

# **National Strategy Report on Adequate and Sustainable Pensions**

**June 2005**

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## 1. Foreword

The Czech Republic underwent since 1989 a substantial transformation of the society as a whole. The functioning market economy has been created, dozens of new institutions formed and hundreds of laws enacted. The Czech Republic became a standard democratic country and within a very short period of time became actively involved in the activities of a number of international organizations (OECD, WB, IMF, ILO). Through these institutions collaboration and consultations are conducted on possible development of the social (pension) system in the Czech Republic. In May 2004, the Czech Republic joined the EU. Despite the fact that deep economic transformation had a very strong impact on numerous groups of the population, it was not accompanied by any serious social conflicts. Social policy based on the dialogue of social partners within the Council of Economic and Social Agreement (Tripartite) definitely played an important role in this respect, since simultaneously with the economic reform also changes of the social system as a whole were started. The field of social security is gradually being improved and accommodated to the needs of mutually balanced and sustainable economic and social development. The social security system includes the field of social security (pensions, sickness insurance, unemployment, employment injuries insurance), state social support (family benefits) and social care. A significant part of social services is ensured by regions and municipalities.

The economic and social transformation influenced during the 90's certain demographic characteristics of the population. The moment of founding a family is being postponed, the number of newly-born children is decreasing (fertility rate at 1.18 in 2003), life expectancy of men is extending (in 1990–67.6; in 2003–72.1) and of women, too (in the years 1990-75.4; in 2003-78.7). The process of ageing clearly manifests itself. This development corresponds to the development in most EU countries. The Czech Republic adopted the *National Action Plan of Social Inclusion 2004 - 2006*<sup>1)</sup> and the *National Employment Action Plan 2004 - 2006*<sup>2)</sup>. In both these documents and especially in the National Employment Action Plan there are sections dealing with the issue of the elderly workers. The *National Programme of Preparation for the Ageing 2003 - 2007*<sup>3)</sup> is an important document dealing with the ageing in wider context.

The nature of the pension system requires that its changes be performed on an ongoing basis. Consequently, the pension system reform should be implemented as a permanent and continuous evolutionary process. The changes must involve not only the public mandatory continuous pillar, but also privately-funded voluntary pension schemes. The essential prerequisite for successful continuation of the pension reform is to reach the widest possible agreement on further reform steps.

The Czech Republic by the preparation of the "National Strategic Report on Adequate and Sustainable Pensions" (hereinafter the "NSRP") participates in the process of the Open Method of Coordination (OMC) in the field of pensions and fully endorses eleven common objectives approved in 2001 at the Laeken meeting of the European Council. NSRP, that has been prepared by MLSA has been discussed with all governmental departments, social partners and selected institutions, social organizations and in June 2005 was approved by the Government. NSRP should become a strategic document serving for further extension of a discussion on maintaining social security for the current and future elderly people. This is desirable for maintaining social cohesion in the society which is one of the most important prerequisites for the sustainable economic growth.

## 2. Introduction

The social security in the territory of the Czech Republic has a more than hundred years' tradition. The first laws laying down social insurance schemes were drafted at the end of the 19th century and the first modern law regulating the public pension scheme in both the institutional and factual terms was drafted already more than 80 years ago (in 1924). After World War II, the Act of 1948 that established the national insurance scheme was an important milestone. Both these legislative regulations were progressive and very modern at the time of their enactment. Between the 1950's and

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<sup>1)</sup> Government Resolution No. 730 of 21 July 2004

<sup>2)</sup> Government Resolution No. 696 of 14 July 2004

<sup>3)</sup> Government Resolution No. 485 of 15 May 2002

1989, however, gradually deformations occurred, the scheme became static and in its certain parts even discriminatory. It did not allow any individual decisions, the appropriate conditions failed to be created for the development of the privately funded voluntary pension schemes, etc. Nevertheless, the Czech social (pension) insurance scheme retained certain positive features of the first half of the 20th century that could be followed up.

The pension reform process was started in the Czech Republic immediately after political changes in 1989. The principle of universality was introduced to the system, discrimination eliminated, the payment of pension insurance contributions introduced and the authority in charge of the insurance system transformed. An act was passed that put in place a voluntary supplementary pension scheme (state-subsidized supplementary pension scheme). In 1995, a reform act on pension insurance was passed in the Czech Republic, as in one of the first countries of Central and Eastern Europe. This act introduced, inter alia, the required flexibility of the scheme, extension of the retirement age for eligibility for the old-age pension, the scheme was harmonized with the rules applicable on an international basis, its regular valorization was introduced. MLSA publishes on a regular basis the actuarial report on the status of the basic pension insurance scheme and the Ministry of Finance issues the annual report on the status of the state-subsidized supplementary pension insurance scheme and on the insurance sector.

Major changes that were made in the course of the past 15 years resulted in the creation of the pension system that is comprised of two parts. The first pillar is the mandatory basic pension insurance scheme, based on defined benefits (DB) and the PAYGO system. It is universal and covers all economically active persons, the legal regulation is uniform for all the insured, no special sectoral schemes exist. Only in the field of organizational and administrative support there are certain differences for the so-called power governmental departments (for instance soldiers, policemen, customs officers, firefighters). Apart from this, there is also voluntary supplementary, capital-funded, state-subsidized supplementary pension scheme based on defined contributions. According to the EU terminology, this system may be considered to be the third pillar of the pension system, since there is no direct link between the employee and the employer. The third pillar also includes products of commercial insurance companies – especially life insurance. The second pillar usual in EU Member States (the occupational pension insurance) does not exist in the Czech pension system and currently, it is not planned to be introduced.

The necessity of future modifications to the pension system arises from demographic predictions. In the last ten to fifteen years there was a steep decline in the fertility rate and at the same time life expectancy was extended. Unusual intensity of these changes will result in gradual and relatively rapid ageing of the population. The share of children (0-14 years) in the total population dropped from 20 % at the beginning of the 90's to 15.6 % at present. This decreasing trend will continue to reach the level of some 13 % in 2030. The share of persons over 60/65 years in the total population will, on the contrary, grow from the current 19/14 % gradually to 23/15 % (in 2010) and further to 29/23 % (in 2030) and 38/31 % (in 2050). The projections further envisage approximately by 6 years higher life expectancy of men and women in 2050, in comparison with the current status. The demographic dependency index (the proportion of people over 65 years to the population aged 15-64 years) will increase from 19.7 % gradually to 22 % (in 2010), 35 % (in 2030) and 55 % (in 2050).

The ageing of the population will have its consequences also for the system of social and health care and for social services that will have to be accommodated to the different age structure of the population. The emphasis is placed on the provision of various field social services in households where a part of the elderly people over 65 years lives alone (30 %), with a partner (38 %) or in a common household with children (23 %). Especially rising number of persons over 80 from the current 300,000 to some 900,000 in the course of the next fifty years will be a serious challenge. The number of users of institutional social care establishments is permanently increasing. Basically, the elderly people are offered services in two types of establishments. The first type is the old people's home securing the comprehensive care. The second type are lodging houses for pensioners where services are offered subject to their health condition. The total capacity in these two types of establishments grew from 38,000 (in 1990) to 51,000 (in 2003). Nevertheless, the number of applicants whose request has not been met is constantly growing. After 1990, apart from the state,

social services began to be provided also by municipalities and towns, churches, civic associations, non-profit organizations, etc.

Increasing the employment rate in general and the employment rate of the elderly people in particular is an important measure aimed at sustainability of the pension system. One of the priorities of the National Employment Action Plan 2004 – 2006 is to increase the supply of the labour force and support active ageing. This may be achieved by using the option of the part-time job combined with pension, more flexible working hours and emphasis laid on the active employment policy (for instance retraining, advisory services), rather than preferring and increasing of cash benefits. The employment rate of people aged between 55 and 64 years currently ranges above the EU average. However, there is a difference between the employment rate of men and women (in the age bracket 55 – 64 years the employment rate of women is approximately half of the employment rate of men). The unemployment rate of people aged 55 - 64 years (4.4 %) is in comparison with the unemployment rate of people aged 25 - 54 years (7 %) relatively small.

Recently, the growth of GDP in the Czech economy has been dynamic and in the near future effects of the EU accession will continue to manifest themselves. In the short-term, (by 2007) the annual growth of GDP at about 4 % is envisaged. An important macroeconomic indicator is the total indebtedness of the Czech Republic which has been rising in recent years. Currently, the public debt is at 37.4 % GDP (in 2004) which is below the Maastricht criterion of 60 % of GDP. Since the second half of the 90's the deficit of the governmental sector ranges approximately from 3 to 6 % of GDP annually. Only in 2003 as a result of the inclusion of extraordinary expenditure it has risen to 11.7 % of GDP. As a result of the public finance reform, the deficit should continue to be reduced gradually with a view to meet the conditions for the adoption of the single European currency by 2010 (in 2004 it was at 3 % of the GDP). The economic level will be gradually harmonized with that of more advanced countries. The overall social security expenditure is below the EU average and accounts for 19.9 % of GDP<sup>4</sup>). Also the basic pension insurance scheme expenditure is currently low when compared with the EU level (8.4 % of GDP), nevertheless in connection with the ageing of the population it is necessary to be prepared for its growth and accommodate the public finance to this growth in such a manner to prevent its potential destabilization.

### **3. Implementation of common objectives**

#### **3.1 Adequacy of pensions**

The adequacy of the pensioners' income is ensured in the Czech Republic by mandatory participation in the single basic pension insurance scheme in the course of pursuit of economic activity and free access to voluntary (state-subsidized) privately funded pension schemes. A minimum guaranteed level of pension from the (public) basic pension insurance scheme arises from the manner of its calculation. In addition to the pension, it is possible to provide both income or means-tested one-off or repeated benefits from the social care system or from the state social support system.

##### **3.1.1 Policy objectives**

**C u r r e n t s t a t u s :**

In the field of adequacy of pensions the emphasis is laid on the implementation of 3 objectives contained in the Laeken Agreement (2001) which ensure comprehensive approach towards the adequacy of pensions. When considering the adequacy of pensions at the level that would guarantee that the elderly people are not exposed to poverty risk, only 4 % of the persons over 60 years in the Czech Republic are below the poverty line. This is less than the figure for the Czech population in general (8 %).

Currently, more than 99 % of the population at the age higher than the statutory retirement age for eligibility for the old-age pension receive the pension from the basic pension insurance scheme. The basic pension insurance scheme creates prerequisites for covering the entire population, regardless

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<sup>4</sup>) Social benefits are not subject to taxation in the Czech Republic, except for pensions from the basic pension insurance scheme; subject to the personal income tax is the amount of pensions exceeding CZK 162,000 per year. Currently, of 3.2 million pensions paid out, approximately only 3.2 thousand pensions exceed this limit.

of the nature of the course of the economic activity. A relatively extensive scope of periods in the course of which no contributions are paid, i.e. so-called non-contributory periods that are included in the calculation of the pension entitlement (it is the period when the insured is not active in the labour market and does not pay the pension insurance contributions but obtains pension entitlement), does not exclude from participation in the pension scheme even persons whose professional career has been interrupted. Universality of the basic pension insurance scheme for all persons at the age of economic activity does not create scope for their different status on the grounds of the nature of a job, sex etc. This universality allows to apply the principle of income solidarity within the system, namely in the society as a whole. The average old-age pension in 2004 was approximately at 44 % of the average gross wage<sup>5)</sup> (57 % of the average net wage<sup>6)</sup>). However, a broad scope of coverage through the institute of non-contributory periods may have an adverse impact on the willingness to pay into the basic pension insurance scheme pension insurance contributions, since the system structured in this way requires a relatively high insurance rate. This rate is currently at 28 % of the gross income.

Apart from solidarity of economically active persons with persons who are not economically active, through the non-contributory periods, another type of solidarity within one generation is the income solidarity. It results in higher level of compensation for the pre-pension income of persons with low income in the long-term and lower level of this compensation in the case of high income brackets.<sup>7)</sup> The application of solidarity principles to the basic pension insurance scheme enables to prevent social exclusion of certain groups of the population and their exposure to the poverty risk. On the other hand, excessive solidarity may have disincentive effect on participation in the basic pension insurance scheme. When considering the level of equivalence in the basic pension insurance scheme, it will be necessary to ensure an appropriate compromise between the level of solidarity and motivation to participate in the scheme.

The proportion of the average old-age pension to the average net wage was gradually decreasing from 61 % in 1998 to 57 % in 2004 (the proportion to the average gross wage decreased from 47 % in 1998 to 44 % in 2004). The participation in the state-subsidized supplementary pension insurance scheme is relatively high (almost 3 million participants), however, the assets held by pension funds are still relatively low (only 3.7 % of GDP). Only about 1 % of participants to whom so far benefits were granted are represented by pension beneficiaries. Currently, as part of private life insurance schemes<sup>8)</sup>, some 3 million contracts have been entered into and the total value of technical reserves of all life insurance products accounts for 5.6 % of GDP.

#### Future development and objectives envisaged:

A long-term objective is to maintain the overall level of compensation for the pre-pension income from the pension schemes, while it is very likely that this compensation from the basic pension insurance scheme will drop. Such drop should be covered by the growing level of compensation from private pension schemes.

### 3.1.2 Current situation, policy instruments

#### 3.1.2.1 Basic pension insurance scheme (1st pillar)

##### **Principles of the basic pension insurance scheme**

The effective legal regulation is contained in the Act on Pension Insurance that came into effect on 1 January 1996. The basic pension insurance scheme is based on defined benefits and on the pay-as-you-go financing. The key principles include the mandatory participation, universality – single regulation for various groups of the insured, obligatory nature of pensions, guaranteeing the acquired rights, securing the court protection, pensions guaranteed by the state and solidarity both within one

<sup>5)</sup> Information of the Czech Statistical Office on the average gross wage calculated from data including also small economic entities.

<sup>6)</sup> The average net wage is the average gross wage net of the corresponding income tax and health and social insurance contributions.

<sup>7)</sup> For instance, after 40 years of insurance the old-age pension from earnings at 2/3 of the average wage amounts to 64 % of the net pre-pension income, but the pension derived from earnings at 1.5 multiple of the average wage amounts to 41 % of the net pre-pension income.

<sup>8)</sup> Privately funded life insurance means only those life insurance products that have the nature of savings for the old age (i.e. the endowment insurance, the whole life and endowment insurance and the pension insurance) with the agreed payment of pension benefits after 60 calendar months and no sooner than upon reaching the age of 60.

generation and between generations. Pension insurance contributions constitute revenue of the basic pension insurance scheme, while the payment of pension benefits is its expense.<sup>9)</sup>

Granted from the basic pension insurance scheme are only pensions derived from the length of the insurance period (including the alternative pension periods) and from the income earned. In contrast with the previous legal regulation, the Act on Pension Insurance has introduced a number of very positive features, namely from the long-term viewpoint.

#### **The key measures adopted by the Act on Pension Insurance with effect from 1 January 1996:**

- commencement of the process of gradual raising of the retirement age for eligibility for the old-age pension,
- gradual extension of the period from which earnings (income) for the calculation of pensions are derived, from the five-year period in 1995 to the thirty-year period as a target in 2016,
- dynamic structure for the pension calculation consisting especially in the indexation of the income earned for the pension calculation subject to the general increase in wages,
- promoting equality of men and women as regards eligibility for the survivor's pension.

The structure of the pension calculation contains a number of components the value of which is changing annually and therefore the level of the granted pensions reflects the general development of wages. Changes in the value of these components are decided by the Government; it must take as the basis for its decisions information of the Czech Statistical Office and the Czech Social Security Administration, which as the main authority in charge of the insurance system decides on eligibility for pensions.

#### **Structure of pension**

The pension is comprised of the basic assessment<sup>10)</sup> which is equal for all types of pensions (independent of the length of the insurance period and income) and from the percentage assessment derived from the insurance period and income earned. The amount of pensions is not limited by any maximum allowed assessment.

#### **Calculation formula**

pension = calculation base<sup>11)</sup> \* percentage rate per year of insurance<sup>12)</sup> \* number of years of insurance<sup>13)</sup> + basic assessment

#### Old-age pension

The insurance period required for eligibility for the old-age pension is at least 25 years and the retirement age stipulated by law that is being raised gradually or at least 15 years of insurance and reaching the age of 65 years as a minimum.

#### Disability pensions

Included in the calculation of full and partial disability pensions as the insurance period is also the time from the moment of becoming eligible for this pension to the reaching of the retirement age for eligibility for the old-age pension for which, however, no contributions are paid. A decline in the capacity for systematic gainful activity must be at least 66 % (full disability), or 33 % (partial disability) and the required insurance period is at least 5 years (it is derived from the ten-year period prior to the occurrence of disability).

#### Survivor's pensions

The percentage pension assessment is determined from the percentage assessment of the pension of the deceased person. The deceased person must meet the conditions for eligibility for the old-age or disability pension; unconditional eligibility for a pension applies for a period of one year from the

<sup>9)</sup> Of 3.2 million pensions paid out, 60 % represent old-age pensions, 17 % full disability pensions and partial disability pensions and 23 % widower's, widow's and orphan's pensions.

<sup>10)</sup> The amount of the basic assessment in 2004 was CZK 1,310 which is equal to some 10% of the average net wage (8% of the average gross wage). Since 1 January 2005 the basic assessment is CZK 1,400.

<sup>11)</sup> The calculation base is derived from the reduction of the personal assessment base which is the monthly average of the sum of annual income for the specified period prior to the granting of the pension indexed according to the general increase in wages.

<sup>12)</sup> In the case of old-age pensions and full disability pensions it accounts for 1.5 % of the calculation base, in the case of partial disability pensions it accounts for 0.75 % of the calculation base.

<sup>13)</sup> Including non-contributory periods.

death of a husband, afterwards the conditions stipulated by law must be met, otherwise the eligibility lapses<sup>14</sup>). Eligible for the orphan's pension is the dependent child, however, until it reaches the age of 26 as a maximum, if the deceased person complied with the conditions giving rise to the eligibility for a pension.

Pensions from the basic pension insurance scheme are neither income-tested nor means-tested, except for the early old-age pension and partial disability pension.<sup>15</sup>) In the case of concurrence of own pension of the insured (for instance the old-age pension) and the survivor's pension (for instance the widow's pension) the payment of the pension which is lower shall be reduced as appropriate.

The minimum amount of pension is derived from the basic assessment<sup>10</sup>) and the minimum percentage assessment<sup>16</sup>). Additional instrument, as regards the social security of the elderly (and not only them), is the institute of the subsistence level which exists, in addition to the basic pension insurance scheme. It is, inter alia, the criterion for the provision of social care benefits to the socially needy citizens (i.e. also to pensioners with low pensions) and for the determination of beneficiaries of the state social support benefits and the amount of these benefits<sup>17</sup>). Benefits from the social care system are income-tested and means-tested.

### 3.1.2.2 Private pension schemes (3rd pillar)

The state provides incentives for the state-subsidized supplementary pension insurance operated by pensions funds and for life insurance schemes of commercial insurance companies.

The state-subsidized supplementary pension insurance scheme was introduced in 1994. Any individual over 18 years having a permanent residence in the territory of the Czech Republic or domiciled in the territory of another Member State may become a participant in this scheme provided that he/she participates in the basic pension insurance scheme or the public health insurance scheme in the Czech Republic. Under the contract, the participant undertakes to pay to the fund a contribution in the minimum amount of CZK 100 per month.

The contract may be concluded with more pension funds, but it is not possible to pay simultaneously to more pension funds (it is admissible to pay to one only). The Act allows to pension funds, except for the disability pension, to offer solely defined contribution plans. The state supports participation in the supplementary pension insurance schemes by the provision of the state subsidy and by the income tax allowance for the participants. The maximum amount of the state subsidy is at least CZK 50 per month (provided that the participant paid the contribution of at least CZK 100) and CZK 150 as a maximum (provided that the participant paid at least CZK 500). The contribution or its part may be paid on behalf of the participant by his/her employer subject to the participant's prior consent. The employer's contribution may be agreed also in the collective agreement. With effect from 1 January 2000, tax allowances have been introduced for both participants and employers.

Apart from tax allowances, there are other allowances for both employees and employers with respect to the payment of social security insurance contributions, the state employment policy contributions, and the general health insurance contributions, since the supplementary pension insurance contribution paid by employer directly to the pension fund is not included in the assessment base for the above mentioned types of mandatory insurance schemes.

Currently, there are 11 pension funds in the state-subsidized supplementary pension insurance market which makes this market transparent. The state-subsidized supplementary pension insurance, as a product, is easily understandable to the widest strata of the population for its simplicity. It enables the involvement of population in low-income brackets and economically inactive population. The average amount of the participant's contribution is low and since 1999 has been stagnating at 2 % of

<sup>14</sup>) In the case of repeated compliance with the conditions within five years from the lapse of eligibility for pension this eligibility is resumed.

<sup>15</sup>) The insured is not entitled to receive the payment of the old-age pension when pursuing the gainful activity until he/she reaches the retirement age for eligibility for the old-age pension; the payment of the partial disability pension will be reduced to one half after the income of the insured exceeds the determined income limit or is completely stopped.

<sup>16</sup>) Currently, it amounts to CZK 770 which is some 6% of the average net wage (5% of the average gross wage).

<sup>17</sup>) Subsistence level currently amounts to CZK 4,300 for an individual which is some 34 % of the average net wage (26 % of the average gross wage).

the average wage (so far, it is even less than CZK 5,000 per year). Employers' contributions represent 27 % of all participants (the average contribution per one participant exceeds CZK 400 per month). Participants over 60 years account for 20 % of all participants and the share of the 40 - 59 years age bracket is 52 %. The level of coverage by the supplementary pension insurance scheme as the percentage of the population aged 15 - 64 years accounts for 35 %. Due to the fact that the participant cannot be younger than 18 years, this rate also applies to the 18 – 64 years age bracket which is 37 %. So far, the state-subsidized supplementary pension insurance scheme has been used for the purpose of mid-term savings rather than as the supplementary income for the elderly. Since the launching of the system lump sum settlements account for 72 % of all pensions granted to date, surrenders for 24 % and the old-age pension (the bulk of which is not the life annuity) mostly accounts for less than 1 % of the benefits.

Apart from the state-subsidized supplementary pension insurance scheme, as part of the third pillar there is also private life insurance available under which each citizen has the right to enter into the contract with the insurance company and negotiate his/her private life insurance.

The contract may be agreed with more than one insurance company. Private life insurance is currently offered by 19 insurance companies. The average annual amount of the contributions paid into the private life insurance schemes per one contract for which a certificate for claiming tax allowances was requested was CZK 5,400 in 2004. Employers provide contributions to 328,000 of their employees, investing the average annual amount of CZK 6,000 per employee. Tax allowances were introduced for insurance products under private life insurance schemes for both the insured and their employers.

### 3.1.2.3 Current situation of pensioners

With regard to the general level of income of the population of the Czech Republic and with respect to the objectives consisting in securing the prevention of social exclusion, maintaining the standard of living of the pensioners and supporting solidarity within one generation and between the generations, the situation of pensioners is adequate and currently these objectives are being met.

The Czech Republic belongs to the countries with a very low level of poverty. 8 % of the total population is below the limit of 60 % median income (for EU this is at 15 %). In the case of persons over 60 years only 4 % of persons are below this limit, with higher age the exposure to the poverty risk is slightly growing – the number of persons over 65 years below this limit amounts to 4.4 % and for persons over 75 years it stands at 6.6 %. The exposure of women to the poverty risk is higher in all age brackets<sup>18)</sup>.

Currently, no large group of the elderly people is immediately exposed to poverty risk. The pension system contributes considerably to the reducing of potential poverty. Without all social transfers 39% of the population would live below the poverty line. The pensions paid out reduce this ratio by 18 percentage points and other social transfers by 13 percentage points to the final 8% of the total population. The income difference between men and women is lower in the pension system than in the remuneration system. This is caused especially by the application of the income redistribution and inclusion of non-contributory periods. The scope of included non-contributory periods is considerable, however, on the other hand, the inclusion of these periods significantly reduces the level of exposure to the poverty risk.

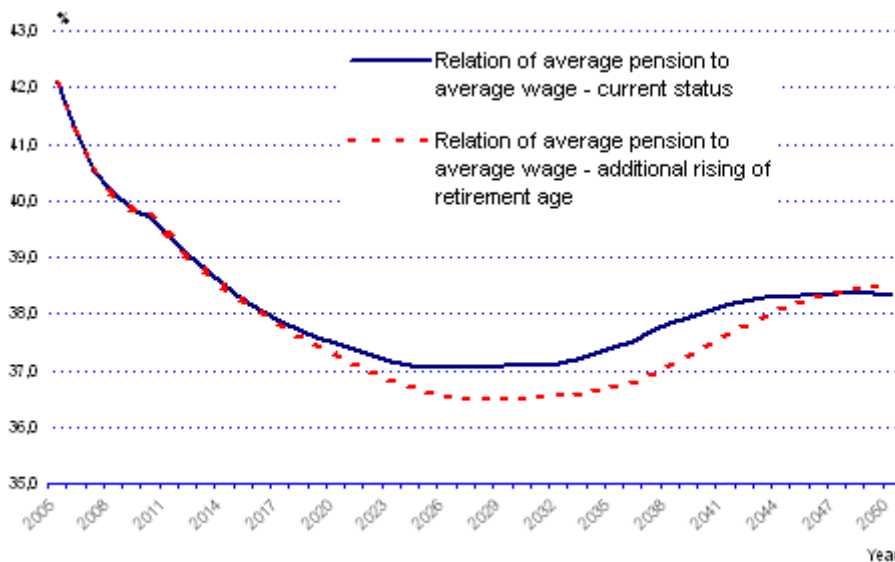
### 3.1.3 Forecasts and tasks within policy objectives

In 2004, the proportion of the average old-age pension (on a „separate“ basis) to the gross wage accounted for some 44 % (approximately 57 % with respect to the average net wage). It is very difficult to predict future development of this indicator since it depends to a considerable extent on several parameters, the future development of which is with certain limitations within the terms of reference of the Government. If we proceed on the assumptions that were used for the long-term projection of expenditure (Chapter 3.2 Financial sustainability) this level should be decreasing in future years to reach some 37 % with respect to the average gross wage (48.7 % with respect to the

<sup>18)</sup> For more details see the Annex.

average net wage) around 2026, with the subsequent moderate growth until the end of the projection in 2050. Future development of this indicator is influenced in particular by the assumption of valorization of the pensions paid out and at the same time the growing share of early old-age pensions in the total number of the pensions paid out in the examined period.

### Relation of the average old-age pension paid out to the average gross wage



The calculations performed on the basis of methodology agreed within ISG that defines the replacement rate as the proportion (ratio) of the pension in the first year of its receipt to the wage in the last year of the economic activity with respect to pre-defined individuals, show elements of income redistribution within the system and also certain dynamic aspects as the level of the pension strongly depends on the relation between the actual retirement age of the old-age pensioner and the applicable statutory retirement age (actual age for the old-age retirement is fixed for a hypothetical individual – 65 years, whereas the statutory retirement age is increasing). Results of the calculation are shown in the table below.

### Replacement rate according to the ISG methodology

CZ	100% of average earnings (last column: 10 years after retirement; relative to projected average earnings)					2/3 of average earnings		100% of average earnings in mean over the worklife, with rising (concave) earning profile (2)		Rising earnings from 80% to 120% of average		Rising earnings from 100% to 200% of average		Broken career: only 30 years of seniority at retirement (3)	
	2005	In 10 years	2010	2030	2050	2005	2050	2005	2050	2005	2050	2005	2050	2005	2050
Gross replacement rate 1 <sup>st</sup> pillar	60,7%	50,5%	58,1%	53,6%	53,5%	78,7%	69,7%	58,8%	51,6%	53,0%	45,7%	35,2%	30,7%	50,6%	43,6%
Gross replacement rate 2 <sup>nd</sup> pillar	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
<b>Total gross replacement rate</b>	60,7%	50,5%	58,1%	53,6%	53,5%	78,7%	69,7%	58,8%	51,6%	53,0%	45,7%	35,2%	30,7%	50,6%	43,6%
<b>Total net replacement rate</b>	79,3%	66,2%	76,2%	70,2%	70,0%	100,1%	88,9%	77,3%	67,9%	70,3%	60,7%	48,8%	42,6%	66,2%	57,2%
Of which means-tested benefits in % of total net RR	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-

Notes: (1) 2005 refers to pension in 2005 with reference to work income in 2004 except in case a MS needs to refer to a different moment or a previous year. (2) Worker starts at 69% and ends at 110% of the average. (3) 15 years of work at the beginning, then 10 years of complete absence from the labour market and finally further 15 years of work.

For the insured with growing income the replacement rate is lower and in the course of time drops slightly more than in the case of the insured with the stable level of income. This is caused by gradual extension of the length of the reference period (since 1986) from which income for the pension calculation is derived. The target status (according to the legislation in force), i.e. the 30-year period prior to the year of granting the pension will be reached in 2016.

In order to obtain the appropriate level of benefits from private pension schemes the citizens' confidence in these schemes should be further strengthened, the probability of higher revenues (yields) increased and thereby also more extensive involvement of citizens accomplished together with the collection of higher pension insurance contributions and subsequent payment of higher benefits. Further, possible modification to the conditions for pension entitlements should be considered and the system of state support reviewed with a view of gradual converting of private pension schemes to the long-term (pension) schemes. The changes in question should be implemented by means of the new legal regulation or major amendment to the current legislation.

### 3.1.4 Strategy of securing future adequacy

#### Current status

Dynamic nature of the Czech basic pension insurance scheme and the adequacy of pensions is based on annual updating of the actually earned income which is taken as the basis for the pension calculation subject to the general development of wages.

As far as the pensions paid out are concerned, the adequate level is secured by their regular valorization.

#### Basic rules for the valorization of pensions:

- the pensions paid out are increased on a regular basis every year in January; a different procedure is applied only in the case of a very low inflation (an increase would be less than 2 %) and high inflation (at least 10 %),
- an increase in pensions will be determined in such a manner that in the case of the average old-age pension it will account for at least 100 % of an increase in prices and also at least one third of an increase in the real wage,
- specific level of an increase will be determined by the Government through a directive and such increase may be higher than the minimum stipulated by law.
- an increase in the General Consumer Price Index for households in the aggregate is upon its regular growth since January fixed for a period of twelve months until July of the calendar year preceding an increase in pensions; the applicable year for calculation of an increase in real wages is the calendar year preceding by two years the year of an increase in pensions,
- an increase in pensions is decided by the Government; its decision-making must be based on data supplied by the Czech Statistical Office and the Czech Social Security Administration.

The legislation in force allows to the old-age pensioners to receive, apart from the pension, also income from gainful activity regardless of the level of their income.<sup>19)</sup>

The measures that enable to the pensioners to maintain the appropriate standard of living include the possibility to increase their pension by gainful activity subsequent to their becoming eligible for pension. This option has a long-standing tradition in the Czech legal order.<sup>20)</sup> The most recent change that consisted in further preferential treatment of the deferred old-age retirement<sup>21)</sup> started to be implemented since July 2001. Despite the fact that the pension for a period of gainful activity is increasing upon eligibility, the current legislation regulating this issue still fails to be neutral in terms of the actuarial calculation and therefore it does not have incentive effect on all income brackets of the insured.<sup>22)</sup>

#### Plans envisaged:

<sup>19)</sup> The sole „limitation“ in the case of concurrence of the old-age pension and income from gainful activity is entering into the employment for a period of at least one year, while such employment may be agreed repeatedly.

<sup>20)</sup> This institute was included already in the Act on National Insurance of 1948. Already at that time the purpose of higher increase of the pension in the case of the deferred retirement after the 60th year of the retiree was better old-age social security.

<sup>21)</sup> For each 90 calendar days of gainful activity pursued upon eligibility for the old-age pension without its drawing the level of the percentage assessment is increased by 1.5 % (6 % annually), in comparison with the former 1 % (4 % annually) of the calculation base. This new rate is the same as the rate for the entire year of the gainful activity pursued for a period preceding eligibility for a pension.

<sup>22)</sup> With the increased level of pre-pension income the „loss“ arising from the deferral of the retirement by one year (the paid pension insurance contributions and pension for one year) is higher than „profit“ (the whole life increase in pensions for the „additional“ year of work).

The basic pension insurance scheme contributes to a considerable extent to the reduction of poverty of the older generation. All its future changes should be performed in such a manner to prevent the occurrence of any threat to solidarity and the danger of social exclusion of persons in the pension and pre-pension age. On the contrary, such changes should be directed towards maintaining the current low level of exposure of the elderly persons to poverty.

An important instrument in combatting poverty is ensuring sufficiently wide and flexible supply of social services and the implementation of the active ageing policy associated with an increase in the employment rate of the elderly citizens. Especially for the older people the support and development of those services that allow staying in the natural environment is important (the family, the community).

Conducive to the mitigation of the current level of exposure of the persons to the poverty risk should be also the prepared amendment to the legal regulation of the institute of the subsistence level and the completely new Act on Social Need. The gist of these changes basically consists in the fact that while currently people who are dependent on social benefits have under comparable conditions equal social income, in the future this income should be different according to whether they actively seek participation in the labour market or not. The persons who do not exercise such efforts will not be eligible for social care benefits up to the subsistence level, but only up to the amount of the newly introduced so-called minimum living wage.

### **3.2 Financial sustainability of pension schemes**

A necessary prerequisite for securing the adequate level of pensions based on the agreed level of solidarity is financial sustainability of the basic pension insurance scheme. Real possibilities of obtaining income from private pension schemes must be also taken into account.

#### **3.2.1 Policy objectives**

Policy measures should be directed towards increasing the employment rate in general, and in particular towards maintaining the elderly persons in the labour market, towards developing and more extensive use of private pension schemes by higher participation of the population in these schemes and especially towards the improvement of the age structure of the population involved and strengthening the security of these systems. In order to accomplish a long-term financial sustainability, it will be necessary to implement further changes in the existing pension system and at the same time take measures in the field of public finance that would prevent further increase of the government debt and guarantee its cutting in the future whereby through savings of interest payments an increase of government expenditure associated with the population ageing may be partly mitigated. Policy measures targeted on the labour market and the pension system should create incentives for the higher employment rate of the elderly (55 to 64 years).

The extension of life expectancy still fails to be accompanied with the corresponding extension of the working life. However, an increase in the employment rate is an important factor for the enhancement of financial stability and sustainability of the pension system. Despite major restructuring of the Czech economy in the course of the past fifteen years and gradual rise in unemployment up to some 8% (according to the ILO methodology) which creates pressure on early old-age retirement, the real age for the old-age retirement has been slightly extended.

In 2003 the employment rate of persons aged between 55 and 64 years was 42.3 % (men 57.5 %, women 28.4 %). The Lisbon objective set the employment rate to be accomplished by 2010 at 50 %. Given the most recent trends, it may be assumed that the Czech Republic might accomplish this level by 2010. In 2004, the average retirement age was 59 years (men 61 years, women 57 years)<sup>23</sup>). It appears that the extension of the retirement age by five years by 2010, as determined by the Barcelona objective, is very unlikely to be accomplished.

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<sup>23</sup>) The average age for the old-age pension and full disability pension retirement was 57 years in 2004 (men 58 years, women 56 years).

## 3.2.2 Current situation in the field of financing

### 3.2.2.1 Revenue and expenditure of the basic pension insurance scheme

The basic pension insurance scheme is financed on the pay-as-you-go basis, the pension expenditure for a given period is covered from revenue derived from the pension insurance contributions paid in this period. Pension insurance contributions (the premium) that have been introduced since 1993 constitute the revenue of the state budget (similarly as the pension expenditure constitutes the expense of the state budget). Since 1996, a special pension insurance account has been established as part of state financial assets. Funds, that have arisen as a positive difference between revenue from pension insurance contributions and pension expenditure (including administrative expenses) and that may be used solely for an increase in pensions or for the redemption of negative balance of the pension insurance contributions, including expenditure associated with the collection of pension insurance contributions for this pension insurance scheme, are maintained in this account.

Since 1996, pension expenditure started to exceed revenue of the basic pension insurance scheme by some 9 %. With effect from January 2004, changes were made to the basic pension insurance scheme.

#### **Key changes in the basic pension insurance scheme adopted with effect as from 1 January 2004:**

- continuation in raising the retirement age for eligibility for the old-age pension, for the time being to 63 years for men and childless women<sup>24)</sup>,
  - limitation of possibilities of an early retirement of old-age pensioners,
  - limitation of the inclusion of the period of studies in the non-contributory period;
- At the same time measures pertaining to the pension insurance contributions were approved, in particular:
- increase in the percentage rate of pension insurance contributions to the basic pension insurance scheme from 26 % to 28 %<sup>25)</sup>,
  - gradual increase of the minimum assessment base for the determination of pension insurance contributions for self-employed persons.

As a result of these system modifications as early as in 2004 a change has taken place and expenditure of the basic pension insurance scheme was by 4 % lower than revenue from pension insurance contributions.

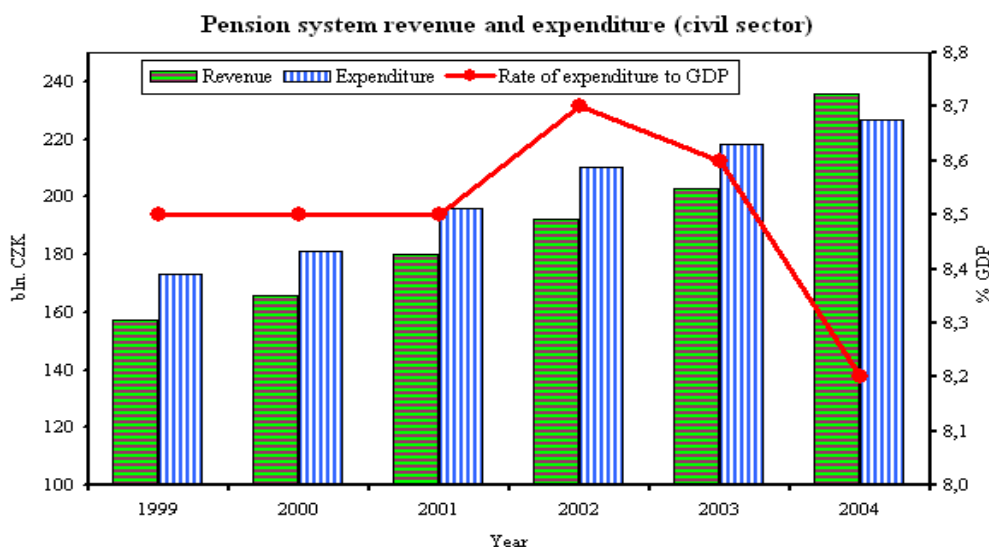
The financial balance of the basic pension insurance scheme is also strongly influenced by non-contributory periods in the course of which no contributions are paid and which account for some ¼ of all insurance periods included in the calculation of pension entitlements<sup>26)</sup>. If in the course of these periods pension insurance contributions were paid, the financial balance of the basic pension insurance scheme would be balanced for a longer period of time, however, such measure would not address the issue of financial sustainability and stabilization of public budgets.

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<sup>24)</sup> Unless there are any other legislative changes, the retirement age of other women will be differentiated according to the number of children brought up from 59 to 62 years.

<sup>25)</sup> Only the internal structure of the social insurance contribution rates and the state employment policy contribution rates has been changed – the overall burden remained the same.

<sup>26)</sup> This is the period of personal care for a child up to the age of 4 or 18 years, if this involves a child with a severe long-term handicap, the period of the compulsory military service or the community service (as alternative to military service), period of registered unemployment in the course of which the insured is eligible for unemployment benefits and the period in the course of which there is no eligibility for unemployment benefits lasting 3 years as a maximum, the period of personal care for a dependent person and the period of receiving full disability pension until reaching the retirement age for eligibility for the old-age pension. From the analysis of these periods prepared by the Prague Research Institute of Labour and Social Affairs (2004) is clear that in the set of the insured born before 1948 most often the period of registered unemployment was included in the calculation of pension entitlements (35 % of all respondents) and the time of personal care for a child (33 % of all respondents). The average proportion of the time of recognized alternative periods to the total recognized time was 22.4 % (20.1 % for men, 24.1 % for women); the proportion of the pension without alternative periods to the pension with included alternative periods was 81.4 % in 2002 (84 % for men and 80.6 % for women).



### 3.2.2.2 Revenue of the basic pension insurance scheme

Pension insurance contributions to the basic pension insurance scheme are paid by employees, employers and self-employed persons. The amount of pension insurance contributions has been determined at a flat percentage rate (28 %; of this amount employers pay 21.5 % and employees 6.5 %) from the assessment base that is constituted by allowable income before taxation.

The development of social insurance revenue is influenced especially by the development of the number of payers of pension insurance contributions and the average payment per one insured. The total number of payers of pension insurance contributions for the period between 1994 and 2004 dropped by 9 %, while in the period between 1999 and 2004 it has been temporarily stagnating. The amount of the average payment per one insured is also influenced by the fact whether the insured earn this income as employees or as self-employed persons.

Self-employed persons participate in the single basic pension insurance scheme (they do not have their own scheme). However, in comparison with other insured, a different legal regulation applies to them as regards the determination of the assessment base for the pension insurance contributions – they choose the level of the assessment base themselves subject to the determined rules. Most of them choose the lowest possible assessment base. As a result, the contribution of self-employed persons to the covering of the basic pension insurance expenditure is much lower than that of employees.

The average assessment base of self-employed persons is considerably lower and, for instance, in 2004 it was 30.8 % only, in comparison with employees. In the period between 1994 and 2004 the assessment base for employees was increased by 172 %, but for self-employed persons only by 69 %. The growing share of self-employed persons in the overall number of the insured (from 9.7 % in 1994 to 15.2 % in 2004) and a difference in the determination of the assessment base for the payment of pension insurance contributions by self-employed persons and employees has an adverse impact on the development of revenue of the basic pension insurance scheme.

In 2003, it has been decided on gradual increasing of the minimum assessment base for the payment of pension insurance contributions by self-employed persons. From 2006 onwards, it will be calculated as 50 % of the difference between income and expense, however, at least in the amount equal to the half of the average gross monthly income in the national economy fixed for the relevant calendar year. The purpose of this change is especially an increase in the participation of self-employed persons in the coverage of the expenditure of the basic pension insurance scheme.

The Government brought before the Chamber of Deputies of the Parliament an act whereby it introduces the maximum assessment base for the payment of insurance contributions also for

employees with a view of its future consolidation with the maximum assessment base for self-employed persons<sup>27)</sup>.

The success rate in the collection of pension insurance contributions is another factor influencing the level of revenue of the basic pension insurance scheme. Pension insurance contributions constitute revenue of the state budget and are collected by the state through territorial offices of the Czech Social Security Administration. For the entire period since the establishment of social insurance contributions in 1993, the proportion of contributions paid (the collection) to the contributions assessed (including fines and penalties) accounted for 97.5 % on the average. The proportion of the contributions collected to the contributions assessed (collection success rate) is improving considerably and therefore currently reaches almost 100 %. The arrears in contribution payments for this entire period account for only 2.5 % of the assessed insurance contributions, while more than one half of this sum represent penalties. More than one half of the receivables are due from deregistered entities.

Based on the above figures we may conclude that the collection of pension insurance contributions is successful in the long-term, but the problem is the legal regulation governing the determination of pension insurance contributions of self-employed persons and large extent of included non-contributory periods in the course of which no payments are made.

### **3.2.2.3 Expenditure of the basic pension insurance scheme**

Currently, the old-age pension expenditure represents the highest share in expenses of the basic pension insurance scheme which at present account for some 8.47 % of GDP. It is due to the fact that of the total number of pensioners most are old-age pensioners and the level of old-age pensions is the highest of all types of pensions. Of the total pension expenditure, old-age pension expenditure accounts for 72 %, disability pension expenditure for 18 % and the survivor's pension expenditure for 10 %. (For more detail see the Annex in table format.)

It may be expected that in connection with future introduction of higher incentives for maintaining the population longer in the labour market within the envisaged reform process, disability pensions will gain in importance as the way towards early retirement from the labour market<sup>28)</sup>. Persons who are eligible for the full disability pension even upon compliance with the conditions for eligibility for the old-age pension are not limited in any manner in the case of concurrence with the gainful activity. The only decisive factor is the examination of the health condition of the insured by the medical adviser of the Czech Social Security Administration.<sup>29)</sup> The problem of disability has an important regional dimension due to the fact that it is related to the situation in the labour market and to the many years of demanding work detrimental to the health of the insured and last, but not least, also to the lower quality of the environment. Currently, some 15 % persons aged between 50 and 64 years receive the disability pension.

### **3.2.3 Forecasts and tasks within policy objectives**

#### **3.2.3.1 Basic pension insurance scheme**

##### **Current status**

The key problem in the solution of the financial sustainability of the basic pension insurance scheme and the adequacy of pensions consists in the anticipated rapid ageing of the Czech population. The dynamics of an increase in the proportion of persons over 65 years to the whole population of the Czech Republic will be unique worldwide.

<sup>27)</sup> In 2007, the maximum assessment base should be quintuple, in 2008 quadruple and in 2009 triple the amount of the average gross wage.

<sup>28)</sup> This risk is higher due to the fact that the level of full disability pensions is in general higher than in the case of early old-age pensions. This results from the fact that in the case of disability pension the time from the occurrence of disability to the reaching of the retirement age for eligibility for the old-age pension is included in the calculation of pension entitlements, but the percentage assessment of the early old-age pension is determined according to the actually acquired reference insurance period which is then reduced because of the early retirement. This means that the percentage assessment of the disability pension is higher.

<sup>29)</sup> In 2004, a total of 71,000 review inspections were performed. Of this number in 32,000 cases full disability was recognized and in 29,000 cases partial disability was granted. In 10,000 cases of review inspections neither full nor partial disability was granted.

Changes in the Czech basic pension insurance scheme should be directed towards higher involvement of the elderly persons in the labour market and thereby to the raising of the real retirement age. In the Czech Republic, the employment rate of persons aged between 55 and 64 years was increased from 36.3 % in 2000 to 42.3 % at present, however, measures will have to be considered consisting in further preferential treatment of the deferred old-age retirement, in the possibility to convert the old-age pension for the working activity pursued subsequent to the granting of this pension during its receipt and in further continuation of the raising of the retirement age for eligibility for the old-age pension. As far as the early old-age pension retirement is concerned, the current legal regulation, subsequent to the measures taken in 2001 and 2004, does not have incentive effect on early retirement from the labour market. This conclusion arises from the calculations performed based on the criterion of implicit tax showing that the current early old-age pension system is in general neutral in terms of actuarial calculations.

#### Anticipated development:

The projection<sup>30)</sup> is based primarily on the current legislation and on the assumption that it is not going to be changed in the future. Even if the legislation remains unchanged, the basic pension insurance scheme is not rigid. It involves certain important parameters the development of which is influenced by the Government's decisions. Specifically, these are reduction limits that reduce the level of income for the pension calculation, the basic pension assessment and the manner of indexation of the pensions paid out.

For the purposes of the projection, the values of the following important parameters have been determined as follows:

- valorization of the pensions paid out: CPI + 1/3 of an increase in the average real wage
- indexation of the basic assessment: according to the development of the average real wage
- indexation of reduction limits: according to the development of the average real wage

Based on the above assumptions, expenditure for the basic pension insurance scheme from the initial level slightly above 8.4 % of GDP<sup>31)</sup> should first drop in the short-term to 8% and then start to grow up to the level of 12.5 % GDP at the end of the projection (year 2050). A short-term moderate drop in expenditure is caused in particular by the assumption of the valorization of pensions at the level lower than the rate applicable to wages (valorization according to the inflation rate and one third of a rise in the average real wage). In relative terms to GDP, therefore, within the next 50 years, pension expenditure will grow by some 50 %.

The development of the total expenditure of the basic pension insurance scheme is determined especially by the dynamics of expenditure for old-age pensions and to a lesser extent by rising expenditure for disability pensions. This is a consequence of the anticipated rise in the number of pensioners in these categories. As far as the number of old-age pensioners is concerned, their rise from 1.95 million in 2004 to more than 3 million in 2050 is anticipated. As far as disability pensioners are concerned, their rise from 555,000 in 2004 to 685,000 in 2035 is anticipated. Afterwards, the number of disability pensioners should gradually drop to the level of some 620,000 in 2050. The total number of pensioners participating in the basic pension insurance scheme should, as a result of the above mentioned trends, grow from 2.6 million in 2004 to 3.8 million in 2050.

As a consequence of the ageing of the Czech population the proportion of pensioners to payers of pension insurance contributions grew from the level slightly below 50 % in 1993 to some 55 % in 2004 and due to the anticipated ageing will further grow up to the level of some 93 % around 2050.

Due to the anticipated development of revenue from pension insurance contributions at 8.4 % of GDP, the basic pension insurance scheme will record until the first half of the 20's slight financial

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<sup>30)</sup> The national demographic and macroeconomic projection was used. This was due to the fact that at the time of preparation of NSRP the agreed demographic scenario prepared by Eurostat was not available and therefore the macroeconomic scenario prepared by the European Commission on the basis of a single methodology was not available, either.

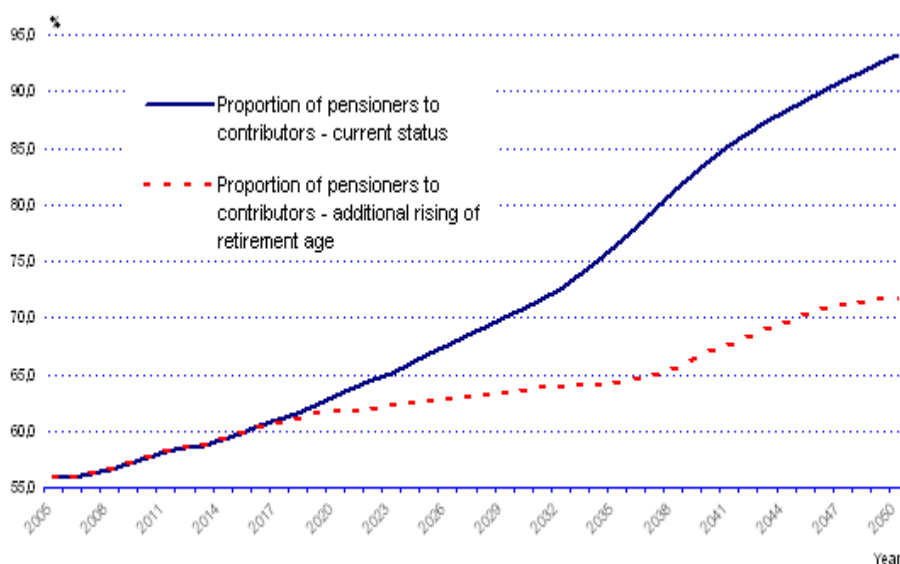
<sup>31)</sup> Including administrative expenses at 1.8 % of income from the pension insurance contributions collected.

surpluses. On a cumulative basis, these surpluses may exceed almost 6 % of GDP at the beginning of the 20's. A rise in expenditure in relation to GDP will first result in the balancing of the financial position and then in gradual rise in the deficit of the basic pension insurance scheme that will reach the level of 4 % of GDP at the end of the projection. The negative cumulative balance will be converted to positive balance around 2035 and around 2050 the debt will account for less than 50 % of GDP.

In the case that no further modifications are made to the basic pension insurance scheme that would either build on the changes already implemented (i.e. especially the gradual raising of the statutory retirement age for the old-age pension retirement) or that would perform extensive restructuring of the basic pension insurance scheme, the financial basis of this scheme would not be sustainable in the long-term.

The deferral of the retirement of old-age pensioners may be deemed to be the most important instrument that enables to face the impacts of population ageing (in particular extending life expectancy). Already now, however, the basic pension insurance scheme includes elements that have incentive effect on the deferral of the retirement of old-age pensioners, specifically a reduction in the amount of the pension granted, if the old-age pensioner retires before reaching the statutory retirement age, and preferential treatment of the retirement deferral until the moment of reaching the statutory retirement age. The calculations show impact of further raising of the statutory retirement age over the currently fixed 63 years for men and 59 to 63 years for women. These retirement ages will be effectively reached in 2016 and 2019, respectively.

#### Development of the proportion of pensioners to contributors

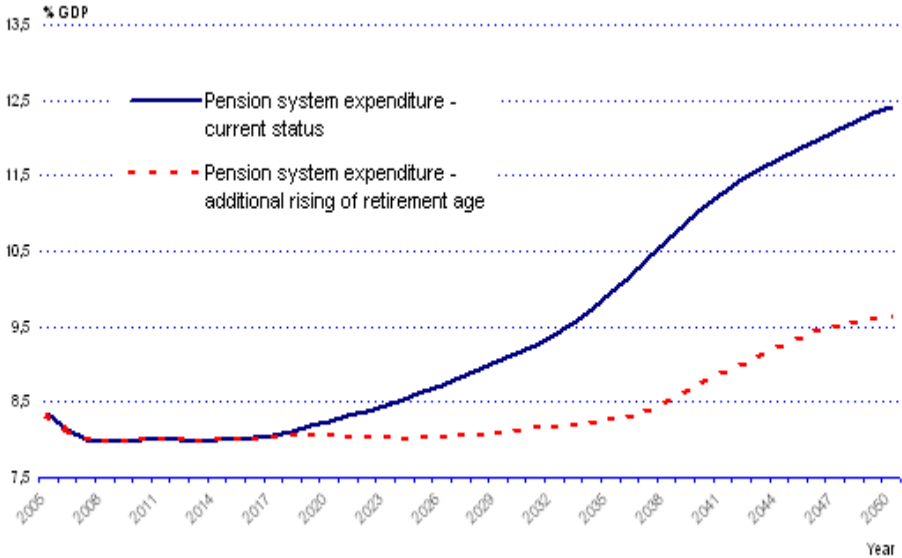


If the raising of the statutory retirement age continues on the basis of the same principles applied to date (i.e. by 2 months for men and by 4 months for women annually<sup>32)</sup> even after 2013, namely until the end of the projection in 2050, men will retire in 2050 approximately in 68 years on the average and women in 67 years on the average (after 2050 the impact of strong age-groups born in the 70's and the low number of citizens born at the turn of the century becomes evident). Pension expenditure will in such a case rise from the current 8.4 % of GDP to 9.6% in 2050, with a trend similar to the one described above. A drop in expenditure will be caused in particular by the lower number of pensioners whose total number will under these circumstances „only“ grow to less than 3.3 million in 2050. Due to the changed development of expenditure, under these circumstances, slight surplus will be generated in the basic pension insurance scheme until the second half of the 30's when it will reach approximately 12.5 % of GDP on a cumulative basis. Afterwards, the basic pension insurance scheme will record a deficit that will be increased up to the level of 1.2% GDP in 2050. From the viewpoint of the cumulative financial position, the basic pension insurance scheme in 2050

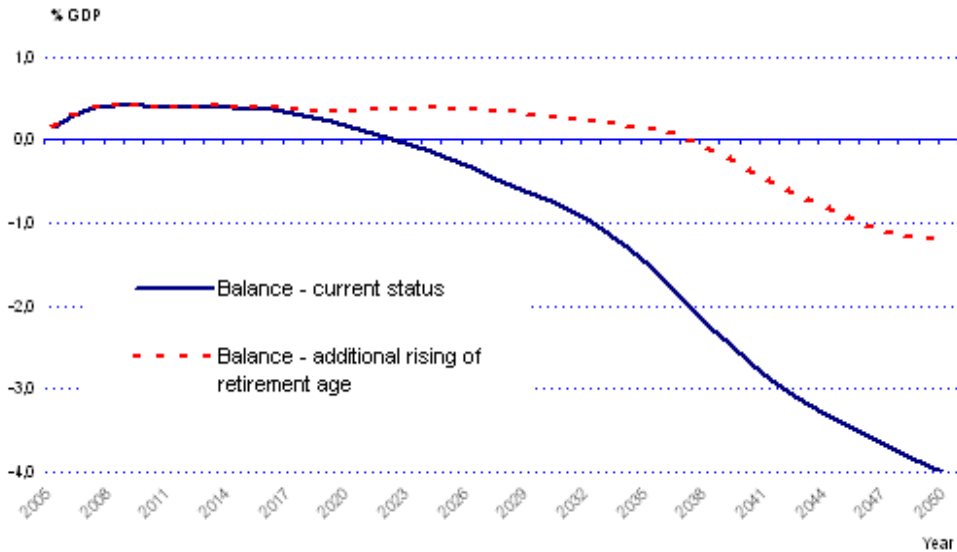
<sup>32)</sup> or even for women by two months annually once they reach the retirement age for eligibility for the old-age pension of men

will be roughly balanced. It is obvious that a shift in the statutory retirement age for eligibility for the old-age pension (and at the same time an increase in the employment rate) has a significant impact on the overall financial stability of the basic pension insurance scheme. Despite this fact, even under these circumstances, the scheme cannot be deemed to be fully financially stable in the long-term, since the deficit in the range of 1.2% of GDP poses a risk for the development after 2050.

**Development of the pension system expenditure**



**Development of the pension system balance**



**3.2.3.2 Private pension schemes**

**Current status**

Currently, the general level of pensioners’ income from private pension schemes is negligible. The average amount of a contribution of participants in the state-subsidized supplementary pension insurance schemes is not high enough to accumulate the funds sufficient for the payment of the „reasonable“ life annuity.

Certain risk associated with state-subsidized supplementary pension insurance pose especially guarantees related to the payment of pension benefits. Such guarantees include in particular

guaranteed interest rates for the calculation of pensions and guaranteed mortality tables. Despite the fact that these guarantees were abolished for new members last year, they are retained for most participants. The law does not stipulate the obligation that the annual crediting of the share in profit/loss, valuation of risk exposure of the pension plan for a long-term financial stability of the pension fund, the calculation of the proper level of reserves, balance of accounts of participants in the pension plan and the reserve fund be verified by the actuary.<sup>33)</sup>

Pension funds are obliged by law to guarantee positive revenue (yield) for participants which is of key importance for investment strategies and thereby for the profitability of pension funds. From 1995 to 2003, the average credited nominal revenue (yield) was 6.2 %, real revenue (yield) was 0.7 %. On the other hand, the lower level of revenue (yield) is compensated by higher security of investments.

The advantage of the state-subsidized supplementary pension insurance scheme is its easy regulation since basically it is regulated by the single act only. The state supervision over pension funds is executed by the Ministry of Finance and the Czech Securities Commission. The Czech Securities Commission is exclusively in charge of the activities of the funds or depositories pertaining to the placement of the pension funds' resources or the control over the placement of the pension funds' resources. Each fund is obliged no later than within 3 months after the end of half a year and the calendar year publish reports on the management of the fund's business operations, the overview of the placement of the fund's resources and the type and amount of investment. Pension plans are authorized by the Ministry of Finance in collaboration with the Ministry of Labour and Social Affairs.

Private life insurance has much longer tradition in the Czech Republic. The regulatory and supervisory activity with respect to life insurance is fully compliant with the EU requirements. Supervision is performed by the Ministry of Finance which co-operates with the Czech National Bank and the Czech Securities Commission especially in the field of supervision over financial groups and conglomerates.

#### Plans envisaged

Future requirements for the financing of adequate pensions will depend on future progress of the pension reform. It is obvious that much more significant portion of the funding will have to be provided from private resources than at present.

Within the state-subsidized supplementary pension insurance schemes it will be necessary to

- separate the shareholders' assets from the participants' assets and thereby enable the pension funds to offer pension plans with diversified investment focus,
- increase the coverage rate, especially with respect to younger age brackets,
- motivate members of these schemes to pay higher contributions,
- motivate employers to higher involvement and higher contributions,
- limit the drawing of the lump sum settlement and
- eliminate the guarantee of the year-on-year positive revenue (yield).

Various experts across individual institutions have agreed that the above changes are necessary. These changes will also require to amend the Act on State-Subsidized Supplementary Pension Insurance Schemes.

Private life insurance schemes are rather chosen by middle and higher income brackets of the population. The fact that no maximum limit on pension insurance contributions for the basic pension insurance scheme has been fixed, is a factor that limits to a considerable extent further development of, inter alia, the private life insurance schemes. The fixing of this upper limit, together with higher tax incentives for both the insured and employers would contribute to higher participation in these schemes and higher contributions paid by participants to both privately funded pension systems.

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<sup>33)</sup> Despite this fact most pension funds have their own actuary and the remaining funds hire external actuaries.

### **3.2.4 Strategy for the solution of differences in financing**

The purpose of the concept of the public finance reform adopted in 2003 and split into two stages was to ensure a long-term sustainability of public budgets. The first stage was focused primarily on the stabilization of the public budget deficit and in the course of its implementation a number of regulations and measures have been adopted with a view to achieving budget cuts. These measures include also changes in the basic pension insurance scheme adopted with effect from 1 January 2004. These measures have ensured the stabilization of the Czech basic pension insurance scheme for a certain period (approximately until 2023), however, they are unable to resolve the consequences associated with future adverse development (especially the demographic one) and thus address the problem of financial sustainability of the basic pension insurance scheme and the adequacy of pensions. Future problems will be so serious that within this decade additional major reform measures must be considered with respect to the existing structure of the system. (Discussions on radical structural changes are under way in the Czech Republic for a number of years already – addressing the issue of strengthening private fund schemes, the level of equivalence, etc.; however, no consensus has been reached, so far).

#### **The following measures need to be considered in particular:**

- a) consider additional gradual extension of the retirement age for eligibility for the old-age pension with a view of its consolidation for men and women. This measure should result in effectively later retirement and thereby the extension of economic activity and finally full application of the principle of equal treatment of men and women,
- b) consider further extension of the period from which income for the pension calculation is derived,
- c) consider the limitation of the possibility to include non-contributory periods in the calculation of pension entitlements and the possibilities of financial covering of these periods,
- d) consider a change in the manner of indexation of the income actually earned for the purposes of pension calculation that would consist in reflecting the revenue of the basic pension insurance scheme in the assessment of pensions,
- e) consider a change in the method of pension valorization,
- f) consider the possibility of introducing gradual retirement of old-age pensioners with the option of converting this pension paid out in addition to income from gainful activity,
- g) consider updating (objectivization) of criteria for the reviewing of the percentage decline in the capacity for systematic gainful activity when determining the disability grading (classification) with regard to the changing external conditions and new scientific knowledge.

When considering the above measures also effects of possible changes in other areas must be taken into account (for instance in the area of the labour market or social care).

### **3.3 Modernization of the pension systems in connection with the changing requirements of the economy, society and citizens**

#### **3.3.1 Relation of the pension insurance to the changing conditions, labour market and various models of employment (gainful activity)**

The aim of modernization of the Czech basic pension insurance scheme should be its capability to respond better to the changing needs of society and its individuals, accommodation to various forms of employment and requirements for territorial mobility, fully respecting the principle of equal treatment of men and women, its transparency and credibility with respect to the citizens. In connection with modernization, continuous and most complete information should be available for the citizens on their entitlements arising from the basic pension insurance scheme.

##### **3.3.1.1 Impact of the changing external conditions on the basic pension insurance scheme**

In contrast with the status prior to the year 1996, the current pension insurance scheme is dynamic, since it responds to the development of the surrounding environment. As a response to the extending life expectancy the statutory retirement age for the eligibility for the old-age pension is gradually being raised. This process is in progress on a continuous basis since 1996. Also the reference period, from which income for the pension calculation is derived, has been gradually extended since

1996 from the originally five-year period to the target thirty-year period in 2016. Thereby the pension system more or less (objectively) reflects the economic activity of the citizens. Values of certain components of the pension calculation structure are changing every year subject to the general development of wages. The valorization of pensions must by law at least fully reflect an increase in prices and reflect by one third a rise in the average real wage.

### **3.3.1.2 Mobility and persons covered by pension insurance schemes**

Universal, single and statutory Czech basic pension insurance scheme is not an impediment to the mobility of persons and covers all economically active persons, including the persons changing relatively often their job and persons who pursue their gainful activity on a part-time basis at least to a minimum extent<sup>34)</sup>. The basic pension insurance scheme is not an impediment to the self-employment activity, either. The amount of the pension may be influenced by the circumstance which applies in general, namely that the insured was not in the reference period, from which income for the pension calculation is derived, continuously pursuing gainful activity and therefore did not have any income in the course of this period.

As far as private pension schemes are concerned, their legal regulation is not an impediment to the labour force mobility.

### **3.3.2 Equal treatment of men and women**

The key area where the principle of equality of men and women needs to be promoted is the labour market, since pension benefits are derived from the amount of previous income. Among the measures that should significantly reduce the difference between men and women, is gradual elimination of differentiated retirement age for the eligibility for the old-age pension of men and women<sup>35)</sup>. As far as the basic pension insurance scheme is concerned, the principle of equal treatment of men and women is being promoted.

The existing different retirement ages for men and women for eligibility for the old-age pension are deemed to be a temporary derogation from the principle of equal treatment that is allowed by the Council Directive of 19 December 1978 (79/7EEC) on the progressive implementation of the principle of equal treatment for men and women in matters of social security. Consequently, it will be necessary, as regards raising the retirement ages for eligibility for the old-age pension, to continue the differentiated raising, namely more considerably with respect to women with the aim of consolidating these limits for men and women. In 1996, also conditions for eligibility for the survivor's pensions of men and women and the manner of determination of their amount were in fact consolidated. Temporarily, only the age in which a survivor becomes eligible for the permanent survivor's pension remained different.<sup>36)</sup> Since 1996, the period of personal care for a child up to the age of 4 years may be recognized even for men, if they really take care for a child (however, the same period of care for one child cannot be simultaneously recognized for a man and a woman). The eligibility for the survivor's pension arises from the basic pension insurance scheme, if at the time of death the marriage continued; the eligibility for pension lapses upon entering into new marriage and in the case of repeated death the widow is entitled to receive the pension from the last deceased husband.

Eligibility for the survivor's pension arises from the state-subsidized supplementary pension insurance scheme for an individual appointed by the participant (in the supplementary pension scheme) in the relevant contract; even more persons may be appointed. If the deceased participant did not receive any pension and no entitlement to the surrender or the survivor's pension has arisen, the entitlement from the supplementary pension insurance scheme becomes subject-matter of inheritance. Where there are no heirs, it becomes property of the pension fund.

### **3.3.3 The progress of preparation of the pension reform and the availability of information**

Previous development:

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<sup>34)</sup> Income of at least CZK 400 per month and the duration of the working activities for at least seven successive calendar days.

<sup>35)</sup> The retirement age for eligibility for the old-age pension has been increased since 1996 every year by 2 months for men and by 4 months for women, for the time being, until 63 years for men and childless women and until 59 – 62 years according to the number of the brought up children for women.

<sup>36)</sup> For women this means reaching the age of at least 55 years and for men at least 58 years.

The Czech basic pension insurance scheme in its current form started to be shaped at the beginning of the 90's and was fully implemented in 1996. However, even subsequent to the passage of the Act on Pension Insurance other reform measures were taken on an ongoing basis.

**The key measures implemented since the beginning of the 90's up till now:**

**In the years 1990 to 1992**

- the discrimination of self-employed persons was removed and preferential treatment within the pension system eliminated and thus almost all economically active persons started to acquire pension entitlements subject to uniform conditions,
- implementation of the pension insurance and sickness insurance was consolidated in terms of its organization,
- rules for pension valorization were put in place.

**In 1993**

- pension insurance contributions were established (as revenue of the state budget).

**In 1994**

- The Act on the State-subsidized Supplementary Pension Insurance Schemes was passed and the Czech pension system comprised of two pillars was formed.

**In 1995**

- new Act on Pension Insurance was passed that laid down such crucial measures as, in particular, gradual raising of the retirement age for eligibility for the old-age pension, reflecting the general development of wages in the assessment of the level of pensions and, basically, equal treatment of men and women.

**In 1996**

- special pension insurance account was established as part of the state financial assets that enables, though within the state budget, to define the balance of the basic pension insurance scheme.

**In 1997**

- the recognition of most non-contributory periods was limited and conditions for pension valorization were specified.

**In 1999**

- By the amendment to the Act on Supplementary Pension Insurance Schemes the level of safety of investments (deposits) of participants in the supplementary pension insurance schemes was increased and the possibilities of these supplementary schemes extended, including the introduction of tax allowances.

**In 2001**

- incentives for early retirement of old-age pensioners were reduced and preferential treatment of the deferral of retirement for this type of pension put in place.

**In 2002**

- rules for valorization of pensions were changed and specified.

**In 2003**

- it has been decided on further continuation of raising the pension age even after 2006,
- possibilities of early retirement of old-age pensioners have been limited,
- inclusion of the period of studies into the calculation of pension entitlements was reduced,
- limitation of the payment of old-age pension benefits by the level of income was abolished,
- the percentage rate of pension insurance contributions was increased and this rate was reduced for the state employment policy contributions – the overall burden remained unchanged,
- it has been decided on gradual increase in the minimum assessment base for insurance contributions of self-employed persons (in the years 2004 to 2006)
- by the amendment to the Act on Pension Insurance the legislative regulation was harmonized with the EU law.

## Current status and future development

After the above parametrical changes the basic pension insurance scheme has been stabilized for a period of approximately 20 years. Revenue from pension insurance contributions will be sufficient to cover the expenditure of the scheme that will range from 8 % to 9 % of GDP. Then, however, a dramatic rise in expenditure will follow. Consequently, due to the inertia of the scheme it is necessary to consider already now further important reform steps.

Based on political negotiations in 2004 the Expert Team was established, in which political parties<sup>37)</sup>, the Prime Minister, the Minister of Labour and Social Affairs and the Minister of Finance have their representatives. Further, a specialized working group was formed, charged with the task to analyze proposals for individual options of the pension reform that were submitted by political parties through the Expert Team (for more details, see the Annex). The process of preparation of these analyses was transparent, open and public. The professional and lay public were given the opportunity to participate in this process or follow it and comment on it through written contributions responding to information published on web sites. Once a month information was made available on the progress of work. This information was placed, inter alia, also on web sites. The results of the work of the Expert Team will be used for further political negotiations.

The course of preparation of the pension reform is also discussed on an ongoing basis at the sessions of the Council of Economic and Social Agreement of the CR (so-called Tripartite). It is comprised of representatives of the Government, employers and trade unions. Participants in the sessions may present their opinions, comments and recommendations.

As far as the main authority in charge of the insurance system is concerned (The Czech Social Security Administration)<sup>38)</sup>, it seeks to enhance continuously the quality of administration in general, especially through the improvement of technical facilities with a view of creating a modern institution with a high quality of contact with the insured. Since 2005 employers submit every year, on a regular basis, to the authority in charge of the insurance system the so-called pension insurance personal files of their employees (the insured) for the previous calendar year. Since 1 July 2005, the Register of the Insured has been established that contains the data stipulated by law on persons participating in the sickness insurance scheme and the pension insurance scheme on account of gainful activity. These data are continuously updated and supplemented. Thereby also conditions have been created for the regular availability of information for the insured on the data pertaining to their pension entitlements. The annual provision of information in writing upon request of the insured pertaining to their reference insurance period and assessment base for the pension calculation in the form of the so-called pension insurance personal information file is envisaged from 2006 onwards. The final purpose envisaged is to inform the insured about their future entitlements from the pension insurance if certain prerequisites are met. Changes implemented by the authority in charge of the insurance system are directed especially towards digitalization of the registered information on the insured, towards centralization of data and process management and decentralization of the execution of agenda in order to be as close as possible to the client.

Conducive to general availability of information on the status and development in the field of pension insurance was also the comprehensive report on activities of the main authority in charge of the insurance system. This report was prepared for the first time in 2004 and is going to be drawn up every year. Apart from this, on a regular, bi-annual basis, the review of the Czech social insurance system is prepared by actuaries of MLSA. Both these reports that were dealt with by the Government in 2004 were placed on freely accessible web sites.

The Ministry of Finance publishes every year annual reports on private pension systems. The public may obtain further information from the web sites of individual pension funds and life insurance companies.

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<sup>37)</sup> All political parties represented in the Chamber of Deputies of the Parliament.

<sup>38)</sup> In the case of members of armed forces and corps, social security bodies of the Ministry of Defence, Ministry of Interior and Ministry of Justice are authorities in charge of the insurance system.

## 4. Conclusions

At the beginning of the 90's of the past century together with the decision on economic reform it has been decided also on the reform of the social system. As far as the field of pensions is concerned, reform measures were taken continuously since 1990. The most important change was the passage of the Act on Pension Insurance in mid-90's which introduced with effect from 1 January 1996 such crucial measures (especially from the long-term viewpoint) as gradual raising of the retirement age for eligibility for the old-age pension together with narrowing the gap between these retirement ages for men and women and reflection of general development of wages in the pension calculation. The current legal regulation is not an impediment to the labour force mobility.

The basic pension insurance scheme covers almost all economically active population and through non-contributory periods also persons who do not pursue gainful activities on specified grounds (for instance care for a child). The average old-age pension was in 2004 at the level of 57 % of the average net wage (44 % of the average gross wage). Open access to voluntary private pension schemes has been enabled, however their contribution to pension income of pensioners is, for the time being, negligible. Only 4% of persons over 60 years are below the poverty line. Despite the fact that with higher age the exposure to the poverty risk slightly rises, less than 7% of persons over 75 years are below the poverty line. The employment rate of the elderly persons aged between 55 and 64 years is approximately at 42 %. This positive situation, however, has also its negative tendencies especially in the field of adequacy and sustainability of pensions. The current pension system is to a considerable extent redistributive and is based on "levelling out", with a relatively high insurance rate. This has negative impact on persons with above-average income who receive low level of compensation for their pre-pension income. The existing level of the insurance rate at the same time does not allow such persons to increase their pension from their own resources.

The dynamic nature of the basic pension insurance scheme arises from the annual updating of income for the pension calculation according to the general increase in wages. The adequacy of the pensions paid out is secured through valorization. Even in the case of a minimal valorization stipulated by law an increase in prices must be fully reflected and a rise in the real gross wage must be reflected at least by one third.

Even after the passage of the Act on Pension Insurance other changes were implemented continuously. These changes were aimed especially at further limitation of inclusion of non-contributory periods in the calculation of pension entitlements, disincentives for early retirement and preferential treatment of the deferred retirement. In 2003 it has been decided to continue the raising of the retirement age for eligibility for the old-age pension.

Through the implementation of the authorized changes, since 2004 the basic pension insurance scheme has been stabilized for a period of approximately 20 years. However, the measures so far taken will not sufficiently guarantee the adequacy and sustainability of pensions. Due to the anticipated ageing of the Czech population that is going to be among the fastest ones in Europe, an increase in the ratio of pensioners to contribution payers may be expected to be shifted from 55 % in 2004 up to the level of some 93 % around the year 2050. This development inevitably needs to be accompanied by the adoption of further reform steps.

Political parties have submitted in 2004 various options of the pension reform. The future shape of the Czech pension system was considered by the Expert Team. The final report will be used for further political negotiations. Also the authority in charge of the pension insurance system is preparing for changes in the pension system. Together with changes in the basic pension insurance scheme (1st pillar) changes in voluntary private pension systems will be considered with a view of increasing their importance. Possible changes will be considered also in the field of employment, in particular with the aim of maintaining older workers longer in the labour market. Social partners have been informed about the progress of the pension reform. Sufficient availability of information for the citizens is also envisaged.

## Summary of abbreviations

- ČR (CR, CZ) – Česká republika (Czech Republic)
- EU (EU25) - Evropská Unie (European Union)
- OMC (OMC) – Otevřená metoda koordinace (Open Method of Coordination)
- HDP (GDP) – Hrubý domácí produkt (Gross Domestic Product)
- SPC (SPC) – Výbor pro sociální ochranu (Social Protection Committee)
- ISG (ISG) – Podskupina pro indikátory SPC (Indicator Sub-Group of SPC)
- MPSV (MLSA) – Ministerstvo práce a sociálních věcí (Ministry of Labour and Social Affairs)
- ČSSZ (CSSA) – Česká správa sociálního zabezpečení (Czech Social Security Administration)
- MF (MF) – Ministerstvo financí (Ministry of Finance)
- KCP (CSC) – Komise pro cenné papíry (Czech Securities Commission)
- ČSÚ (CSO) – Český statistický úřad (Czech Statistical Office)
- ČNB (CNB) – Česká národní banka (Czech National Bank)
- APF (APF) – Asociace penzijních fondů (Association of Pension Funds of the Czech Rep.)
- ČAP (CIA) – Česká asociace pojišťoven (Czech Insurance Association)
- MOP (ILO) – Mezinárodní organizace práce (International Labour Organisation)
- SB (WB) – Světová banka (World Bank)
- MASZ (ISSA) – Mezinárodní asociace soc. zabezpečení (Internat. Social Security Assoc.)
- MMF (IMF) – Mezinárodní měnový fond (International Monetary Fund)
- OECD (OECD) – Org. pro ek. spolup. a rozvoj (Org. for Econ. Cooperat. and Development)
- CPI (CPI) – Index spotřebitelských cen (Consumer Price Index)
- PF (PF) – Penzijní fond/y (Pension Fund/s)
- PAYGO (PAYGO) – průběžné financování (pay-as-you-go financing)
- DB (DB) – dávková definovanost (defined benefits)
- DC (DC) – příspěvková definovanost (defined contributions)
- ŽP (LI) – životní pojištění (life insurance)
- NDC (NDC) – příspěvková definovanost v PAYGO systému (notional defined benefits)
- RHSD – Rada hospodářské a sociální dohody (Tripartite)
- OSVČ – osoba samostatně výdělečně činná (self-employed person/s)
- IFRS (IFRS) – Mezinárodní finanční standardy (Internat. Financial Reporting Standards)
- mil. – milion (million)
- mld. – miliarda (milliard (UK), billion (US))
- Kč (CZK) – česká koruna (Czech crown – Czech currency)