PRIVATE PENSION FUNDS AND PENSION REFORM IN THE CZECH REPUBLIC

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1. Introduction

The Czech pension system is going through an extremely important phase of its development. While the underlying trends are as worrying as elsewhere in developed or transition countries, the short term accounts look balanced and radical reform does not seem imperative. In this article we argue, however, that the pension system's long term properties are more important than its immediate characteristics, and that pension reform would promote the development of the Czech economy. It would better prepare the Czech Republic for the future when almost one half of its adult population will consist of pensioners. As we have argued,[1] a funded pension system would lead to higher economic growth and would leave the state with a proper role to play: guaranteeing a decent, albeit modest, income level for the poor. Such a reform nevertheless would require a very clear set of rules and a strong regulatory authority to guarantee the prudent behaviour of pension fund management. The Czech experience seems to suggest that a strong financial network is unlikely to emerge without a substantial and radical pension reform that would divert a major part of pension savings to the private pension funds. We, therefore, examine suitability of existing private pension funds' network and its main flaws.

2. The Current Czech Pension System and Its Metamorphosis

The current social security dilemma can be described as follows. First, the Czech Republic is beginning to feel the fiscal impact of increasing numbers of pensioners as it spends almost 10% of its GDP on pensions. Second, the relatively generous pension benefits promised by the state hamper the development of private pension funds (PFs) and insurance companies. Third, social security system is subject to widespread manipulation and evasion. This causes higher benefits to be paid out and lowers the contributions collected by the state, thereby exacerbating the social security balance. Last, but not least, social security system is dangerously under-funded, as it operates on a pay-as-you-go basis, and is therefore poorly suited to cope with ageing populations.

While various partial measures aimed at trimming the cost of pension systems are highly desirable, the need for a thorough reform is mounting.[2] Such a reform has to proceed

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[1] And as has been argued elsewhere, see among others *Averting The Old Age Crisis*, The World Bank, 1994, Larry Kotlikoff "Privatization of Social Security - What It Is and Why It Matters", NBER 1996 or Robert Holzmann "Funded and Private Pensions for Eastern European Countries in Transition?", *Revista de Analysis Economico*, June 1994, Ondrej Schneider "Simulation of Pension Reform", *CERGE Discussion Paper*, 1996.

[2] Without a change, in 2020 the Czech pension system will have accumulated debt of about CZK 1,500 billion, equivalent to about 40% of GDP at that year.

along several parallel dimensions. First, a significant downsizing of the public system, featuring increases in retirement age and tightened eligibility for early retirement, is urgently needed. Second, the replacement ratio that measures the share of pension in the average wage, needs to be decreased from the current level of 42%. Such a high replacement rate leaves scarcely any space for introduction of private pension schemes, as people believe that the pensions provided by the state will secure sufficient income during the retirement. The relative share of the "flat" part of pensions (i.e., pension that is independent of previous salary) needs to be increased, so that pensions can play a genuinely redistributive role and provide greater social security. The pension system's insurance aspect, as reflected in the notion "the higher the salary, the higher the pension," should be abolished and left to private markets, where people can seek appropriate insurance contracts. The contribution rates need to be decreased appropriately in line with fall in the replacement rate.

3. Private Pension Funds in the Czech Republic

Perhaps most importantly, a pension reform needs to increase the private pension funds' role. Although pension reform would require a new and tightly regulated network of pension funds that would be licensed to seek workers' contributions, it might be useful to look at the current pension funds, which operate on a voluntary basis. The private pension fund system in the Czech Republic was launched in September 1994. Between September 1994 and November 1996, 44 private pension funds were established in the Czech Republic, a country with labour force of about 5 million people. The number of PFs is therefore generally recognised as being too high for the potential pool of participants, which is estimated at 2-3 million. As of October 1996, about 1.6 million people participated in the Supplementary Pension Insurance System (SPIS), and 200,000-300,000 clients are estimated by the Finance Ministry to join the program in 1997.

Table 1 Participation in SPIS

Date	**Number of participants in APIS**	**Government Contributions** (CZK mill)
December 31, 1994	183 336	23,859
June 30, 1995	998 579	271,279
December 31, 1995	1 290 126	360,382
June 30, 1996	1 489 232	499,594
September 30, 1996 (preliminary)	1 600 000	500,000

Source: Ministry of Finance

The majority of participants are concentrated in the four largest PFs. Twenty funds with less than 10,000 participants are likely to either be swallowed up by a larger fund or cease to exist, as their relatively small size will not allow them to allocate clients' savings efficiently.

According to data from December 1996, the average monthly contribution per participant was 315 CZK (about 3% of average wage), which implied an average state contribution of 110 crowns[3] Average contribution to the state pension system reaches 2600 CZK monthly. [4]. Therefore, if we assume that a client contributed this average amount to his/her private account during all of 1996, the final annual increase of his/her savings, without taking into account the possible profit from PF, would be 5,100 CZK ($189).[5] The average client was therefore able to save an amount of money equal roughly to one half of the average monthly wage.[6] This amount cannot significantly relieve the pressure on the state pay-as-you-go system, and lacks the strength to influence the Czech capital market. This is especially unfortunate, since these funds could serve as a backbone for further reform of the Czech pension system. Moreover, only a fully-fledged reform would bring appropriate incentives and would have a prospect to reap rewards of prudent investment strategies.

The age structure of participants is significantly biased towards the older generation, as only about 10 percent of all participants are under 30. Both for men and for women, the age cohort immediately proceeding the retirement age is the most represented among the private pension participants. This is a clear consequence of the current pension system which crowds out almost all pension savings by levying 26% contribution rate on wages. Moreover, the average contribution is strongly correlated with distance to retirement as well. As shown in Figure 1, men and women make the highest contributions in the immediate pre-retirement 55-59 and 50-54 age cohorts, respectively. This points out to the main weakness of the Czech private pension system. It is dominated by short-term saving incentives, predominantly by people in their fifties, and its primary attractiveness for contributors lies in the state subsidies, not in the long-term returns on savings achieved by funds.

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[3] In December 1995 there were only 2,705 clients who contributed more than 1,000 crowns per month to their accounts.

[5] While precise information about the average return on additional pension savings is not available, it would reach only a few hundred CZK.

[6] The average wage was about 9,600 CZK in December of 1996. Individual income in the average family reached 5,135 CZK during first half of 1996.

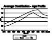

Figure 1 Average Contribution to Private Pension Funds for Men and Women

The low interest on the part of the younger generation in pension insurance also indicates that, in general, people in the Czech Republic rely almost exclusively on pensions provided by the state pay-as-you-go system, and that they view private pension savings merely as a substitute for other forms of savings, attractive only because of the state subsidy. This fact is reflected in SPIS's relatively low accumulation of financial resources. The sum of all contributions was only equal to 1.1 percent of GDP (678.8 billion CZK) as of mid-1996.

Two years after the beginning of the SPIS, individual funds are beginning to report profits. Industry losses were 236 million CZK in 1995, due to high initial start-up costs. After a slow start in 1996, when pension funds recorded a further loss of 14 million CZK, the numbers have improved, so that profits of 127 million CZK had been recorded by the end of the third quarter 1996.[7] The impact of competition between various funds on the industry's development and profits remains to be seen.

Unfortunately, the direct comparison of individual funds' profitability is all but impossible as of now. It is caused by insufficient information provided by pension funds as far as their investment portfolios and returns are concerned. Poor financial results are often being disguised by subsidies from pension funds' shareholders that try not to hamper the image of funds as responsible investors. Nevertheless, we claim that the reform would also undoubtedly spur capital market development and thereby reduce problems of inadequate financial instruments. It is important not to use the shortcomings of the current system for limiting further competition and introducing the "provident" single, state-managed fund.

If only a single, state-managed fund were created, the government would be tempted to force the fund to buy its under-performing bonds, or to support failing public enterprises. Such an arrangement could, in fact, eliminate all the advantages of private savings schemes. While they are an extreme example, the negative returns achieved by state-run "provident" funds in several countries serve as a warning on this count (see Table 2). Likewise, the 3% of return achieved by the state-managed fund in Singapore's booming economy is also a meagre result. The difference between private American funds, which average 8 percent returns, and the publicly managed fund OASI (Old-Age and Survivor's Insurance) fund, is also instructive.

By contrast, the Chilean funds, which have to compete for workers' contributions,

[7] Hospodarske noviny, 7 January 1997.

have become the dominant players on the domestic capital market. The Chilean arrangement gives ultimate power to workers who seek the best-performing funds. It has other problems, such as the potential for insufficient information on the part of the workers, but these have been reduced by the strict regulation of the Chilean funds. Most importantly, pension reform in Chile has fostered the development of numerous financial instruments and institutions, which have in turn vastly improved the functioning of the Chilean capital market.

Table 2: Annual Returns of Different Pension Funds
Source: World Bank (1994)

4. Regulation of Czech Pension Funds

The current Czech voluntary private pension system places strong emphasis on the defined contribution schemes. This approach means that pensioners bear all risk, since their contributions are fixed while the returns they receive vary with the market performance. In the case of a stock market crash just prior their retirement, this risk could be severe.[8] On the other hand, the defined contribution scheme does create conditions for a relatively stable system that could be extremely useful if the importance of private insurance grows in the future. Generally speaking, the main goal of regulation is to insure that the Supplementary Pension Insurance System offers a relatively safe form of investment for average citizens, and that pension plans are fully funded.

However, we have identified two main areas of regulatory deficiencies. First, there is significant problem with obtaining information on a fund's performance. The law is not specific enough about the type of data, which have to be publicly disclosed. Moreover, the six-month period which PFs have for publishing information about their performance is very long. Even the Czech Association of Pension Funds is aware of this fact, but so far it has not been able to reach an agreement among its members about the types of data that should be disclosed. The second problem is connected with the investment rules that should emphasise profitability and safety. Given the present, quite vague and unenforceable investment rules and an unsatisfactory state of the Czech capital market, lack of information on PF performance, and lack of regulatory power create the potential of future shocks, when some PFs will not be able to fulfil commitments towards their own clients.

5. Conclusions

The pension system in the Czech Republic faces tough choices, as do most other pay-as-you-go pension systems in Europe. Broad agreement that a change is unavoidable

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[8] See Davis: *Pension Funds in Great Britain*, 1993.

seems to be emerging from discussions among Czech economists. The exact shape of such a change is still disputed, however. In this paper, we have argued for a substantially more important role to be played by private pension funds.[9]

The most obvious and troublesome aspects of the current system concern the lack of information on the pension funds' performance and the structure of their investments. So far, the state contribution, which generates the main part of the return on their savings, has been the main incentive for people to participate in SPIS. But many funds function as a "black box;" indeed, some of them may not have been established with the intention to provide pensions. Financial institutions that decide to offer a pension fund can reap a number of advantages besides getting a subsidised return on investment. Special tax treatment allows a fund to be used in order to avoid paying tax on bond coupon payments or stock dividends. The collapse of several funds, due either to bad investment strategy or direct fraud, could have a disastrous impact on the development of SPIS and particularly on prospects of a pension reform. At present, regulation by the Finance Ministry is concentrated mainly on checking the legality of claims for state contributions; as the law does not give the Ministry much influence over portfolio risk. The lack of such information led the regulatory authorities to set much stricter boundaries on investment decisions.

The lack of interest in private pension insurance among Czechs is a second troublesome aspect. It reflects two factors: a common mistrust in long-term financial instruments among the population (bolstered by current banking and investment funds scandals) and by moral hazard effects. As people still expect the state pension system to have sufficient future sums to cover their basic needs, they do not feel the need to purchase additional insurance for themselves.

Indeed, both of the Czech pension system's current pillars are ill suited to serve as a backbone for a substantial reform. The dominant pay-as-you-go pillar should be diminished significantly to cover only the basic pensions for needy; while the second pillar needs to be created almost from scratch. This is because the current pension funds are inadequately controlled and their performance and supervision will not guarantee sufficient returns and safety for contributors. If there is no change in the information-openness, the existing pension funds will be limited to play the role of the third, voluntary pillar, where supervision standards could be much more relaxed.

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[9] Two of possible alternatives of the pension reform are discussed in details in Jelínek, Schneider: "Dùchodová reforma v ÈR - milardy ve høe", *Ekonom No.8*, 1997 (in Czech).