The Expert Advisory Forum’s Final Report

The executive summary

The Expert Advisory Forum (Poradní expertní sbor) was established in January 2010 by the Minister of Finance and the Minister of Labour and Social Affairs with the aim of (i) updating the projection of the state pension system and (ii) recommending changes in the pension system which would help achieve higher resistance to various risks in the medium and long-term.

(1)

The new projections of the state pension pillar (PAYG) have confirmed the trends ascertained in previous years. PAYG is unsustainable in the long term in its current form and with its current parameters and it will lead to deficits of around 4% of GDP per year. Unchanged, PAYG will probably remain in permanent deficit. The positive effect of the parametric adjustments from 2008 and the slightly improved demographic data have been overshadowed by the deteriorating macroeconomic outlook.

It is also possible to state that the current pension system in the Czech Republic is not overly diversified and that it includes an extreme degree of solidarity which makes it risky in the long term both for the state and from the point of view of individuals.

It is therefore necessary for all of society to accept that it is essential to continue in the gradual parametric adjustments in order to secure the financial balance of PAYG and therefore the full coverage of its future liabilities with funds. It is necessary to outline these adjustments to the public sufficiently in advance so that people have time to suitably prepare for the new situation and to adapt to it. This message must especially reach the current generation who are in their thirties and younger and who will be significantly affected by the consequences of the aging population in the Czech Republic. An integral part of this message to the younger generations must also concern the fact that those, who do not voluntarily save for their futures over and above the compulsory reformed pension system, will risk a significant fall in their living standards after entering retirement.

(2)

Upon the basis of its calculations, the processed materials and the studies of the available information, the Expert Advisory Forum has reached the conclusion that the Czech pension system requires reforms which will lead to its

(i) greater diversification,
(ii) fiscal sustainability,
(iii) fairer distribution of the inter-generational burden over time and
(iv) a certain increase in equivalence.

The Expert Advisory Forum also considers it important to emphasise the fact that the discovery of substantial socio-political agreement concerning its form and the subsequent stability of

the chosen solution and its parameters over time is a key prerequisite for successful pension reform. This is a fundamental task for the representatives of the political parties and not for economists or experts. At the same time, it is necessary to take into account the fact that the most advantageous time for pension reform has already passed and that there is no time to waste when making a decision.

(3)

In the area of the adjustments to PAYG, the Expert Advisory Forum unanimously proposes the series of specific steps which have been set out in Chapter 5. When considering the pension system, its consequences and its inseparable connection with other areas of the economy, the Expert Advisory Forum has transcended the boundary of a "mere" pension system and has also proposed a number of steps with a potential impact on the structure of the tax system.

In the area of the creation of a savings pillar for pensions, the Expert Advisory Forum has agreed on the need to create such a pillar and to reform the area of pension insurance. Nevertheless, a complete consensus as to the specific method of creating the second savings pillar for the pension system was unable to be reached.

The majority of the members of the Expert Advisory Forum have recommended the allocation of 3 percentage points from the compulsory PAYG insurance contribution rate to all citizens younger than 40 at the time of the start of the reform and the use of these funds for their individual pension savings.

The minority variant presupposes a significant increase in state support from the state budget to the (reformed) pension insurance system, whereby the precondition for this support (3 percentage points) from the state would be savings of at least the same amount (3 percentage points of the wage) by the individual. The decision to save or not to save would, of course, remain fully voluntary.

The Expert Advisory Forum's recommendation also includes the principles of corporate governance, according to which the 2nd pillar should function, including the definition of its clear interface between the potential area for the private sector and the public domain. It is also possible to set the payment (so-called annuity) phase of the savings pillar with the use of already existing studies.

(4)

The Expert Advisory Forum is convinced that the application of the aforementioned recommendations will lead to the achievement of the set goals both in the area of the pension system and at the fiscal level and that they will also be of assistance in the dimension of the Czech economy's international competitiveness. The Expert Advisory Forum believes that these recommendations will be the subject of serious discussion and will be reflected in the specific adjustments to the pension-economic policies.

Prague, June 2010.

Introduction

The Expert Advisory Forum was established in January 2010 at the request of the Minster of Finance and the Minister of Labour and Social Affairs. It had the following members (alphabetically): V. Bezděk, J. Fialka, M. Frankl, M. Gellová, K. Hájková, J. Hoidekr[1], P. Kohout, J. Král, J. Rusnok and V. Samek.

After an agreement between the Expert Advisory Forum and the Ministry of Labour and Social Affairs and the Ministry of Finance, Vladimír Bezděk was charged with the task of managing the Expert Advisory Forum and the timeframe for the Expert Advisory Forum's activities was limited so that the results of its work, especially as expressed in the Final Report, would be published at the beginning of June 2010.

The goal of the Expert Advisory Forum's work was

(i) updating the projection of the state pension system and

(ii) formulating recommendations for adjustments to the Czech pension system;

The Expert Advisory Forum based its expert activities on the support of the expert apparatus of the Ministry of Labour and Social Affairs and the Ministry of Finance. The activities of the Expert Advisory Forum would not have been possible without this cooperation; the members of the Expert Advisory Forum would like to take this opportunity to thank both ministers and their colleagues for this support.

All of the background materials, calculations and minutes from the Expert Advisory Forum's meetings were published on the internet from the very beginning in order to ensure transparency of the Expert Advisory Forum's activities. The Expert Advisory Forum's specialist work methodology was fundamentally identical to the methodology used by the so-called Bezděk Committee in 2004 - 2005.

The results of the Expert Advisory Forum's work including this report the background materials and the key input preconditions (especially the updated demographic prognosis and the current macroeconomic scenario) are available to the public online at http://www.mfcr.cz/cps/rde/xchg/mfcr/xsl/vf_duchod_ref_pes.html.

The Expert Advisory Forum also based its activities on a number of expert documents and studies and on the suggestions and recommendations contained within them. The goal of this final report is not to submit an in-depth and detailed study of the pension system in the Czech Republic, but to outline the main principles, steps and reasons which the pension reform in the Czech Republic should contain.

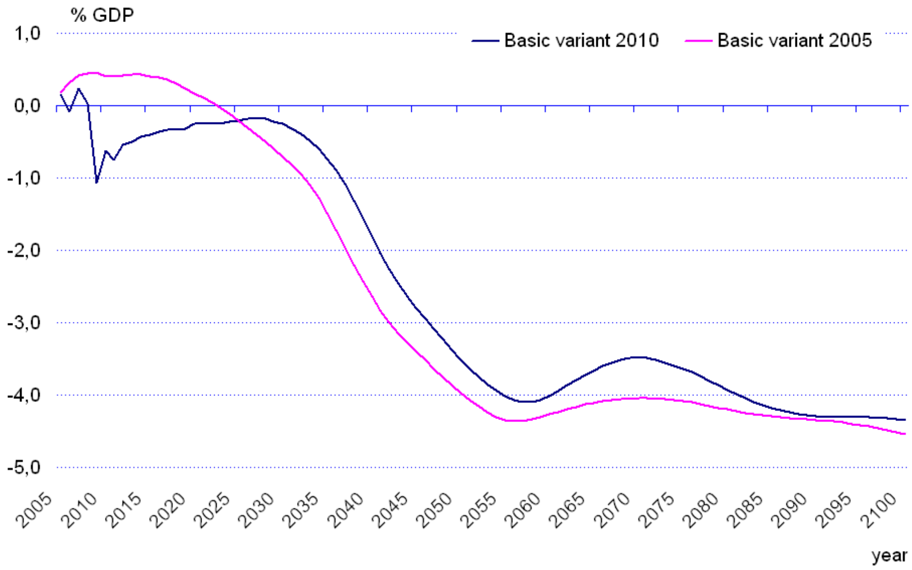
[1] J. Hoidekr resigned from his membership in the Expert Advisor Forum at the end of April.

Chapter I: The current state of the pension system

The Czech pension system consists of two pillars. The first pillar is constituted by a compulsory pay-as-you-go pension insurance system, organised and administered by the state (hereafter PAYG). The second is a voluntary, supplementary private pension insurance with a state contribution (hereafter PISC). Private life insurance products also represent a source of supplementary retirement income.

At present, there are 1.8 contributors for every pensioner and this ratio will continue to worsen – unless the system's parameters are changed, this indicator will be approximately 1.2 in 2050. Maintaining the current level of replacement rate would create pressure on the financial sustainability of the basic pension insurance.

Graph 1: The basic variants[2] for 2005 and 2010, the balance as a % of GDP per year



[2] The basic variant for 2010 in the graph in based on the wording of section 15 of Act no. 155/1995 Coll. before the Ruling of the Constitutional Court dating from April 2010. The information of the Ministry of Labour and Social Affairs concerning the preparation of adjustments reacting to this ruling shows that these adjustments will not affect the balance of the pension insurance in the medium term. The Expert Advisory Forum is aware of the fact that (given that the new legal regulations would have to come into effect by September 2011) the solution to the Constitutional Court's ruling must precede the realisation of the Expert Advisory Forum's recommendations. The Expert Advisory Forum presupposes that this solution would be in accordance with recommendations set out in this report.
A further judicial ruling which can influence the form of the Czech pension system is the ruling of the European Court of Justice concerning the matter of C-343/08, the lawsuit brought by the European Commission against the Czech Republic from January 2010 with regard to the contested incomplete transposition of Directive 2003/41/EC of the European Parliament and Council dated 3rd June 2003 on the activities of the institutions of employee pension insurance and the supervision of them. The obligation to transpose Articles 8, 9, 13, 15 to 18 and Article 20, paragraphs 2 to 4 of this directive, which mainly concern the requirements for domestic employee pension insurance institutions, will arise for the Czech Republic from this ruling. Given the non-existing adjustment to employee pension insurance, the Czech Republic has only partially transposed the directive.

The basic variant[3] for the projection of the pension system is based on the following preconditions:

- the legislative form of PAYG will remain fixed in the state valid as of 1.1.2010
- the retirement age will increase according to the amendment to the Act from 2008, i.e. with the aim of reaching an age limit of 65 for men and women (with a maximum of 1 child) around 2030 (the retirement age for women will remain lower according to the number of children raised with a minimum of 62 in the case of 5 or more children)
- pension indexation only at the level of the legal minimum (inflation + 1/3 of the average real wage growth)
- pension formula parameters (reduction limits, basic amount) will be tied to the development of the average wage.

The basic message arising from the analysis has not changed since 2005: PAYG with its current parameters is financially unsustainable; promises to future generations of pensioners remain partially uncovered by funds or revenues.

Since 2005 the balance of the pension system has been significantly influenced by the following changes:

- the economic recession since the end of 2008 (negative impact),
- parametric changes in PAYG (positive impact),
- demographic prognosis update (positive impact).

Parametric adjustments adopted in 2008 stabilised the pension system's balance for approximately 20 years by the, but instead of achieving "a positive zero" the economic recession caused the PAYG balance was already in the red in 2009. The crisis also had a negative effect on the parameters of the macroeconomic scenario which the Expert Advisory Forum used when carrying out its model calculations. They proved that, without any further changes, PAYG is going to achieve an approximately 1% annual deficit after 2035 and a 4% deficit after 2050. One third of the pension expenditures in that period will therefore not be covered by premiums. Just after 2050 the total accumulated PAYG debt will exceed 50% of GDP and this debt will grow over 100% of GDP in 2065.

In the Czech Republic the PISC) does not currently represent a important source of retirement income. Approximately 70% of economically active individuals (including participants in the post-productive age, a total of 4.5 million people) are participating in this system. Pension funds manage over 200 billion CZK of savings, which means that the average amount of the savings of a single participant corresponds to less than 5 months payments of the average pension from PAYG. In 99% of cases, the saved funds are paid out in a lump sum. Over the long term the participants' average monthly contribution into the system in relation to the average wage has declined .

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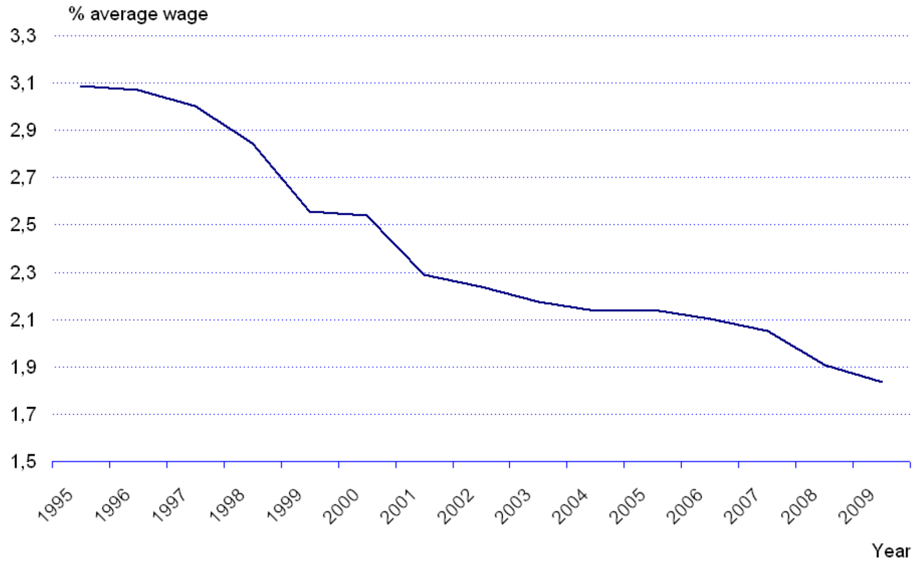
[3] See Annex 1 "The Basic Variants for the Development of PAYG" for more detailed calculations of the variant.

Graph 2: the participants' average contributions in relation to the average wage



Chapter II: the evaluation of PAYG and the PISC

II.1 Strengths and weaknesses of PAYG:

a) Weaknesses:

1. The promises to future pensioners are not sufficiently covered by funds, which exposes both the citizens and the state to a large degree of uncertainty and risk. Therefore:
    a. there must be a reduction of the value of the pension promises (= the state system will not be able to provide future generations with the replacement rate which are provided to today's pensioners) or
    b. pensions will have to be paid from a higher age or
    c. revenues will have to be increased, resulting in a higher degree of taxation of the economically active generation.
2. Low awareness of citizens as to the insufficient long-term coverage of the system's liabilities.
3. The deficit financing of PAYG will increase inter-generational inequity.
4. Income (i.e. intra-generational) redistribution in the PAYG pillar with the current parameters has reached a very high level.
5. Tax system and other parameters are causing differences in the status of self-employed individuals and employees during the payment of the premiums.
6. High contribution rate motivates people to avoid paying it.
7. Non-transparent solidarity (for example, the method of calculating the non-contributory periods, the length of the reference period).
8. The unlimited concurrence of all types of pensions and wages.

b) Strengths:

1. Significant reduction of the risk of poverty for pensioners
2. High level of coverage (universality).
3. System uniformity.
4. Tradition and public trust.
5. Long-term sustainability can be achieved by parametric adjustments.

II.2 Strengths and weaknesses of the PISC:

a) Weaknesses:

1. Low level of contributions paid by participants (not linked to wages).
2. Inefficient state support.

3. Obsolete institutional framework (for example, not separated property).
4. Extremely conservative investment strategy arising from the requirements for guaranteed positive year-on-year yields.
5. Lack of a linkage to the pension (used more frequently for a one-off settlement instead of a lifelong annuity).

b) Strengths

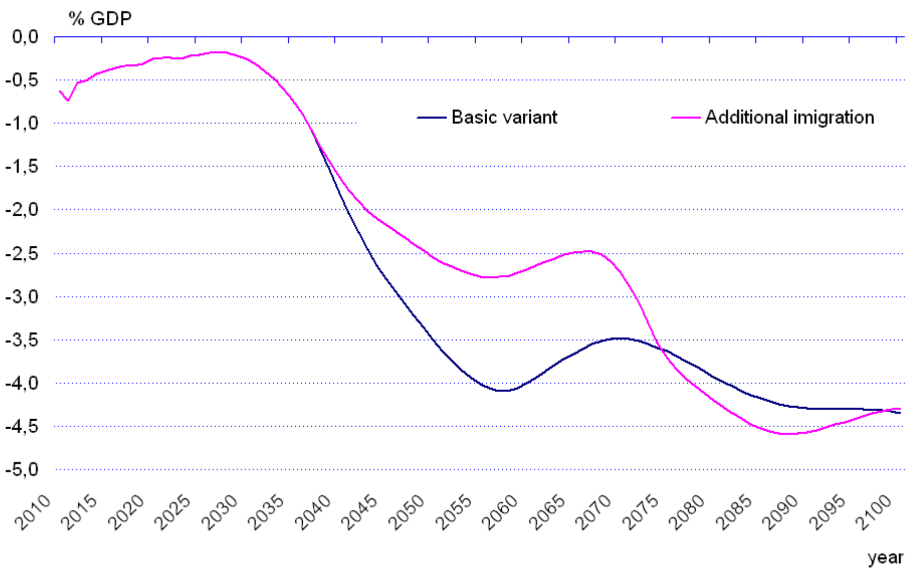
1. High degree of participation.
2. Safety of the invested funds.
3. Employer's participation.
4. Functional infrastructure of the system of individual accounts, including the direct state support agenda.

Chapter III: Selected contexts for pension reform

1. Immigration cannot resolve the problem of aging

The sensitivity scenarios[4] have shown that the long term unsustainability of the PAYG system with its current parameters cannot be solved by (higher) immigration, not even when using exceptionally optimistic assumptions. From a certain point, increased immigration will even have a counterproductive influence on the pension system balance.

Graph 3: The development of the PAYG balance given the basic variant and under the condition of additional immigration[5] as a % of GDP



2. A PAYG financially sustainable over the long term is a goal of the pensions reform

Pension reform can secure long-term financial sustainability of PAYG and may thus contribute to the greater stability of the public budgets. It will prevent the long-term deficits which would arise, if no adjustments were made to the pension system, but it will not create of long-term and significant surpluses.

3. Pension reform in an aging society will not ensure higher pensions from PAYG

Pension reform must ensure that unlike today's prospects the future replacement rate is based on realistic assumptions and is fully covered by funds. On the other hand, it is necessary to be

[4] See Annex 2: The PAYG sensitivity scenario to increase immigration
[5] Essentially maintaining a stable workforce size during immigration

prepared for the fact that the future generation of pensioners, especially those who are forty or younger today, will not receive as high replacement rates from PAYG from the state as today's generation of pensioners.

4. Pension reform will not threaten already acquired rights

Pension reform must not threaten the entitlements of pensioners or individuals approaching retirement age; it may, however, in the interest of a more stable PAYG financial balance, change the rules for the indexation of the paid out pensions, so that the real value of the paid out pensions is always at least preserved.

5. Pension reform cannot be put off

Postponing the pension reform, which should secure the long-term financial sustainability, sends a wrong signal about the future pension security to the population and increases the total costs to society for resolving this matter. As such, it will burden down the future generations more than is absolutely necessary and will increase the intergenerational inequity in the pension system.

Chapter IV: Goals, principles and theses of pension reform

The goal of the pension reform is to achieve socially adequate and long-term financially sustainable pensions by respecting the principles of:

1. Diversification.
2. Fiscal sustainability.
3. Inter-generational burden sharing.
4. Strengthening the link between pensions and previous earnings (contributory principle).

The precondition for successful pension reform is:

1. reconciling the interests of all the subjects involved (the insured individual, the state, the pension system operators and administrators and the employers) and
2. achieving a significant social agreement about:
   - The final form of the pension system,
   - Types and amounts of the funds securing its financial sustainability.

The basic theses for pension reform:

1. Diversification

The Expert Advisory Forum has reached the conclusion that in the Czech Republic the aforementioned goals can best be achieved by means of a multi-pillar pension system, which combines the advantages and balances out the risks of PAYG and fully funded pension pillars[6] and enables securing of an expedient combination of the elements of solidarity and contributory principle. The situation where 94% (2008) of the current pensioners income come from the state is in neither the citizen's nor the state's interest.[7] The priority goal of the funded pension pillar is to increase the contributory principle of the pension system and to contribute to its diversification.

The importance of diversification is illustrated in the table below which compares PAYG and FF financing and the DB and DC character of the pension systems.

[6] See the 2005 Final Report for more detail (http://www.mpsv.cz/files/clanky/2235/zaverecna_zprava.pdf), pg. 57-64.
[7] Data from the Czech Statistics Office (http://czso.cz/csu/2009edicniplan.nsf/t/5800201908/$File/3012091a.xls) for one member of a pensioner household (without working individuals). The analysis of this figure according to the earnings quintiles (96.3% in the lower quintile; 98.7%, 97.8%, 97.2% and 83.3% in the highest quintile) - http://czso.cz/csu/2009edicniplan.nsf/t/5800201916/$File/3012094a.xls

Table 1: A comparison of PAYG versus FF and DB versus DC pension systems

	Advantages	**Disadvantages**
PAYG	Resistance to cyclical development in the economy	Sensitivity to demographic development (birth rate and migration) Sensitivity to life expectancy growth Dependence on domestic economic development Risk of intergenerational inequality (PAYG DB) - risk of political abuse
FF	Resistance to demography (birth rate and migration) Possibility of international diversification Intergenerational equality (FDC) Dependence on quality institutional environment (1)	Sensitivity to development on financial markets High administration costs Sensitivity to life expectancy growth Dependence on quality institutional environment (1)
DB	Allows solidarity within generations Higher certainty regarding benefit amount, when system is sustainable and immune to political risks Possibility of motivating later retirement	Risk of demotivation in respect to remaining on labour market Unclear benefit amount in the event of long-term unsustainability of the system and political intervention. The risk does not decline with an increase in an individual's age. Cannot react automatically to life expectancy growth
DC	Does not penalise for remaining longer on At an older age, the uncertainty relating to the benefit amount declines. Automatic reaction to life expectancy growth	Risk of poverty for vulnerable groups Less certain benefit amount at start of career

Note: (1) this may be both an advantage and a disadvantage for the FF system. The institutional environment is understood to mean regulation and supervision, political intervention and the effectiveness of the fund (administrative costs).
Source: The Executive Team’s Final Report, June 2005

2. *Effective cooperation between the private and the public sector*

The precondition for effective cooperation between the public and the private sectors in the area of the pension system is a long-term stable setting of the key rules and parameters. Otherwise, as shown by examples from some Central European countries, the fulfilment of the basic goals of pension reform may be endangered.

3. *PAYG will remain the fundamental part of the system*

The current redistributive PAYG, whose priority task is to ensure the protection of the insured individuals against poverty and the provision of an adequate level of pensions, especially for insured individuals with low or medium incomes, should remain the basis for the pension system.

4. *The necessity of continuing in the adjustments to the PAYG parameters*

Continuous parametric adjustments to PAYG will secure the long-term financial sustainability of the pension system. It is essential to at least partially allocate further funds from public finances in order to establish and develop the funded pillar.

5. *It will not be possible to maintain the standard of living in old age without savings*

The Expert Advisory Forum examined the ability of households to create savings. An analysis of the family accounts in 2005, 2007 and 2008 (see Annex 3) shows that approximately 15-20% of the households in the 20-34 age group do not save at all (or they achieve negative savings), while approximately 20-25% of such households create savings of less than 3% of their income and approximately 25-30% of households save less than 5% of their income.

The reason for Czech society's low savings in an international comparison[8] is especially the interrupted tradition of capital accumulation, low level of income of part of the households, preference for short-term consumption, a strong feeling of certainty concerning the provision of state support and insufficient awareness of the necessity of creating pension savings.

The Expert Advisory Forum is convinced that those who will not voluntarily save in excess of the second pillar will have to cope with a significant fall in their living standards in old age.

6. *Use the existing infrastructure for diversification*

The Expert Advisory Forum is of the opinion that it will be efficient to make use of the already created institutional infrastructure for the private sector (reformed pension funds, insurance companies, investment companies managing unit trusts or other asset managers) for the FF pillar during the pension reform in the Czech Republic.

These institutions are subject to the standard supervision exercised over financial institutions. The quality of the regulation and supervision in the Czech Republic has increased significantly since the end of the 1990s. The high degree of the Czech financial sector stability during the period of the global financial crisis proves this. The state has an option to set the appropriate degree of regulation which will ensure a high degree of security for pension savings and reliable yields during the use of various investment strategies according to the demand of the participants.

7. *The high quality resolution of the annuity (pay-out) phase*

Pension savings managers should only focus on the investment of the participants' pension savings according to the designated rules. The pension savings will be compulsorily converted to lifelong annuities at the end of the savings phase in the FF pillar. Only life insurance companies should provide lifelong, simple and maximally standardised annuities[9]. It is necessary to ensure easily accessible and comparable information about the annuity products which allows citizens to compare and make the right choice. A simple standardised product is the key principle.

[8] See Annex 4: The Savings of the Populace in the Czech republic and Europe for more details

[9] See Annex no. 5, pg. 55-67 for more details.

8. *The "opt-out" variant has insufficiently fulfilled the diversification principle for the pension system*

The Expert Advisory Forum did not incline towards the "opt-out" variant of pension reform[10], especially due to the fact that a significant part of the population would probably never enter the second pillar. This would water down the fulfilment of the goals of greater diversification and stronger contributory principle of the pension system.

9. *Guarantees, regulation and supervision in the pension system must be mutually balanced*

The state guarantees the value of the designated liabilities in the Czech PAYG system. Nevertheless, the law is not unchangeable over time. This explicit state guarantee usually does not exist in the funded pillar. However, the state can significantly minimise the risk of the abuse of pension savings by determining the rules of regulation and supervision, but the participant still bears the investment risk.[11] Within the framework of strengthening of public trust, it is possible to consider a model which on the basis of the participant's explicitly formulated demand enables investing the second pillar funds exclusively in Czech state bonds. In the economic sense of the word, the Czech state would thus directly guarantee the investment risk to the participant by its loan credibility.

[10] Part of the insurance contribution (3 percentage points) removed from PAYG upon the basis of a citizen's voluntary decision and paid into the individual saving pillar is conditional upon the citizen's further contributions made to the same pillar (3 percentage points)

[11] See Annex 6 for more detail.

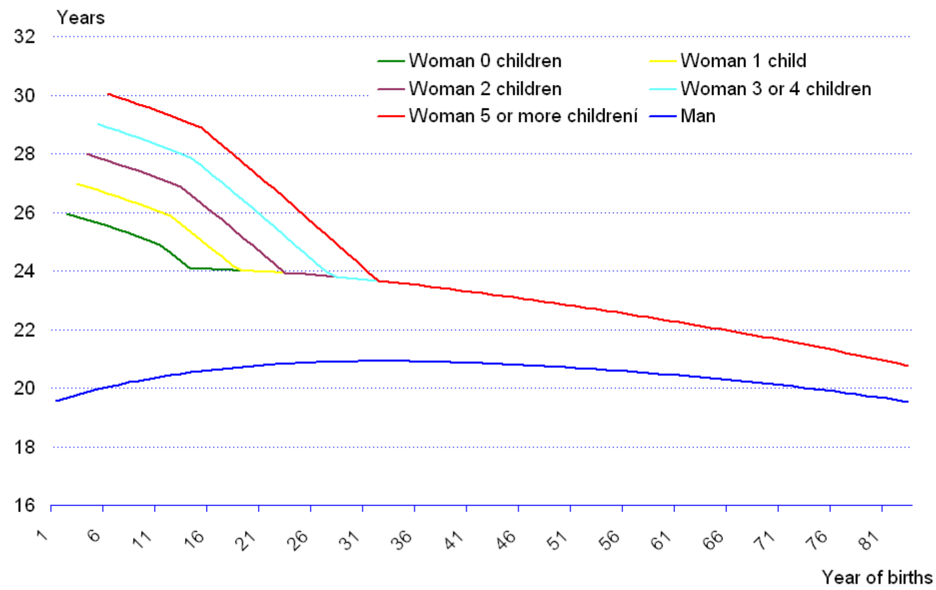
Chapter 5: The Expert Advisory Forum's pension reform recommendations

A. PAYG

In the interest of the long-term sustainability and stability of PAYG it is absolutely essential to conduct further parametric adjustments. The Expert Advisory Forum specifically recommends the following measures:

1. Continue with the gradual increase in the retirement age at the existing pace (temporarily accelerating the growth rate of retirement age for women to 6 months per year until their age limit reaches the same level as that for men), provided the life expectancy continues to rise. This means that the retirement age for men and for women will converge by 2035. When applying this approach various generations will not spent a shorter time on pension (in comparison with the current generation of pensioners), with the exception of the removal of the unjustifiable advantage for women. Women will, however, still spend longer time in retirement than their men counterparts after the unification of the retirement age (due to their higher life expectancy).

Graph 4: The average life expectancy upon reaching retirement age



2. In association with point 1, it is possible to consider introducing occupational pension plans (or insurance) for hazardous (especially demanding) jobs in a supplementary pension system paid for from the funds of the employers or the insured individuals.
3. Eliminate the government's option of designating a higher percentage of pension indexation and gradually introduce price indexation of the paid pensions at the latest by 2025.
4. After the start of the reform (planned for 2015), cancel the lifelong payments of widows' and widowers' pensions (section 49, letter e) of Pension Insurance Act no. 155/1995 Coll.). The original concept for this entitlement has outlived its purpose, it does not fulfil any justifiable objective and it is significantly fiscally costly. This measure will not affect the pensions already paid out.

5. Introduce a mechanism for sharing the assessment bases between spouses which will secure the division of the earnings of both spouses for the purposes of calculating their pension entitlements.
6. Implement the concept of notional earnings at the representing from 40 to 80% of the average wage for the evaluation of the non-contributory periods (see Annex 7 for more details). The premiums for these periods will be funded from VAT (see point 7).
7. Reduce the contributory rate (28%) by 5 percentage points (to 23%) and fiscally compensate this by unification of VAT rates at 19%.[12] These tax revenues (ca 50 billion CZK) will be used to defray the premiums for the non-contributory periods. This measure will have a positive impact on the labour market and on economic growth. It will, at the same time, reduce the imminent intergenerational inequity and the differences in the status of self-employed individuals and employees when paying premiums and it will reduce motivation to avoid paying premiums. The Expert Advisory Forum considers this change to be optimum with respect to the setting of the pension system's parameters and its connection to the other components of the public finances. If there is not enough political will to push through these fundamental parametric changes, it will be essential to resolve the aforementioned weaknesses of PAYG separately, more complicatedly and probably less effectively (for example, in the area of the assessment bases for premiums, administrative regulation of self-employed individuals and employees etc.).
8. The Expert Advisory Forum recommends reducing the cap on contributions to the level of three times the average wage.
9. A significant majority of the members of the Expert Advisory Forum support the plan to unify the collection of premiums and taxes (JIM).[13]
10. Continue in the gradual extension of the reference period in PAYG until it includes all of the lifelong earnings of the insured individual.
11. The current system parameters give rise to the risk of an increase in the number of unjustifiable disability benefits in association with the increase in the retirement age. The Expert Advisory Forum therefore recommends that the definition of invalidity should be regularly revised in line with the increase in the age limit and with advances in medical science and with changes in the labour market. Options for effective rehabilitation should always be assessed before awarding a disability pension and the quality of the medical assessment service should be improved. The Expert Advisory Forum recommends that a disability pension should only be paid up to the age limit for entitlement to an old age pension, after which the individual will be paid the old age pension. The Expert Advisory

[12] The reduction of the insurance rate is a consensual proposal of the Expert Advisory Forum. The balancing out of the fiscal impact by means of the unification of the VAT rates at the level of 19% is a majority recommendation of the Expert Advisory Forum. Three members (M. Frankl, J. Fialka and V. Samek) preferred the tax source for the financing of the reduced insurance contribution rate not to be specifically designated.

[13] V. Samek expressed a different opinion.

Forum further recommends that disability pension would not be awarded in the period when the individual has become entitled to an early old age pension.

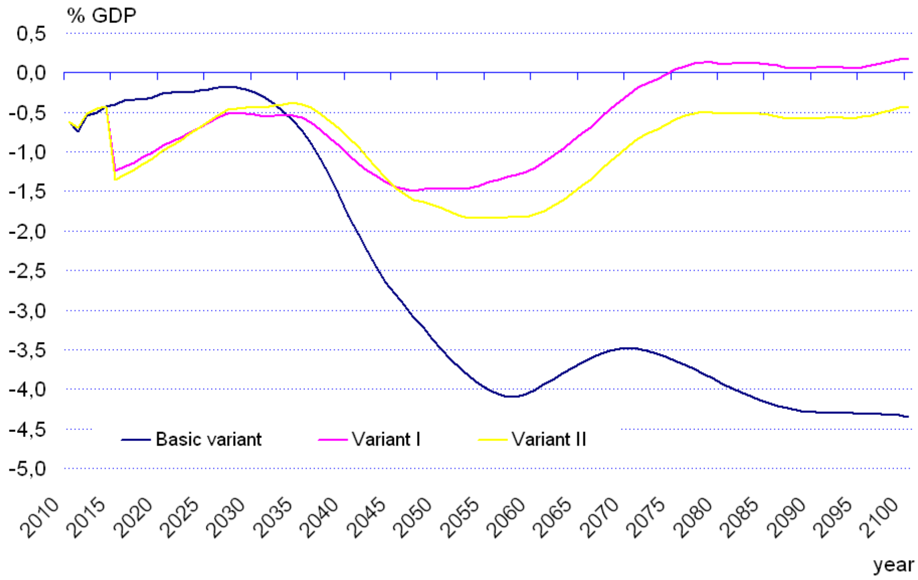
12. The Expert Advisory Forum recommends resolving the question of the unlimited concurrence of pensions and work earnings indirectly by means of the tax system rather than by expensive and ineffective means of administrative intervention (for example, reductions of pensions according to the amount of earnings). It is possible to make use of the suitable setting of the PIT system for the area of pensions (without any impact on those pensioners, for whom the pension is their sole source of income).
13. The Expert Advisory Forum recommends increasing the total state support to families with children in the area of tax and the accessibility of services associated with the family.

B. The individual funded pillars

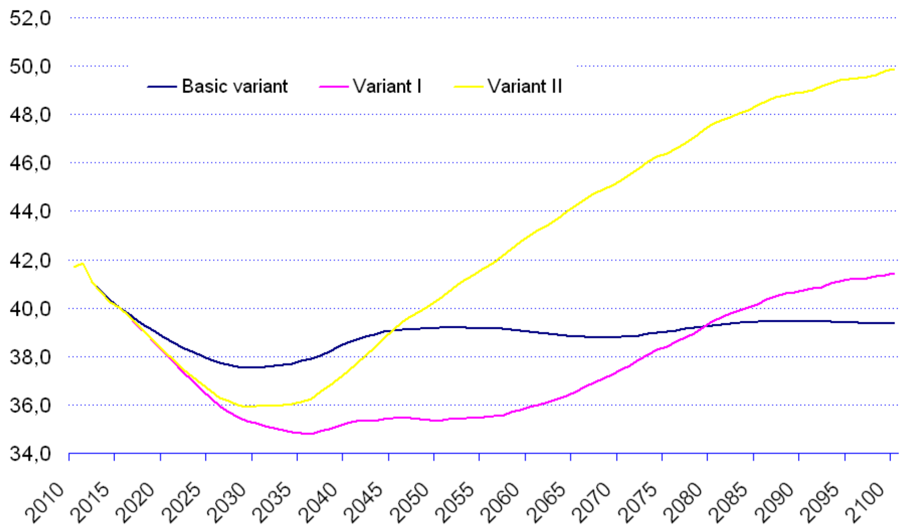
The Expert Advisory Forum has reached the unanimous conclusion that the creation of the funded pillar is essential for achieving greater diversification and strengthening the contributory principle of the pension system as a whole. No consensus was reached at the Expert Advisory Forum as to the specific way of fulfilling this plan or creating the funded pillar (unlike in the case of the proposals for the adjustments in PAYG). Therefore, two variants are presented of which variant 1 is the majority variant and variant 2 is the minority one. The graphs below set out a basic outline of the key variables development for both variants, including the comparison with the basic variant.[14]

[14] The detailed results of variants 1 and 2 can be found in Annexes 9 and 10.

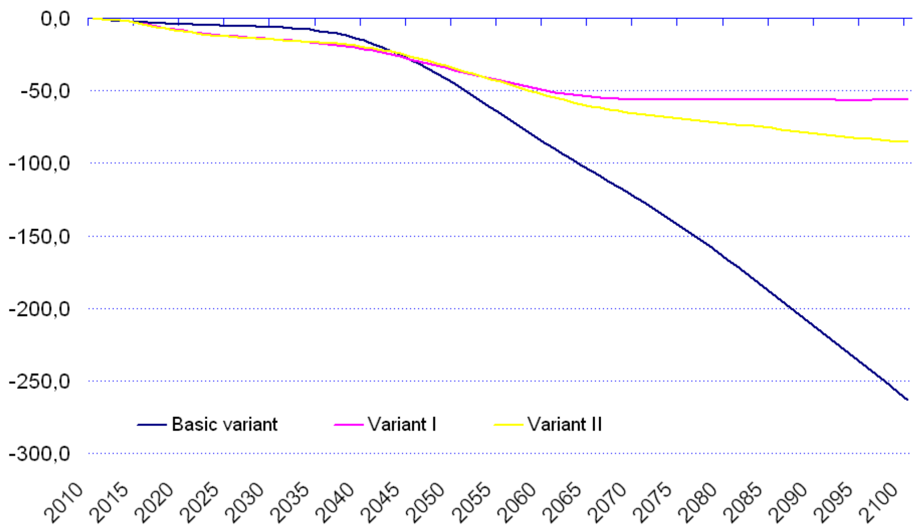
Graph 5: PAYG balance (the basic variant, Variant 1, Variant 2) in % of GDP



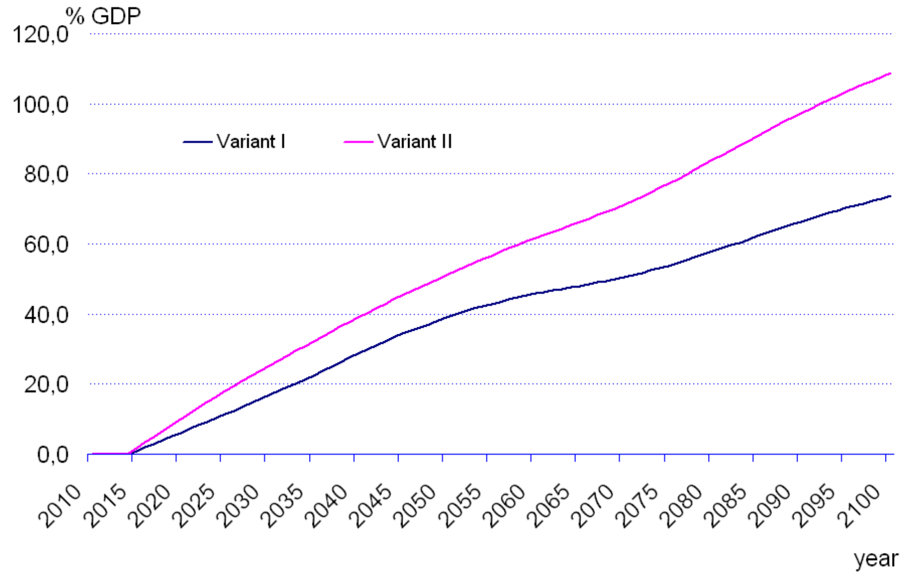
Graph 6: Total replacement rate of the pension system (the basic variant, Variant 1, Variant 2) in % of the average wage



Graph 7: Accumulated PAYG balance (basic variant, Variant 1, Variant 2) in % of GDP



Graph 8: Assets of the funded pillar (Variant 1, Variant 2) in % of GDP



Variant I (the majority variant)[15]

PAYG will gradually divide into two independent pension pillars, where

- **The 1st pillar** will consist of the current PAYG, into which 20 percentage points of the 23% contribution rate will be passed and it will be adjusted according to the aforementioned proposals.
- **The 2nd pillar** will consist of the new funded pillar financed from 3 percentage points taken from the 23% contribution rate.

[15] This variant is supported by the following members of the Expert Advisory Forum: V. Bezděk, J. Fialka, M. Frankl, M. Gellová, K. Hájková, P. Kohout, J. Král and J. Rusnok.

Participation in both reform pillars will be compulsory for all individuals under 40 (in the year the reform starts) and the pension from the 1st pillar will be proportionally reduced for these individuals.[16]

Individuals who are over 40 at the start of the reform will remain fully within PAYG.

The CSSA will collect premiums and carry out the administration of the 2nd pillar. The reformed pension funds, investment companies or other asset managers will manage investment of the pension savings within the framework of the 2nd pillar according to the participant's choice. In the case of the participant's explicit demand, it will be possible to invest the funds from the second pillar directly into Czech state bonds, thus the investment security of the funds will be guaranteed by the loan credibility of the Czech republic (from an economic point of view).

The funds collected in the 2nd pillar will be compulsorily paid out only in the form of a lifelong annuity. If the insured party dies before retirement, the funds will be transferred to the individual account of the beneficiary.[17]

The 3rd pillar will beside life insurance consist of reformed voluntary PISC, based on the government bill of the Pension Savings Act submitted to the Chamber of Deputies in 2009 (see Annex 8 for more details). Majority of the members of the Expert Advisory Forum are of the opinion that the direct state support should be preserved for the reformed PISC.[18]

Variant II (the minority variant)[19]

- **The 1st pillar** will consist of the existing PAYG adjusted parametrically according to the above mentioned proposals. The contribution rate (23%) will not be changed in any way.

- **The 2nd Pillar** will be managed by the reformed pension funds; the direct state support will be 3 percentage points of the contribution rate, provided the participant saves at least the same amount. The same ceiling on premiums applies to this state support as in the PAYG pillar, i.e. up to the amount of three times the average wage. The entry into the 2nd pillar will be voluntary, but after entering participation and payment of the premiums will be compulsory.

Investment administration of the pension savings within the framework of the 2nd pillar will be realised by the reformed pension funds which will offer participants several pension plans with different strategies, including occupational plans for employees working in hazardous jobs.

Participation in the new system will only be possible, if the participant's contribution reaches at least the aforementioned 3 percentage points.

The existing pension funds will manage pension plans under the current conditions for those supplementary pension insurance participants, who will not become participants in the 2nd pillar.

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[16] The reduction of PAYG is undertaken as if there had been no reduction of the contribution rate from 28% to 23%.

[17] K. Hájková expressed the opinion that voluntary contributions should also be made possible over and above the framework of the compulsory 3% rate to the account in the 2nd pillar and that this should apply both to the employer and the employee.

[18] Some members (K. Hájková, M. Frankl) preferred that the state should only support the 3rd pillar with tax tools.

[19] This variant is supported by the following members of the Expert Advisory Forum: V. Samek.

The funds collected in the 2^{nd} pillar will be compulsorily paid out in the form of a lifelong annuity, with the exception of occupational plans for employees working in hazardous jobs, for whom it will also be possible to pay out pensions for a set period.

In the case of the death of an individual insured in the 2^{nd} pillar before retirement, the funds will be transferred to the individual account of the beneficiary or will become the subject of heritage.

The list of used abbreviations

- CSSA: the Czech Social Security Administration
- DB: defined benefit
- DC: defined contribution
- VAT: value added tax
- PIT: personal income tax
- FF: fully funded
- GDP: gross domestic product
- JIM: single collection point
- MF: the Ministry of Finance
- MLSA: the Ministry of Labour and Social Affairs
- SEI: self-employed individual
- PAYG: Pay-As-You-Go
- PISC: supplementary Pension Insurance with a State Contribution

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Annex 2: The PAYG sensitivity scenario to higher imigration, the MLSA, May 2010; http://www.mfcr.cz/cps/rde/xchg/mfcr/xsl/vf_duchod_ref_pes.html

Annex 3: Household savings and gross household income, the MF of the Czech Republic, April 2010; http://www.mfcr.cz/cps/rde/xchg/mfcr/xsl/vf_duchod_ref_pes.html

Annex 4: The savings of the populace in the Czech Republic and Europe, P. Kohout, May 2010; http://www.mfcr.cz/cps/rde/xchg/mfcr/xsl/vf_duchod_ref_pes.html

Annex 5: The processing of the draft principles for the adjustment of the opt-out option from the basic pension system, Deloitte materials prepared for the MLSA in May 2009; http://www.mfcr.cz/cps/rde/xchg/mfcr/xsl/vf_duchod_ref_pes.html

Annex 6: Guarantees in additional pension insurance with a state contribution, the MF of the Czech Republic, May 2010; http://www.mfcr.cz/cps/rde/xchg/mfcr/xsl/vf_duchod_ref_pes.html

Annex 7: Crediting substitute periods, the MLSA; http://www.mfcr.cz/cps/rde/xchg/mfcr/xsl/vf_duchod_ref_pes.html

Annex 8: Supplementary systems – additional pension insurance with a state contribution, the MF of the Czech Republic and the Expert Advisory Forum, May 2010; http://www.mfcr.cz/cps/rde/xchg/mfcr/xsl/vf_duchod_ref_pes.html

Annex 9: Variant 1 (the majority variant), the MLSA, May 2010; http://www.mfcr.cz/cps/rde/xchg/mfcr/xsl/vf_duchod_ref_pes.html

Annex 10: Variant 2 (the minority variant), the MLSA, May 2010; http://www.mfcr.cz/cps/rde/xchg/mfcr/xsl/vf_duchod_ref_pes.html