

1 Summary

The second Report on the Long-Term Sustainability of Public Finances prepared by the Czech Fiscal Council (CFC) shows that despite a slight improvement compared to last year due to a more favourable demographic projection, Czech public finances remain unsustainable in the long run. Compared to last year, a new demographic projection by the Czech Statistical Office (CZSO), which is updated every 5 years, and the latest version of which was published at the end of November 2018, was available to the CFC for the preparation of the Report. However, the new CZSO data does not point to any major reversal in long-term trends. The Czech population continues to age. The ratio of people aged 65 years or more to the total population is currently 19% and will rise to 30% over the next 50 years. Given current revenue and expenditure policies, this will lead to a significant increase in pension and health and long-term care expenditures. Furthermore, education and defence expenditures will increase as well.

Real convergence to more developed countries and economic growth accompanied by an increasing share of wages in GDP (leading to increased collection of personal income taxes and social security contributions relative to GDP) will not suffice to compensate for such developments on the expenditure side. The general government's primary balance, which is positive in the early years of the projection, will drop into marked deficits after 2030 as particularly numerous cohorts begin to retire and will peak at just below 7% of GDP around 2060.

According to the projection's baseline scenario, the "debt brake" threshold, which is legally set at 55% of GDP, will be breached around the year 2047. The general government debt will, however, continue to increase, due not only to growing pension system deficits, but also to an increase in interest rates spurred by the country's growing indebtedness. At the end of the projection's 50-year horizon in 2069, the debt in our simulation will reach some 222% of GDP. Even if financial markets were not to react to the increasing debt, leaving the rate of return on bonds at the level prior to the debt brake breach, the debt-to-GDP ratio would amount to 175% of GDP at the end of the projection.

Alternative scenarios that count, for example, on linking the retirement age with expected life expectancy or on favourable effects of digitisation, automation and robotics on labour productivity, show that the debt in relation to GDP would be lower than in the baseline scenario at the end of the 50-year projection horizon. However, the Czech Republic would not achieve long-term sustainability of public finances even under such favourable scenarios. It is obvious that the public finance trends described in the Report will require a response from political representatives. The political representation will need to adjust tax and expenditure policies at the latest when the limits set by law are reached (1% of GDP in the case of the structural deficit and 55% of GDP in the case of the general government debt). The considerable increase in projected debt in the simulated period, indicating the size of the long-term imbalances, at the same time implies that the adjustments will have to be very strong and not merely cosmetic.

Although the period over which the deficit and the debt reach the limits defined by law seems to be long enough to find a consensual solution to the long-term unsustainability of Czech public finances, the opposite is true. Neither politicians nor the general public should be lulled into a false sense of security by the expected developments over the next few years, in which Czech public finances may seem at first sight to be in good condition in terms of debt to GDP and by international comparison. The projection clearly shows that the unfavourable trend will accelerate after 2030. The costs increase with each year of postponement of the necessary

changes. The later reforms are adopted, the more painful they will be for society. Obviously, it is necessary to start a serious debate that will lead to concrete measures as soon as possible. Such debate would help distribute the burden of demographic change over more generations and at the same time provide economic agents with more time to adapt.