An Analysis of the Voluntary Pension Fund System in the Czech Republic

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1. INTRODUCTION

The Czech Republic, as well as other transition countries, is undergoing a fairly rapid process of ageing, when the mortality has been decreasing (and life expectancy thus increasing) and the fertility has been decreasing. This relatively fast change in age structure undermines the predominant pay-as-you-go (PAYG) pension systems in transition countries and leads to growing budget deficits in Hungary, Poland and Slovakia. The Czech Republic has been spared this development as it has kept an extremely low unemployment and has reformed the PAYG system thoroughly. Nevertheless, the growing budget strains and increasing ranks of pensioners bring the Czech pension system under pressure, as well.

The Czech government, however, seems to be reluctant to launch a more radical reform and instead focuses on introduction of voluntary private pension funds as a universal remedy for the pension system. The voluntary pension funds in the Czech Republic are inspired more by the typical European pension schemes than by mandatory pension funds known in the Latin America. Unfortunately, as our results show, the government's hopes are to be disappointed, as only a minority of eligible persons takes up a pension insurance and, moreover, the amount of contributions is inadequate.

Ageing process that is firmly established in the Czech Republic, due to steadily increasing life expectancy, has yet another unattractive consequence: it contributes to a fall in national savings.[1] As the share of pensioners expands and as the old age income is still seemingly secured by the state, fewer people are able to save. For example, the saving rate in the Czech Republic decreased from 30,6% in 1995 to 26% in 1997. Although this development may have various explanations, ageing process certainly plays a role. In this paper we focus on the hitherto pension reforms in the Czech Republic with a particular attention to the introduction of voluntary private pension funds.

Increase in private savings, namely in long-term savings for retirement may represent an important factor which would abate future problems in financing pensions. Voluntary private pension funds, launched in 1994 and encouraged by the government through the matching grants, were seen as an important vehicle for increasing private savings. Their results so far have been disappointing, measured by amount of assets they have accumulated.

If, as it now seems likely, the current working generation cannot rely on the state to provide for its pensions by taxing future workers, it becomes crucial to understand whether private voluntary pension funds can substitute the state's pension system. Therefore, relationship between saving behaviour and institutional changes, namely introduction of private pension funds aiming at channelling resources to long-term savings, is closely analysed.

2. VOLUNTARY PENSION FUNDS IN THE CZECH REPUBLIC

In this section we focus on the institutional and performance aspects of voluntary private pension funds. The first part deals with the regulatory issues and explains the role of the state, while the second part gives an overview of the role of pension funds.

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1 See, for example, Disney (1996)

2. 1. REGULATORY FRAMEWORK

The main regulatory framework for voluntary pension fund activities in the Czech Republic is provided by *The State-Contributory Supplementary Pension Insurance Act* (SCSPIA), which was approved by Parliament in February 1994. The SCSPIA was proposed by the government in order to create an addition to the traditional pay-as-you-go pension system, and has the goal of decreasing the target replacement ratio to less than 50 percent of gross average earnings after the year 2000.[2] Each permanent resident over 18 years of age currently has the option to start a private pension program with any of established voluntary private pension funds (PFs)

PFs are set up as corporations with at least CZK 20 million[3] of capital value.[4] Anyone who wants to establish a PF must apply for a license from the Ministry of Finance, which checks on professional capabilities of potential members of the PF's statutory bodies (i.e., the Board of Directors, Control Committee, etc.). The Ministry has to approve the PF's articles of association, pension plan proposal, status proposal, and the depository bank. The status proposal has to include the main goals of the PF's investment strategy, ways of management, and rules for dividing profit. The SCSPIA pays particular attention to potential conflicts of interest, so that a whole list of government officials and members of statutory bodies in other financial institutions (e.g. investment funds, insurance companies, the stock exchange) are excluded from working in pension funds.

A pension plan can offer four types of pensions: retirement pensions, old age pensions, disability pensions, and widow's pensions. All pensions are defined contribution pensions, which means that the amount of final pension is given as a sum of individual contributions and shares of PF profit paid during years when the client is in the program. Only for the disability and widow's pensions does the SCSPIA allows a defined benefit scheme, when the amount of money paid as a pension by PF is prespecified in the client contract with a PF. However, every PF has to keep the sources of the defined benefit pensions and defined contribution pensions in two separated funds. The old age pension can not be paid to a person younger than 50 years old. All defined contribution schemes have to allow pension payments after five years. If a young person decides to sign a contract for a retirement pension, the minimum savings period is 15 years. When a PF offers a disability pension under a defined benefit scheme, according to SCSPIA a client must contribute to PF for at least 5 years in order for this pension to be provided.

A client has to pay a fixed contribution (at least 100 crowns) per month to one of the authorised PFs. Clients can change the amount of their future contribution whenever they want. Employers or other individuals may also contribute to a client's account. Such payments are not tax deductible, however. The state budget contributes quarterly to all clients' accounts according to their monthly (or average monthly) payments. The legal specifications of the state subsidy are listed in Table 1.

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2 Proposal to the SCSPIA, p.34, Ministry of Finance.

3 The exchange rate hovered around 28 CZK per USD.

4 This implies that they are also to some extent regulated by the Business Code.

Table 1 - State subsidies for Private Pensions

Client contribution per month	State subsidy per month
100 - 199 CZK	40 CZK + 32% from above 100 CZK
200 - 299 CZK	72 CZK + 24% from above 200 CZK
300 - 399 CZK	96 CZK + 16% from above 300 CZK
400 - 499 CZK	112 CZK + 8% from above 400 CZK
500 CZK and more	120 CZK

Source: Ministry of Finance, Pension Fund Supervision Department (PFSD)

As a special incentive, the state subsidy is increased by 25 percent during the first two years when a client contributes to a private pension fund. SCSPIA also allows the government to increase its contributions in the future. No such increase has been made so far, however, and the government does not intend to increase the subsidy any time soon.

According to the SCSPIA, a PF's financial resources can be invested only in instruments that ensure a safe return, such as state bonds, bank bonds, papers publicly traded on the PSE, real estate and property. In practice, this legal formulation has been consistent with investment in almost every type of financial instrument on the Czech capital market. PFs are not allowed to buy or sell publicly traded papers at prices that differ from those on the public market.[5] SCSPIA also restricts the total value and structure of the funds' portfolio. The value of papers (except for state bonds) from one emission are not allowed to exceed 10 percent of portfolio value, and no single property can exceed 5 percent of the portfolio value. A fund is not allowed to have more than 20 percent of the publicly traded papers emitted by a single legal body, either. Whenever a PF does not keep within those limits, it must inform the Finance Ministry, and it has six month to return its portfolio to a state of compliance. Funds are not permitted to buy shares in other funds, or to issue bonds.

The investment rules described above follow "the prudent man" principle used in the developed western economies. Limits are not set on different classes of assets as is done, for example, in neighbouring Hungary or in Chile. Given the present state of the Czech capital market, lack of information on PF performance, and relative tolerance of investment rules create the potential of future shocks for SPIS, when some PFs will not be able to fulfil commitments towards their own clients.

Contributions and state subsidies are deposited in individual accounts. A fund has to divide its profits so that at least 5 percent go to the reserve fund and no more than 10 percent can be used according to the decision of the shareholder's meeting. The rest of the profit has to be allocated to the clients.

The state does not legally guarantee a minimum pension or minimum return on contributions. The Finance Ministry is the main regulatory body that is responsible for protecting the clients of voluntary pension funds, and has to monitor PFs compliance with the SCSPIA. The Ministry has the right to demand all the information from PFs needed to fulfil its supervisory mission. A fund that violates its commitments to its clients or other regulations may be punished with a maximum fine of 5 million CZK, by reduction of the profit that may be distributed among shareholders, and by other measures.

Participant and state contributions are essentially tax-free. While supplementary contributions (made, for example, by employers) are taxable, a privileged tax rate of only 15 percent is levied on them. (This rate also applies to interest income on individual savings and

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[5] This should ensure that PF can not easily transfer the savings of their clients to someone else through the trading with shares.

benefits paid by private insurance companies in respect to private insurance plans.) Tax payments on interest and dividend income are deferred until the period when pensions are provided, whereby the interest and dividend income is capitalised in full and contributes toward the participant's final benefit. PFs are not taxed on their income from interest and dividends. Their capital gains are taxed at 25 percent; and other sources of profit (e.g. income from real estate sales) are taxed at the standard corporate tax rate (39 percent).

Defined contribution pension plans are based on individual accounts. This enables the easy transfer of savings (contributions plus state subsidy plus returns) to another fund. If the client and a new PF agree to the transfer, the client's former fund is obliged to transfer the client's savings within three months. Contributions to defined benefit scheme may be transferred only if allowed by the pension plan of the PF.

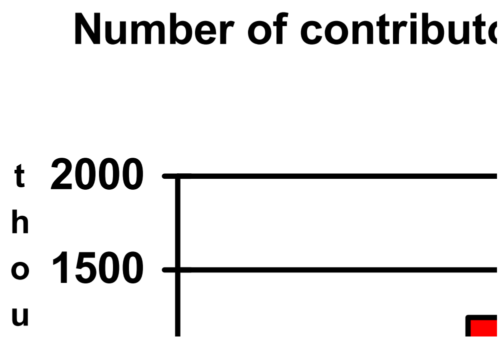
PFs are required to send annual statements to their clients, showing all the items that have been accumulated in a client's account, and describing the fund's future investment strategy. Pension funds have to provide information about their business performance to the Finance Ministry and to the depository bank at least twice a year. But while the SCSPIA also requires that all clients have access to information about fund performance, it does not specify the type of information the PF should provide. The law is not specific enough about the type of data that have to be publicly disclosed. Moreover, the six-month period in which voluntary pension funds can publish information about their performance seems to be very long. The Czech public, as well as the PFs' clients would need more frequent and specific information in order to feel more confident about investing with pension funds.

2. 2. DEVELOPMENT AND PERFORMANCE OF VOLUNTARY PENSION FUNDS

Between September 1994 and November 1995, 44 private voluntary 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.[6] One pension fund was closed and its assets transferred to another fund by the Ministry of Finance in 1997 and there have been five mergers of fund managers and several more are being discussed. Therefore, the first phase of industry consolidation is already under the way. As of September 1997, 1.614 million people (or almost 33% of the labour force) were participating in the Supplementary Pension Insurance System (SPIS).

[6] Tomas Bulena: „Pripojisteni na rozcesti”, *Ekonom* 51/1996, p.69 (in Czech).

Figure 1: Participation in pension funds



Two thirds (65%) of SPIS participants are concentrated in the six largest PFs. Fifteen voluntary pension funds with less than 10,000 participants are likely to be either swallowed up by a larger fund or cease to exist, as their relatively small size will not allow them to allocate clients' savings efficiently.

The age structure of participants is significantly biased towards the older generation, as only about 10 percent of all participants are under 30. The skewed distribution of women shows the strong impact of the state run pay-as-you-go pension system. The 55-59 year age cohort is the only one where the absolute number of women contributing to a PF is lower than the absolute number of men. This is a consequence of the current pension system which allows women in the 54-57 age cohort to retire, depending on number of children they have raised.

Table 2 - Clients' age structure - June 1997 (absolute numbers in thousand and percents)

Age cohort	Men		Women	
	Number in thousands	Percent	Number in thousands	Percent
18 - 24	29	3.94	30	3.47
25 - 29	38	5.16	38	4.40
30 - 34	49	6.66	55	6.37
35 - 39	59	8.02	71	8.22
40 - 44	90	12.23	111	12.85
45 - 49	119	16.17	153	17.71
50 - 54	127	17.26	168	19.44
55 - 59	101	13.72	98	11.34
60 - 64	52	7.07	57	6.60
65 - 69	37	5.03	46	5.32
70 and more	35	4.76	37	4.28
Total	736	100	864	100

Source: Ministry of Finance (PFSD)

According to data from September 1997, the average monthly contribution per participant was 305 crowns, which implied an average state contribution of 102 crowns.[7] Therefore, if we assume that a client contributed this average amount to his/her private account during the whole year, the final annual increase of his/her savings, without taking into account the possible profit from PF, would be around 5 thousand crowns ($150) on an annual basis.[8] The average client was therefore able to save an amount of money equal roughly to one half of the average monthly wage.[9]

In December 1995[10] there were only 2,705 clients (only 0.1% of all clients) who contributed more than 1,000 crowns per month to their accounts. Moreover, the average contribution is strongly correlated with distance to retirement. As shown in Figure 2, 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.

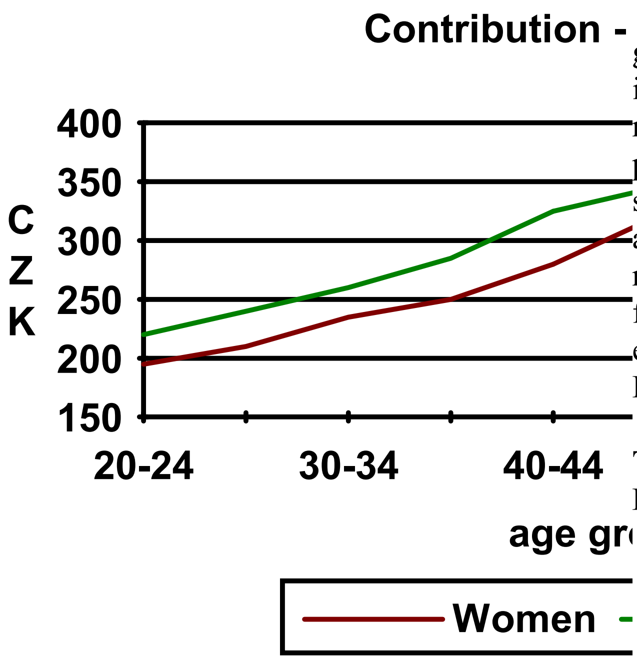


Figure 2 Average Monthly Contribution to Private Pension Funds for Men and Women
Source: Ministry of Finance, PFSD

The disinterest on the part of the younger generation in the voluntary 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. They also view private pension savings rather 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 equal to about one percent of GDP (CZK 19 billion) as of December 1997.

Table 3 - Accumulation of financial resources (as of December 31, 1997)

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7 Here we consider only participants who had paid their contributions. There is about 1/6 from all participants who did not contribute. If we include all participants the average contribution would be 280 CZK with the state subsidy 97 CZK.

8 While precise information about the average return on additional pension savings is not available, it would reach only a few hundred crowns.

9 The average wage was about 10,300 CZK in December of 1997.

10 The last period for which this data is available.

Date	Contribution of participants (CZK million)	State contribution (CZK million)	Total (CZK million)
December 1994	675	225	900
December 1995	2 625	875	3 500
December 1996	5 325	1 775	7 100
December 1997	5 550	1 850	7 400
Total	14 175	4 725	18 900

Source: Ministry of Finance, PFSD and own estimates

Enterprises' interest in contributing on their employees' behalf has developed only recently. While no detailed data are presently available, this trend seems to be strongest among firms which themselves own shares in some of pension funds. Several energy firms established the Energie pension fund, which had about 45,000 participants as of December 1997 and reported 10 percent annual nominal return on contributions in 1995 - 1997.[11] Similarly, several chemical firms have shares in the pension fund Koruna, which had 36,000 participants and reported a 12.4 percent return. These are among the funds with the potential for attracting large industrial firms as contributors.

The investment strategy of voluntary pension funds has been very difficult to analyse. Most of pension funds do not report detailed investment portfolio and we therefore depend on the aggregate data supplied by the Ministry of Finance. From this source follows that voluntary pension funds portfolio has changed significantly between 1995 and 1996 (data for 1997 are not available yet). 1996 in the Czech Republic was characterised by a tightening of the monetary policy. Pension funds reacted by closing their positions in government bonds and investing instead to banks' bonds.[12] Voluntary pension funds also decreased significantly their deposits as bank bonds became more profitable. As 1997 was even more turbulent year but the one in which pension funds achieved highest profits in their history, it remains to be seen how they manoeuvred during the year.

Table 4: Investment Portfolio of Voluntary Pension Funds

	Gov. bonds	Banks' bonds	Firms' bonds	Shares	Deposits	Other (real estate)
1995	3%	12%	33%	17%	30%	5%
1996	0%	41%	31%	8%	19%	1%

Source: Ministry of Finance, PFSD

Three years after the beginning of the SPIS, individual funds are beginning to report profits. Industry losses were 236 million crowns 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 crowns, the numbers have improved, so that profits of 389 million crowns had been reported in 1996. Voluntary pension funds indicated profit of 720 million CZK in first three quarters of 1997. Therefore, the profits are increasing steadily, but they still do not serve as a sufficient

11 Inflation rate in this period hovered around 9%.

12 According to the Ministry of Finance definition, the central bank bonds are included in the banks bonds.

motivation for unconvinced public. Many fund managers therefore boost they results by transfers from fund shareholders. Unfortunately, there is only limited and not systematic evidence on the pension funds' management. Funds do not publish comparable data as far as their return on assets is concerned and it is, therefore extremely difficult to separate good and prudent funds from the rest.

As this strategy is unsustainable in a longer horizon, voluntary pension funds must find ways how to improve their performance. The impact of mergers and increased competition between various funds on the industry's development and profits remains to be seen.

3. INDIVIDUAL DECISION TO PARTICIPATE IN THE OPTIONAL PRIVATE PENSION INSURANCE SYSTEM: EMPIRICAL EVIDENCE

To look closer at the determinants of savings we now turn our attention to individual-level data. This part of the study uses individual records from a survey that has been designed by the authors specifically for studying the attitudes of the Czech population towards saving in voluntary private pension funds. The survey was conducted in June 1997, i.e. 2.5 years after the private pension savings scheme has been launched, by a specialised polling agency[13] which conducts nation-wide opinion polls concentrating primarily on political and sociological issues. Besides a standard set of questions on demographic characteristics, three special questions were added at the end of a survey questionnaire that aimed at explaining why the person is/is not participating in a private pension fund.[14] Multiple responses were sought for the last question and all possible alternatives were ranked using four possible alternatives: decisive reason, important reason, less important reason, negligible influence (for more details see the Appendix).

The initial sample of the survey was the sample that is normally used by the polling agency for their own surveys. This sample is obtained by a stratified sampling method and is representative at the national level. It covers about 1 600 persons aged 18 years and more. For the purpose analysing pension savings we focused on the subsample of individuals who were not yet retired. This left us with a sample of 1 151 individuals who were either studying, employed, unemployed or caring for a household at the date of the survey. Employed persons can either be employed for salary/wage or self-employed. We do not discriminate between permanent, short term or seasonal jobs, or between part-time and full-time jobs.

For the individuals in our sample we identified two possible outcomes: "saving in a private pension fund" (status = 1) and "not saving in a private pension fund" (status = 0). Out of the total of 1 151 observations, 356 persons (31%) were saving in a private pension saving fund. Some 410 persons have indicated that some member of his/her household is participating in any saving program. In 22% of observations both the respondent and another member of his/her household participated in a pension saving scheme.

First we look at the distribution of "savers" and "nonsavers" across different categories.

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13 Prague based agency Středisko empirických výzkumů (STEM).

14 See the appendix for the exact wording of questions.

Table 5:

		Total Sample	Savers	Nonsavers
Percentage		100%	31%	69%
Average age		44 years	48 years	42 years
Income	Average	7053 CZK	8289 CZK	6498 CZK
	Above 125% of 7053 CZK	23%	32%	18%
	Average	21%	26%	18%
	50-75%	23%	22%	24%
	Below 50%	33%	20%	40%
Education	University Degree	12%	14%	10%
	High School	32%	37%	30%
	Apprenticeship	38%	35%	39%
	Elementary Education	18%	13%	21%
Marital Status	Married	61%	72%	56%
	Single	22%	9%	28%
	Divorced	14%	16%	13%

Source: The authors' calculations

The results, reported in Table 5, reveal that people who take up private pension insurance tend to have a higher income (118% of the average income in the sample) and they are 4 years older than the average age. As far as education is concerned, there is only minor difference between two groups: savers tend to be better educated (14% of them have a university degree as opposed to 10% of nonsavers), but the difference is not overwhelming. Marital status plays a more important role, as 72% of savers are married, but only 56% of nonsavers are. Single persons who are significantly less inclined to take pension insurance make up the difference. However, the marital status effect is at least partially explained by the age factor: the older people get, the more they take pension insurance (and the more often they get married). Indeed, the age plays a crucial role: each year increases the probability of joining a voluntary pension fund by 1,03 %.

This simple analysis confirms earlier hypothesis that the private pension insurance is predominantly seen as a short time saving vehicle used mainly by people shortly before their retirement.[15]

Analysing reasons for not saving (details are presented in the Appendix) reveals that it is a lack of confidence in pension funds that hinders their faster development most. 63% of those who do not save stated the lack of confidence as major or important reason for their decision. It is easily the most often reason, beating even a lack of financial means, which was quoted by 56% of non-savers as a major or important reason. Little less than half of non-

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[15] See Jelínek, Schneider: Penzijní fondy v České republice", RESPEKT 31/1997, in Czech.

savers - 45% - think the pension saving plans are unattractive and 20% use a better vehicle for their saving. Substantial part of population - 41% - assumes that the state will provide them with an adequate pension and similar share - 40% - plans to accumulate retirement savings only in last few years prior the retirement. Interestingly, and worryingly, only 20% of non-savers believe that their children would take care of them in retirement.

These answers reveals that behind a usual lack of consistence of answers (people believe that a few years of savings will enhance their retirement income significantly) there is an alarmingly high suspicion that voluntary pension funds might behave improperly. This approach may be explained by failures of a number of investment funds to deliver returns they had promised or by bankrupts of several smaller banks in 1995 and 1996. Interesting is, that once this confidence barrier is broken and one member of a family begins to save, other have much higher probability to join a pension fund as well.

4. CONCLUSIONS

A number of analyses suggests that the Czech pension system will not escape from the demographic trap, hampering all pension system based on the PAYG method. Introduction of voluntary private pension funds in the Czech Republic has not fulfilled the expectations of the government, as the voluntary pension funds remain only a marginal source of income. More specifically, voluntary pension funds do not serve as a long-term saving vehicle. They are used rather as a short-term investment tool for people near the retirement age, or even retired. By the same token, the state subsidies seem to be supporting rather low contributions and does not encourage higher contributions than, say, 500 CZK. Such a low level of contributions, however, cannot guarantee a reasonable pension even for long-term savers, not to speak about saving shorter than a decade.

The question facing the Czech pension system is therefore the very same as two or three years ago: rely on the state financed PAYG system (and adjust it to a changing demographic structure) or embrace a more radical reform? Unfortunately, while the question remains the same, we have not proceeded in providing any reasonable answer to it.

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Appendix - Questions in the survey and reasons for not saving divided according to the age groups

Questionnare:

1. Whether he/she is participating in a saving program of any private pension fund.

2. Whether any other member of his/her household is participating in any such program.

3. What is the reason for not saving in a private pension fund:

a) lack of information
b) lack of confidence in pension funds
c) having enough financial and other means guaranteeing secure retirement
d) lack of money for contributions
e) confident that the state pension system will provide enough means
f) using different forms of saving
g) planning to start saving shortly before retirement
h) pension saving is not beneficial
i) children will take care of me in retirement if needed.

Answers to question 3) have four levels of importance:

1 decisive reason
2 important reason
3 less important reason
4 negligible reason

Age 18-29	decisive reason	important reason	less important reason	negligible reason
a)	13%	24%	33%	30%
b)	27%	32%	27%	14%
c)	6%	7%	40%	47%
d)	31%	27%	21%	79%
e)	9%	28%	33%	30%
f)	9%	15%	24%	52%
g)	24%	37%	22%	17%
h)	16%	29%	32%	23%
i)	4%	10%	34%	52%

Age 30-44	decisive reason	important reason	less important reason	negligible reason
a)	10%	23%	36%	31%
b)	33%	32%	23%	12%
c)	5%	14%	40%	41%
d)	27%	28%	28%	17%
e)	10%	29%	37%	24%

f)	19%	17%	26%	38%
g)	15%	35%	24%	26%
h)	19%	26%	32%	23%
i)	6%	15%	38%	41%

Age 45-60	decisive reason	important reason	less important reason	negligible reason
a)	13%	26%	31%	30%
b)	38%	33%	18%	11%
c)	6%	16%	38%	40%
d)	34%	20%	25%	21%
e)	12%	32%	31%	25%
f)	13%	28%	21%	38%
g)	9%	26%	28%	37%
h)	23%	28%	31%	18%
i)	8%	16%	35%	41%