Higher incomes do not enter into calculations of the benefits and insured persons do not pay contributions to the system from them.

governing coalition concerning the basic parameters of the reformed system, and the pertaining legislation is being prepared. Before the end of the year, the Czech Parliament should discuss the acts so that the second pillar begins to operate from the beginning of 2013.

The current form of the proposal ensues from certain recommendations of the Expert Advisory Group which has prepared its proposal for the pension reform, and also from recommendations of the government’s National Economic Council.

The government’s proposal introduces the second pillar with voluntary entry into the reformed system for persons under 35 years of age at the time of initiating the reform. Older persons will be able to decide about joining the new pillar half a year before the reform’s initiation – that is in the second half of 2012. It will not be possible to change the decision taken by an insured person in the future.

Financing of the second pillar will be provided by funds transferred from participants in the first pillar in an amount of 3 percentage points from the total contribution rate of 28% (the employee pays 6.5 percentage points and the employer 21.5 percentage points). In addition to this, each insured person will have to pay an additional 2 percentage points from his or her own sources.⁶ Moreover, each person will have the option to pay an additional 1% from his or her assessment base for insurance on the account of his or her parents drawing old age pensions.⁷

In the accumulation phase, the funds will be administered by pension companies, which will be obliged to offer the clients four funds with varying levels of risk: general, conservative, balanced and dynamic. The pay-out phase for the saved funds from the second pillar will be provided by a life insurance company selected by the participant. It will be possible to draw the paid benefit either in the form of a life-long annuity (optionally with an agreed payment of a survivors’ pension for 3 years from the death of the participant) or an annuity paid for 20 years (in case of earlier death, the remaining funds will be subject to inheritance).

Creation of the second pillar will result in an immediate decrease of revenues in the PAYG first pillar, compensated by lower expenditures in the future. The government plans to cover this temporary period

⁶ Thus, the overall premium rate will increase to 30%, while 25 percentage points will be transferred into the current PAYG system and the remaining 5 percentage points into the newly formed second pillar.

⁷ In case of utilising this option, the total premium rate for persons participating only in the first pillar would thus amount to 29%. It would be 31% for persons participating in the second pillar.

using additional revenues from the unified VAT rate (see Chapters 3.2.1 a 6.1.1).⁸

5.2.3 Reform of the Health Care Financing System

With respect to the sustainability of public finances, ensuing changes in the health care system are now relevant. The Government of the Czech Republic has approved an adjustment in regulatory fees (in particular fees for a stay in a hospital or medical facility and the fee for visiting a general practitioner with whom the patient is not registered) and is newly introducing a fee for visiting a specialist without previous recommendation of a general practitioner.

Standards for health care paid from public health insurance are being prepared. In this context, patients will accordingly be able to pay for additional uncovered above-standard care.

More information on reforms in the health care sector is presented in Chapter 6.2.4.

⁸ A re-direction of additional revenues from the increased VAT rates towards the pension account is being discussed now. In case these additional revenues should not be related exclusively to the pension system, analyses of the long-term sustainability could not take this element into account.