

1 Summary

The third Czech Fiscal Council *Report on the Long-Term Sustainability of Public Finances* was produced in the shadow of the coronavirus pandemic. By affecting the change in the medium-term projection, the pandemic pointed to insufficient resilience of public finances to withstand shocks of a similar nature. Recent fiscal policy has been highly procyclical, and the use of massive expansionary policy in 2018 and 2019 despite favourable economic developments has drained the government's resources to stimulate the economy in bad times. Due to discretionary measures, the public sector's finances will operate with a large deficit in the coming years. This will contribute to a significant increase in general government debt.

Although from the long-run perspective it is usually essential to disregard the business cycle and temporary effects, the impact of the pandemic is so significant that we have included it in our government debt projection. But this is not the only reason why the debt projection is significantly higher than it was a year ago. Among other things, an increase in pensions beyond the valorisation scheme introduced at the beginning of 2020 will affect the expenditures of the pension system for several years ahead.

The projection of public sector revenues and expenditures rests on two basic assumptions. First, similarly to the previous report, it is based on real convergence of the Czech economy, characterised by labour productivity growth and an increasing share of wages in the economy. The second key parameter is the updated demographic projection, which reveals a slightly more favourable path, mainly due to a higher migration balance. However, the Czech population continues to age. Should no fundamental changes in the pension system occur, the share of retirement pensions in GDP will increase from the current 7.5% to 12% over the next 40 years. The next generation to draw a pension will not only be larger, but will also live longer. This will affect the pension system significantly. However, the demographic changes will affect other areas of public finances, most of all health care, education and the cash benefits system. Economic growth, which will be reflected in higher wages and consequently higher income tax revenues and social security contributions, will not be enough to offset the higher expenditures.

In terms of assessing the sustainability of public finances, the situation has deteriorated significantly compared to last year. If the current tax and expenditure policies are maintained, the "debt brake" threshold, which is legally set at 55% of GDP, will be breached as early as 2043. This is four years earlier than we anticipated in the 2019 projection. Before the pandemic shock we counted on a positive primary balance of the public sector in the coming years, whereas the government's past fiscal policy and the economic impact of the pandemic will result in the primary balance turning negative right at the beginning of our projection. Subsequent demographic developments, resulting in baby-boom cohorts retiring, will significantly widen the public deficit to 7.5% of GDP.

Under these conditions, the projected government debt will reach 298% of GDP at the end of the 50-year horizon, significantly higher than in the previous projection. This is not only because of unfavourable initial conditions and increasing costs resulting from demographic trends, but also due to rising interest rates in response to higher indebtedness of the economy. At the same time, interest rates on government debt rise earlier because the debt brake will be breached earlier. Even if the financial markets were not to react to the growing indebtedness and the interest rate was kept at zero, the accumulated government debt would approach 160% of GDP. But for the government debt to be no higher than the debt brake threshold in fifty years' time, the public balance would have to improve by 3.28% of GDP in each year of the projection. Recall that last year we reported this indicator as being half a percentage point lower.

Being aware of the uncertainty associated with our baseline scenario, we have calculated several alternative scenarios. However, neither the incorporation of the positive effects of digitisation and robotics, nor more favourable demographic trends solve the problem of the long-term sustainability of public finances. Even when we consider a rather unrealistic scenario with high fertility at the 1970s level, the pension system deficits remain very large. Despite some improvement, the problem persists even when the retirement age is linked to life expectancy.

The increase in projected debt in the simulated period suggests that the system is in a long-term imbalance. Correcting this imbalance requires more than merely cosmetic changes. A quick response is needed to solve the problem. The remaining time for legislators to adjust tax and spending policies before the country's debt reaches the debt brake threshold is shortening quickly. The later these changes are made, the more painful they will be. It is thus in the interests of all of society that a debate leading to specific measures be launched as soon as possible.

