PENSION REFORM IN THE CZECH REPUBLIC
PAST AND FUTURE

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1. Introduction

This reports aims to describe briefly the Czech pension system development during the last twelve years with the focus on development of supplementary pension schemes and their position within the system of security of Czech citizens against the risk of old age.

The report is structured into key four chapters. First describes the development of pension system from 1990 mainly from the view point of basic pension insurance scheme. Second chapter describing the development of supplementary pension schemes development while the third one aims to position the use of third pillar arrangements within the employee benefits program. Last chapter outlines the current reform concepts and projections for different scenarios of supplementary pension schemes development.

2. Czech pension system

2.1. Czech pension system heritage

The Czech pension system originated in the Austro-Hungarian Empire. Under the inspiration of Bismarck’s reforms in Germany, the first mandatory pension insurance scheme for salaried employees was adopted by Parliament in 1906 (De Deken, 1994). At that time, the mandatory insurance approach was considered to be the only viable solution for the protection of employees against old age and other social risks.

After the First World War, the newly formed Czechoslovakia faced a fragmented system of old-age security. Different pension schemes existed in Slovakia and Carpatho-Ukraine (which had belonged to the Hungarian part of the Empire until 1918), and Bohemia and Moravia (which had been part of Austria). Furthermore, the system could be described as a status-oriented pool of separate schemes for different categories of employees, the most privileged category being civil servants. In the new Republic, efforts were made to increase the quality and coverage of the system. A key social insurance act was passed in 1924, providing a unified pension scheme for manual workers. The chief components of retirement benefits were a flat rate and an earnings related element, pensions being granted from age 65 (Mácha, 1993).

All Czechoslovak pension schemes – for civil servants, miners, manual workers etc. – suffered badly during World War II. Some of the funds were confiscated by Nazi Germany, whereas others decreased in value due to economic developments during the course of the war. In the meantime, the Czech government exiled in the UK had started to prepare new social reforms, which were strongly inspired by the Beveridgean model.

A milestone of post-war development was the adoption of the Law on National Insurance in 1948. This legislation combined the formerly fragmented schemes into one, providing the same conditions for all workers and employees, including the self-employed. Given the depletion of reserves, a pay-as-you-go (PAYG) system was adopted in place of the fully-funded model. The scheme included both pension and health insurance, and was to be administered by the National Insurance Company, a tripartite self-governing body (Mácha, 1993).

This law reflected the traditions of the Czech lands, as well as modern trends in social security, and was the outcome of post-war discussions on a reform concept that had been developed by the government in exile. Although the law was only passed in 1948, the year the communists took over, it was the insurance principle stipulated during the early 1940s that was put into operation. Soon afterwards, however, the approach to old-age security was fundamentally altered by the communist government. New legislation, influenced by the Soviet system, was passed in 1951-52. The pension system was fully transferred into the hands of the (non-tripartite) State Pension Administration (Law 102/1951), insurance contributions were abolished, and financing from taxation was introduced instead (Law 46/1952).

To sum up, the Czechoslovak pension system started out with a tradition shared with western European countries, but it was significantly altered during the communist period. The only player involved was the ruling party, and reformers approached the pension system as an instrument for fulfilling the political and ideological aims of the regime (Biskup, 2001). While being generous to some labour categories, the system discriminated against others. The pension system was financed through general taxation, and the level of pensions was not subjected to regular indexation. The system would not have been able to deal with future demographic developments, notably the ageing of the Czech population. The main aim of the reforms after 1989 was to deal with this legacy (Král, 2001).

2.2. Development of pension system during the nineties

Three important stages of reform can be distinguished, all of which are reflected in decision making and implementation over the past decade.

The first strategy can be characterised as "the federal concept." Predictably, it can be dated from 1989 to the collapse of the federation in late 1992. Its main principles are reflected in the first drafts of pension reform at the beginning of the 1990s. There was an inclination towards the PAYG pension insurance model with a strong earnings-related element, administered and financed in accordance with the classical social insurance system, i.e. establishing a public pension fund administered on a tripartite basis. With regard to the second pillar, there was an attempt to introduce a model involving voluntary occupational schemes.

The second stage began when the liberal-conservative coalition gained a parliamentary majority in the 1992 elections, and it lasted until 1997. During this period, the key reforms implemented were a compromise between the principles of the "federal concept" and the neoliberal model. New law on Basic Pension Insurance was passed by the Parliament effectively form 1995 and also, a key third pillar scheme supplementary pension insurance with state contribution was introduced in 1994. Further on, political statements and expert analyses were available proposing pension privatisation, taking into account the ageing of the Czech population, international experience, and the World Bank blueprint. However, these were vague and did not result in concrete steps to reform.

The third stage began in 1997 when left-wing parties became more influential in Parliament, but they were part of minority governments. This last phase has been characterised by broader public debate about the future of pension security, and a balance of public/political support for the "liberal" and "continental" reform concepts. Although pressure was put on decision-makers and political figures by the rising deficit in the pension system and new demographic projections, up to now no formal pension reform concept have enjoyed a broad political and social consensus.

2.3. First pillar scheme and its function

Main characteristics of the basic pension insurance system are:

- Legislation: 155/1995
- Participation - mandatory for economically active and voluntary for others
- Financing - PAYG as the part of state budget
- Type of plan - defined benefit
- Benefits - old age, invalidity, survivors
- Administration - state
- Equal treatment and transfer of benefits abroad
- Contribution rate - 26% of payroll (from which employer - 19,5 %,employee - 6,5 %).

Eligibility criteria

Retirement pension is payable to insured person who have completed at least 25 years of employment or 15 years of employment and reach the age of 65. Men gain the right for retirement pension at age 60+, women gain the right to retirement pension at between ages 53+ and 57+ (still after 25 years' service), depending upon the number of children raised. Reforms agreed in 1995 are raising the age for normal retirement gradually since 1996, so that by the year 2006 for men it will become 62, and for women 57-61. It increases by two months each year for men, four months for women.

The law also allows for early retirement up to two years prior to normal retirement age. The condition is that an insured person has accumulated 25 years of insurance, and been at least 180 days on the register of an unemployment office as a job applicant. The calculation of the pension is reduced in such cases by 1.3 percent of the calculation basis per every, even incomplete, 90 days of pension taken prior to retirement age. Entitlement is then granted to an unreduced pension.

The opportunity for early retirement three years prior to retirement age is introduced. For such a pension to be granted the person must not be registered as unemployed seeking work. The person himself, at his discretion, selects the retirement date. The only condition is the necessary duration of insurance, i.e. 25 years, and the situation where retirement age would be reached no later than within three years, from 1 January 2001, four years, and after 31 December 2006, five years. Reduction for a non-working period from the pension granting date to the retirement age reached, is lower and permanent (it represents 0.9 percent of the calculation basis per every, even incomplete, 90 days).

Concurrence of old-age pension with earnings without any limitation is available only after two years from the date the title to such a pension was granted. Within these two years, payment of the old-age pension is possible only in the months during which the earnings do not exceed twice the amount of the cost-of-living minimum, applicable for an individual. The government is authorised to increase amounts of the cost-of-living minimum through a decree, this thereby following an increase of prices by five per cent.

From the original legal provision, the opportunity was taken up to increase old-age pension for a 'productive' activity performed after reaching pension age, provided this pension is not paid out. For every 90 days of such economic activity where old-age pension is not received, an increase by one percent of the calculation basis is provided.

Pension Formulas

The rules for designation of earnings decisive for pension calculation are:

- The earnings cited for pension calculation was at the beginning (1996) the average earnings reached during the ten year span before retirement. Every year the law remains in effect this period is extended by one year (currently 15 years), satisfying the objective (after 20 years), of covering the period of 30 calendar years.

- All earnings within the given period will be incorporated into calculation. The highest earnings for a certain period will no longer be singled out. These earnings however, will be reassessed so that their levels are maintained in relation to the average wage at the period in which they were reached. This will result in so-called 'indexation' of earnings, i.e. multiplying by coefficients that express development of an average wage, beginning at the pension-granting year when earning levels were reached.

- The method of determining the calculation base from indexed earnings while excluding certain active periods remains unchanged compared to original calculations of average monthly earnings. Only the reduction amount is changed; the personal assessment base (earlier non-reduced average monthly earnings) is fully incorporated into the amount of CZK 7100. From CZK 7100 to CZK 16000, 30 percent are incorporated (not the original one third), and anything over CZK 16000 ten percent is incorporated without further limitations. These fixed limitations by law will be adjusted regularly so that the relation between paid out and newly granted pensions, and between pensions and earnings is kept.

There is a two tier construction of pension from the system. Every pension consists of the following two tiers:

- Basic amount (flat rate) which is equal for all pensions. It is provided through fixed amount. The government is authorised under the law to increase this amount according to strict rules. The basic amount is granted only once in concurrence with two or more pensions, and it is not incorporated into the area from which a survivor's pension is calculated. The basic amount represented CZK 1,310 monthly as at June 30, 1998.

- Percentage amount (earnings related) which is calculated from the calculation base, and the number of years of insurance, differ according to the type of pension:

    1. For old-age pension and full disability pension, 1.5 percent from the calculation base is given each year of insurance (minimum CZK 770/month);

2. For partial disability pension, 0.75 percent of the calculation base;

3. For survivors pensions, the basis is the percentage amount of the pension received by the deceased person or to what he was entitled at the time of his death, tariffs represent 50 percent for a widow's or a widower's pension, 40 percent for orphan's pension (with respect to orphan's pensions from both sides), from the amount of the deceased person's pension.

Also for full or partial disability pensions, the so-called additionally calculated period, i.e. the period from origin of disability to reaching retirement, is taken as a period of insurance.

Adjustment of Pensions

The pension insurance law newly specifies the manner of pension adjustment:

- The most important change is criterion for growth of the overall retail price index (from five percent as an obligatory condition for each individual increase of pensions.
- In addition to decisions on pension increases, development of wages will be taken into account from now on.
- The law allows for an increase of pension according to the principles provided by a government decree, so that the legislative process is accelerated, and the amount of pension continually reflects the prices and wages development.

The amount of pension is not limited to 'pension maximum limit'.

Normal retirement pension

As a result of the income redistribution the pension - wage relation in the basic pension insurance system drops in line with growing wages. Under the existing legal regulations this relation for newly awarded pensions in case of a bellow-average wage and a wage three times higher than the average is 58 and 26 per cents, respectively. The underlying reason is that the substantial reduction of earnings which determine the pension computation (see above). The scheme is thus very generous to pensioners with previous bellow-average wages and does not provide sufficient replacement ratio to pensioners with previous above-average wages.

Gross wage		Old-age pension	Replacement rate
% of average wage	Monthly in CZK	Monthly in CZK	In %
50	6,329	5,098	80.5
70	8,861	5,554	62.7
100	12,658	6,239	49.3
150	18,987	6,802	35.8
200	25,316	7,182	28.4

In any case it appears necessary to motivate employees to participate in the third pillar schemes and to increase the participants’ contributions, particularly employees with middle and higher level of wages whose compensation in the old age cannot be sufficiently covered by the basic mandatory system.

3. Current role of supplementary pensions in the Czech Republic

3.1. Supplementary Pension Insurance with the state contribution

General
In 1994, the Czech government implemented legislation enabling the establishment of open pension funds. This is regulated by Act No 42/1994 Coll. Supplementary Pension Insurance with state contribution. This act stipulates the collection of contributions, state subsidy, financial management of pension funds, benefit payment. Supplementary pension insurance is defined contribution plan where all residents are entitled to participate. This scheme enables also employers to contribute to the employees' individual accounts and participate on employees' security in retirement.

Pension Fund is a Czech Republic based legal entity and has to be established as Joint Stock company with the minimum register capital of CZK 50,000,000. In the first years the number of pension funds grew in around 43. This number has since reduced to 18.

All employees aged over 18 with permanent residence in the Czech Republic are entitled to participate in supplementary pension insurance. Membership in scheme is voluntary. Currently over 2.5 million of participants join this scheme.

The following type of pensions can be provided under this scheme:

- old-age pension
- disability pension
- survivor's pension
- length of service pension

Start of Participation
Contract is to be signed between and individual and pension fund. Participant agrees to transfer agreed contributions to pension fund upon the stipulated terms. Participant appoints in the contract the person entitled to death benefits, if there are more entitled persons, the division of benefits is required. Contract must always include old-age pension, other pensions might be negotiated depending on the decision of the participant.

Normal Retirement Age
According the legal regulations (Supplementary pension insurance Act No 42/1994 Coll.), the participant is not permitted to receive the pension before the age of 60 and after paying contributions for at least 60 calendar months unless he/she met the requirements for statutory pension or length of service pension is agreed
Length of service pension
Early retirement pension is possible only if the length of service pension is negotiated in the contract. If negotiated, participant becomes eligible for a benefit provision (before the agreed retirement age) when he/she has completed at least an insurance term of 180 calendar months. Maximum half of accrued funds (employee's and employer's contributions, state contribution and investment return) can be withdraw.

Disability Pension
Participant becomes eligible for disability pension from supplementary pension scheme when he/she has completed at least an insurance term of 36 calendar months and if the statutory disability pension has been granted and he/she does not receive already old-age pension.

Survivor pension
Survivor pension can be provided from scheme if agreed in contract. The entitlement for inheritance pension raised after paying contributions for at least 36 calendar months. The amount of inheritance pension is based on the accrued funds on the participant account.

Termination Settlement
The participant is not allowed to withdraw the fund or part of fund during his/her participation in the plan unless the length of service pension is negotiated in contract (please, see paragraph early retirement). Apart this arrangement participant is entitled to receive termination settlement upon his/her termination in supplementary pension scheme.

If the participant terminates his/her participation in the supplementary pension insurance scheme he is entitled to termination settlement only under condition he/she paid at least 12 calendar months. Then the amount of termination settlement is equal to paid contributions plus investment return, but without state subsidy, if received

Contribution payment
Participant chooses the level of contribution. The law determines only minimum contribution needed for participation in the scheme, which is set in the amount of 100 CZK per month. The state subsidy is provided on participant’s contribution (not on employer contribution) in the range of 50 CZK up to 150 CZK per month depending on the level of participant contribution as follows:

Participant Contribution	**State Contribution**
100 CZK – 199 CZK	50 CZK plus 40% of amount of over CZK 100
200 CZK – 299 CZK	90 CZK plus 30% of amount over CZK200
300 CZK – 399 CZK	120 CZK plus 20% of amount over 300 CZK
400 CZK – 499 CZK	140 CZK plus 10% of amount over 400
500 CZK and over	150 CZK

Benefits
Benefits respectively all pensions are always based on accumulated savings including the member’s contributions (employee’s and employer’s), the state contribution, and the investment return. The benefits can be paid as lump sum or annuity pensions.

Tax implications
In January 2000 tax incentives on supplementary pension insurance were introduced for both the individual (employee's) and employer's contribution. Currently, the participant can deduct the annual amount of contribution between 6 000 CZK – 18 000 CZK respectively 12 000 CZK per year. Tax deduction of the employer is limited up to 3% of employee gross salary.

State Supervision
Operation of pension fund is supervised by the state to oversee adherence to this law, the statute and pension plan and protect the rights of participants. Bodies of pension funds are obliged to provide information, data and requested documents

Investment of Pension fund
Pension fund must manage its assets in accordance with the law and not to threaten the interests of participants. Pension Fund can be involved only in activities which are directly related to supplementary pension insurance. Investment of assets is regulated by the law as follows:

- State bonds and state guaranteed bonds
- Mortgage certificates
- Czech National Bank bonds
- Corporate bonds traded on the stock exchange
- Shares and certificates of unit trusts accepted for trading on the stock
- Bank guaranteed or bank issued municipal bonds
- Bonds issued by OECD member states
- Movable that constitutes a safe deposit guarantee for financial means
- Real estate which consistently produce revenue

A pension fund cannot purchase securities at a price higher, or sell securities at a price lower, than the price at which the securities were traded on the stock exchange on the day of the transaction.

The value of securities in the portfolio of a pension fund is calculated on the basis of stock exchange prices on the date of the calculation.

The valuation of real estate and other assets in the portfolio must be made before their purchase, and as often as it is determined in the statutes of a pension fund, but not less than once a year. The valuation shall be done pursuant to the regulations valid at the time of the valuation. If such regulations do not exist, the valuation must be done by an independent court expert.

The accounting rules for valuation of assets of a pension fund are based on the provision of a special legislative act.
The value of the securities traded by one issuer on the stock exchange must not represent more than 10 per cent of the pension fund's assets. This limit does not apply to state bonds.

The value of one piece of real estate or one movable asset may not exceed 5 per cent of a pension fund's total assets.
A pension fund may not own more than 20 percent of the total nominal value of securities issued by one issuer and traded on the stock exchange.

3.2. Life insurance within the Czech market

Life insurance is traditionally indivisible part of insurance market. In EU countries premium on life insurance forms more than 50% of total volume of paid insurance premiums. This share is still significantly lower in the Czech Republic, nevertheless during last years the dynamics of this share accrual have been confirming, that tendency of life insurance as most significant kind of commercial insurance has already came up as well.

In principle, life insurance provides the security of insured person in case of life event, which would cause rapid decrease of income of insured person or his family. Such events can be e.g. accident, illness, retirement or death of insured person.

It is very difficult to define the income decrease itself. In first instance, the public authorities and state react on this event and endeavour to reduce the impacts of event by the provision of statutory benefits from the social security system. The Czech Republic is still waiting for the main steps of the reform of state pension insurance that forms the main state programme of citizens' security in case of death or retirement. Nevertheless, it is apparent, the role of state in terms of citizens' security will be reduced based on the economic situation and demographic development. The principle of solidarity is very strong in current system of state pension insurance, what means that pension benefits expressed as ratio of previous income decrease rapidly together with increasing income. The pension's of employee having below-average income is forms about 70% of his previous income, the one of employee with average income it is about 55% of his previous income and the one of employee with above-average income it is only about 20% and less.

These facts creates favourable conditions for commercial insurance companies to provide those not satisfied with such income replacement and wanted to secure themselves more, with other supplementary insurance opportunities. Also there is possibility for employers that want to react to current situation in state social security, to establish attractive social programmes for their employees that increase employer's remuneration competitiveness, promote retention and favourable work climate.

Because state is also aware of this fact, the increase of citizens' participation and employers on private security is encouraged by suitable motivational tools. Such tools are predominantly the state contribution (e.g. supplementary pension insurance with state contribution since 1995) or tax incentives (e.g. supplementary pension insurance with state contribution since 2000, life insurance since 2001) for individual as well as for employers.

Life insurance products

Life insurance is predominantly regulated by insurance act n.363/1999 Coll. and other related legislation.

Within life insurance products we can distinguish chiefly these four main kinds:

- Risk life insurance (insurance against risk of death)
- Endowment policy (insurance against risk of death and on survival)
- Pension insurance (insurance on survival)
- Investment life insurance (insurance against risk of death or on survival with the possibility to actively balance risk part and endowment part, and also the investment strategy of insurance company)

The accidental insurance can be also categorised into life insurance, on condition that it is included as a rider of some of above life insurance products. In case accidental insurance is taken out individually, it is not considered as „life insurance" according law n.363/1999 and is classified as „non-life insurance".

Apart from these insurances the insurance companies offer currently some other products, but taking into consideration the fact that such products are provided by the employers within employee benefits programmes marginally, this part of report is limited only to the above mentioned kinds.

The important criteria of distinguishing different products in relation to employee benefits programmes is the fact „who is the policy-holder" and "who is the insured". Employers can take out group life insurance when employer is policy-holder and employees are the insured persons within such insurance contract. On the other hand, employees can be policy-holders themselves (individual life insurance policy) and in this case the role of employer is limited to organizational support and possibly he contributes to employees. This definition is very important because based on that various tax implications apply (see below).

Risk life insurance
This life insurance product is oriented only on coverage of death risk. It enables to financially secure family and other relatives of insured in case of his death and it is not possible to create any assets from the premiums paid. All financial means paid on this insurance remain to insurance company as a fee for risk coverage (that's why it is called „risk insurance") and insurance company does not pay out to insured person any benefit at the end of insurance.

Endowment policy
This product is a combination of risk insurance (insurance against risk of death) and accumulation of assets during the insurance period. Part of premium is a fee for the insurance company to cover the risk of death and part of premium is „lend" to insurance company for purpose of investment in suitable manner and valuating the assets. The insurance company guarantees payment of accumulated amount including its

investment return at the end of insurance or also during the insurance in case of death of insured person. The minimum investment return is usually guaranteed by insurance company in advance on agreed level ("guaranteed technical interest rate").

Pension insurance
Pension insurance is focused just on premiums accumulation. In case of death of the insured the entitled person receives the benefit in the amount of accumulated premiums. This product is very similar to supplementary pension insurance scheme. The minimum investment return is again guaranteed by insurance company in advance on agreed level ("guaranteed technical interest rate").

Investment life insurance
Investment life insurance provides the insurance against risk of death or on survival similarly as endowment policy. However in comparison with endowment policy the insured has the possibility to decide about investment strategy of the assets. The insurance companies offer to invest to various funds. This kind of insurance can give to insured higher assets evaluation but on the other hand also lower. The insurance company is not responsible for the investment risk of insured.

Tax implications
The premium paid towards life insurance can be mostly paid monthly, quarterly, half-yearly or annually. In case of quarterly, half-yearly or annually premium payment, the insurance companies usually offer discount.

Czech legislation enables to take advantages of tax incentives from 1.1.2001. It is necessary to differentiate between:

- Individual income tax deductions
- Corporate income tax deductions
- Deductions from statutory contributions payment towards social security, health insurance and employment policy for employees (it is 12,5% from personal assessment base - from gross salary if simplified)
- Deductions from statutory contributions payment towards social security, health insurance and employment policy for employer (it is 35% from personal assessment base-from gross salary if simplified)

The tax incentives on life insurance premium can be avail only when following conditions are fulfilled:

- The insurance has got the nature of insurance against risk of death and on survival or only on survival.
- The individual contract has to be concluded – what means the contract between the employee and the insurance company. In case of group insurance contract (policy-holder is an employer), it is not be possible to avail tax incentives.
- The end of insurance contract has to be concluded at least at age of 60 of insured person and in the same time, length of contract has to be at least five years.

The Income Tax law sets maximum amounts of paid premium that can be deducted from the annual tax assessment base. The annual amount of premium paid by the employees themselves (e.g. from salary) is deducted from their annual tax assessment base up to the amount of 12 000 CZK per year. When an employer contributes to the employee towards his life insurance, this contribution does not increase tax assessment base of employee if up to the amount of 12 000 CZK per year. This employer's contributions is also considered as tax-deductible expense, but only up to the amount of 8 000 CZK per year.

The following table expresses in general tax, social security & health insurance charges implications for each above structured kinds of life insurance:

Kind of life insurance		**Tax deductions**	**Social security charges deductions**
Life insurance against risk of death (risk insurance)	Group policy	NO	NO
Life insurance against risk of death (risk insurance)	Individual contracts	NO	NO
Endowment policy covering risk of death and survival	Group policy	NO	YES – without limit
Endowment policy covering risk of death and survival	Individual contracts	YES-limit of 12 000 CZK per year for employees and 8 000 CZK per year for employer	YES – without limit
Pension insurance	Group policy	NO	YES – without limit
Pension insurance	Individual contracts	YES-limit of 12 000 CZK per year for employees and 8 000 CZK per year for employer	YES – without limit
Investment insurance against risk of death and on survival (investment insurance)	Group policy	NO	YES – without limit
Investment insurance against risk of death and on survival (investment insurance)	Individual contracts	YES-limit of 12 000 CZK per year for employee and 8 000 CZK per year for employer	YES –without limit

* Concerning individual life insurance, it is required all other conditions will be fulfilled to use tax advantages.

4. Role of employers within the third pillar – employee benefits

4.1. Supplementary pension insurance

Supplementary pension insurance became one of the most typical part of employee benefit programme of both local and multinational companies, definitely the most popular in terms of company retirement plan. The main reason of significant increase in last years is the introduction of fiscal incentives for both an employee and an employer in January 2000. Currently around 50% of companies operating on the Czech market have already established such plan via supplementary pension insurance.

Eligibility
The majority of plans offer the participation to all employees. Usually the employees can join the programme after finishing the probation period. In most cases, no other eligibility criteria are set. The companies using the possibility of setting the eligibility criteria links the participation in programme to length of service. The most usual is minimum 1 year with the company.

Contribution
Based on current legislation, there are no restrictions for the employers in terms of setting contribution levels. The employers have control over the level of their contributions; they can impose different levels for different employees' groups. However they are not allowed forcing the employees to join the company plan. It is up to employee's will.

Around half of the companies set the contribution as % of employee salary with the maximum 3% which is also the most typical contribution level. The reason of such employer' decisions is chiefly the tax effectiveness and the fact that percentage would more appropriately address income replacement needs. The employer contribution is typically calculated from only base salary.

Other half of companies defines the contribution as fixed amount. The average employer's contribution amount is 430 CZK.

About half of companies contribute to their employees based on individual employee contribution. The most frequent minimum 100 CZK is required.

Market development

It is expected the proportion of companies providing supplementary retirement benefits will be still increasing in near future.

4.2. Life insurance as a part of employee benefits programme

This section has been written based on Mercer's market knowledge and experiences and also surveys' results organised by either Mercer or other consulting companies. We describe most common procedures how life insurance products and supplementary pension insurance are used within employee benefits programmes.

Before tax incentives were implemented in 2001, life insurance was implemented by employers predominantly via group risk policies and mainly by multinational companies. From the view of participation entitlements, the programmes were designed mainly for selected groups of employees, e.g. company management, on which an employers had an interest to provide them with above standard employee benefits and to promote retention. However this benefit could not be rated as “typical benefit” (Mercer calls “typical benefit” such programmes which are offered more than by 50% companies in the market) because only about 15% of companies offered life insurance in the Czech market.

During the year 2001 and 2002 when tax incentives were introduced, the employers have demonstrated increased interest about life insurance as a part of non-cash employees’ remuneration. This tendency is now very significant. It is even sometimes observed, that companies tend to implement rather life insurance instead of supplementary pension insurance. This can be explained by several hypothesis (mostly verified by Mercer experiences):

- In comparison with supplementary pension insurance, life insurance has an immediate effect for the employee. The employees are insured against particular risk and that’s why they feel more secured, they can also for example apply for mortgage etc. Lower interest of younger employees about supplementary pension insurance is well known; in comparison, life insurance as benefit is appreciated also by younger employees.
- The conservative investment portfolio of pension funds (regulated by law 42/1994 Coll.) has such impact on investment return, that while comparing the one with investment return of insurance company, it is higher in case of insurance companies (in average about 2% difference). Moreover insurance companies offer the guaranteed technical investment return.
- From employers’ administration perspective, it is more advantageous and efficient to determine the contribution as a fixed amount rather than as % of employee’s salary - tax incentives are defined in life insurance by fixed amount (up to 8 000 CZK per year/per head) and in supplementary pension insurance by % from the salary (up to 3% of salary per year/per head).

However it is important here to emphasize, that while the supplementary pension insurance is provided by more than 50% of companies in the Czech Republic and can be considered as “typical benefit” (60% of economic productive population in the Czech Republic participate in supplementary pension insurance), life insurance was implemented in 2002 at least for some employees categories only by about 25% of companies in the Czech Republic (predominantly for company management). The market pressure on employers to implement life insurance is so far low and does not endanger the remuneration competitiveness of companies that do not offer these programmes to employees. Nevertheless taking into consideration the non-decreasing tax burden it is only the question of time when the employers learn to use suitably this product and use such tax efficient employees’ remuneration method. For the time being life insurance is mostly provided by multinational companies, predominantly in pharmaceutical sector, FMCG sector and also in financial sector, which is of course quite closely connected with this products. However it is very difficult to quantify the companies' share in the field of life insurance within sectors because for this purposes life insurance is benefit with very low market prevalence. Furthermore life insurance is such a structured product and each company operates variously with it. Our market experiences can be partially in details explained by following table:

Group x Individual arrangement

Group life insurance policy is used as motivational and retention element in management remuneration (there are no tax incentives, however company does not pay social security and health insurance charges on premium). Individual life insurance arrangement is used as kind of tax effective non-cash remuneration and refers consequently to larger groups of employees or all employees. Some companies use the possibility of combination of both arrangements.

Market prevalence

The group risk insurance is mostly provided life insurance kind by companies (predominantly accidental insurance) –about 40% of companies implemented such programme for management or for selected sales representatives. However only few companies insure all their employees against the risk of death (typically low representation of multinationals from the view of staff number). More than 25% of companies provide endowment policy just particular group of employees, concerning larger employers the endowment policy is provided by only about 15% of companies in the Czech Republic.

Entitlement criteria

The group life insurance policies are taken out for shorter period (e.g. for 3, 5, 10 years) and the insurance company pays out to insured person target insured benefit. During the insurance period the insured person is covered for the risk of death. The insurance is mostly constructed by determination of target insured benefit paid after the end of insurance and based on that level of benefit the premium is calculated. About 10% of companies use this possibility, predominantly those where are above-standard remunerated key managers and company needs to further motivate and stabilise them.
Concerning individual life insurance policy the main motivation factor for its implementation are tax incentives. However this arrangement does not have direct impact on employees' retention as employee takes the insurance policy with him if he leaves the company. This kind of insurance is then offered to larger groups of employees or universally to all employees. Nearly 15% of companies use this kind of life insurance arrangement, about one half of such companies determine the employees' categories for the purposes of the benefit provision (according income level or position) and about half of them provide this benefit to all employees universally. Concerning this attitude, it does not depends in most cases on neither size of company nor sector where the company operates, but it mostly reflects company culture, power of Trade Unions, or vision, value and strategy in the area of HR defined by the employer. Some employers, predominantly with higher staff number, require the contribution of

employee himself to be entitled to participate in a programme and receive employer's contribution.

Premium and benefits

As was already mentioned, concerning group life insurance policies the employers prefer to determine the amount of insured benefit (e.g. 2-times of salary), however employers rather define the amount of premium (mostly by fixed amount, less then as % of salary) concerning individual life insurance policies based on which insurance company calculates the insured benefit.

Regarding group life insurance policies, there is the prevalence of insured benefit defined as 100% of annual base salary in case of death or survival (standard of benefit payment is after 5 years of insurance). The premium is exclusively paid by the employer.

In terms of individual life insurance policies, the decision making is much more complicated and differentiate case by case. The problem is, that if premium is defined as fixed amount, than the proportion of the premium and also of insured benefit to employee salary is higher for lower-income categories of employees and lower for the higher-income categories of employees, on which however these programmes are mostly focused. That's why the employers make various variants of premium definition: The first one is the provision of flat contribution (typically 8 000 CZK) to selected group of employees or all employees universally. Predominantly smaller companies with up to 100 employees receiving quite high incomes use this method, or also employers who decided to implement the individual life insurance policies only for selected group of employees (typically for management). In case of flat contribution, the duty of employee's contribution can be defined in advance, however it is not typical (used e.g. in case of Ceske Drahy-Czech Railways).

The second method is to define several groups of employees and graduation of the employer's contribution amount for such groups (group 1 – 4 000 CZK, group 2 – 6 000 CZK, group 3 – 8 000 CZK, group 4 – 12 000 CZK). This method is applied by middle size and larger size employers from the view of staff number (cca 500 – 1000 employees respectively more than 1 000 employees in case of large company), who envisages all employees will join the programme. Such similar employees selection and natural premium division can be seen also when the amount of employer's contribution is linked to the amount of premium paid by the employee himself. In this case several groups are separated in dependence on their level of interest about life insurance which is confirmed by the amount of premium paid by employee himself. However also this is not typical.

Third, less usual method, used also mainly by middle-size employers, is to define the employer contribution as % of employee's salary (typically 1-1.5%).

Financing methods

New programmes are financed through the increase of budget on payroll & employees' benefits (typically) or through replacement of part of yearly payroll increase by employer's contribution on life insurance of employees (predominantly done by larger employers where Trade Unions have strong power).

5. Current pension reform debate – a second pillar arrangement?

Based on the experience from last eight years of supplementary pension schemes development, main problems of the third pillar can be described as follows:

- Lower security of invested funds caused especially by the fact that the powers and activities of state supervision are fragmented and do not concentrate on the initial minor problems in management of pension funds, but rather on stages, where the pension fund can no longer be saved. An important security element, which has not yet been adequately developed, is provision of comprehensive information to the general public on management of pension funds.
- Inadequate transparency of management following from inconsistent separation of financial means belonging to participants and shareholders.
- High operating costs, especially due to the individual (open-ended) nature of the system. Operating costs expressed in percent of overall income (contributions by the participants, state contribution and yields on investments) have gradually decreased slightly from 13.4% in 1996 to 12.5 % in 2000. However, real yields in the 1995-2000 period have substantially lagged behind the trends in countries with developed stock markets. In a majority of countries with functional pension systems, the amount of administrative costs is regulated, either as a percentage of the assets of the pension fund or as a percentage of received contributions. To date, no uniform regulation has been adopted in EU.
- The short-term character of supplementary insurance which serves as a beneficial savings instrument rather than as a manner of providing funds for retirement. This also follows from the age structure of participants, where almost half (48 %) were older than 50 years of age in 2000, thus being of pre-retirement or retirement age. Thus, state support (state contribution and tax allowances) does not fulfil its purpose and often allows for unfair competition against other products in the financial market.

In the voluntary pension system enough space will be created for the citizens to be able to opt for forms of both individual and collective pension insurance. The purpose of supplementary pension systems is to allow the citizen to increase, through his/her own initiative their income in old age in the form of a supplementary income to the old-age pension provided by the basic system. Supplementary pension systems will simultaneously allow the alleviation of the pressure exerted by mid- and high-income citizens on the enhancement of benefits provided from the basic pension insurance system by giving them an option to provide for a supplementary income beyond the framework of the basic pension insurance system. This personal initiative of citizens will be supported by the government in the form of targeted tax allowance and provision of the state contribution.

According to the latest documents prepared by the Ministry for Labour and Social Affairs, it is proposed:

=> **To introduce the Second Pillar in the form of collective occupational supplementary insurance** based on the non-profit principle. The aim of occupational supplementary pension insurance is to provide to former employees supplementary annuity in addition to the old-age pension paid from the basic pension insurance system. An employer establishes an occupational pension fund voluntarily; the employee may decide whether he/she wants to become a member or not. Both employees and the employer contribute to the occupation pension fund. The occupational pension fund is legally a separate entity with separate accounts. In the event of dissolution of the employer's company, the occupational pension fund shall not be dissolved, but continues managing the accrued resources. The payment of contributions by the employer and his presence in management and supervisory bodies shall however cease. The occupational pension fund shall be managed by a special legal entity of its kind - the pension society. The pension society shall be founded by the employer and both the employer and the insured employees shall be represented in its bodies. Investment decisions may however be made only by qualified investment managers. The profit accrued by the management of the occupational pension fund may be used only in the benefit of the occupational pension fund. Early withdrawal of resources from the fund shall be excluded to secure the fulfilment of the purpose of occupational supplementary pension insurance. In the event of change of employer, the transfer of accrued rights of members shall be guaranteed. Like in other labour-law relations, occupational supplementary pension schemes shall extend equal treatment to men and women and exclude discrimination. There will be a tax allowance for occupational supplementary pension insurance. Occupational pension funds will be subject to state supervision.

The prepared system of occupational supplementary pension insurance will, from 2003, broaden the offer of supplementary pension insurance; pension funds providing supplementary pension insurance with the state contribution and commercial insurance companies will also have a role in this system.

-> **To promote further supplementary pension insurance with the state contribution** operated by joint-stock companies - pension funds, as individual provision within the framework of the Third Pillar (in spite of the fact that tax allowances also apply to employer participation). Tax allowance applies to the payments of individuals into the system. Together with the state contribution both tax allowances may be combined, making it possible to pay into the system as contributions relatively high untaxed amounts.

During the further development of supplementary pension insurance with the state contribution the security of deposited funds will be increased, the transparency of the management of pension funds enhances, and the costs of the system reduced. The planned further increase of the security of deposited funds and greater transparency of the management of pension funds will have a positive effect in greater trust of the public in supplementary pension systems, and thus greater involvement of the citizens in such systems.

-> **To consider as an indivisible part of the Third Pillar individual commercial pension insurance** offered by commercial insurance companies, where tax allowances apply to insurance products designated for enhancement of income in old-age.

6. Conclusions

It is evident that, as a general principal, the future of pension security lies in a sophisticated mix of different pension schemes and arrangements in the next millennium.

The following modifications should be considered when formulating future Czech reforms:

- Extend the financial basis of the PAYG basic pension system (payment from general taxation sources for non-contributory periods and for part of the flat rate element of the pension)
- Restrict the non-contributory periods
- Promotion of actuarially fair benefit formula
- Closer linkage between contributions and benefits (Notional Defined Contributions as a target)
- Support (especially by tax incentives) for participation in voluntary pension schemes:
  - Current pension funds (with state contribution)
  - Employers pension funds, however under the umbrella of current supplementary pension insurance scheme
  - Private life & pension insurance
- Improve administration and compliance
- Increase the democratic features in the governance of the system
- More transparency in financing
- Continue with the increase in retirement ages after 2007