# 6 Sustainability of Public Finances

## 6.1 The Government's Strategy

Long-term sustainability is one of the weak spots of public finances. The most serious risk is the expected demographic development, which will somewhat dramatically increase the share of persons at retirement age in the working population over the next several decades. Currently, the government is intensively engaged in the issue of an ageing population and its impact on the long-term sustainability of public finances, and the preparations for reforming the pension system and the healthcare system are taking on a more concrete form.

### The pension system

The approach to resolving the pension system issue has been divided into three phases. The first phase has already been prepared. The proposal contains stabilising parametric adjustments to the current pay-as-you-go scheme. The main points include continuing to increase the retirement age gradually to 65 years old, coordinating the age for entitlement to "permanent" widow's or widower's pension based on retirement age, and converting full disability pension into old-age pension at the age of 65. After implementing these measures, there should be savings of about 1 percentage point of GDP for the pension system's expenditures in 2050. It has also been proposed to extend the minimum insurance period, to limit its non-contributory periods, to modify the current definition of disability and to create a reserve account for pension reform.

The second phase will involve separation of the assets of shareholders and clients in the voluntary supplementary pension insurance scheme and additional adjustments geared to increasing the motivation of clients and the participation of employers in supporting supplementary pension insurance. A guarantee of minimum income for pensioners in the amount of the minimum subsistence level will also be introduced.

During the third phase, an additional voluntary savings pillar for the pension system will be created based on a scheme to "opt out" (or partially opt out) of the state pay-as-you-go system.

In addition, the political debate over the strategic issues concerning the pension system was reopened. In June 2007, a team made up of the leaders of the parliamentary parties met for the first time to discuss the long-term issue of pension reform. The task of the team is to negotiate a generally acceptable proposal for pension reform based on the input of the executive team in 2005[13]. At the same time, an expert discussion took place on the options for resolving the separation of shareholder and client assets in pension funds, which should allow the funds to be used for introducing an opt-out system.

[13] *An independent expert team carried out an in-depth analysis of the current state of the pension system and assessed the fiscal impact of the reform scenarios proposed by the main political parties. The team prepared comprehensive background materials for deciding on the concept of pension reform.*

### The healthcare system

The healthcare system reform has also been divided into phases. The first phase has already been launched and incorporated into the set of measures for stabilising public finances (measures already approved, see Box 6.1)

#### Box 6.1: Adjustments to the healthcare system

The amendment to the Act on Public Health Insurance will come into effect on 1 January 2008 and will introduce **service charges** for doctor's visits, for items on a prescription, and for the number of days spent at healthcare facilities. The amount of the charges for doctor's visits, prescription items and certain supplementary payments for medication paid by one person is limited to CZK 5,000 per year. Additional legislative changes have been made with respect to **setting prices and the payment of medication**.

The income gained by healthcare facilities from the services charges are estimated at CZK 4.4 billion. Moreover, savings in health insurance expenditures are expected to be around CZK 4 billion, thanks, for example, to motivating the public to limit their doctor's visits and limiting the duplication of treatment at specialists. The savings effect will be partly reduced by the increased administrative expenditures and expenditures associated with returning a part of the charges to the insured persons exceeding the CZK 5,000 limit.

The state budget's mandatory expenditures for healthcare will be reduced by a temporary **freeze of the government payment for state insurance** (see Box 5.2).

Specific systemic changes aimed at strengthening fair competition in healthcare facilities are being prepared at this time, including the conversion of health insurance companies into joint-stock companies with increased operating transparency. The scope of health insurance will also be revised and the option of choosing more comprehensive insurance will be introduced with the possibility of paying for higher standard care (or arranging supplementary health insurance).

With its resolution of June 2007, the government established a committee of independent experts (similar to the pension reform executive team) who will assess the current state of the healthcare system and its outlook. The committee should also analyse the strategic reform proposals of the political parties. However, implementation of the results of this committee's work will most likely not occur until the next election term.

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

The analysis of public expenditure development over the long term is primarily based on the common assumptions and methodology discussed by the EPC's Working Group on the Ageing Population (AWG) and on the Czech Ministry of Finance's medium-term macroeconomic prediction. The long-term prediction does not include any of the unapproved measures planned as a part of the pension and healthcare system reform discussed in the previous sub-section.

### Table 6.1: Macroeconomic projection assumptions

| % of GDP | Year 2006 | Year 2010 | Year 2020 | Year 2030 | Year 2040 | Year 2050 |
|---|---|---|---|---|---|---|
| Labour productivity growth | 5.0 | 5.1 | 3.0 | 2.7 | 1.9 | 1.7 |
| Real GDP growth | 6.4 | 5.3 | 2.5 | 1.9 | 0.4 | 0.8 |
| Participation rate males (aged 20–64) | 83.2 | 84.6 | 87.4 | 87.1 | 84.4 | 85.6 |
| Participation rates females (aged 20–64) | 68.5 | 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 | 7.1 | 4.5 | 6.5 | 6.5 | 6.5 | 6.5 |
| Population aged 65+ over total population | 14.4 | 15.5 | 20.8 | 23.6 | 26.8 | 31.0 |

*Source: Czech Statistical Office (2006), Ministry of Finance, AWG*

The estimates of the effects of population changes have not changed substantially with respect to last year's CP update. They point to increasing pressures, especially in the area of expenditures sensitive to the age structure of the population. These expenditures are estimated to increase by almost 8 percentage points of GDP between 2006 and 2050. Old-age pensions (an increase in the same period of 6.0 percentage points of GDP) and expenditures for healthcare and long-term care (an increase of 2.4 percentage points of GDP) will contribute most to this rise.

### Table 6.2: Long-term projection of general government revenues and expenditures

| % of GDP | Year 2006 | Year 2010 | Year 2020 | Year 2030 | Year 2040 | Year 2050 |
|---|---|---|---|---|---|---|
| Total expenditure | 43.6 | 39.4 | 39.8 | 42.7 | 48.4 | 55.5 |
| *of which:* Age-related expenditure | 19.7 | 18.1 | 18.6 | 20.7 | 24.3 | 27.4 |
| Pension Expenditure | 8.3 | 7.7 | 8.3 | 9.5 | 12.2 | 14.3 |
| Social security pensions | 8.3 | 7.7 | 8.3 | 9.5 | 12.2 | 14.3 |
| Old-age and early pensions | 7.5 | 7.0 | 7.5 | 8.7 | 11.5 | 13.6 |
| Other pensions | 0.8 | 0.7 | 0.7 | 0.8 | 0.7 | 0.7 |
| Occupational pensions | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Health care | 6.5 | 6.2 | 6.5 | 7.1 | 7.9 | 8.7 |
| Long-term care | 0.3 | 0.3 | 0.3 | 0.4 | 0.5 | 0.5 |
| Education expenditure | 3.5 | 3.0 | 2.6 | 2.7 | 2.8 | 2.9 |
| Other age-related expenditures | 1.1 | 1.0 | 0.9 | 0.9 | 1.0 | 1.0 |
| of which: Interest expenditure | 1.1 | 1.2 | 1.2 | 2.0 | 4.1 | 8.0 |
| Total revenue | 40.7 | 37.1 | 37.1 | 37.1 | 37.1 | 37.1 |
| *of which:* Property income | 0.8 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 |
| *of which:* From pension contributions (or social contributions if appropriate) | 8.7 | 8.7 | 8.7 | 8.7 | 8.7 | 8.7 |
| Pension reserve fund assets [(a)] | 0.2 | 3.3 | 10.6 | 8.9 | 0.0 | 0.0 |
| *of which:* Consolidated public pension fund assets (assets other than government liabilities) | 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 increase in these expenditures, under the assumption of a stable political environment, would cause deterioration of the primary deficit, a rise in interest payments and a rapid accumulation of government debt.

**Chart 6.1: Projection of expenditures**

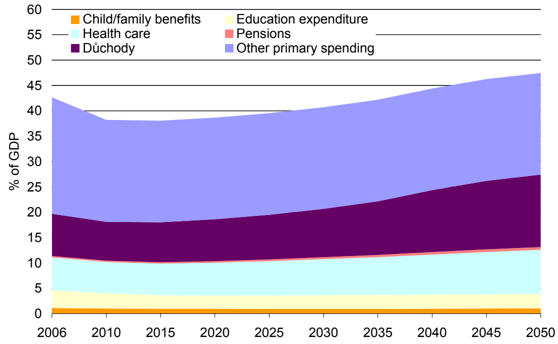
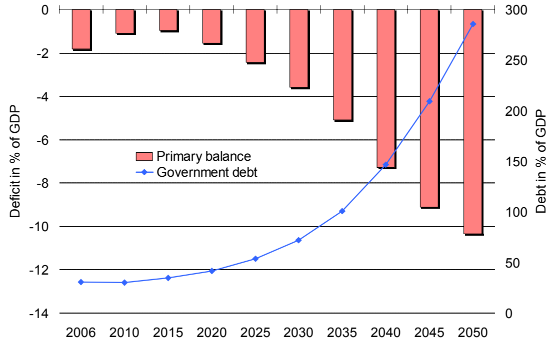



**Chart 6.2: Primary deficit and debt**




*Source: Ministry of Finance*

The deviations of the projected development from the compliance requirements of the Stability and Growth Pact, i.e. maintaining the debt at a maximum level of 60% of GDP, are assessed on the basis of these predictions.

The analysis identifies the scope of fiscal consolidation, under the assumption of a stable political environment, that would be needed to meet this requirement by 2050. The Czech Republic would need to implement measures reducing the share of expenditures or increasing the share of revenues in GDP by 3.8 percentage points in 2010 (i.e. the S1 indicator). This means that the overall general government balance should register a surplus in 2010 of 1.5% of GDP. In order to ensure the permanent solvency of the general government, a fiscal correction of, in fact, 7.9% of GDP would be needed in 2010 (i.e. the S2 indicator).

**Table 6.3: Scope of needed fiscal consolidation**

| % of GDP | Year 2010 | Year 2011 | Year 2012 |
|---|---|---|---|
| **1. Revenues** | 37.1 | 37.1 | 37.1 |
| **2. Primary expenditures** | 38.2 | 38.2 | 38.1 |
| **3. Primary balance (1-2)** | -1.1 | -1.1 | -1.0 |
| **4. Sustainability gap S1 (1)** | 3.8 | 3.9 | 4.0 |
| **5. Required primary balance (3+4)** | 2.7 | 2.8 | 3.0 |
| **6. Required total balance** | 1.5 | 2.0 | 2.1 |
| **Sustainability gap S2 (2)** | 7.9 | 8.0 | 8.1 |

*(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*