THE ROLE OF PRIVATE PENSIONS IN THE CZECH PENSION REFORM

PRACTICAL LESSONS IN PENSION REFORM: SHARING THE EXPERIENCES OF TRANSITION AND OECD COUNTRIES
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The views expressed are those of the author and do not commit either the Organisation or the national authorities concerned.
SUMMARY

This paper describes the development and current situation in pension reform in the Czech Republic and discusses the supplementary pension scheme as well as the newly prepared occupational pensions scheme and private insurance. Pension entitlements in the Czech Republic before 1989 were, in principle, very generous. In order to resolve shortcomings of the systems, several reforms have been enacted since, including the removal of discrimination of self-employed (1990-92); the separation of contributions from taxes (1993); supplementary pension insurance (1994); changes in qualifying periods and the retirement age (1995); special pension insurance accounts (1996); and the state contribution act related to security of supplementary pensions (1999). Currently, the law for a supplementary occupational pension has been prepared but can be enacted only after the next elections (June 2002). The objective of the introduction of this scheme is not to substitute the existing systems (private pension open funds system with a state contribution, life insurance) but to complement the range of pension funds’ schemes with those of the closed-end occupational pension funds. New laws on occupational pensions have been prepared and are under discussion. The government’s pension concept relies on mandatory pay-as-you-go system, guaranteed by the state, and on voluntary private supplementary fully funded schemes. Alternative ideas, such as a low flat rate pension and voluntary savings on top, or a mandatory private savings scheme as a second pillar have been proposed by other political parties. A broad political and expert consensus is, however, the most important condition for further development of the scheme.
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I. The developments before 1990

1. Social insurance in the territory of the Czech Republic has a tradition that is more than a hundred years old. Its history predetermines to a certain extent also the decisions being made on the future concept of the pension system.

2. The system of obligatory social insurance in the Austrian part of Austria-Hungary, i.e. also in the Czech Lands, was introduced in 1888-1889 (the “Taaffe Reform”) along the model of Bismarck’s reform in Germany. It was becoming evident at that time that the principle of voluntary insurance had not been very effective since some employees were not responsible enough when it came to providing for their own future. This experience, and especially the development of industry and the progress of society as a whole, was the reason for the transition of self-help associations, trusts and workers’ insurance funds based on the principle of voluntary mutuality to the system of obligatory insurance of employees. The Czechoslovak Republic adopted the original Austria-Hungarian social security regulations, which it then started developing. The laws of the First Republic continued to have effect after World War II. The situation was complicated very much by the fact that social insurance funds had either been confiscated or devalued by the war economy. An important milestone in the development of social legislation in the former Czechoslovakia was the adoption of the Social Insurance Act in 1948. This law was modern and progressive in its time; it was based on the model presented in the Beveridge Report. The law provided for the implementation of a new unified national insurance system which placed on a more equal footing the rights of blue-collar workers and of other employees and for the first time extended old-age pensions to private farmers. After 1948, the original intentions of the National Insurance Act became increasingly distorted; the new regulations bore marks of the strong influence of the Soviet model. What happened was essentially the assumption of care for the citizens by the state as an expression of the ideology of the redistributive concept of socialism, that is the transfer from a system of social insurance to a system of social security. In spite of these tendencies, the Czech pension system did preserve certain elements of “insurance” because the right to pension continued to depend on the length of the period of employment and on the amount of income, although this dependence was restricted in various ways. Such were the circumstances, which later led to the reform steps of 1989.

3. Pension security in the Czech Republic before 1989 was, in principle, very generous, especially towards certain groups of individuals. This generosity was reflected especially in the conditions for entitlement to benefits rather than in the level of the benefits. In actual fact all citizens were covered by pension security. Various forms of preferential treatment, using both benefit rates and conditions of
entitlement, dealt with circumstances that were not related to the pension system. On the other hand there were certain groups of people whom the system discriminated against – for example self-employed persons. The usefulness of blanket provision of certain pension benefits started being questioned since these benefits no longer met their purpose. The system of pension security provision was financed from the state budget and contributions into the system were an undefined component of tax.

4. A critical analysis of the relevant legislation in effect, performed in 1990, revealed serious defects of the system that could have a very strong negative impact on the standard of pension insurance during the transition to a market economy. The main defects indicated were the following:

- The static nature of the system based, especially, on a system of restrictive provisions. No rules were set for a flexible change of these restrictions. The level of pensions could not therefore react flexibly to the development of wages and of living costs.

- The pension amount did not adequately reflect the level of earnings from work during the whole active life. The pension was calculated on the basis of income during only the last ten years before retirement and out of these ten years the five, which were the most gainful in terms of income, were selected.

- Lack of preparation for the future age structure of the population: There were to be an increasing number of pensioners per 100 economically active individuals. This means that an increasingly smaller number of economically active persons were to be creating resources for the payment of a higher number of pensions.

- Few options for individual decisions on the time of retirement.

- Insufficient protection of the system against abuse of certain relatively soft conditions.

- Impossibility of “transferring” accrued entitlements to other countries at a time of more free movement of people (both during productive and pension ages).

- Limited possibility of applying individual voluntary forms of pension insurance.

5. Thus, in 1989 there was the legacy of an ineffective, complex pension system, unable to respond to the expected demographic and planned economic developments.

6. The aim of the pension security reform was to resolve these shortcomings. That has been possible however only by the implementation of essential changes leading on the one hand to an improvement of the existing situation and on the other hand to certain unavoidable restrictions being applied to preserve feasible pension costs.

The Developments in the period 1990 – 2002

7. The pension system in the Czech Republic is not at the beginning of a reform "leap". On the contrary it is within a reform process, which was already started in 1990 as a consequence of political, economical and social changes, which took place after 1989.

8. In 1990-1992 the discrimination of self-employed persons was removed and preferential treatment abolished. The measures resulted in all economically active people acquiring entitlement to their
pensions under uniform conditions, giving thus rise to extremely favourable conditions for future reform steps.

9. In 1993 pension insurance contributions were introduced as a special payment outside of the taxation system. Draft legislation on occupational supplementary pensions was submitted to the Government for discussion. The Government, however, rejected the concept and an individual supplementary scheme in an open pension fund was prepared. In 1994 the Supplementary Pension Insurance was adopted with the State Contribution Act.

10. In 1995, following major expert and political debates, a new Pension Insurance Act was enacted. It brought the dynamism that the new economic conditions demanded. The process of increasing the retirement age was started, a flexible retirement age was introduced, the qualifying period for the inclusion of earnings was prolonged gradually, the definition of disability was specified more accurately, widower’s pensions were introduced (contributing to the enforcement of the principle of equal treatment of men and women) and compliance in the system with European Union rules was ensured.

11. Since 1996 a special pension insurance account has been a part of state financial assets, allowing a clear definition, albeit within the context of the state budget, of the balance of the pension insurance system. In 1997, as a part of austerity measures, indexation of pensions was tightened and some non-contributory periods of insurance (i.e. periods when contributions are not paid but which are taken into account for the rise of claim as well as in the calculation of the pension benefit amount) were made stricter. However, the scope of non-contributory periods still remains very generous compared to other countries. In 1999 an amendment to the Supplementary Pension Insurance with the State Contribution Act was enacted, enhancing to a certain degree the security of deposits by scheme members, but mainly expanding the possibilities of the system an increase of the state contribution, tax advantages for employers paying contributions on behalf of their employees and a tax allowance for a part of the contribution paid by scheme members.

12. In 2000 a high level Interim Committee for Pension Reform was established in the Chamber of Deputies. In November 2000, the Government submitted to the Parliament the Social Insurance Agency Bill. The aim was to separate the financing of social insurance from the state budget and so to enhance the transparency of management of social insurance resources, to reduce the dependence of this management on political decisions, to allow better and more flexible contact with the client, but, mainly, to create, by transforming the current member of the scheme into a modern entity, the prerequisites for further reform steps.

13. In 2001 amendment of the Pension Insurance Act providing an actually fair reduction, on increase, of early retirement, on deferred, old-age pensions came into force. In April the Government approved and sent to the Parliament for further discussion its report on “Further Continuation of the Pension Reform”. In October the Parliament rejected the Governmental draft amendment of the Supplementary Pension Insurance with State Contribution Law, and also after discussions lasting one year, the draft on the Social Insurance Agency. The financing of social insurance thus has remained part of the state budget. In October the Government passed to the Parliament the new law on Occupational Supplementary Pension Insurance, but in December it was also rejected. The Parliamentary Committee on Pension Reform finished its activity in December without any consensus on the next steps. In the 1990 to 2001 period, pensions were adjusted sixteen times. After the not too successful period of the last two years concerning the Governmental legislative initiations, it is much clearer that broad political and expert consensus is the most important condition for further development of the scheme.

14. For enabling broader consensus also among different countries, the Czech Government together with the Government of the Netherlands prepared in 2002 for the Summit of EC in Barcelona the Joint
Memorandum on Pension Reform with the aim to support the principles of the welfare state and the after Lisbon discussions and to declare that the Czech authorities are ready for being involved in the discussions between EU member countries on the future development of the member's pension schemes.

II. Current Situation in Pension Reform Development

15. There are number of problems which need to be solved, both in the mandatory basic pay as you go pension insurance as well as in the voluntary private fully funded supplementary scheme:

- The decrease in the real value of pensions, reaching the level of 90–95% (average level compared to the level of 1989).

- The high degree of levelling out of pensions together with high level of income solidarity, resulting especially from unsuitable calculation of pensions (the degree of levelling out remains still higher than prior to 1990).

- The increase in number of early retirements and resulting in stagnation of real retirement age (men 60 years, women 56 years).

- The increased proportion of pensioners compared to the total number of premium payers, resulting in particular from demographic development, increased number of early retirements and reduced the rate of economic activity.

- Low contributions paid by the self-employed; thus the payment of their benefits is ever more transferred to employees, employers and the state budget.

- The extent of persons not contributing to the system (approximately 30%), which has become the main reason for the imbalance between incomes from insurance premiums and expenses for benefits (so called non-contributory periods).

- Insufficient security of invested assets in private supplementary schemes.

- Insufficient transparency of management and high costs of administration.

- The short-term nature of the supplementary scheme, which serves rather as an advantageous saving scheme, and not as the means of securing funds for old age. The support provided by the state (contributions and tax deductions) thus does not fulfil fully its aim.

16. In April 2001 the Government approved the report prepared by the Ministry of Labour and Social Affairs, *The Concept of Continuation of Pension Reform*. The report addressed the present and future problems of the pension system and contained the possible development and necessary changes.

17. The report was passed to the Parliament for further discussions. After several months of discussions it has been clear that the governmental concept is the only detailed concept in the country, but nevertheless there are also other quite different ideas presented by some political parties. For example the ODS party prefers the low flat rate pension and voluntary savings on top of it, or the Union of Freedom prefers the mandatory private savings as a second pillar. So it is clear that the majority concept of further development of the Czech pension scheme may be adopted only after election, which takes place in June 2002.
18. The following principles of the future pension system are part of the Governmental Report from April 2001. In spite of different opinions on the future development, it seems that they may be taken as the guidelines for any future reform:

- **Maximum possible participation (coverage) in the system and uniformity of the system.** The basic mandatory system must not motivate the economically active population to evade the legal labour market and thus to avoid payments of premiums. The system must not contain any preferences for certain groups of insured subjects. Additional voluntary pension systems must provide maximum incentives for participation (safety of the system, tax advantages and variety of products offered).

- **Financial feasibility of the system.** According to short-term and long-term projections, the basic mandatory system must be continuously adopted to ensure long-term resistance of the system against ageing of the population and ability to react to demographic developments, migration and inflation. Essential parameters of the system must be adjusted so that the benefits might be on the appropriate level and at the same time the costs of the system must not excessively burden the economically active part of the population.

- **Maintenance of solidarity between generations in the process of payment for the basic pay-as-you-go system.** Additional forms of capital saving as typical financial products should be supported in their voluntary forms only. Among other factors it should be taken into account that such systems require considerable costs for transition and involve high level of social risks related to the introduction of mandatory systems of saving.

- **Stronger link between paid amounts of premiums and amounts of benefits** would limit excessive levelling out within basic system; additional systems should be developed on the basis of principle of full equivalence.

- **A Guaranteed minimum income** for a pensioner should ensure that after many years of participation in the system that pensioners should not be dependent on income tested social benefits.

- **Increased personal responsibility** of citizens and also of the state (or system administrators). The responsibility must extend over the preparation for old age, system safety and availability of information to the population.

- **Improved trust of the population in the system** by means of principal increase of system transparency and transformation of the bearer of insurance system from the state body to the public Social Insurance Agency, which were to be able to fulfil the tasks related to future changes in the area of incomes and benefits and will become a client-orientated institution, providing financial services and information with the support of latest technology so that each person could be acquainted with the way of spending his/her contributions.

- **Improved rate of employment** by means of the elimination of motivation for early retirement, the elimination of barriers for entering the labour market and especially by supporting the longest possible period of economic activity of each person.

- **Fulfilment of the requirements resulting from relations to EU** – not only by means of harmonisation of legal regulations but also through the quality of implementation and enforcement.
The Concept of the Government is based on the following steps:

19. The pension system were to be based also in the future on mandatory pay-as-you-go system, guaranteed by the state, and on voluntary private supplementary fully funded schemes, which proportion of the income of older generation will be gradually increased up to approximately one fourth of total. The system will ensure appropriate compensation for low-income, medium-income and upper medium-income groups.

20. An average old-age pension on the level of 55–60% of gross salary (about 45% of net salary) will be provided from basic mandatory pension insurance system for the period of at least another 10 years. The trend of decreasing proportion as a function of total salary will be reduced (strengthening of the principle of equivalence).

21. After 2010 further to the development of other additional systems the above-mentioned incomes of pensioners from the basic system will be supplemented with additional incomes from voluntary private supplementary pension schemes with the state contribution amounting another 7–10% of net pre-pension income plus incomes from supplementary occupational pension schemes amounting another 7–10% of net pre-pension income.

22. The system of basic mandatory pension insurance will be guaranteed from legal, economic and administrative aspects.

23. Fundamental Principal corrections will be made in the pay-as-you-go system, which will ensure the stability of the system. As an alternative it is proposed to arrange a gradual transition from the current defined benefit (DB) pay-as-you-go system to the notional defined contribution (NDC) pay-as-you-go system. The introduction of this system provides for a possibility to carry out a fundamental reform of pension system in a gradual way and without large additional costs. At the same time smooth transformation can be arranged without creating significant differences between the pensions granted during different periods (prior to starting the transformation, during the transformation and after its end). The transition to NDC will be rather demanding to the administration of the insurance system, since the new system is typical by high demands on information. This is related among others to the fact that individual accounts of insured persons will have to be established and managed and that during a certain period two different pension systems will have to exist alongside each other.

24. The current state administrator of the insurance system (the Czech Social Security Administration) will be transformed into public Social Insurance Agency, which will be separated from the state budget. This subject will create the conditions for principal improvement in system administration and transition of the bearer of the insurance system in an up-to-date client-orientated financial institution. This is the only way how to create prerequisites for further reform measures. Experience from abroad has shown that underestimation of good preparation of the administrator may jeopardise any reform even with best intentions. Therefore the establishment of the Social Insurance Agency is considered to be a high priority.

25. Additional pension schemes will be further developed by means of establishment of 2nd pillar of the system (collective employees insurance) in compliance with the best experience of developed countries, strengthening of safety and transparency of 3rd pillar (individual systems of private supplementary pension schemes and life insurance) and strengthening of its long-term nature.
Table 1: Proposed target structure

<table>
<thead>
<tr>
<th>Parameter</th>
<th>1st pillar: Pension insurance</th>
<th>2nd pillar: Occupational supplementary scheme</th>
<th>3rd pillar: Open supplementary scheme</th>
<th>3rd pillar: Private insurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Guarantee by the state</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>Extent</td>
<td>all economically active persons</td>
<td>groups of persons by occupation voluntary</td>
<td>individual</td>
<td>individual</td>
</tr>
<tr>
<td>Participation</td>
<td>obligatory</td>
<td>voluntary</td>
<td>voluntary</td>
<td>voluntary</td>
</tr>
<tr>
<td>Financing</td>
<td>pay-as-you-go</td>
<td>fully funded</td>
<td>fully funded</td>
<td>fully funded</td>
</tr>
<tr>
<td>Relation of contributions and benefits</td>
<td>alternative 1: DB</td>
<td>based on the amount of contributions paid and individual lifetime (regardless of sex)</td>
<td>alternative 2: NDC</td>
<td>DC</td>
</tr>
<tr>
<td>Amount of benefits</td>
<td>alternative 1: based on the period of insurance and achieved income</td>
<td>based on the amount of contributions paid</td>
<td>based on the amount of contributions paid</td>
<td>based on the amount of contributions paid</td>
</tr>
<tr>
<td>Solidarity</td>
<td>none</td>
<td>none</td>
<td>none</td>
<td>none</td>
</tr>
<tr>
<td>Tax deductions</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>Contribution by the state</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
</tr>
<tr>
<td>Administration of the system</td>
<td>Tax deductions</td>
<td>yes</td>
<td>private</td>
<td>private</td>
</tr>
</tbody>
</table>

III. Overview of the Supplementary Pension Scheme with State Contribution

26. The supplementary pension scheme was designed in order to allow people in the pre-retirement age group to enter into the system. Between September 1994, when the first private pension funds received their license, and during the end of 1996, more than 1.5 million people entered the supplementary private pension scheme (in 2002 the number of participants exceeds 2.5 million). On the other hand, the supplementary private pension scheme gained the undesirable nature of a short-term saving scheme for purposes other than those of providing supplementary income in old age. This was partially due to the low retirement age for old-age pension (50 years) and due to a short waiting period for a pension (maximum of 5 years).

27. After its successful start in 1994, the system began to show signs of stagnation. In spite of the fact that wages were growing, participants were not increasing their contributions and the average contribution level remained at approximately 300 CZK. The state contribution has not been adjusted. The participant’s maximum contribution limit of 500 CZK, for which the amount of state contribution does not further increase, has not been enlarged. The state supervision had a restricted scope of authorities.

28. After several years of the system’s operation, the long-term aspects of the supplementary private pension scheme were intensified, and a stronger emphasis was placed on its purpose as a support in the old age. The amendment of the *Law on Supplementary Private Pension* introduced stricter conditions (for instance a retirement age of 60 years). At the same time it introduced further incentives for the participation in the system – higher state contribution, tax allowances for participants, and for employers if they make contributions to the pension funds of their employees’ pension schemes.
29. The supplementary private pension scheme with state contribution is based upon a long-term payment of smaller contributions to a pension fund. The pension fund increases those means by an appropriate investment. Participants themselves decide on the amount of their contributions. The state provides to each participant a state contribution (50-150 CZK monthly).

30. The fundamental benefit of the supplementary private pension system is the old-age pension. Apart from this, the disability pension, the retirement pension, and the temporary survivor’s pension can be provided. Only the DC types of plans are allowed.

31. The amendment of the Law on Supplementary Private Pension in 1999 terminated the provision of temporary old age, disability, and retirement pensions. When meeting conditions for the provision of a pension, the participant can decide to have instead of a pension, all the money paid out at once in the form of a one-off settlement. If a participant does not meet the conditions for the pension provision and wishes to leave the supplementary private pension scheme before the time, the participant receives back the contributions paid in the form of severance payment. This includes the investment returns, but not the state contribution or returns from the state contribution. Due to the fact that the supplementary pension scheme did not meet its purpose, the state contribution does not belong to the participant.

32. Enrolment into the supplementary private pension scheme with a state contribution is voluntary for the participants. The enrolment conditions are a minimum age of 18 years and permanent residence in the territory of the Czech Republic. There are no links to occupational performance, as this is not a system based upon the employment relationship principle. It is based upon the civil principle. Remaining in the scheme is a voluntary decision of the participant. A participant can leave the scheme at anytime and the financial assets deposited will be paid back to the participant in the form of a severance payment.

33. The amount of the life pension is determined on the retirement of the participant, by dividing all means at the participant’s individual account according to the assumed period of the participant’s average life expectancy by the mortality tables of the Czech Statistical Office. The amount of pension is not pre-defined in the defined contribution scheme and it depends not only on the amount of the participant’s contributions and the state contribution but also on the level of returns from the pension fund’s economic management. It also depends on the retirement age and on the participant’s gender (mortality tables vary for men and women).

34. In case a participant is not satisfied with a pension fund, he/she can at anytime give a two months’ notice and leave for another pension fund, including the transfer of the participant’s financial assets. The circulation of participants across pension funds is not economically positive because of administrative costs). However if a participant is not satisfied with his/her current pension fund, preference is given that the participant changes the pension fund and remains in the supplementary private pension system rather than leaving the system.

35. The custodian of the supplementary private pension system with a state contribution is a private legal entity. Private joint stock companies – pension funds, operate the supplementary private pension schemes with a state contribution. Pension funds have stricter rules for the establishment, activity and termination of their activity than ordinary joint stock companies, and these in main represent:

- An approval of a state authority is necessary for the establishment, termination of activities, consolidation or merger;

- Registered capital of a pension fund must amount to at least the minimum 50 million CZK (1 million CZK is sufficient for an ordinary joint stock company). During the foundation, it
must be constituted only by a monetary deposit and paid up prior to submitting an application for the pension fund’s establishment;

− The law defines rules of safe and provident investments for the purposes of the private pension funds, and the preference is given to a safe investment with lower returns, rather than a risky investment with higher returns;

− Control instruments (Depository, state supervision of the pension funds);

− Method of profit distribution defined by the law – the maximum of 10% of the profit belongs to the shareholders, the minimum of 5% of the profit belongs to the statutory fund and the remaining amount is determined for the benefit of the participants;

− Members of the management board, members by of the supervisory board and the pension fund’s secretary are subject to an approval of the state authorities, and must comply with requirements for professional competence, having no criminal record and be in compliance with the rules against potential conflicts of interest in terms of their other work activities.

The state supports the supplementary private pension system in four forms.

**State supervision of the pension funds**

36. The activities of the pension fund and of the depository (the bank that maintains the pension fund’s accounts) are subject to state supervision, performed by the Ministry of Finance and by the Securities Commission. The state supervision is empowered with a control authority and sanction authority (for instance penalisation, suspension of the entitlement of the management board to handle the pension fund’s assets, appointment of a custodian, withdrawal of a license to operate a pension fund). The purpose of the state supervision is to protect the participants’ interests, both the security of their accumulated financial assets means and in individual cases for instance the compliance with the supplementary pension scheme agreement.

**State contribution**

37. The state provides from the state budget a state contribution to the participant’s contribution. The minimum monthly amount of the state contribution is 50 CZK, if the participant paid a contribution of a 100 CZK. The maximum co-contribution is 150 CZK, if the participant paid 500 CZK or more. A participant can obtain a maximum of 1 800 CZK annually as a state contribution (compare with construction savings where the maximum state contribution represents 4 500 yearly).

38. At the beginning of the system in 1994 state contributions were lower, but they were increased by 25% in the first two years. Legal regulation adopted in 1999 in the amendment of the Law on Supplementary Private Pension that became effective on the 1st January 2000 regulated the contributions to be permanently higher by 25%. The state contributions have not been adjusted since the beginning of the system.

**Tax allowances**

39. Tax allowances are available to pension funds for the returns from their economic activities, so in fact most pension funds do not pay any or rather insignificant amounts of income tax.
40. Tax allowances were introduced with effect from the 1st January 2000 for the participants and for employers who pay contributions for participants:

a) Each participant, who in a year paid more than 6,000 CZK in contributions, can deduct the amount above 6,000 CZK of paid contributions from the participant’s income tax base. For example, a participant who has paid a monthly contribution of 1,700 CZK, will be provided with a state contribution of 500 CZK, and can deduct 1,000 CZK from the base tax, and for the 200 CZK there are no further benefits provided by the state.

b) Contributions can be paid on behalf of and with the agreement of the participant - employee by the employer. The contribution paid by the employer to a pension fund has the following tax allowances:

- The contribution can be included in the employer’s costs up to the amount of 3% of the assessment base of the participant-employee for social insurance and for the state employment policy contribution;

- The employee is free of tax on income coming from the contribution paid by the employer up to the amount of 5% of the employee’s assessment base for social insurance and for the state employment policy contribution.

- Tax allowance derived from the participant - employee income motivates so that the amount of the contribution corresponds with the amount of wage. With regard to the fact that the supplementary retirement income should be a substitution of the previous income from the gainful employment, the link between the amount of contribution and amount of income is logical.

Allowances for the payment of insurance for the mandatory insurance

Social insurance and state employment policy contribution

Health insurance

41. The contribution for the supplementary private pension scheme with the state contribution paid to the pension fund by an employer to an account of the employee is not included in the assessment base for the above mentioned types of mandatory insurance, i.e. insurance is not paid against it.

42. Currently there are a total of 14 private pension funds in operation, of the original 44 private pension funds. The number of pension funds decreased as a consequence of their consolidation into larger entities, with 11 funds being liquidated. The number of participants in the dissolved funds who have their benefits affected represents 1% of the total number of 2.5 million participants. Further liquidations are not envisaged, though further consolidation of pension funds is expected. The average age of participants’ age has stayed at 48 to 49 years.

43. Foreign shareholders with have gained a strong majority position in many pension funds. The volume of assets in the pension funds exceeds 55 billion CZK. To date, the participants have gained 14 billion CZK as a state contribution, in 2001 alone it was close to 3 billion CZK.
44. The composition of pension funds’ portfolios include bonds (57%), treasury bills (23%) and stocks (8%). The average investment results achieved range closely around the inflation rate, maintaining, the real value of the money deposited.

45. The main concerns of the current supplementary private pension scheme with a state contribution include:

- Insufficient security of the funds deposited, caused mainly by the fact that authorities, activities and intervention of the state supervision are diffused and in fact delayed;
- Insufficient transparency of management as a consequence of the inconsistent separation of the financial assets of the participants from those of shareholders;
- High operation costs, mostly as a consequence of the individual (open) character of the system.
- The so far short-term character of the supplementary private pension schemes that serve rather as convenient means of savings and not as a method of old age security.

46. Improving the current situation, i.e. mainly to increase the stability and safety of the system and to increase the effectiveness of the state supervision, was one of the objectives of the amendment of the Law on Supplementary Private Pension with a State Contribution. The alterations proposed can be characterised as necessary alterations to the current legal regulation, based on both the EC requirements and on the practical experience of the state supervision. The proposed changes were mainly aimed at:

- Increasing the transparency of the management of the pension funds, by the separation of the pension fund’s assets from the assets constituted by the participants’ contributions, state contributions and returns coming from these contributions;
- Increasing the cost-effectiveness of the management of the participants’ means;
- Expanding the investment opportunities of the pension funds,
- Making state supervision stricter and strengthening the role of public control,
- Harmonisation of the legal regulation with international law, international treaties and the EU legislation in association with the entry into the EU.

47. The draft was rejected in October 2001 by the Czech Parliament and the new attempt may be prepared only after the election in June 2002.

IV. Characteristics of the newly prepared Supplementary Occupational Pension Scheme

48. At the beginning of October 2001, the Government submitted to the Parliament after more than two years' preparation, the draft of the Law on the Occupational Pension Funds. In December the Parliament rejected the draft, so the next attempt may be tried only after the election, i.e. not before the end of 2002.

49. In the Czech Republic, the necessary conditions for the development of closed-end occupational supplementary pension systems functioning on similar principles have not yet been created. The existing
system of the supplementary private pension schemes with a state contribution, and several products offered by the insurance companies are using the tax advantageous contributions paid by employers for the benefit of individually concluded agreements with employees who are the clients of companies (pension funds, insurance companies). This system, however, does not provide for using all advantages of the European model of occupational pensions. The current system must ensure financial effect not only for the participants of the supplementary private pension scheme, who are individually gained and maintained at a high cost in a competitive environment. But also for the pension funds’ owners, who invested considerable financial resources into the pension funds’ operation and who expect profits corresponding to the returns from the financial investments. When compared to the standard characteristic for the West European and American mutually not competing occupational pension systems the following features arise as characteristic for the current pension funds. The apparent tendency to concentrate the market into several large pension funds controlled by foreign financial groups, which in its consequence markedly unifies this system both in terms of the benefits and in terms of applied investment strategies. And at the same time the system’s small transparency for the participants (which is prevented by the competitive nature of the system and by the requirement for the protection of the pension funds' shareholders’ business interests).

50. The submitted draft of the Law on the Occupational Pension Funds was based upon experience of the EU member states, the USA and other developed countries. It regulated conditions for the establishment and development of the occupational pension funds system, operated by non-profit pension companies and established by employers through occupational pension funds administered by them and separated from them in terms of accounting. It also regulated the operational and investment activities relating to the administration of occupational pension funds and the state supervision of the occupational pension funds.

51. The objective of the introduction of the new supplementary pension system was not to substitute the existing systems (private pension open funds system with a state contribution, life insurance). The objective was rather to complement the range of pension funds’ schemes with those of the closed-end occupational pension funds, which are a standard worldwide. The significance of the private supplementary pension savings as an income source for retired citizens in the ageing Czech population will necessarily have to increase, as arises from the "Concept of the Continuation of the Pension Reform" approved by the Government on the 2nd of April 2001. Therefore it is vital to utilise all proved, effective and safe types. In countries with a developed market economy the significance of private supplementary pension systems has been growing and forms the most fundamental element of pension systems.

52. The reason for the broad application of the occupational pension systems is their natural connection to dependent employment and the comprehensive care of an employer for his employees. The comprehensive care is a result of a company social dialogue, and its specific form is negotiated within collective bargaining on a company or sector level. The Occupational pensions represent in this regard deferred wage, protected by the means of wage protection, guaranteed by the employment relationship regulation. The guarantees of the system on the part of employers, the use of communication of the pension fund custodian with the employer and the non-profit nature of the organisation of this pension system co-create very favourable prerequisites for the system's transparency, its cost-effectiveness and safety from the point of view of the employees. The proposed occupational pension system strove after a maximum simplicity, safety, effectiveness and transparency. It might have been in many ways different from the fundamental principles of the current private pension funds schemes with a state contribution.

53. Occupational pension schemes were to be financed only from the contributions of the employees and their employers and from the returns gained by the group investment of these contributions through qualified external custodians.

54. Occupational pension funds were not to be subject to trading.
55. Competition costs relating to the gaining of participants, mainly through dealers were not to be associated with the occupational pension funds system.

56. The priority of the activity of the pension companies were to be the interests and needs of the participants in the maximum long-term returns for the participants, and not the short-term interest in profit of the owners of a joint stock company – the benefit system was to be fully compliant with this, and it will not allow for early withdrawals of the assets determined for the provision of income source for the old age of the participants.

57. The pension company were to administer more occupational pension funds (the employer were to be able to offer to the employees a range of pension schemes, which should differ both in terms of the benefits and in terms of the investment strategy), which would allow for achieving cuts in operational costs when compared to the concept - one custodian - one pension fund.

58. Enabling only defined contribution pension schemes and ensuring the portability of the funds means on the change of employment to the pension company of the new employer, the system would not impair the labour force mobility.

59. The representation of the employees would have a significant role in the activity of the occupational pension funds system, the employees were to be the owners of their pension savings entrusted into the custody of a pension company and they would participate in the decision making about the savings management through the elected representatives in the pension companies' bodies.

60. The system was to use collective bargaining both at its establishment and during its operation (mainly in relation to the determination of the amount of contributions, which in fact represents deferral of a part of the wage for the time after retirement).

61. Operation of the new system would require the minimum administrative requirements both on the part of the pension companies or the external operation custodians and on the part of the state supervision. Matters relating to the individual collection of contributions and to the application of claims for the state contributions, business activity associated with gaining participants and relationships to dealers, advertisement agencies and the like were to be eliminated. Due to the lower operational costs the system were to enable (this is a long-term proved experience in the countries with the strongest private pension systems) to increase faster and achieve a higher value of the participants’ means, on the basis of which the supplementary pensions were to be assessed.

62. Occupational pension funds were to be very transparent and consistently separated legally and in terms of accounting from their founders, operational custodians and investment custodians.

63. The nature of the individual accounts which would accurately continuously truly depict the real value in the occupational pension fund's assets belonging to the participant according to the amount of contributions gradually paid by the participant and his/her employer, would contribute to the system's transparency.

64. Operational costs of the funds were to be transparent due to the fees defined by the law for the operational and investment administration, these can be paid from the assets in the occupational pension fund and their amount were to be limited - fees other than those defined by law cannot be charged to the occupational pension funds.

65. The participants would have an easy and continuous access to information on the activity of the pension fund and on their benefits through the pension company administrating the pension fund, through their employer, or through the trade unions they are members of. Participants would also be able to request
explanations without any delay from their pension company representatives who they would meet daily at their workplaces.

66. External investment administration through the state authorised investment custodians, which was to be mandatory for the occupational pension funds, would contribute to the higher professionalism and security of the pension savings and to achieving higher returns for the participants - the founders of the pension companies, their bodies or the members of their bodies would not be able to invest in any way the means of the occupational pension system.

67. Occupational pension funds would contribute to the competition on the market of the investment custodians, who were to be forced to offer their services at advantageous prices and to prove their long-term investment achievements in the administration of a conservative portfolio in the sphere of supplementary pension systems.

68. The occupational pension funds were to be able to use for the payment of the benefits of the occupational pension schemes, if desirable, the services of external entities, i.e. insurance companies and pension funds providing pension schemes with a state contribution, and this way they would contribute to the development of the annuities market in the Czech Republic.

69. The occupational pension funds were to find their place in the social programs of successful companies, where they would strengthen the company team spirit, help in the sphere of collective bargaining and use many natural connections of the companies that effectively substitute costly services in the business contact.

70. Among the fundamental changes, as compared to the private pension funds schemes with a state contributions and life insurance, was the use of a non profit legal entity for the purpose of an occupational pension fund administration based upon international experience. The elimination of competition during the process of enrolling participants and distribution of returns coming from the contributions investment markedly decreases the costs and increases the returns, and at the same time the participants' benefits. Another fundamental change was the use of a competitive environment mainly in the competition of the external investment custodians of the pension funds, which the participants evidently benefit from.

71. The occupational pension system was to be operated by an independent legal entity, a pension company, separated in terms of accounting from the pension fund, that would represent the volume of the participants' pension savings (employees' and employers' contributions and returns), and from its founders.

72. The non-profit nature of the administration and distribution of returns of the fund guarantees that all returns coming from the investment would serve only for the constitution of resources for financing supplementary pensions. This means that the costs for a pension on the part of the occupational pension participant were to be lower than, for instance, those of the participant of the private pension funds with a state contribution. The pension fund was to be administered by the representatives of the employers, employees and pensioners in the bodies of the pension company, who would decide on all major issues, mainly with regard to the fund's management, selection of investment custodians, determining investment strategy and distribution of returns. The actual expert activities, most of all the investment of financial assets, were to be carried out for an agreed transparent fee by the external custodians who would regularly present the results of their activity to the bodies of the pension company. If their results are not satisfactory, they can be replaced. The occupational pension fund were to be separated from the employers, who would not have the chance to independently decide about it and misuse its financial means. Investment into the firms of the founders of the occupational funds was to be to a large extent restricted by law.
73. A competitive environment was to be applied mainly in the sphere of operational and investment administration, where as mentioned before, it results in cutting down costs and thus in higher returns for participants. A competitive environment would not be applied in the sphere of enrolling participants where competition on the contrary markedly increases costs (dealer services, business units, advertisement and the like) and represents a burden on the funds not only for the current year but also for the future.

74. A special tax regulation relating to the employees' and employers' contributions, returns from the economic management of the pension funds or the paid benefits, similar to that of the "private pension funds system with a state contribution" was proposed for the support of the occupational pension funds. The state would control the activities of the occupational pension funds through supervision. State supervision was to be founded on the same principles as that of the "pension funds with a state contribution" in compliance with the Act no. 42/1994. The state supervision was to be carried out by the Ministry of Finance and the Securities Commission.

75. The proposed system provided, based on experience from other countries, conditions for the occupational pension funds to be operated with a minimum administrative staff and minimum costs so that the potential employer's ceasing of existence, or a change in employment, did not threaten the occupational pension fund or the participants.

76. It was assumed that only large employers or groups of employers (in developed countries there are often sector pension funds), who were successful and had the prerequisites for a long-term economic development would found independent occupational pension funds.

V. Private insurance

77. Pension insurance is provided by private insurers as a part of life insurance, which besides pension insurance contains also capital insurance (life insurance, endowment insurance, whole of life and endowment assurance, investment insurance). Provision for old age may be taken out in the form of pension insurance or endowment insurance, the latter however being often taken out (under a different name) for the benefit of the security of children.

78. While supplementary pension insurance with the state contribution managed by pension funds is designated as a provision for members’ old-age, private insurance deals with a whole range of insurance claims and old age is only one such claim. Insurance policies signed by the policyholder and the insurance company commonly combine various insurance claims and it is only possible to separate statistically the pension products designated for old age with limited accuracy. These issues are currently combined in insurance contracts concluded between a beneficiary of insurance and respective insurance company.

79. Insurance companies offer many variants of pension insurance which usually contain a provision for a life annuity to be paid from an agreed date of termination of insurance, for a temporary pension to be paid in the event of full disability or from the date of the termination of insurance, for a bereavement pension, exemption from payment of contributions in case of full disability while maintaining all entitlements from insurance, share in profits even after the inception of payment of pension, return of contributions paid in case of death before the end of the qualifying period.

80. Instead of regular payments of an annuity, the policyholder has the option of taking the amortised value of the pension in one lump sum, including a share of profits, to defer the start of payment or to choose a shorter period of payment during a certain number of years (when a higher pension is paid). The employer has the option of concluding a collective pension insurance agreement on behalf of his employees.
81. In 2001, tax allowances have been extended to insurance products designated as old-age provisions of private insurers. The tax allowances do not apply to collective insurance – *i.e.* policies signed by the employer as policyholder with the insurance company for the benefit of employees.

82. The higher premium rates of private companies imply that their clients come mainly from middle and high-income groups. For such persons private life insurance may be an effective way of providing a supplementary income in old age.
Supplementary Pension Insurance in the Czech Republic
(Statistical Data)
1994-2001

Number of pension funds

Pension funds assets

billions of CZK
Number of participants

Income and expenditure of pension funds
Development of average monthly contribution

![Graph showing the development of average monthly contribution over years 1994 to 2001. The graph compares participants' contribution and state contribution.](image)

Development of real value of average contribution and of ratio of average contribution to average wage

![Graph showing the development of real value of average contribution and ratio of average contribution to average wage over years 1994 to 2001.](image)