Pension Reform in the Czech Republic: A Gradual Approach

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1 Introduction

Pension reforms ranked among the most discussed economic topics in the 1990s, when the population aging problem was brought to light. The vulnerability of the prevalent pay-as-you-go schemes with defined benefits against adverse demographic shocks made both economists and politicians aware of the risks that different pension schemes face. Central European countries are no exception; moreover, they will be hit by the aging problem even more dramatically than Western European countries.

Hungary, Poland and finally even the Slovak Republic introduced profound "big-bang" reforms of their pay-as-you-go pension schemes in the last decade. The Czech Republic has remained apart from this trend and has implemented only a number of gradual reform steps since 1989, always remedying only the most burning weaknesses of the pension system. The partial success of this gradual approach made it possible to postpone more thoroughgoing and unpopular measures beyond the election horizon of past governments.

The paper investigates the Czech approach to pension reform from the beginning of the transition period up to now. It demonstrates the weaknesses of the recent pension system thoroughly, especially in the light of the difficult budget situation of the Czech Republic, and presents the expected course of further reform steps in the near future. The aim of this paper is not to present an explicit solution for the Czech pension system, as many other economists have already done.[3]) Instead, I will concentrate more on the assessment of the recent government's drafts with respect to its ability to challenge the problem of population aging. The paper continues the analysis of pension reforms in the Central European region initiated by the paper of János Kun in an earlier issue of Focus on Transition[4]) and offers a closer look at the Czech Republic.

The paper is set up as follows. In section 2, a brief description of a development of the mandatory pension pillar in the 1990s is presented. I focus on the 1995 Pension Act and its amendments effected after 1997. In section 3 the weaknesses of the current setting are pointed out, most notably the challenges represented by population aging are examined. Section 4 provides a review of the voluntary pension pillar, and section 5 offers a discussion of recent reform proposals. Section 6 concludes.

2 Transition to the Recent Pension Insurance System

The last act from the communist era that regulated the sphere of pension security embodied some features characteristic of the Soviet pension model, e.g. participants did not have to pay any extra contributions to the pension security system, as it was financed entirely by general taxes. Further, pension spending was fragmented into many kinds of benefits and differentiated even by the status that the government acknowledged for different occupations. After the breakdown

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2 *Disclaimer: the opinions contained herein do not necessarily express the opinions of the Czech Ministry of Finance.*

3 *For papers in English see, for example, the contribution of Schneider and Kreidl (1998).*

4 *Kun (2001).*

of the communist regime, reforms of the social security system as well as other parts of the economy were introduced. The main attention was directed to institutional aspects, the static nature of the pension system and the disproportionate relation between selected occupations. The organization of the system was centralized, the Czech Social Security Administration was put in charge, and new legislation was introduced to adjust pensions, which brought the necessary dynamics into the system. Mandatory contributions were enacted along with a comprehensive tax reform, which came into force in 1993. Subsequently, contributions to private pension funds were permitted and supported by state subsidies and tax benefits.

The modern Czech pension system has features of a two-pillar system consisting of: (1) a mandatory, defined-benefit pillar, which is financed on a pay-as-you-go basis, and of (2) a voluntary, supplementary pension insurance run by private pension funds. In the World Bank's terminology, the voluntary pillar would constitute the "third" pillar subsequent to the mandatory pay-as-you-go pillar and the mandatory funded pillar, which has not yet been introduced in the Czech Republic. The government has recently been trying to enforce an additional occupational pension scheme; I shall come back to this issue in the last section of my paper, in which I deal with recent reform proposals.

This section of my paper will comment on the mandatory pay-as-you-go scheme. I will depict the crucial characteristics of the scheme and track reforms that have already been effected in certain segments. I refer to this style of reforming as gradual, and at the end of the section, I will outline the most important challenges this approach will face in the near future. The aim is to point out how inadequate the gradual, partial reforms are to tackle really challenging issues.

2.1 The Mandatory Pay-As-You-Go Scheme

In 1996 the new Act on Pensions (no. 155/1995 Coll.; 1995 Act), which provides a unified regulation for all occupations in the mandatory pension insurance system, came into force.[1]) The 1995 Act contributed substantially to the modernization of the pension system. It initiated a slight shift upward in retirement ages (especially for women),[2]) extended the period for computing average earnings, introduced innovative changes in disability and survivor pensions and even allowed for some degree of flexibility in choosing the individual retirement age. Unfortunately, the real challenges of the deteriorating demographic situation remained practically unaddressed. Moreover, necessary compromises and oncoming elections made politicians reduce contribution rates and increase pension benefits, which has worsened the financial stability of pension system even further.

The *revenue* side of the pay-as-you-go pillar provides universal coverage for both wage earners and self-employed persons. Participants have to pay contri-

1 *The army forces represent the only exception, i.e. civil servants employed in the army, police forces, the customs service and jail forces. Their separate pension schemes account for 2.5% of all pension benefits.*

2 *To be specific, increases of four and two years for women and men, respectively. Newly legislated statutory ages of 61 and 62 years for women and men will be phased in until 2007. Henceforth, women will even be allowed to retire earlier depending on the number of children they have.*

butions totaling 26% of salaries or profits; there is a minimum for all contributions, but no ceiling. The minimum is equal to the minimum wage (for employees; for self-employed persons, the minimum is expressed in a more complex way). The scheme is administered by the Czech Social Security Administration (CSSZ), which is a governmental body directed by the Ministry of Labor and Social Affairs (MLSA) with competence basically in the sphere of pension insurance (the mandatory pillar only) and health insurance. It administers the system relatively successfully, with the collection rate for contributions ranking high in an international comparison, and fairly low operating costs.

The *expenditure* side of this pillar provides for three kinds of pensions – old age, disability and survivor pensions. All benefits are based on a defined benefit scheme and always consist of two segments: a flat rate, and an earnings-related pension. The flat pension applies to all pensioners equally and independently of the amount of their earnings-related pension. At present, this flat rate amounts to approximately 20% of the total amount of an average pension.

The earnings-related part depends on the length of the contribution period and the average income earned in last 30 years. The 1995 Act introduced a tighter link between contributions and benefits, which represents a positive move towards computing pensions on the basis of lifetime earnings. The full 30-year period is being phased in gradually and will be reached by 2015. At this stage, I would like to relate some details of the computing formula, as it will be of interest for changes effected after 1995 and for the leveling of pensions.

The formula consists essentially of two steps. The first is the definition of the assessment base, which represents the average earnings of a worker earned in the last 30 years; the second step constitutes a reduction of this assessment base to the so-called computational base from which individual pensions are ultimately derived. The conversion happens by way of certain limits (so-called bend points) that are tied to relatively low levels of wages; hence, there is a significant break between the contributions paid in and benefits received.[1]) The earnings-related part of the old-age and full disability pension is then calculated by adding 1.5 percentage points (the so-called accrual rate) of the computational base for every year in which contributions are made.

The sum of the flat and the earnings-related parts of a pension amounts on average to 63% of the net average wage, with a high degree of leveling.[2]) Empirical surveys on living standards for retired persons show that this pension level is sufficient to assure a dignified existence during retirement.[3]) The trajectory of the replacement ratio in the second half of the 1990s exhibits a somewhat declining trend, which may be due to the government's efforts to reduce redistribution and pension leveling.

1 *The full value of the assessment base is taken into account up to 45% of the average wage, approximately. Amounts exceeding approximately 107% of the average wage are reduced by 70%, and if the assessment base exceeds even this limit, then solely 10% of wages surpassing the threshold are taken into account.*

2 *For persons who retired in 2002 at the statutory retirement age or even later. Pensions are tax exempt; hence, only a ratio of pensions average net wages provides a meaningful interpretation.*

3 *For details see Kuchařová, 2002.*

2.2 Changes Effected after 1995

Efforts to modify the 1995 Act were initiated already in 1997, when the financial accounts of the pension system closed with a deficit for the first time; two additional "reform packages" followed in the years 2001 and 2002. Amendments to the 1995 Act pertained basically to three spheres; in particular, they concerned the valorization scheme, early retirement mechanisms and noncontributing periods. While changes in the valorization scheme were rather of a technical nature, the other two reforms aimed to restore the financial balance.

2.2.1 Valorization Scheme

Originally, the government was obliged to adjust the earnings-related part of pensions whenever the consumer price index (CPI) surpassed 5%. The extent of an adjustment had to cover 70% of the CPI growth, and every second year at least a third of the real wage increase, but in fact, the government did not adhere to these minimum rules. Pension increases covered virtually the full growth of inflation and almost the full growth of real wages in the past.[1])

The 2002 amendment to the 1995 Act specified that the government has to adjust pensions regularly on January 1 whenever the CPI index surpasses 2%. On the other hand, the government has still retained the competence to determine the exact amount of valorization; only the minimum is set by law and covers the full growth of CPI and a third of annual real wage growth. The law does not stipulate precisely how to adjust the flat part of pension and the bend points, as they are set in nominal terms, which gives the government full control of the range of redistribution in the pension system.

2.2.2 Early Retirement Procedures

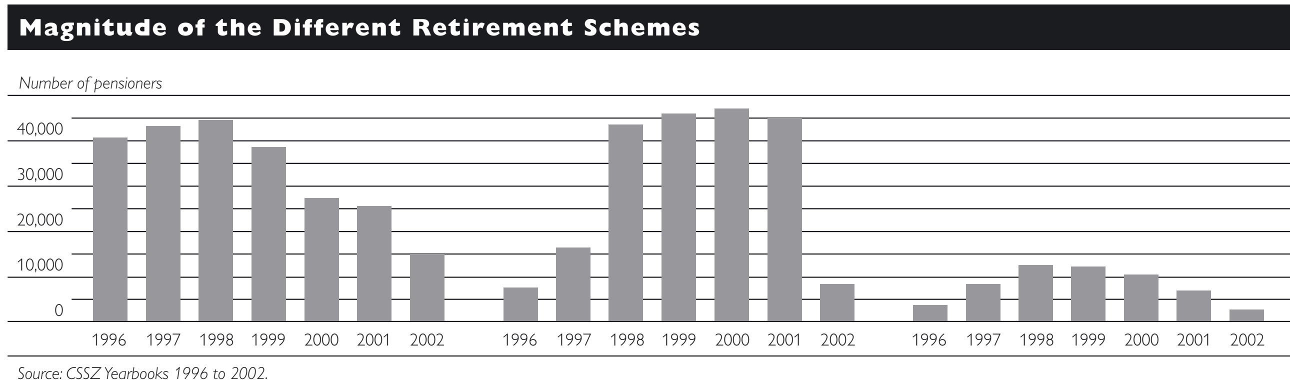
The law provides for two options. The first is regular early retirement with a permanent reduction of a pension, which is accessible three years ahead of the statutory retirement age. Originally, it was available even five years prior to the statutory age, which was changed in 1997. The second is a so-called "unemployment pipeline," which can be drawn two years prior to the statutory age, but only if a person is unemployed for a certain period. The penalty is only temporary for this kind of early retirement, and persons receive their full pension once they reach the statutory retirement age.

The penalties were originally set in such a manner that they virtually favored persons retiring early compared with persons working until the statutory retirement age or even later. The result was that people were discouraged from working. Indeed, they were leaving the labor force on a large scale; the number of early pensioners reached a dramatic level during the depression after the 1997 monetary crisis, and the popularity of early retirement remained practically unchanged until 2001. It regularly outweighed the conventional retirement option (see chart 1). The 2001 amendment to the 1995 Act significantly raised the penalty for early retirement. Even in 2001 the effective retirement age was only 56 years on average for women and and 59 for men, whereas the statutory retirement ages were 59 and 61.[2]) The amendment demonstrated its force in 2002, when the figure for early retirement dropped to just 20% of that recorded in the previous year.

1 *Lasagabaster et al. (2002); pension increases between 1993–2000 equaled 100% of the CPI and 87% of real wages.*
2 *MLSA (2002a).*

Chart 1

Magnitude of the Different Retirement Schemes



Source: CSSZ Yearbooks 1996 to 2002.

2.2.3 Noncontributing Periods

Noncontributing periods, i.e. periods that are acknowledged as periods of participation in the pension insurance scheme even without the payment of contributions, reached a considerable dimension in the Czech pension system, as they account for a quarter of total insurance periods.[1]) They cover periods of unemployment, studying, short-term illnesses, periods during which disability pensions are drawn, military service, care of children up to four years of age per child, and care of a helpless person. The extent of these periods was somewhat reduced in 1997; since then, only 80% of the length have been taken into account. However, this rule does not relate to all noncontributing periods – child care, care of a helpless person and military service are still counted to the full extent.

Noncontributing periods remain a weak point of the Czech pension system even now, and as such will be cited in the next part of this study, where I will comment on the main drawbacks of the current setting in greater detail.

3 Weaknesses of the Czech Pension System

3.1 Financial Instability

Financial instability occurred for the first time as early as in 1997, after the dramatic growth of the number of people benefiting from early retirement schemes, and the equilibrium has not been restored yet, despite the measures explained above (see table 1). The pension system had been running surpluses until the year 1996, but these were unfortunately regularly absorbed by the state budget. Due to growing criticism of this practice, parliament obliged the government to establish a special "pension account" in the state budget, to which the surpluses should have been transferred annually, with the aim of earmarking them only to increase pensions or to pay off future deficits. However, the critique came late, as the only year in which a surplus occurred after the account was established was 1996.

Table 1 shows that the deficit fluctuated around 0.9% of GDP in recent years, which could mislead one to conclude that the deficit was stable, whereas the opposite is true. The deficit was held stable only because of the discretionary softening of expenditure pressures at the expense of declining replacement

1 *MLSA (2002b).*

Table 1

Financial Situation of the Pension Account[1])

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
	% of GDP									
Contributions	7.8	8.3	8.2	8.1	8.3	8.1	8.1	8.2	8.2	8.2
Expenditures	7.2	7.1	7.7	8.0	8.6	8.8	9.1	9.2	9.0	9.2
Balance	0.6	1.2	0.6	0.1	–0.3	–0.7	–1.0	–0.9	–0.8	–1.0

Source: State Financial Statements, 1993 to 2002.
[1]) Revenues are without penalties and charges. Expenditures exclude operating costs; moreover, they include advance payments granted in the preceding year and exclude the payment granted for the following year.

ratios for new retirees and postponed valorization of pensions in 2002. If this had not been the case, the Czech Republic would have recorded a steadily rising imbalance on its pension account. As will be shown in following paragraphs, the deficit of the pension system is not counterbalanced by other expenditure items in the state budget and furthermore will be significantly worsened by the upcoming adverse demographic changes.

3.2 Impacts of an Aging Population

The Czech Republic will be hit substantially by the aging problem. A widely used indicator of changes in the demographic structure is the old age or demographic dependency ratio (the number of people aged over 65 to the number of people aged between 20 and 64). In 2000 its value for the Czech Republic came to 21.9%, so that the Czech Republic ranked 16th among the OECD member states, which implies a relatively young population. According to the OECD forecast, the dependency ratio will peak at 57.2% by 2050, thus putting the Czech Republic in 5th place in the ranking. The unfavorable situation may be pinpointed to the low fertility rate, which stagnated at the level of 1.14 children per woman in the 1990s (the lowest rate among OECD countries) and to the rapidly rising life expectancy. The Czech Republic will occupy the third place among the countries under consideration with regard to the speed of the adverse demographic change.[1]) Even the expected widening of the active immigration balance will not significantly reduce the relative size of the old age cohort.

Another indicator that combines demographic changes and labor market forecasts within the framework of a country-specific pension system is the system dependency ratio, which compares the number of retirees to the number of people contributing to the pension system. In 2001, the ratio of retirees to the contributing population amounted to 0.55, which implies that approximately 18 working persons supported 10 retired persons. In 30 years the ratio should rise to 0.82, meaning that only 12 persons would support 10 retired persons.[2])

Increases in the system dependency ratio can be directly translated into forecasts of financial claims demanded by the pension system. So far, several analysts have estimated the future evolution of pension expenditure in the Czech Republic. MLSA forecasts predict a growth of the expenditure share from

1 *OECD (2002); the sample does not include the Slovak Republic, Mexico, Turkey and Luxembourg.*

2 *MLSA (2002a). Projections assume constant participation rates of men whereas the participation rates of women are expected to increase slightly in the forecast period.*

9% of GDP at present to more than 14% of GDP in 2030, whereas pension contributions are expected to remain stable at the recent figure of around 8% of GDP, if all system parameters remain constant.[1])

Under these assumptions, deficits in the pension account would rise from the current 1% of GDP to more that 6% of GDP annually by 2030 in the baseline scenario, which would interfere with the general budget, which is currently grappling with difficult structural problems. The gap between revenue and expenditure in the general budget has recently widened mainly due to the autonomously decreasing tax quota and rising expenditure, which are both driven by mandatory items. The impacts of both transformation costs and privatization revenues, which influenced both sides of the budget significantly in the past, will vanish in the coming years. Unsustainable trends in the state budget and the need for fiscal consolidation are appropriately illustrated by the rise in the share of mandatory expenditure items from 65% to 82% in recent years, which restrains the scope for conceptual budgetary programs.[2])

The general government budget deficits will autonomously accelerate from a recent –3.9% of GDP[3]) and will surpass 6% of GDP between 2003 and 2006, if no fiscal consolidation takes place. Although the debt level at 19.5% of GDP in 2002 is fairly small compared to that of some EU countries, without any corrective measures it will double until 2006.[4]) As mentioned above, pension expenditure will burden the state budget significantly in the future, and in the baseline scenario, which only replicates current growth paths of spending items into future, the pressure of pension expenditure will not be mitigated much by the development of other budgetary items.

Below, I present long-term forecasts carried out in the framework of the OECD projects "Fiscal Implication of Aging" and "Projections of Health Care to 2050" from the years 2000 and 2002, respectively, as reported for the Czech Republic recently by Krejdl and Bezděk (2003). These figures describe the impact of population aging on age-related spending, i.e. pension expenditure, health care, education expenditure and child or family benefits. With a rising share of elderly population, it stands to reason that pension spending and health care will gain importance, as elderly people access health care much more than other age cohorts, and as they draw pension benefits, of course. These pressures can be somewhat mitigated by the drop in education expenditure and child or family benefits resulting from the decline in the share of young people; however, the course shaped by pension expenditure will determine the state budget as a whole.

As Krejdl and Bezděk (2003) note, the baseline scenario they use is not the most likely scenario. Fulfillment of EU accession criteria (subsequently also the Stability and Growth Pact) and financial market constraints will make the government bring public finance in a healthier direction. However, the autonomous

1 *MLSA (2002a).*

2 *Figures include both mandatory and quasi-mandatory items. Mandatory items consist of expenditures defined by the legislature (e.g. social transfers) and of expenditures defined by contractual obligations (e.g. state guarantees). Quasi-mandatory expenditures include active employment policy, defense, public service wages and predefined investments. Ministry of Finance (2002).*

3 *Ministry of Finance. Without net lending and transfers to transformation institutions.*

4 *Ministry of Finance (2002).*

development of budgetary items as they are enacted today represents a useful baseline for assessing the effectiveness of consolidation measures and might motivate policymakers to react in due time.

Table 2

Impact of Population Aging on the State Budget and Debt

	2000	2010	2020	2030	2040	2050
	% of GDP					
Expenditure						
Pension spending	9.3	9.4	10.1	11.4	13.7	15.2
Health care	6.6	7.0	7.6	8.0	8.4	8.5
Education expenditure	4.1	3.9	3.6	3.6	3.5	3.5
Child/family benefits	1.6	1.3	1.3	1.2	1.3	1.3
Total age-related spending	21.5	21.6	22.6	24.3	26.8	28.6
Other gen. government spending	20.1	22.6	22.5	22.5	22.5	22.5
Total spending	41.6	44.2	45.1	46.9	49.4	51.2
Revenue						
Social security contributions	14.5	14.9	14.9	14.9	14.9	14.9
Other gen. government revenue	24.9	24.9	24.9	24.9	24.9	24.9
Total revenue	39.3	39.8	39.8	39.8	39.8	39.8
Primary balance	−2.3	−4.3	−5.3	−7.1	−9.6	−11.3
Debt interest payments	1.1	1.9	4.1	8.1	14.9	25.7
Debt	16.7	55.0	112.5	217.8	397.3	680.6

Source: Krejdl and Bezděk (2003).

It is useful to keep in mind that a poor starting position in the primary balance causes the forecast debt figures to deteriorate significantly and obscures the real impact of population aging on primary deficits and debt. If recent deficits were removed in the next few years, public debt would stand at a substantially lower level; however, it would still amount to a dramatic 280% of GDP in 2050 instead of 680% as reported in table 2.[1])[2])

Table 3

Changes in Primary Balances due to Population Aging

	2000 level	Change 2000–2050	
	Primary balance	Primary balance	Old-age pension spending only
	in percentage points of GDP		
Belgium	6.8	−4.2	−2.4
Denmark	4.3	−4.0	−1.0
Finland	5.5	−10.2	−6.4
Netherlands	4.2	−6.9	−1.8
Sweden	4.3	−7.0	−5.4
United Kingdom	4.0	−1.5	−0.6
Czech Republic	−2.4	−6.8	−6.7
Poland	−0.9	1.0	1.3

Source: OECD (2001).

As the OECD project on the fiscal impacts of aging was carried out internationally (to a certain extent),[3]) it is possible to compare the position of the Czech Republic to that of other OECD countries. Although the outcome of

1 *Krejdl and Bezděk (2003). Figures represent decade averages, i.e. the 2010 figures stand for the period 2000 to 2010. Only the 2000 data stand for the period 1995 to 2000. Pension spending includes operating costs.*

2 *Krejdl and Bezděk (2003).*

3 *Only a few countries reported the necessary data to the full extent. The figures for these countries are listed in table 3.*

the deteriorating demography on the Czech primary balance will not be the worst one among the countries under consideration, the contribution of pension expenditure as a single item will impact the budget more than in any other country. This demonstrates the worrisome circumstances of the Czech pension system quite well.[1])

3.3 Redistribution

The redistribution from those paying more to those contributing less is even larger today than it was in 1989, at the end of the communist era.[2]) The 1995 Act did not help much in this respect, as the rate of pension leveling has decreased only marginally since it was enacted.[3]) Table 4 illustrates the degree of redistribution: persons who earn just 70% of the average wage receive a pension equal to 76% of their net previous income, while persons earning e.g. double the average wage are entitled to a pension equal to only 38% of their net personal income. It is easy to see that the persons with a rather wide range of different earnings are eligible for a comparatively narrow range of pensions between 55% and 75% of the average net wage.

Table 4

Leveling of Old-Age Replacement Rates

Personal wage/ average wage	Pension/ personal wage	Pension/ average wage
%		
70	76	54
100	61	61
150	46	67
200	38	71
250	33	75

Source: MLSA (2002a) and own calculations.

The government has already taken some steps to reduce pension leveling; however, its efforts were limited and subordinated to the need to keep expenditure under control. As mentioned above, the government has full authority over two devices to regulate the extent of redistribution – the flat part of a pension, and the bend points that are used to convert incomes earned during a working career into the computational base of pensions. The flat pension has been held unchanged since 1998, and its share has subsequently decreased from 24% of the total pension in 1998 to 20% in 2002, and changes in the bend points went in the same direction. The lower bend point was valorized less than the average wage increased, and the upper bend point a little more, which somewhat mitigated the leveling of pensions; however, this came at the cost of lowering replacement ratios.

3.4 Favorable Treatment of Self-Employed Persons

A risk that is inherent to all pension schemes that do not pursue a reasonable link between contributions paid in and pension benefits received is that the

1 *The figures for the Czech Republic noted here are not fully comparable to those in table 2, because the figures here represent the relevant years only (changes between them) and not averages (see Krejdl and Bezděk, 2003).*

2 *MLSA (2002b).*

3 *MLSA (2002a).*

governing authority might lose its overview of all built-in redistribution mechanisms. The Czech Republic is a case in point, for the recent establishment of the system unintentionally substantially favors self-employed people. This is the case because self-employed persons are able to rationalize their contribution base more widely than employees and because the minimum contribution base is relatively low. The result is that the contribution base of self-employed persons amounts on average to only 28% of the contribution base of wage earners.[1]) Hence, owing to high degree of pension leveling, resources are in effect shifted from employees to the self-employed.

Recent discussions in the government coalition suggest that the government is aware of these weaknesses. The coalition agreed on an increase of the contribution base for self-employed persons, which is set to be phased in by 2006, and even the minimum contribution base is scheduled to be increased, most likely from 2004. Furthermore, it agreed on a proposal to correct the redistribution pattern to some extent by introducing a ceiling for the contribution base for all participants. The suggested ceiling would be five times the average wage. However, these proposals have not yet been submitted to parliament.

To sum up the main points of this section, the biggest weakness of the current pension system is that it is unprepared to handle adverse demographic shocks. Moreover, the high leveling of pensions alongside an abundant extent of noncontributing periods breaks down the link between contributions and benefits and might cause distortions on the labor market. The favored position of self-employed persons represents a partial problem; it exploits weaknesses in the redistribution pattern of the pension system. In the next section, I turn my attention to the second pillar of the Czech pension system.

4 The Voluntary Funded Pillar

Within this pillar, individuals have the opportunity to take part in state-contributory supplementary pension insurance or in personal pension plans managed by insurance companies. As mentioned above, the pension insurance scheme was introduced by the 1994 Supplementary Pension Insurance Act (Act no. 42/1994 Coll.); it is provided exclusively by means of pension funds. The law stipulates detailed rules on pension fund governance, the activities of supervisory authorities, financial requirements and rules on investment diversification.

Participants are obliged to pay monthly contributions (they may be even paid in by employers on behalf of their employees). In order to encourage participation in voluntary supplementary pension schemes, the state grants subsidies and tax benefits for their participants. Pension funds provide benefits, which can take the form of lump sums or pensions (old-age and disability pensions, and early retirement or inheritance life annuities). The minimum period after which an old-age pension may be drawn is currently five years and is conditional on the eligibility for an old-age pension from the state pension insurance or on reaching of 60 years of age. A pension plan can be even terminated before attainment of the statutory age, but the state contributions must be returned in such cases.

1 *MLSA (2002a).*

There are more than 2.5 million participants in the supplementary scheme, which seems to be relatively high (50% of the labor force); the drawback is that the scheme has only lately begun to fulfill its original intention well. Instead of providing a source of additional income in retirement, it served mostly as a short-term saving instrument, with a generous state contribution that made the scheme very attractive. At the end of 2001 the cumulative state subsidies accounted for 35% of total assets held by all pension funds.[1])

The reason for this use of short-term savings lies in the original legislature, which contained several elements that motivated savers to short-term behavior. The minimum required saving period was originally only one year, and the bottom age for drawing a lump sum without losing the state subsidy was just 50 years. This explains the age structure of participants. The average age of participants is 49 years, with nearly 20% of the population over 60 (retirees) participating in the system. On the other hand, only 20% of the population younger than 35 are participating in the system.[2]) Another factor fostering the short-term behavior of depositors is the rather small size of the average contribution (around 3% of the average gross wage). With respect to the age structure of participants, this amount is not enough to build up a sufficiently high capital stock to cover a significant lifetime annuity in retirement. On the other hand, low contributions might even be motivated by the structure of the state subsidy, which declines (in relative terms) as contributions rise.

The 2002 amendment to the Supplementary Pension Insurance Act brought about important advances in the transparency of pension funds' governance, increased effectiveness and tightened supervision in this field. While the main legislative weaknesses of the supplementary scheme have already been eliminated, the pension funds still remain unattractive for savers due to their low real returns averaging around 0.6% between 1995 and 2001.[3]) Low real returns might be related to the short-term investment horizon of depositors, which implies owning rather liquid instruments in the investment portfolio, and to the conservative investment strategy of pension funds. The future of private pension funds depends crucially on further progress in pension reform. Especially the proposal on creating occupational pension funds, which I describe in the next section, would bring about tough competition for pension funds, possibly raising their operating costs (e.g. for advertisement) even above the present high level.[4])

Having reviewed the situation of both pillars of the Czech pension system, I will now concentrate on the future course of reforms as indicated by the latest government or ministerial drafts. These drafts or proposals concentrated on three issues – the reorganization of the mandatory pillar, changes of the pension formulas towards a defined contribution system, and the introduction of an occupational pension scheme.

1 *MLSA (2002b).*

2 *Lasagabaster et al. (2002).*

3 *MLSA (2002b); deflated by the average CPI.*

4 *Lasagabaster et al. (2002). The current level of operating costs lies between 14% and 18% depending on whether the state contribution is included in the denominator or not.*

5 The Recent Reform Proposals

5.1 The Social Insurance Agency

From August 2000, the government's draft for the establishment of the Social Insurance Agency (SIA) has been at the center of discussion. The SIA was to have taken over the duties of the existing Czech Social Insurance Administration in the spheres of pension and health insurance. The main difference compared to the recent status would have been that a control group consisting of the main players in the pension system should have operated the new body independently from the government. The draft targeted an improvement of transparency and public control of the pension system. The proposal also provided for the creation of a reserve fund that was to have financed unexpected fluctuations of revenues and expenditures and prevented frequent changes of system parameters.

Nevertheless, parliament rejected the draft, because it did not put forward any substantial efforts to tackle major problems of the pension system and would in fact have obscured the real problems. Furthermore, the proposal might simply have moved the problems out of the pension account and into other parts of the state budget without really solving them. For example, the draft proposed the introduction of regular payments from the state budget for noncontribution periods and the flat part of a pension, which would be problematic owing to the difficulties of the state budget. The draft drew criticism from international organizations as well, as the proposal would have led to a further fragmentation of the general government sector; the current extent of the fragmentation already makes it difficult to maintain full fiscal transparency across its components.[1])

After the SIA draft was refused, the government did not submit any other draft on a complex pension reform. The MLSA and independent experts remain reserved regarding their views on the shape of reform. The MLSA will rely on gradual adjustments of the existing system and on reinforcing supplementary pension insurance. At present several committees are dealing with pension reform – one in the Chamber of Deputies (at the level of a subcommittee, which means it is of secondary importance), one expert group at the MLSA and one at the Council for Economic and Social Accord (labor unions, employers and the government). They are discussing two major points at the moment: (1) the shift of the defined benefit pay-as-you-go scheme towards the defined contribution pay-as-you-go scheme (the so-called notional defined contribution system, NDC) and (2) the introduction of supplementary employers' pension funds.

5.2 The Notional Defined Contribution System

The pure NDC system works in a simple way: participants pay their contributions into the state budget, like today, and the CSSZ spends this money immediately on pensions for current retirees. The main difference compared to the defined benefit scheme is that an individual's contributions are recorded on an individual account, and when the individual retires are converted into a lifetime annuity applying actuarial mathematics. Hence, the NDC system includes some automatic stabilizers against increasing longevity and shifts the discretion to determine the retirement age to individuals. More precisely, it disengages the

1 *OECD (2003).*

government from the unpleasant obligation of disclosing the fact that people will have to contribute longer to get the same pension as today.

However, even these stabilizers will not be able to prevent a financial imbalance. To really do so, recorded contributions would have to bear "notional" interest equal to the growth of the covered wage bill. This solution would establish a financial balance, but at the expense of a declining replacement ratio. Applying another interest-bearing formula presupposes additional financial reserves in the state budget or additional savings of individuals to prevent them from falling into poverty. Admittedly, the NDC system might bring about positive effects on the labor market due to the tighter link between contributions and benefits. However, in the presence of the severe demographic shock that will occur in the Czech Republic, it can suggest no other solution than to "pay more to get less."

5.3 Occupational Pension Funds

Since 2001 the MLSA has promoted an enlargement of supplementary pension schemes with pension funds provided by employers for their employees. The MLSA presents this proposal as the missing "second" pillar of the pension system on account of its funded nature (in the World Bank's terminology); however, participation in these funds is intended to be voluntary. Thus, it would in fact only widen the already existing "third" funded pillar.

The main line of reasoning in support of the draft is the reputedly low operating cost of occupational schemes, because occupational funds will not need to attract new clients, unlike commercial pension funds have to now. Hence, employers' funds would save money on advertisement. The administrators of funds will have to cooperate with professional portfolio managers – although the type of cooperation was not precisely defined in the draft. However, external cooperation might make the system more expensive and in addition, the experience in this field from the United States shows that the operating costs of occupational funds are not particularly low.[1])

As proposed, the funds would have to satisfy some minimum interest rate condition. It can be argued that this condition could lead to herding behavior by the funds' managers, which could end in the management of almost identical portfolios at thousands of small employers' funds. Thus, a few more centrally managed funds might bring about the same outcome at presumably lower costs.[2])

As was the case for the NDC draft, the supplementary employers' funds are not able to address satisfactorily the issues associated with the problem of population aging, especially with regard to two facts. First, these funds are to be run on a voluntary basis without any state guarantee and even without the explicit state subsidies that exist in the voluntary funded pillar now. It is assumed that contributions to employers' funds would be motivated only through tax benefits. Second, considering the high contributions to the first mandatory pillar and the confidence of the government about the sustainability of the pay-as-you-go pillar, it is rather unlikely that its participants would *en masse* consider it necessary to pay additional money to a new supplementary pension system.

1 *Andrews (1993).*

2 *Musílek (2000).*

6 Conclusions

In this study, I have tried to summarize the evolution of the Czech pension system in the transition period and to illustrate its most striking weaknesses, as I am convinced that addressing these weaknesses represents one of the most important challenges the current government will face. The difficulty of the recent situation lies not only in the worrisome prospects of the young generation for their pension insurance, but even more in the fact that the pension system may become a threat to the financial stability of the state budget in the near future. I have pointed out that recent deficits of around 1% of GDP have been pushed down so far artificially due to discretionary measures operating mainly in the short-term horizon. Once the response to these measures peters out, the Czech Republic will have to tackle rising imbalances more seriously than has been the case until now. The issue is becoming even more relevant in light of future EMU accession, when it will coincide with the need to remedy the general budget as a whole.

The gradual method of reforms adopted implicitly in the Czech Republic, as compared to the "big-bang" approach of neighboring transition countries, has helped to tackle the most burning problems so far; however, it has in fact succeeded in obscuring the actual intensity of the issue. The government has not learned from the examples of other Central European countries – Poland, Hungary and recently even the Slovak Republic – which have introduced mandatory funded pillars beside reforming their pay-as-you-go systems. A move towards a more active role of funded pensions would better prepare the Czech Republic as well for the challenges of the next decades.

I aimed to highlight the true nature of the recent reform proposals, i.e. the Social Insurance Agency, the transition to the notional defined contribution system, and the introduction of occupational pension funds. As these proposals indicate, the Czech Republic is going to continue its gradual reforms, which in my opinion cannot really solve the problem of population aging and will only postpone the needed steps further.

To close on a somewhat more optimistic note, it is likely that coming closer to EU accession and EMU membership means that certain fiscal rules will have to be met, so that the new obligations will move the focus more towards issues requiring sound fiscal policies, and that the gradual reform approach will be replaced by more thoroughgoing reforms.

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