Czech Pension Reform: What Further?[1]

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Abstract

The current Czech pension reform concentrates on introducing the partial opt-out in the so-called second pension pillar, which, in principle, has not proved good in the world, moreover in the totally inappropriate macroeconomic situation given by the economic recession. In parallel, a part of the third pension pillar, which is exclusively operated by 9 private pension companies and uses special public subsidies that are the highest in the world, is subject to a reform. The same pension companies will now be able to operate pension savings under the second pillar, with contributions amounting to 5% of wage. Even with a significant government restriction concerning fees charged by pension companies, the direct and especially transaction costs of such scheme will be considerably higher than the same costs of the potential NDC and/or FDC social insurance. Under comparable circumstances, the social insurance / supplementary insurance is more beneficial for clients than mandatory private insurance and voluntary private insurance with government subsidies. The optimal solution is the Pan-European pension system that has been recommended by the World Bank since 2003.

Keywords: Czech Republic. Pension reform. Old-age pensions. Public pensions. Private pensions. Pan-European pension system.

JEL: G11, G23, H24, H55

Introduction

In 2011, the "small" and "large" pension reforms were enacted in the Czech Republic and one of the curiosities of the new legislation is also the fact that V. Klaus, the significantly liberally oriented president of the Czech Republic, refused to sign them. However, the president's disapproval of their direction does not change anything in respect of their force within the Czech environment. At the same time, the regulations had been drafted by the right-wing

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Czech government, with marked and also rather peculiar assistance of the pension lobby. The final adopted concept of the pension reform adds the Czech Republic to the list of post-communist countries that have performed a paradigmatic pension reform, a new alternative of the reform. Moreover, it is typical – not only for the Czech Republic – that the reform was being prepared in a great hurry, concurrently with other reforms, without the corresponding preliminary studies and peer reviews, and against the will of the largest parliamentary party that is not part of the government three-party coalition. Therefore, we can expect major changes after the next election.

The objective of this piece is to briefly characterize the initial Czech pension scheme and its current reform – from the perspective of the contemporary modern global pension theory and policy. On the basis of the characteristics, we will attempt to outline the course of further development of the Czech pension policy.

Overview of public pensions

Table 1 gives an overview of the basic indicators of the Czech scheme in accordance with the last year's OECD publication. The data in the table apply to the year 2007. With regard to the relation of public expenditure on pensions to GDP, it is to say that the specified expenditure does not include public expenditure on private pensions (and expenditure on mandatory private pensions) and especially the fact that the given relation has significantly increased since then, as a result of the economic crisis and recession. This fact has not even been registered by the OECD, at least not in respect of the Czech Republic. The background materials for the economic overview of the Czech Republic prepared in 2011 show that the relation of public pensions to GDP amounts to approximately 8% (Smidova, 2011), whereas the figure for 2010 already amounted to 9.1% - in spite of the fact that certain parametric changes of the public pensions have been implemented since 2010 aimed at reducing public expenditure on such pensions. These parametric changes were enacted in 2008, whereas according to a statement of the former Minister of Labour and Social Affairs (and the present Prime Minister) P. Nečas, the changes were to stabilize public pensions for the period of several decades. In 2011, the relation of expenditure on public pensions to GDP already amounted to more than 9.4%. Even today, it is apparently true that this relation is slightly higher than the average of OECD countries. At the same time, it also holds true that the average relation of expenditure on public pensions to GDP in the average of EU is significantly higher than in the Czech Republic, the difference being approximately 4% of GDP. The Czech relation reached a figure that had been forecasted for the period of 2040-2050 in a number of studies.

Table 1: Key indicators of the Czech public pensions in relation to the OECD average

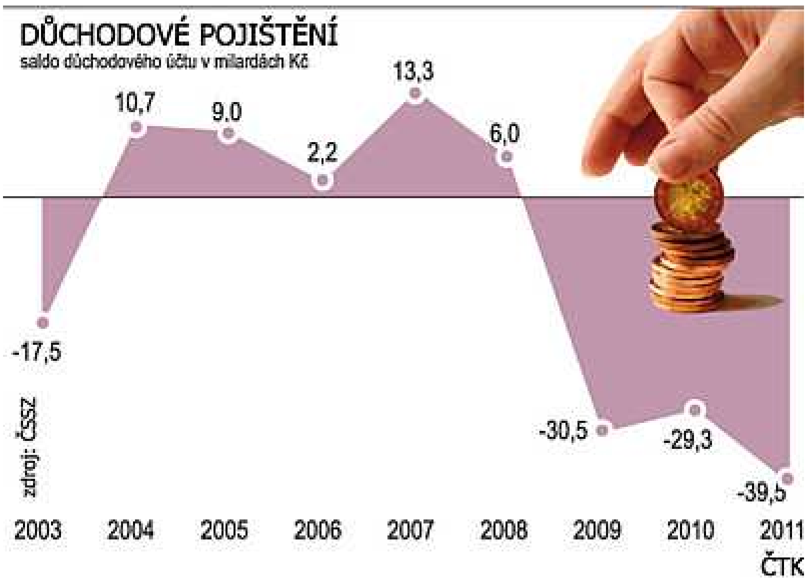
		Czech Republic	OECD
Average earnings	CZK	274 500	693 400
	USD	16 100	40 600
Public pension spending	% of GDP	7.4	7.0
Life expectancy	At birth	76.4	78.9
	At age 65	80.8	83.1
Population over age 65	% of working-age population	22.6	23.6

Source: OECD (2011)

It is useful to adjust the relation of expenditure on public pensions to GDP according to international standards: Czech pensions are taxed only exceptionally and the public healthcare financing is not reflected in the expenditure level on pensions at all. Therefore, for the purpose of international comparison, it is suitable to increase the given relation by the minimum of 1% of GDP – to 10.5 – 11% of GDP.

The existing Czech public pension scheme has historically evolved from the state pensions inherited from the period of the communist party rule. During the transition of the economy to capitalism, the real value of public pensions decreased substantially, whereas the pensions were significantly equalized. Since 1996, public pensions have been a sum of two components: 1) basic pension; and 2) earnings-related pension; however, with high level of progression. According to the last calculation of the OECD, the progressivity index amounts to 68.4, which is considerably more in comparison with all neighbouring countries (Germany: 25.1, Austria: 25.5, Poland: 3.7, and Slovakia: 0.8). Earlier materials of the OECD (2009) even included the Czech Republic in one cluster with countries with universal public pensions (New Zealand, Ireland, and South Africa have a progressivity index of 100, while Great Britain has a progressivity index of 82.8). It is remarkable how the public pension conceptions vary in the Czech Republic and Slovakia today. The right-wing governments in fact directed the Czech public pensions towards universal pensions, while the Slovak right-wing government targeted the relation of pensions and earnings, which resulted in a pragmatic reform that introduced a social insurance point scheme (2004) and an opt-out to private insurance amounting to 9% of wages. The initial pension scheme had been unified/same in both countries until the partition of Czechoslovakia.

Chart 1: Balance of the so-called pension account (CZK bn.)



Source: ČSSZ (2012)

The Czech public pension scheme uses the insurance terminology; however, it lacks significant social insurance attributes. The expenditure on public pensions is part of the public budget expenditures, similarly as defence expenditure. One of the public budget revenues is the social security insurance premium, which also includes the "pension insurance premium". The rate of the "insurance premium" amounts to 28% of wages, with 6.5% paid by employees. Either the Constitution or other regulations do not specify the financing of public pensions or the social security as a whole in the form of insurance premiums. However, government officials and right-wing authors often use the term "pension account", which comprises expenditure on public pensions and pension insurance premiums. In 2004-2008, the pension account was in surplus; however, since 2009, it has been in a permanent and ever increasing deficit that has already exceeded 10% of expenditure on public pensions. This financial development has resulted from the economic crisis that also affected the Czech Republic.

One of the typical features of the existing pension scheme in the Czech Republic is the low level of poverty among the elderly. According to international comparisons, the Czech Republic is usually mentioned as the OECD country with the lowest rate or risk of old-age poverty. The main reason for this is the already mentioned construction of old-age (and disability) pensions, as their smaller component (basic pension) is independent of earnings and although their larger component is derived from earnings, the reduction is very high for higher earnings. This complicated construction of pension cannot be competently justified – it is only possible to explain its historical development (in the first half of 1990s). A flat high-expense allowance was introduced for the entire population in Czechoslovakia at the time, as an immediate reaction to the basically sudden increase in consumer prices in connection with the price liberalization. A year later, only the high-expense allowance for pensioners and children remained, while the allowance was "directly included" in pensions and child allowances as a next step. With regard to pensions, this has been the case since 1996. The subsequent governments then valorised pensions based on their political intentions – either with an emphasis on the basic pension or on the earnings related component.

As a result of the aforementioned construction particularities of the pensions in the Czech Republic, the net replacement ratios according to the OECD pension model under the conditions of 2006 derived from earlier earnings were as follows: for persons with earnings at 50% of the nationwide average, the so-called full public pension amounted to 93.5% of the prior income, while the pension only amounted to 62.2% of the prior income for persons with earnings at 100% of the nationwide average. With regard to persons with earnings at 150% of the nationwide average, the model replacement ratio only amounted to 47% of the prior income. On the other hand, the same three figures amounted to 54.8%, 56%, and 55.6% respectively in Germany, and 91.3%, 89.9%, and 84.6% respectively in Austria (OECD, 2011). The aforementioned values could have significantly changed not only in those countries since 2006; however, the basic principle of the public pension construction has not changed in those countries. The values are in compliance with the above mentioned public pensions progressivity index values.

The relations of full pensions and prior earnings were modified to a certain extent following the Decision of the Constitutional Court of the Czech Republic, which considered it important to strengthen the adequacy of pensions to prior earnings and force a legal amendment, effective from October 2011. The Decision of the Constitutional Court seems to be based on the assumed existence of the social pension insurance scheme, moreover with a higher assessment ceiling for insurance premium and for the inclusion of earnings in the pension amount than in Germany, for example. According to the opinion of the Czech government and according to my opinion, the Decision of the Constitutional Court is not supported by the Czech legislation; however, it was necessary to respect it. The government included the response to the Decision of the Constitutional Court in its "small" pension reform of public pensions.

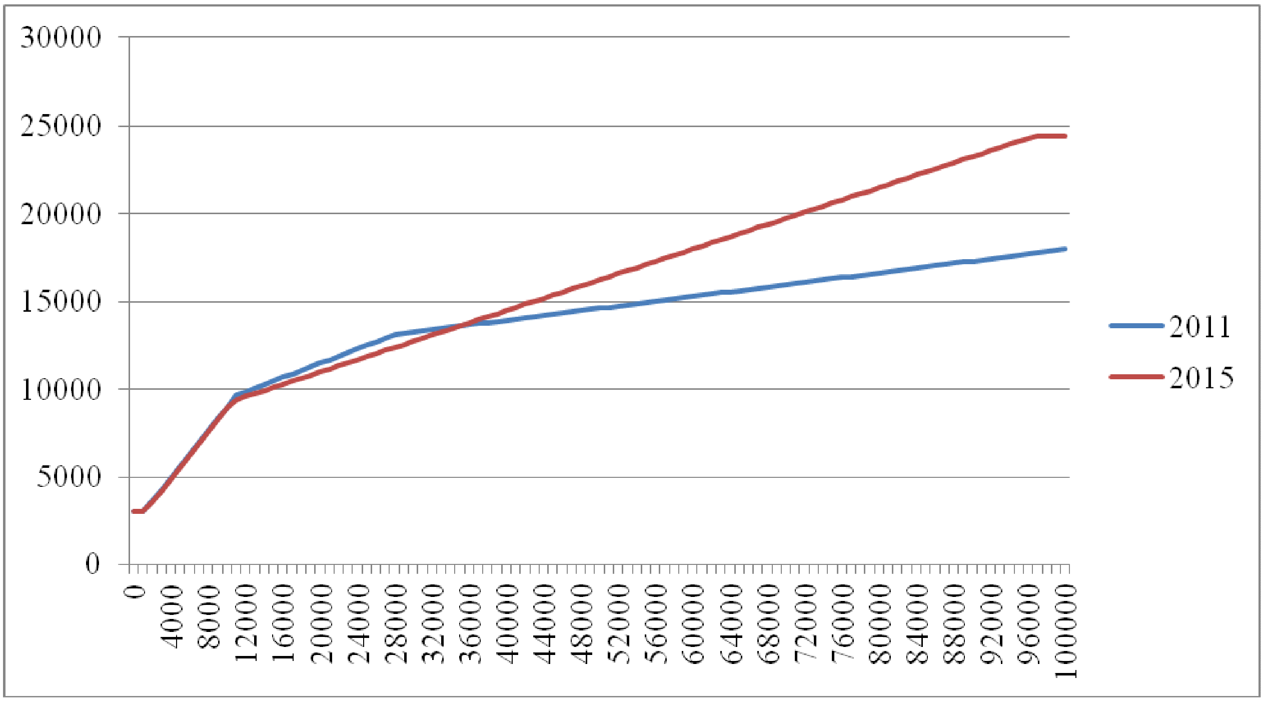
"Small" pension reform 2011

The basic pension, which is identical for all "insured persons", who become entitled to receive pension, only changed minimally under the small pension reform – it is newly determined parametrically, i.e. as a relation (9%) to the average nationwide income.

Consequently, the government loses the possibility to adjust its amount upon pension valorisations. The first bend point also has a new, parametric construction; it newly determined not as an absolute number but rather as a relation (44%) to the average nationwide income; this parameter also corresponds to the existing first bend point. The objective of the first bend point has been to reduce the inclusion of income in excess of the limit in the old-age pension. Therefore, there are no reductions up to the first bend point and it is obvious from the two aforementioned "new" parameters for the pension assessment (9 + 44 = 53) that full pensions for people with earnings at 50% of the nationwide average will continue to be relatively very high.

Real changes take place in terms of the calculation of pensions from incomes that exceed the existing first bend point. Starting from 2015, the second bend point will be significantly increased from the original 114% to 400% of the average nationwide income and the initial reduction rate in excess above the first bend point will be reduced from 30% to 26%, all in five gradual steps. At the same time, the inclusion of income in the old-age pension in excess of the second bend point will decrease from 10% to 0%; i.e. any income exceeding 400% of the average nationwide income will no longer be considered in the pension amount. Any incomes over 400% of the average nationwide income will newly be exempt from the pension insurance premium payments. The small pension reform parameters have been set in a manner that would prevent the increase of public expenditure on pensions as a result of their change. Therefore, pensions will be slightly reduced for the majority of new pensioners and, moreover, persons with earnings in excess of approximately 150% of the average nationwide income will have significantly higher pensions – see Chart 2. Nevertheless, it is obvious that it is no major pension reform. In spite of this, the discussion on and adoption of the changes in the calculation of pensions have still reflected in accelerated old-age retirements and thus in the increase of public expenditure on pensions in 2011.

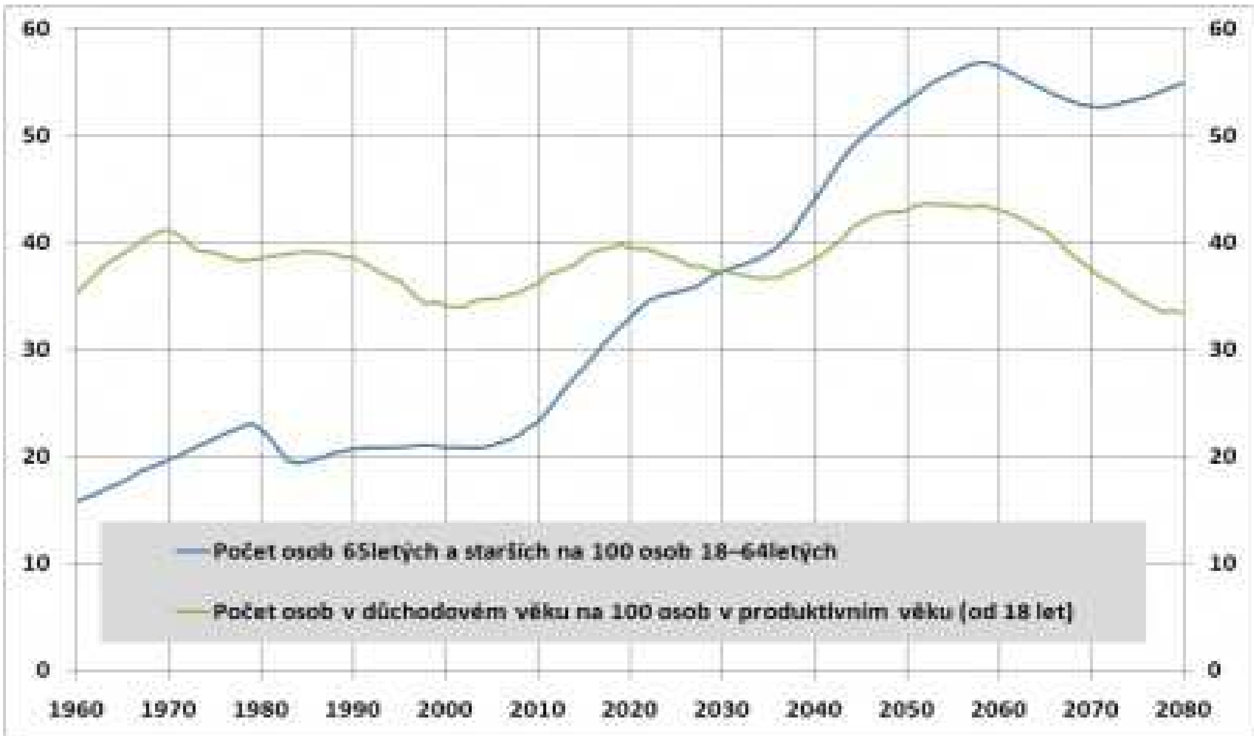
Chart 2: Relation of the net monthly pension to gross wage (in CZK) in the Czech Republic: initial situation (2011) and target phase of the small pension reform (2015)



Source: own calculation

In addition to the modifications of bend points and reduction rates that resulted from the Decision of the Constitutional Court, the government included a number of other parametric changes in the small pension reform. The most important change is the accelerated increase of the future retirement age for women as well as the transition to the system of infinite increase of the retirement age by 2 months per year. Both measures will have a practical significance in decades. The retirement age according to the aforementioned scheme will be unified for both men and women starting with the year of birth 1975 (66 years and 8 months), whereas the retirement age in 2100 will be 75 years. In theory, this could be the right step and the Czech Republic could get in textbooks around the world; however, the question is to what extent the current population prognoses will be successful. Foreign experiences rather show that the prolongation of human age has usually been faster than expected. In general, it would be more accurate to link the retirement age to the development of life expectancy for persons of higher ("retirement") age, moreover, considering the health of the population. However, the importance of the population prognoses quality, which is – by nature – rather limited, increases for this theoretically more accurate approach.

Chart 3: Development trend in the number of persons aged 65 and over per 100 persons aged 18 through 65 and the number of retirement age persons per 100 productive age persons in the Czech Republic (1961-2080)



Source: Fiala, 2011

Increases in the retirement age according to the new Czech scheme should – in compliance with the basic alternative of the population prognosis – lead to long-term stabilization in the number of persons of retirement age and the number of persons of economically active age. In the Czech environment, this relation should even be more favourable in 2100 than today. This is documented by the green line in Chart 3. On the other hand, the blue line in the same chart shows a typical presentation of adverse effects of aging population in the Czech Republic and elsewhere in the world; this *de facto* assumes constant retirement age of 65 years. This concerns the current basic alternatives of the population developments – nothing more and nothing less. Since the Czech government introduced infinite increase of the retirement age as part of its small retirement reform, it should stop using the aging population as an argument in favour of the partial privatization of public pensions. However, this is not the case. Both the government officials and lobbyists reiterate aging as the initial argument for the large pension reform.

"Large" pension reform 2013

The implementation of the current "large" pension reform in the Czech Republic commences, in principle, at the beginning of 2013. The basic manoeuvre of the reform is the partial privatization of old-age pensions in the form of an opt-out to the extent of 3% of wage, by which the pension insurance premium paid by "insured persons" would be reduced. At the same time, opt-out participants must add another 2% in the form of an add-on to the 3% of wage. The total contribution of 5% of the opt-out participants' wage will go to one of the four pension funds (portfolios) managed by a private pension company of the participants' choice. These pension funds represent investment, defined contribution (DC) products. The government significantly regulates the amount of administration fees for such funds as well as of commissions for the acquisition of clients. Once the retirement age is reached, a client uses his/her "savings" to purchase one of the three available pension products with private life insurance companies. Commissions for the acquisition of an insurance company client are forbidden. All insured persons may select the opt-out in the first half of 2013; the opt-out will subsequently be available to insured persons of up to 35 years of age only.

The specific form of the paradigmatic (so-called) large pension reform came into being as a rather distinctive comprise of three coalition parties. Virtually no one endorses the reform from the expert perspective and this is also a symptom of a missing economic fundamental of the pension reform. The key justification of the reform seems to be the fact that the reform has been discussed for more than 10 years and it is necessary to finally execute it. In second place is the argument relating to the diversification of old-age security. This argument is still "popular" in the world pension literature – currently being perhaps the most significant in OECD studies. Many OECD studies mention as their motto the statement of Don Quixote's servant concerning the charming proverb about not venturing all eggs in one basket (Whitehouse et al, 2009). It is certainly a humorous English proverb that had once been used by a translator from Spanish. However, it is not an argument in favour of dividing the mandatory old-age pension pillar into two pillars – one public and one private. We would have to use the same logic to divide all social insurance programs to public and private pillars. Even the social disability insurance and public health insurance – we could create technical (insurance) reserves in these public programs as in the private insurance. A propos: the statement of the Don Quixote's servants in the Spanish original of M. de Cervantes is not about eggs and baskets – it is rather a demonstration of laziness: the servant suggests moving some of the work to the next day. This means that the "diversification" consists in the division of work in two days, even though it could be managed in one day.

The diversification of savings or investments is meaningful for more affluent persons, who do not wish to invest their disposable funds in their respective businesses. However, more than 90% of adults do not have this problem; most insured persons definitely do not want to deal with seeking the best pension funds. The consumer inertia in this regard is currently an undisputable fact, to which it is only possible to react in two manners: through mandatory old-age insurance or savings or by forming a default fund, to which any funds are credited under the theoretically voluntary opt-out scheme – unless a client initiatively decides otherwise.

The original proposal of the existing Czech pension reform was prepared by lobbyists headed by managing directors of two pension funds (ING and AEGON), whereas neither of the two funds is among the leaders of the Czech supplementary pension insurance market. The original proposal envisaged partial use of the Swedish model of "premium pension" with the so-called central clearing house, where clients invest in private portfolios without the providers of such portfolios (funds) knowing the names and addresses of their clients. This lobbying group also envisaged the existence of a state pension fund; however, it did not recommend a default fund and attributed the pensions from the scheme to private insurance companies. The typical feature of nearly all of these recommended constructions is that the used arguments were as those given in case of a sale of products to clients – i.e. no scientific analyses, solely sales arguments. Inclination to the clearing house method can be explained by the fact it concerned representatives of second-rate pension funds. Former managers of the market leader, who joined relevant ministries as advisors, took advantage of the coalition government squabbles and the proposal for a state pension fund and anonymous clients of pension funds providers was annulled at the right moment.

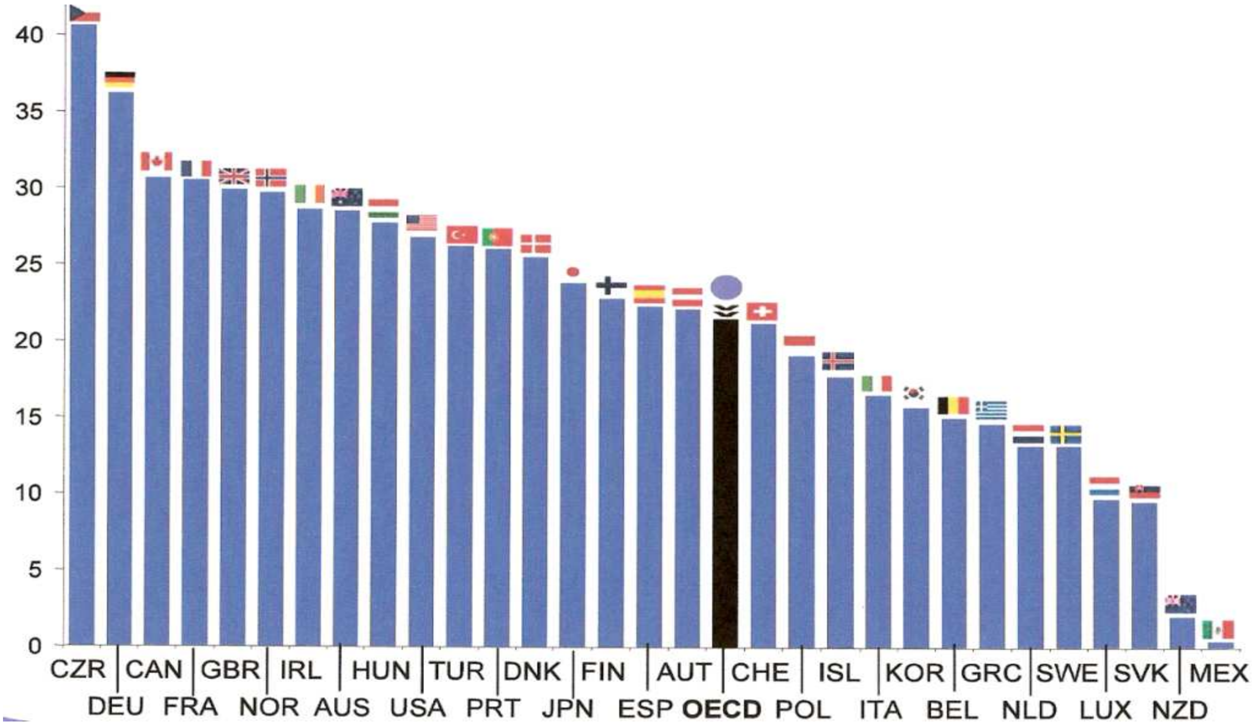
Each major element of a pension or any other reform should be rigorously and impartially analyzed. This also applies to the diversification principle or, as appropriate, to the requirement for the existence of two parallel old-age security schemes. Even a slight economic glimpse suggests that the "second", parallel pension pillar is associated with the existence of dual administrative costs – for the maintenance of two systems. The costs of one system are extra. No analyses and prognoses of these (and not only these) costs have been performed or they are not publicly available, as appropriate, and it is thus not possible to comment them. In connection with this fact, no forecasts of the investment revenues under the so-called second pension pillar are available either. We can only rely on one short reference in the speech of the Prime Minister, who said the real revenues should be at 2-3% a year. In a different speech, the Prime Minister stated that "An alternative to not implementing the pension reform is only a mass poverty of Czech pensioners" (8th Annual Gold Crown International Forum, 2010). Based on the aforementioned statements, we could come to a conclusion that the pension reform will lead to a significant increase in the replacement ratio – in comparison with the continuation of the existing situation or with an alternative reform representing, for example, one of the modern pension schemes, as appropriate. The redistribution impacts of the opt-out to individual income groups have not been subject to rigorous analyses either.

The basic argument in favour of the "diversification" or partial privatization of the public pension pillar within the Czech environment is not the (comparative) economic profitability of a new private pillar, but a thesis relating to irresponsibility of governments. When expressed with the use of economic theory terminology, it is a marginal formulation of the government failure. At the same time, the supporters of this approach do not mention the classic issues relating to the annuity markets failure. However, this approach is associated with an absolute rejection of public insurance pensions, not their combination with mandatory private pensions (including opt-out). The opposite side to this argumentation uses "threats" of frauds, bankruptcies of private pension funds. Even this position is, in principle, incommunicative. Nevertheless, it is a fact that, in general, it is not possible to rule out anything. No pension scheme is ideal and each scheme must have stabilization mechanisms and corresponding governance in place that would be immune to gross ineffectiveness and frauds.

Third pillar reform

Concurrently with the large pension reform, the reform of the so-called supplementary pension insurance with state contribution and their providers, i.e. pension funds, is being implemented in the Czech Republic. It concerns the so-called third pension pillar, under which 9 private pension funds currently operate. The supplementary pension insurance market is substantially concentrated, with the three largest pension funds managing 55% of all pension funds' assets. The number of participants within this peculiar old-age savings scheme corresponds to 45% of the entire Czech population. Within an international comparison, we had the highest coverage of voluntary private pension schemes in 2010: 61.2% of the working age population; with New Zealand in second place with 55.5%, Germany only third with 36.9% of the working age population (OECD, 2012). Though we do not have a simple, marketing-oriented product name (such as KiwiSaver or Riester-Rente), but we have the relatively highest government subsidies of this product type in the world.

Chart 4: Public incentives for private pension voluntary savings



Source: Whitehouse (2006)

There are two types of government subsidies for the so-called supplementary pension insurance in the Czech Republic: 1) this product is entitled to the so-called state contribution provided from the state budget with regressive rate of 50-30% from the participant's contribution up to the annual contribution of CZK 6,000; 2) income tax payers are entitled to a deduction from the income tax base – provided their contribution exceeds CZK 6,000 per year (tax deduction of up to CZK 12,000 per year). This combination resulted from the activities of the pension lobby in the parliament – it was inserted in a legal amendment in the form of a parliamentary modification, effective from 1999. One year later, the same tax support was awarded to the private life insurance products that include endowment upon reaching the minimum age of 60 years. While the tax support of qualified life insurance in the form of deductibles (deductions from income tax base) is common in the world, the combination of this support with direct state contribution may be a world rarity. We know how this occurred; however, no one has in principle attempted to explain it. The only argument I have heard in this regard is the system may also be used by retirement age persons to increase their revenues.

The supplementary pension insurance product represents a very primitive savings product with special institutions, formed solely for this purpose (pension funds). Clients save Czech crowns in accounts with a pension fund and, following the end of each calendar each, the pension fund credits their accounts with the shares in the profit of the relevant pension fund in the year in question. Therefore, the pension fund acts as a savings bank, whereas the interest rate is communicated to clients on a post facto basis. Following the end of the savings program – i.e. at the age of 60 – clients may request the payment of a pension according to the construction included in a pension plan; however, almost no one does so. The optimum client strategy is to withdraw all the money and, in some cases, arrange the product again (the minimum savings period is 5 years). In case the government acted in the best interest of the citizens, the simplest reform of this system would be a mandatory transformation of pension funds to life insurance companies – considering the right of a client to claim lifelong annuity. The only reason for the continuing existence of the Czech pension funds has been the state contribution that is only awarded to a pension fund product (even if the same product were to be sold by a life insurance company, clients would not be entitled to the state contribution).

Typical occupational pension schemes do not exist in the Czech Republic. The existence of "institutions for occupational retirement provision" (IORPs) in accordance with the EU Pension Directive was finally enabled last year, after repeated proceedings were conducted with the Czech Republic due to non-implementation of the aforementioned Directive and the Czech Republic was sanctioned to pay penalties for the failure to comply with the EU rules. Therefore, the Pension Directive was finally implemented; however, only formally – relevant potentially concerned employers and their occupational pension schemes would have to incorporate a special institution for the implementation of such schemes within the territory of the Czech Republic, while the wording of the relevant Czech regulation states that there is no legal claim for the license for such institution. In practice, no one obviously cares. The problem is not only on the Czech side, but also in certain naivety of the EU Pension Directive. The Directive had a respectable intention – i.e. to increase the level of the occupational pension schemes benefits through costs reducing, thanks to higher competition throughout the EU. Our country would definitely need something like this: higher competition could reduce the prices of pension and other financial products. However, the road to this goal unfortunately does not lead "through competition", but through the regulation harmonization of pension funds within the EU. In brief, the EU does not need Pan-European occupational pensions, but a uniform fundamental legislation of pension funds – similarly as of other financial institutions and products. When considering the formation of pension institutions, it is easy to come to a conclusion that special pension institutions, namely the IORPs, are useless. Global tendencies show quite clearly that there does not have to be a significant difference between occupational and personal pensions from the perspective of legislation. Companies do not have to have their own occupational pension funds – they may simply make contributions to accounts of their employees with their pension or other financial institutions. One potential advantage to occupational pension funds would be the lower administrative costs. However, nothing generally prevents companies from forming their own pension funds according to the universal, uniform legislation of the EU.

The reasons for nonexistence of occupational pension schemes in the Czech Republic are primarily ideological. As it is very well known, Milton Friedman, our present Czech president Václav Klaus, and other Neo-Liberals in principle reject the idea of companies "mediating" health insurance, pension insurance, etc. for their employees. Each person may and should only buy what he/she needs, at the person's discretion. Each person knows he/she would get old (unless he/she dies early) and may provide for himself/herself accordingly. These views are extreme, disregarding the standard behaviour of people, as reflected in behavioural economics, for example. However, it is at least useful to take these views into account in education, textbooks, etc. – simply for the reason that they properly refine one's mind. In any case, V. Klaus significantly affected private old-age security by refusing the proposal of the Minister of Labour and Social Affairs in the first half of 1990s (i.e. at the time he was the

Prime Minister of the Czech Republic) for the implementation of a voluntary system of occupational pensions, based on the model of a number of Western countries. The government headed by Václav Klaus adopted a resolution relating to the implementation of the supplementary pension insurance with state contribution, which later became sort of a predecessor of the Riester pension in Germany as it utilized a state contribution scheme, which was "progressive" in the sense that a relatively higher state contribution was awarded to a lower contribution of a participant. In addition to this, the former Czech government enabled employers to contribute to employees in respect of "their" supplementary pension insurance. In principle, this was an ideological concession in the interest of higher support of a partial public pension reform, which consisted in the cancellation of the so-called working categories under the state pension security: it concerned the cancellation of a privileged construction of old-age pensions for miners and other high-risk occupations, which represented typical part of the communist old-age security scheme. Higher pensions for higher-risk occupations were "replaced" with the chance of an employer to contribute to its employees in respect of their personal pensions. In any case, it was a significant and successful political move.

With regard to the employer's contributions to the supplementary pension insurance, the state has not provided any state contribution; such contribution belongs to a participant, provided such participant pays his/her own contributions. This is, in principle, in compliance with the liberal ideology of the authors of this product at the time of its formation (1994). However, several years ago (since 2008) our pension lobby pushed through – without any publicity – considerable benefits for the contributions of employers in respect of this product – in the form of an exemption of the employer's contribution to supplementary pension insurance from social and health insurance premium computation. Furthermore, such contributions are also exempt from (personal) income tax on the part of employees. These multiple benefits awarded to the employer's contributions resulted in a situation, in which the state (indirectly) subsidizes this product (as well as private life insurance, provided the insurance premium payments are made by an employer) significantly more than in case of contributions of an employee/any other person to the supplementary pension insurance. The subsidy of the employer's contributions is equivalent to a situation, in which the state would match contributions of an employee from his/her wage after taxes in the amount of 94.5% of an employee's contribution. Even though something like this is not a rarity in the world, it should not be considered a natural thing – especially under the recently prevailing fiscal conditions. I definitely do not share the enthusiasm of MDC (Matching DC) supporters, especially not in respect of the case, where the state should match participant's contributions. State subsidies in any form are not free and the same applies to the overhead of these products. However, the interests of private financial institutions are different and are significantly promoted, especially in the Czech Republic.

The supplementary pension insurance is to transform significantly since 2013: both the product and its providers shall change considerably. The existing contracts and pension plans remain in force (however, new contracts may not be negotiated) and will form a "transformed participant fund" with individual providers. The providers will no longer be "pension fund plc", but "pension company plc", which will also manage the newly formed "participant funds", the number of which is not limited by legislation. The newly created participant funds will be mutual funds with special government regulation and the pension companies will have an interest in the transformation of old products within the transformed fund to new products (participant funds). New participant funds will no longer be able to provide lifelong annuities and clients will bear standard investment risk as it typical for DC products.

The pension lobby and the right-wing government have agreed on modifying the state contribution construction to the contribution of a participant to the product, which is newly called “supplementary pension saving”. The state contribution rates are decreasing; however, both the lower and upper limits of the participant’s contribution, from which the state contribution is calculated, are increasing. The maximum monthly state contribution will newly amount to CZK 230, as opposed to CZK 150 so far. This state contribution will still not be awarded to comparable products of the other financial services providers.

Solely the pension companies, who would first obtain a license for the sale of supplementary pension saving, will be eligible to receive a license for the so-called retirement savings under the second Czech pension pillar. The effort aimed at reducing administrative costs has been cited as a reason for the aforementioned limitation. However, I mainly view this as an attempt to limit competition on the new pension market, favour the existing providers of supplementary pension insurance and other financial services. Even the existing situation is such that almost all pension funds basically represent “empty shells”, the activities of which are usually outsourced to affiliates within the relevant financial groups.

Costs and benefits of the public pension privatization

A key argument for the existence of public pensions in the public economics textbooks is the failure of annuity markets. This failure is interpreted mainly as an adverse risk selection which takes a significant place in the voluntary private insurance - due to the fact that clients with poorer health may not have an objective interest in the annuity. But healthy people have no big interest in the pension insurance as well. The failure of annuity markets is mentioned also due to the existence of the aforementioned longevity risk. We may assign here significantly higher administrative costs of providing private insurance as well. (Tresch, 2008)

Arguments in favour of privatization of public pensions in the literature are derived from the high investment returns, which were reached in the financial markets - on average - in recent decades. The second major argument used was the expectation that the monetary savings, which arise in systems of private savings (investment) and insurance, will provide additional savings in the national economy; the national economy transforms it in an additional investment, which causes additional economic growth. The original concept of privatization of public pensions ignored the transition costs, consisting in the fact that while pulling out contributions from public "pay-as-you-go" pillar into private pension funds these contributions lack in the state budget. The original concept of privatization was based on the assumption that thus resulting explicit public debt is a converted form of the so called implicit public pension debt only. (World Bank, 1994) Implicit public pension debt refers to already existing future pension entitlements, which are not backed by the accumulated funds or insurance reserves.

The existence of implicit public pension debt is associated with the existence of the pay-as-you-go public pension system. In practice, it clearly showed that financial markets are not interested in the "implicit debt". The theoretical concept of implicit public pension debt was thus devised and used only for the purposes of privatization of public pensions. In any case it has not materialized and the only case, when temporary budget deficits beyond the Maastricht criterion were tolerated, was the evaluation of the fulfilment of this criterion by the post-communist countries in the framework of EU. Extension of this exemption was rejected in 2010.

Purchase of units in the equity and bond mutual funds is a risky operation which is nevertheless a subject of business of public pension institutions in developed Western countries. I mean only investing in private assets, according to a typical model of the functioning of private investment companies. It is not an investment of funds into government bonds. Mentioned market approach applies to the default fund in the Swedish premium pension system. Management of state pension funds' assets may be passed - on a competitive basis – to private investment companies, such as for example in the case of the U.K., governmental NEST Corporation, which now begins to function as a low-cost provider of corporate pensions (occupational schemes). Similarly, it is in the U.S. system of occupational pensions of federal employees (Thrift Savings Plan - TSP).

The establishment of public-private investment in the Czech Republic requires, of course, a political decision with a wide support across the political spectrum. Revenues from this system can serve to sole participants in the retirement subsystem or to all insureds under the social old-age insurance and possibly also to all citizens in case of connection to the state budget. Revenues could ultimately serve well as amortization of transition costs of paradigmatic pension reform. Implementation of these variants of investment activity depends not only on the specific investment returns in the long and short term, but also on the administrative costs involved.

The original idea of privatization, under which the privatization of public pensions alone causes an additional economic growth, which shall lead to increased tax revenues from which the massive losses in state revenues as a result of this privatization should be covered, relatively quickly proved to be totally unrealistic. Soon there appeared the above mentioned theory of diversification of the pension system, which requires only a partial privatization of public pensions.

The theory of diversification of the insurance pillar to a private pillar and a public pillar has been developed mainly by Polish authors, the theory led to the proposal to create two equal insurance pillars, which specifically refers to the same contribution rate (from the wage) in a private system (FDC) and the public one (e.g. NDC). (Chlon - Gora - Rutkowski, 1999) Politicians finally decided, with regard to the anticipated fiscal impacts, that the contribution to the private FDC system has a lower rate, "only" 7.3% of payroll. The theoretical concept of "halving" contribution between private and public sectors does not and can not have any theoretical justification - it is similar to the historical tendency to "share" the social insurance premiums between employees and employers in the ratio 50:50. In fact it was the result of political negotiation, which was subsequently explained by many theorists as a logical manifestation of involvement of both stakeholders in the social security of employees. The "pure" form of the "diversification" of contributions into public and private insurance pillars was done in Slovakia since 2005 - each of these pillars receives 9% of salary.

In case the insurance pillar diversification theory were to be correct, it should naturally also be applied in those countries with no public insurance pillar. These countries include, among others, Chile, Kazakhstan, Australia, and Switzerland. Obviously, no one has proposed anything similar so far. Diversification proposals have only occurred on the “other side”, with a view to reach at least semi-privatization of the public pension scheme – inasmuch as the full privatization cannot be implemented.

The "diversified" rate of mandatory contributions to private insurance or savings pillar at 7-9% of wages also substantially influenced the public finances, Poland and Slovakia used financial reserves from the privatization of other sectors of the economy to cover the budget deficit but it was not enough, and they had to increase taxes and budget deficits and public debt. Instead of the positive impact of privatization of public pensions on the economy in these countries, the opposite happened, though no longer the full privatization of public insurance pillar was pushed through.

As for products used in the public pension pillar Poland introduced a NDC system and Slovakia introduced a point system of social insurance, which is close to the NDC. None of these countries considered it necessary to introduce a solidarity pillar. Progressivity index of mandatory pension pillars in the two countries is very close to 0. (OECD, 2011)

Experience clearly shows that even the partial privatization of the public pension pillar is associated with very high and virtually prohibitive costs of transformation. Even if there are very good average investment returns of the privatized pension pillar, as happened in Poland (over 7% annually in real terms), also in combination with a positive economic development (also in Poland), notwithstanding the Polish government decided to modify substantially the parameters of the pension reform. The complete abolition of compulsory private savings pillar was also under consideration; in the end "only" the contribution rate was reduced from 7.3% to 2.3% of payroll.

The issue of investment returns in pension systems has been intensively analyzed by the OECD. OECD studies are based on historical data (25 years prior to 2007) of equity and bond returns in 8 OECD countries (G7 + Sweden) and arrive at a median real return by 7.3% p.a. from the portfolio consisting of equities and bonds in the ratio 1:1. (D'Addio - Seisdedos - Whitehouse, 2009) This high yield according to calculations by the OECD provides a life pension equal to 87% of earnings, assuming 10% contribution rate per year for the period of 40 years. Investment returns (7.3%) have a significant variance, which the study estimates from 5.5% (1^{st} decile) to 9% (9^{th} decile). Adequate pension replacement rates are between 55% (1^{st} decile) to 139% (9^{th} decile). These are great results and it is necessary to consider their utilization in the insurance and savings systems.

The given historic investment returns are not achievable in reality for individual clients; they represent the model yields of pension funds, not revenues for their clients. They need to be reduced by administrative and similar costs of pension funds - not only by the asset management fees. In modelling the privatization of public pension pillar it is necessary to take into account the future costs of pension payments, too. OECD estimates thus conceived administrative costs 1.25-2% per year, in terms of sample used in developed countries. In addition, there are also other factors that reduce or may reduce the investment returns of pension funds: for example the impact of problems connected with structured interests of "agents" (agency theory) and with governance is estimated to reduce annual revenues by about 1% or more. The tracking error has according to OECD staff many causes and results in lower yields and it is an inevitable part of the investment process. Future investment returns may be reduced also due to population aging. For these reasons, the OECD paper reduces median investment returns for clients from 7.3% to 5% annually in real terms. Annual real return of 5% according to OECD calculations corresponds to 49% replacement rate, assuming a contribution of 10% of wages paid for 40 years. (Whitehouse - D'Addio - Reilly, 2009) Administrative costs and other systemic problems have thus reduced the pension by 44% but even so, the replacement rate of 49% can be considered as excellent.

Administrative and other costs in the new pension pillar will be significantly higher than in the original draft of the pension lobby. The amount is difficult to estimate. While the law regulates the asset management fees in individual types of the retirement funds (limits 0.3-0.6% of assets) and allows a success fee in case of appreciation of assets in these funds up to 10% of the appreciation amount, there is no regulation of insurance premiums for the purchase of annuities from the life insurance companies, notwithstanding the additional costs and losses caused by the functioning of the whole system of institutions and markets (transaction costs in the theory of institutional economics).

For illustration, let us mention the operation costs of the NDC system in Sweden: they reduce the pension provided from this system by 0.5%. The Swedish premium pension system, which is very efficient from the international point of view, reduces the resulting pension by 7.5%. Gross international rule states that a fee of 1% of assets reduces the paid-in contributions (or the final fund value) by approximately 20%. (Diamond, 2011) The administrative and other annuity costs are to be added. Under Czech conditions we may assume relatively high additional costs and losses in the mentioned concept of the OECD and losses resulting from the anticipated appreciation of the Czech currency. A final basic issue then is the investment income that remains to clients after deduction of all costs and system losses. Generally we can suspect that it will be - in the model example - substantially less than it was in developed countries, on which data the OECD model is based. However we cannot exclude that it will be on average a few (2-4%) percentages of assets annually, after adjusting for inflation.

High investment yields represent the key positive factor of private pension products and also the argument for the public pension privatization. This argument cannot be underestimated or even ignored. On the contrary, it is necessary to consider various alternatives of using such high investment yields in the public sector as well, i.e. within the public pension scheme. Practice of more Western countries shows that the public sector is able to utilize these investment returns effectively and under the state of matter when the nationwide social insurance systems are strongly low-cost ones, it is without doubt that these systems are for their clients substantially more favourable than the best private pension products.

Conclusions and recommendations

Czech pension reform is rooted in:

- Transformation of the existing private pension funds into private pension companies providing mutual ("participants´") funds with different risk profiles,
- Introduction of new, so-called second pension pillar which may be entered - with no return available (“opt-out”) - by the insureds of the public pension system, diverting 3% of their salary to the selected private pension company, subject to increasing their contribution by further 2% of the salary.

Pension theory is not able to convince politicians refusing participation of public sector in the provision of old-age pensions. Always the extent of public pension provision and the extent of private pensions subsidization will be a matter of public choice. An essential role plays here also the construction of the products. In practice, these concepts and designs are substantially influenced by the pension lobby, especially in post-communist countries.

High investment returns in previous decades led to changes in the private protection products; part of this trend is the increase in the use of defined contribution products, at the expense of defined benefit products, and the tendency to shift investment risk to individual clients. The private sector started to offer the same products as a replacement of public pensions, too. Experience has confirmed that the cost of a single-stage transformation of the pay-as-you-go public pensions for mandatory private pensions is a fundamental problem of such a paradigmatic pension reform.

Most countries that embarked on the path of the partial privatization of the pension system carried out also a fundamental reform of public pensions, transiting to social old-age insurance, applying substantially the earnings-related principle. To a remarkable extent the tendency to divide the public pension system into two pension pillars displayed: one of them is a solidarity pillar and the other one an insurance pillar. New products of the social old-age insurance are: NDC and point system.

The result of the tendency towards privatization is a revival of interest in the creation of reserves (funds) in the social insurance system. Funds can be (and in many countries are) generated in the NDC system and generally there is no reason not to think again about the restoration of the fully-funded social insurance, specifically in the FDC form. Social NDC insurance with partial funds and social FDC insurance itself are (relatively new) competitors to private FDC savings/insurance products.

Social FDC insurance may use the same investment techniques and methods as private savings/insurance does. It turns out that social FDC/NDC insurance is capable of much better use of high investment returns than competitive private products. Moreover, the use of investment income for the benefit of all insureds is substantially more logical and meaningful than purely individual investment. More than 90 % of the insureds fully comply with state mutual fund in the role of default fund.

The social FDC insurance product can be used as supplementary social insurance, instead of subsidizing private pension savings and insurance products. Supplementary social insurance yields will be - ceteris paribus - significantly higher than the returns of private pension savings. Government subsidies to supplementary retirement savings can be abolished and the saved money may be used in a meaningful manner for the benefit of the insureds and citizens, for example to create funds in the system of social insurance.

Pension reform - as enacted by the Czech government - follows a different way than the modern pension theory. It is to be expected that the potential investment returns will be wasted on high administrative and other systemic costs of several financial groups.

The Czech pension reform is being implemented at an absolutely inconvenient time. The development of the Czech economy has been significantly worse in comparison with all neighbouring economies; the Czech fiscal policy, one-sidedly oriented on the reduction of the public budget deficit, significantly contributes to this. The fiscal policy has considerable pro-cyclical effects. The large pension reform will intensify adverse impacts of the fiscal policy to economic development. The reason is the fact that increased fiscal expenditure will be compensated by higher rates of the value-added tax and reduction of the public pension valorisation.

The present Czech government has been ignoring conclusions of a long-term intensive scientific research, in the Czech Republic in principle only performed at the University of Finance and Administration in Prague. Consequently, we recommend the following to the next government of the Czech Republic:

- Basically immediately end the opt-out and consequently any further operation of the so-called second pension pillar, whereas its clients would still have the possibility to contribute to relevant pension funds; however, with the obligation to pay full insurance premiums for the public pension insurance;
- Basically immediately cancel the state contribution for the existing supplementary pension insurance and future voluntary supplementary pension savings with pension companies, whereas this product would be entitled to the deduction of any contributions of participants from their income tax base, consistently with the existing government support of the qualified private life insurance;
- Basically immediately cancel the government support for employers' contributions to old-age security in the form of deductions of contributions from the social and health insurance assessment base;

- Prepare a public pension reform based on the current recommendations of the World Bank (Pan-European pension system), i.e. namely the division of the existing public expenditure program to financially separated social insurance scheme in the form of NDC scheme (or even FDC scheme, as appropriate) and to the public expenditure program of social pensions in the form of flat pensions or Swedish guaranteed pensions (Holzmann – Palmer, 2006).

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