7 Sustainability of Public Finances

7.1 Introduction

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.[17]

Chart 7.1: Dependency rate[(a)]

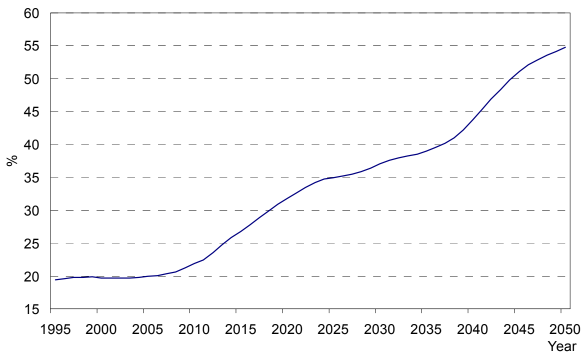
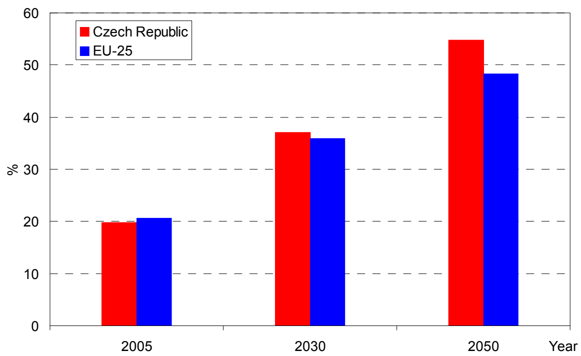


Chart 7.2: Dependency rate in the CR and the EU



(a) 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 the medium demographic scenario.

Source: 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 2005 and 2050 by 7.1 years for men (from 72.6 to 79.7 years) and by 5.1 years for women (from 79.0 to 84.1 years). The aggregate fertility rate will remain far below the level that ensures simple reproduction (an increase from 1.28 to 1.5). Even significant growth in net immigration (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

[17] *This demographic projection was produced by Eurostat in cooperation with the national statistical offices and is the basis for calculating the long-term projections. Use of this projection permits comparison with the demographic developments in other EU countries.*

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 for the problems associated with an ageing population.

7.2 The Government's Strategy

Preparations for the long-term challenges of an ageing population continue to be a priority for economic policy. The main instruments for ensuring the long-term sustainability of public finances are the continuation of fiscal reform, the planned modifications to the pension and healthcare systems and increasing the total employment rate. There was, however, no substantial shift in the issues of pension and healthcare reform against the situation described in last year's CP.

Preparations for the pension system reform were launched in 2004 with the creation of an independent expert team, which carefully analysed the current state of the system and assessed the fiscal impact of the reform scenarios proposed by the main political parties. The expert team prepared detailed materials for making decisions on the pension reform. Nevertheless, the subsequent political negotiations were interrupted by the elections in June 2006. Despite the difficult post-election political situation, negotiations on the basic parametric changes have continued across the political spectrum.

The issue of the overall reform concept for healthcare also remains open. The draft reform stabilising the healthcare system is prepared, however, in view of the complicated political situation, further discussions are very uncertain at this time.

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

The Czech Republic supports the EU's efforts to maximise the comparability of the long-term fiscal projection results, and this is why it works as much as possible with the common assumptions and methodology discussed by the EPC's Working Group on the Ageing Population (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 2009 is based on national projections. After 2009, the input assumptions have been taken from the baseline scenario prepared by the AWG (see Table 7.1 for the main assumptions).
- The pension system projection relies on the national model apparatus. It assumes the validity of the current legislative framework, pension indexation at the level of the mandatory minimum and indexation of the pension system 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 sector and the share of other expenditures per student.

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

Table 7.1: Macroeconomic projection assumptions

% of GDP	Year 2005	Year 2010	Year 2020	Year 2030	Year 2040	Year 2050
Labour productivity growth	4,8	3,4	3,0	2,7	1,9	1,7
Real GDP growth	6,1	3,6	2,5	1,9	0,4	0,8
Participation rate males (aged 20–64)	83,5	84,6	87,4	87,1	84,4	85,6
Participation rates females (aged 20–64)	68,2	70,6	76,4	76,1	72,9	74,0
Total participation rates (aged 20–64)	75,8	77,6	81,9	81,6	78,7	79,8
Unemployment rate	7,9	7,3	6,5	6,5	6,5	6,5
Population aged 65+ over total population	14,2	15,5	20,8	23,6	26,8	31,0

Source: Czech Statistical Office (2005), AWG

The share of age-related expenditures in GDP will increase by about 8 percentage points of GDP from 2005 to 2050. The main driving factors are 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 family allowances.

Table 7.2: Long-term sustainability of public finances

% of GDP	Year 2005	Year 2010	Year 2020	Year 2030	Year 2040	Year 2050
Total expenditure	44,0	42,5	43,3	46,2	52,0	59,2
of which: Age-related expenditure	19,9	18,5	18,9	20,9	24,5	27,7
Pension Expenditure	8,4	7,7	8,3	9,5	12,1	14,2
Social security pensions	8,4	7,7	8,3	9,5	12,1	14,2
Old-age and early pensions	7,6	7,0	7,5	8,7	11,4	13,5
Other pensions	0,8	0,7	0,7	0,8	0,7	0,7
Occupational pensions						
Health care	6,5	6,4	6,7	7,3	8,1	8,9
Long-term care	0,3	0,3	0,3	0,4	0,5	0,6
Education expenditure	3,6	3,1	2,7	2,8	2,9	3,0
Other age-related expenditures	1,2	1,0	1,0	0,9	1,0	1,1
Interest expenditure	1,2	0,9	1,3	2,2	4,3	8,4
Total revenue	40,4	40,3	40,3	40,3	40,3	40,3
of which: Property income	0,7	0,7	0,7	0,7	0,7	0,7
of which: Pension contributions	8,7	8,7	8,7	8,7	8,7	8,7
Pension reserve fund assets	0,5	4,9	12,9	12,4	0,0	0,0
of which: Consolidated public pension fund assets	0,0	0,0	0,0	0,0	0,0	0,0

(a) The cumulative positive balance on the pension account (assets of pension security funds) will be depleted between 2030 and 2040.

Source: Ministry of Finance

A substantial rise in age-related expenditures will cause the primary deficit to worsen, interest expenditures to increase from the current 1.2% of GDP to 8.4% 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

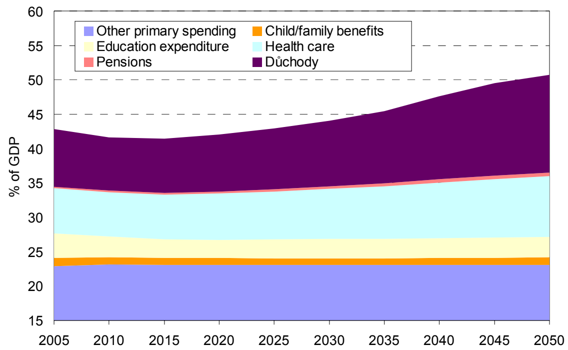
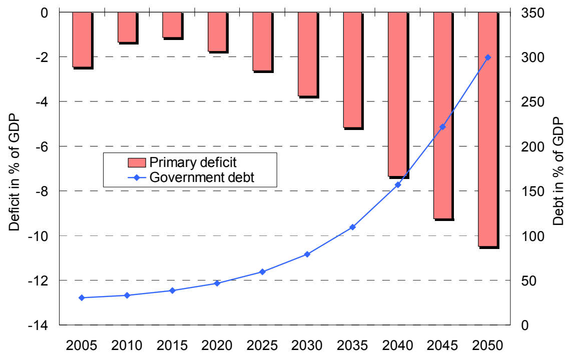


Chart 7.4: Primary deficit and debt



Source: Ministry of Finance

The results of the projections correspond, in principle, to those published by the European Commission for the Czech Republic in reports assessing the effects of an ageing population on the public budgets and the long-term sustainability of public finances[18]. Certain differences may stem from taking 2005 as the base year and from using the national medium-term macroeconomic outlook for 2006 to 2009. However, differences in the long-term projection period are minimal and do not have a substantial effect on the conclusions relating to the sustainability of public finances in the Czech Republic.

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 2009 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 four percentage points in 2009 (i.e. the S1 indicator). This means that the overall general government balance should register a surplus in 2009 of 1% of GDP. In order to ensure the long-term solvency of the general government, a fiscal correction of, in fact, 7.9% of GDP would be needed in 2009 (i.e. the S2 indicator).

[18] European Economy Special Report n° 1/2006 from March 2006 and Special Report n° 4/2006 from October 2006

Table 7.3: Scope of needed fiscal consolidation

% of GDP	Year 2009	Year 2010	Year 2011
1. Revenues	40,3	40,3	40,3
2. Primary expenditures	41,7	41,6	41,5
3. Primary balance (1-2)	-1,4	-1,3	-1,3
4. Sustainability gap S1 (1)	3,9	4,0	4,1
5. Required primary balance (3+4)	2,5	2,7	2,9
6. Required total balance	1,0	1,8	1,9
Sustainability gap S2 (2)	7,9	8,1	8,2

(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