DISCUSSION PAPER №2

CZECH PENSION REFORM: WILL IT GO FUNDAMENTAL?

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Economy and Society Trust

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Editor: Jan Drahokoupil

Editor's note

There is a number of reforms that Czech public sector has to undertake. Most notably, the present shape of pension system is not sustainable. The reform is a necessity any government will have to follow. Reforming (and thus leaving) contemporary pay-as-you-go model of the pension system is one of the main priorities. These are dominant storylines in Czech press that are also prominent among policy-makers. Political parties, both Left and Right, propose a transition from the present pension system. This, however, is a measure of an immense importance that deserves to be investigated beyond dominant clichés. Is the pension-system reform really necessary? Why? To what extent? What are the consequences of the proposals that are on the table?

This discussion paper offers a roadmap to finding answers to these questions. Ivan Lesay discusses pros and cons of proposed reforms in a very accessible way. Among others, he refutes a number of myths that accompany the discussion. He clarifies actual meanings and consequences of individual reform proposals. This reveals many of the dominant ideas to be misleading.

This text is a major contribution that allows us to understand the pension reform and to identify possible directions that it can follow. There is a lot at stake. There are many reasons to believe that the policy proposals that are actually available in the Czech Republic can have rather unpleasant consequences.

Jan Drahokoupil
Editor of the publications of the EST

Abstract

This paper analyses the Czech pension reform and its prospects. Unlike most of the other Central and East European (CEE) countries, the Czech Republic still keeps its mandatory pension scheme exclusively pay-as-you-go based (PAYG). However, it is highly likely that the Czech government—no matter what political affiliation—will reform the scheme more or less fundamentally in the following years. The aim of this paper is to assess the future prospects of the Czech pension reform in terms of how fundamental it can go, why, and what are the possible risks of such a move. The introduction to the paper presents the general context of reforming pensions in CEE and states that the Czech Republic is an exception. The following paragraphs discuss what the term 'fundamental' means in this paper. A description of the historical developments of the Czechoslovak pension scheme follows. After that, the Czech reform of the pension system after the split of the Czechoslovak federation is introduced. The next section is devoted to bringing attention to the fundamental pension reforms that are taking place in other CEE countries, and to a brief discussion of how the institutionalist theory can contribute to assessing pension reforms in CEE. Following this *intermezzo*, the Czech pension reform is analysed and—being parametric and path dependent—defined as exceptional; several explanatory factors are offered. The last section of the paper discusses the future perspectives of the Czech pension reform under most likely political scenarios. Major grounds for a fundamental pension reform are presented and tested; and possible risks and social impacts of such a pension reform shift are listed.

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Introduction

In the previous decade, almost all around the world, the so-called pension reform has become the buzzword of international social policy debates. I claim that pension reform is one of the most revolutionary ideas in this realm. The first aim of this paper is to try to substantiate this claim and to explain why this is so. To spell it out, I will try to argue that the most fundamental point about the World Bank three pillar model of pension reform is the shift from collective sharing of old-age risks to individual insurance against them. This turns the essence of pension systems upside-down.

The pension reform frenzy first swept across Latin America. In 1981, the original pension system reform took place in Chile. This 'reform' was a complete one—Chilean pension system was totally abolished and substituted by a system of private saving. Next reforms in the region were not that radical. 'Classical' pension systems were only partially dismantled and replaced by private insurance elements. However, only after the World Bank published its seminal volume Averting the Old Age Crisis in 1994, the pension reform trend gets really trendy.

The book recommends that the public pillar be funded by payroll taxes or general revenues and focuses on redistribution. The second pillar is a funded ('capitalisation') system, where individuals' mandatory contributions are being saved in their accounts and invested to pay for their future pensions. This allows individuals to save for their own old age, and generally there is no redistribution. Finally, the third pillar represents voluntary savings, allowing individuals to choose how to allocate their income over their lifetime. The three pillars constitute the so-called World Bank pension reform model.

This model has become extremely popular in the states of Central and East Europe. In their transition societies, post-Communist elites find too much motivation for and too little opposition against the luring idea of privatising pensions. There are several reasons. After the fall of Communism, anything that smells after collectivism, state and solidarity is identified—simply and with not much public debate—as bad; on the other hand, anything that resembles capitalist principles of individualism and privateness is looked up to as a panacea. The drive for privatisation is furthermore significantly spurred by international financial institutions and private companies. The amount of public money pension systems store is a bite way too big to resist. Coupled with the weakness of traditional welfare state defenders—trade unions—the push for pension reform in CEE seems just overwhelming.

Nevertheless, there are exceptions to this trend and the Czech Republic is one of them. It has reformed its pension system, but has not stepped out of the lines of the system itself. Why? What was different here? And is this (non)-decision written in stone, or the Czech pension system will converge sooner or later with other CEE pension systems? What are the prospects of a fundamental pension reform in the Czech Republic? In this paper, I shall try to analyze the Czech pension reform development and debate, thereby providing some answers to the questions raised.

Fundamental When?

I shall label the Czech pension reform 'parametric,' as opposed to 'fundamental' pension reforms of other CEE countries except Slovenia. But before doing so, I shall try to set up criteria for defining a pension reform and for how one can estimate the level of its 'fundamentality.'

A pension reform can be seen basically as any alteration in the institutional design of a system that provides old-age pension benefits. Recently, pension systems all around the world have been facing many economic, ideological, political and other challenges and pressures.[2] The result is that in most of the countries that had some sort of pension system, this institution has been, or is planned to be reformed. This change can take many faces, but it has become conventional to distinguish between a) parametric and b) fundamental (radical, major structural) pension reforms. The former occurs within the previous

[2] The most famous manifesto of the worldwide problems that challenge pension systems is the mentioned World Bank's (1994) publication Averting the Old Age Crisis.

system and is dependent on the path this institution has walked in the past, whereas the latter departs from its previous path by fundamentally (radically, structurally) altering or replacing the whole essence of the system.

What does it mean in practice and what does a fundamental reform look like? The most common view of a fundamental pension reform is that a privately managed, mandatory, and prefunded pillar is established, replacing a part of the PAYG; and/or the PAYG pillar changes from defined benefit (DB) to notional defined contribution (NDC)[3] principle that is based solely on merits and demographic-economic development (James and Brooks 2001: 136). Mainstream scholarship and media attention has been focused primarily on the shift from publicly run to privately managed pension systems, but Brooks is right to point out that "it is not the 'privateness' of the new institution that marks it as a fundamental structural shift in the welfare state. Rather, it is shift from risk pooling to self-insurance that classifies pension privatization that represents a fundamental break with the established path of institutional development" (2006a: 4).

It is therefore analytically useful to distinguish between two categories—the type of management in pension systems, i.e. whether it is public or private, and the type of responsibility, i.e. whether it is collective or individual. Usually, pension reforms imply a switch both from public to private management and from collective to individual responsibility. These two categories thus get somehow merged and, probably because it is more apparent, privatisation becomes a pension reform hallmark. Nevertheless, the categories do not have to necessarily go together. We can easily find public schemes based on individual responsibility, such as the NDC systems of Poland, Latvia, or even Sweden.[4] At the same time, one can observe private schemes based on collective responsibility, such as the defined benefit occupational schemes in countries like Netherlands, Switzerland but also USA or Great Britain (Samek 2006). Of course, it is still necessary to recognise the dimension of public vs. private management. This dimension is important as it can tell more especially about security of the system and its costliness. Publicly run pension systems are generally easier to monitor, supervise, and regulate than private ones, although it is not a rule. And public pension systems are usually also less costly as they do not make profit, but the example of the mentioned occupational schemes shows that a private pension scheme can be non-profit, too. As we can see, privateness is important and it has a variety of modes. Nevertheless, this category itself cannot tell us much about how fundamental a pension reform is.

What rather matters in defining pension reforms' fundamentality is the second category—the type of responsibility. If we accept the basic premise that pension systems are primarily about pensions—who pays for them and how much, and who gets them and how much it is, then it does not matter too much who provides them, whether a public or a private institution. Fundamental pension reforms are radical in the sense that, by introducing new elements such as (usually private) funding or (public) NDC system, they practically abolish redistribution and intragenerational solidarity, thus significantly reshaping the pattern of social contract within and among generations. Introduction of these elements means that it is no more the members of society who collectively share the risk; it is rather the individual who, by saving on her (real or notional) pension account, individually insures herself against the risks in old-age. Therefore experts critical about fundamental pension reform even argue that it is not a reform of pension systems, but rather its dismantling by introducing a completely new principle—individual private saving. This form of saving cannot be considered to be a pension system anymore—for it does not guarantee either the level of future pension benefits, or a certain standard of living; it is rather just another part of

[3]An NDC scheme is still public and PAYG based. However, all pension contributions are recorded on individual—so-called virtual—accounts where capital accumulation is also only virtual. Individual benefit levels depend on the sum of contributions and their notional rate of return. The latter is a discretionary factor, boiling down to an indexation of the virtual pension capital to the growth of the contributions base. Automatic mechanisms of reflecting the development of mortality and the chosen retirement age are also incorporated into the NDC system's pension benefit formula (Müller 2002b: 161).

[4] Such systems are based on individual saving, but they can contain an element of collective responsibility, too—namely they might guarantee a minimal pension benefit. This, however, does not have to be the case.

capitalisation sector (Polák 2006). Therefore one can talk about two poles—the 'real' pension system as we know it and any 'other' system trying to imitate the functions of the 'real' pension system by 'other' means. A move from the former pole to the latter gives us right to call a pension reform fundamental. The extent of that move determines the level of a pension reform's fundamentality. How fundamental was and will be the pension reform in the Czech Republic? That is the question I shall ask after introducing the pension system this country shared with Slovakia till 1993.

Czechoslovak Pension System [5]

The Czechoslovak Republic was established after World War I—in 1918. As Bohemia and Moravia (parts of the today's Czech Republic) belonged to Austria, and Slovakia to the Hungarian monarchy, their pension systems were different. Mácha describes them as "a status-oriented pool of separate schemes for different categories of employees, the most privileged category being civil servants" (2002: 75). Czechoslovakia was trying to develop its pension system and the first achievement of this effort came in 1924 with a unified pension scheme for manual workers. It was based on social-insurance contributions and combined flat-rate and earnings-related benefits granted from the age of 65.

World War II damaged all the Czechoslovak pension schemes (for workers, employees, self-employed etc.). Nevertheless, the 1948 legislation combined all these fragmented schemes into one, PAYG financed scheme based still on non-Communist insurance principles. However, the Soviet-style legislation from the early fifties abolished social insurance contributions and introduced tax-based financing instead. The new pension formula passed in the act of 1956 distinguished among three categories of workers depending on riskiness of their occupation. Despite some earnings-related elements in it, the pension benefit formula was strongly redistributive. The retirement age was lowered by the same act to age 60 for men and 55 for women.

Economic problems at the end of the fifties led to a reconsideration of pension benefit levels. After the act of 1959, pension benefits became even more equal by the introduction of ceiling to both benefits and pensionable income. The legislation passed in 1964 instituted several measures. First, the retirement age of women was on average still 55 but now it depended on the number of children brought up; the range was from 53 (five or more children) to 57 years (no children). Second, the vesting period was increased from 20 to a minimum of 25 years. And third, a progressive personal income tax started being applied for pensions. However, the taxation was abolished in 1975. The indexation of pension benefits was first introduced in 1988 into the Czechoslovak pension system. Lowering the ceiling imposed on pensionable income by the same act strengthened the link between earnings and benefits.

There were several major changes to the pension system after the Velvet Revolution of 1989. An act of 1992 reintroduced social insurance contributions from employers and employees. Privileges were removed from the system—categorisation into three labour categories was eliminated and personal pensions granted to the Communist nomenclature and prominent artists and sportsmen were abolished (Večerník 2006: 4). These are the latest major developments in the pension system; on January 1, 1993, the history of common Czechoslovak pension system comes to its end.

Czech Parametric Reform

Czechs adjusted their pension system parametrically[6] and relatively soon after the split of the federation. The major law in this area was passed in 1995 and came to effect at the beginning of 1996. It contains several important modifications. First, the pension benefits in the new system are composed of two tiers. The first

[5] If not indicated otherwise, the sections where I describe the Czechoslovak pension system and the Czech pension reform draw on Mácha (2002).

[6] As opposed to fundamentally, see the discussion in chapter "Fundamental When?"

one is a fixed flat-rate component. This part of the benefit can be changed by the government but only following strict rules, and it is payable only once even in case that beneficiaries take more pensions. The second component of pension benefits is computed according to a relatively complex formula.[7] This part is more earnings-related than the old one but has still a redistributive character.

The second important change is a gradual postponing of the retirement age. In 2007, men will retire at the age of 62 (from the original 60) and women at the age between 57 and 61 (from the original 53—57). These measures caused widespread protests and, therefore as compensation, generous conditions for early retirement were introduced. However, as Král (cit. in Mácha 2002: 83) observes, "the temporarily-reduced early retirement pension was still so high that it produced a pension exceeding the regular one by 10 percent." As the number of early retirees threatened the fiscal balance of the pension fund, conditions for early retirement were restricted in 2001.

On several occasions, the Czech policy makers were trying to separate the pension fund from the national budget. However, this goal has not been achieved so far. The only step forward in this area was the creation of a special account within the state budget in 1996, in order to record the difference between pension revenues and pension expenditures. Potential surplus in this account was intended solely for the purposes related to the area of pensions. However, the surpluses were eventually the cause of decreasing the contribution rate from 27.2 to 26% in the same year—1996, and thus they very quickly disappeared.

The last novelty in the area of pensions was launching a supplementary private pension scheme in 1994. Employees can contribute to private profit making companies that run pension funds from which pension savings can be withdrawn in the age of retirement. This scheme has only a defined contribution, the level of pension benefit is not guaranteed. Although this scheme is private in character, there is also a public involvement in it—the state supports the system; it subsidises each participant by a monthly sum of money, the level depending on participant's contribution. The law on supplementary insurance scheme was amended in 1999. This amendment was aimed at improving security, regulation, and supervision of pension saving. In addition, it introduced tax advantages for both employers and employees.

CEE Pension Reforms—A Challenge to Existing Theories

As indicated in the introduction, this cautious pension reform in the Czech Republic occurred in the period of delirious efforts to reform pension schemes radically across the CEE region. Starting with Hungary and Poland, going through the three Baltic States, and recently also Slovakia, all these countries followed the World Bank three-pillar model, the introduction of mandatory private prefunded pillar being its most original element.

However, these fundamental pension reforms are a relatively recent phenomenon. Earlier scholarship did not anticipate such reforms to happen.[8] The core argument of earlier welfare literature can be shortly summarised as follows: Once a welfare-providing institution is in place for a long time—reaches high levels of maturity[9], it is very difficult to reform it; and if a reform nevertheless occurs, it will rather take a form of incremental adjustments to existing institutional design (Pierson 1998). This feature of an institution has been called 'stickiness' and it causes that its potential reform will be 'path dependent', i.e. it will be shaped and constrained—'locked in'—by the legacies of already existing institutional arrangements (Pierson 1998, 2000, 2001, Myles and Pierson 2001). The major reason why it is unlikely that a fundamental reform will be enacted is that welfare state retrenchment is generally unpopular and policy makers do not usually want to risk being punished by the electorate for making unpopular decisions (Weaver 1986, Pierson 1996). This is a general rule of the welfare state institutionalism.

Why are the welfare state reforms in general, or

[7] For details see Mácha (2002: 82).

[8] See for example Pierson (1994, 1996, 1998, 2000, 2001), Myles and Pierson (2001), Pierson and Weaver (1993), and Weaver (1986, 2003).

[9] Except the criterion of how long the system is in place, maturity as defined here comprises also other criteria such as the level of coverage, the size of acquired entitlements (i.e. the 'generosity' of the system), and the age structure of population.

pension reforms specifically, unpopular? Stated simply, it is unpopular because a) it entails large financial costs that would have to be covered by taxes or other revenues flowing from the working population (future pensioners), and b) because the welfare state has created a large clientele who has "a concentrated interest in the maintenance of social provision" (Pierson 2001: 413), i.e. present pensioners—beneficiaries who do not want to lose their benefits.

A shift from a mature PAYG pension system to a prefunded one is very costly. PAYG pension systems are based on channelling the current workers' contributions to current pensioners. Governments 'promise' current workers that they will get a pension in the future, too—from the contributions of the then productive citizens. This promise, however, is not covered by existing resources; it forms an unfunded liability, called also an implicit pension debt (IPD). There are several ways of defining and measuring the IPD, but I shall use the definition of James and Brooks (2001: 138—141), for it is most suitable to express the state's financial obligation towards pensioners (covered in the old system) in the time of transition shift. The IPD is the stock of obligations accrued to date—the present value of the accrued rights that current workers have in the old system in the present time. The IPD is measured as a proportion of GDP.[10]

According to Snelbecker (2005: 36), a country with an IPD over 125% of GDP could be considered to have an excessive pension burden. Additional estimation is offered by Bravo and Uthoff (1999: 10)—the IPD is substantial when it is over 20% of GDP, and it is extremely large when it leaps over 200% of GDP.

The costliness of reforming a mature PAYG to a prefunded system is caused by the fact that such a reform transforms the IPD into a transparent debt, thus creating the problem of 'double payment'[11]—current workers must save for their future pensions and, at the same time, pay for the pensions of current pensioners whose entitlements were established in the previous PAYG system (Myles and Pierson 2001: 313). This transition cost is then rather a relabelling of implicit pension liabilities as explicit debt (Brooks 2006b: 92, italics mine). High fiscal costs associated with this problem "would place an untenable burden on current workers" (Pierson 2001: 416). It might be therefore politically very difficult to convince workers to accept that they have to pay twice. Any government trying to shift towards funding would thus risk electoral punishment; such a decision has a blame-generating potential (Pierson and Weaver 1993). Probably no informed constituency would voluntarily accept the necessity to sacrifice and sponsor the costly reform proposed by government—government would be rather blamed for such a proposal and turned down in the next elections, the argument goes.

It is necessary to point out that, on the one hand, many welfare state theorists do not entirely exclude the possibility of a reform. Myles and Pierson, for example, just say that "the options available to policy makers […] are constrained by institutional and programmatic designs inherited from the past" (2001: 306, italics mine).[12] To put it in other words, "past sequences make certain trajectories just more likely than others" (Natali 2004: 354), or "[p]ath dependence is a way to narrow conceptually the [political and economic] choice set and link decision making through time" (North 1990: 98). But on the other hand, some statements seem to be more restrictive. Myles and Pierson (2001: 307) assert that "[b]ecause of politically prohibitive transitional costs, radical shifts towards funding are precluded" in mature earnings-related pension systems.[13]

The financial costs of transition to a prefunded pension pillar will be borne mainly by current workers, but current pensioners may obviously be affected by a pension reform, too. If the reform entails cuts in old-age pension benefits, pensioners-voters are expected to get mobilised and threaten governing parties with voting them down in the following elections. The reason is simple—as Pierson (1994:29) noted, "[…] retrenchment is not simply the mirror image of welfare state expansion," meaning that welfare

[10] For the countries where there were no direct IPD estimates available, James and Brooks imputed the level of IPD in two ways, based on current public pension spending and on the age distribution of the population.

[11] The problem of double payment has been alternatively called the 'transition cost problem' (James and Brooks 2001: 139).

[12] See also Weaver (2003).

[13] They do so despite the fact that they are aware of radical pension reforms going on in post-Communist Europe (Myles and Pierson 2001: 313, 319). See also Weaver (2003: 16, 41)

state cutbacks are unpopular, contrary to welfare state expansion. There is namely one great difference between the expansion and cutbacks in welfare state. Whereas expanding the public programmes is generally very popular, rolling them back might well cause a general public outrage. The policymakers are thus forced to consider retrenchment very carefully and to choose an approach radically different to the one used when claiming the credit for a popular welfare state expanding policies. They are more likely to employ strategies for minimising political costs of retrenchment (Weaver 1986). Pierson (2001: 413) further claims that, whereas benefits of retrenchment for welfare state opponents are diffuse and uncertain, welfare state clientele is concentrated to keep the status quo and, what is more, the reaction of the latter group to potential loss is stronger than to commensurate potential gain. Together with the generation of future pensioners threatened by the transition cost burden, the generation of present pensioners would thus also make a fundamental pension reform undesirable from the electoral point of view.

This chapter tries to suggest that whereas fundamental pension reforms going on in the bigger part of the CEE region challenge the institutionalist predictions, the Czech pension reform seems to be rather in line with them. The following chapters will present a test to this statement.

Czech Path Dependent Pension Reform

First one needs to make sure that the Czech pension system fulfils the criteria applied in the reviewed theories. And the evidence suggests that it does—the Czech scheme is PAYG financed and mature[14]; the contribution rate is 28% of gross wages, the system's compliance is between 98 and 100%, the number of pensioners is 2.6 million out of the total population of around 10.5 million, the replacement rate is 40% of the average gross wage, and the expenditures for pensions represent 9% of the GDP (Král 2004: 3).

As indicated already in the previous chapters, the pension reform in the Czech Republic was characterised by parametric adjustments to the existing system. The Czech PAYG scheme was subject to various reforms in the 1990s, including the gradual increase in the retirement age for men and women, longer contribution periods for calculating pensions, changes in the benefit formula and in the indexation regime, and restricted criteria to determine disability. Remaining privileges for special occupations were also eliminated, which made the Czech Republic one of the first transition economies to abolish these costly provisions (Lasagabaster, Rocha, and Wiese 2002).

Another assumption of earlier welfare state scholarship—namely that welfare state institutions are popular, whereas their rollback is not—appears to hold for the Czech case, too. The Czech citizens "generally praise this [public PAYG] system" (Samek 2006) and it also enjoys the support of consecutive Social Democratic ČSSD-led governments and the trade unions (Potůček 2004: 259). The Czech policy makers could taste the power of the latter welfare state constituency in 1995—the trade unions organised a rally against the new draft law on pensions, which turned out to be the largest demonstration in Prague after 1989 (Mácha 2002: 96). It is necessary to stress that this demonstration was against only a parametric reform, mainly against the proposed raising of retirement age. According to Mácha, this demonstration frightened one of the coalition partners—Christian Democratic KDU-ČSL—to such an extent that they rejected the draft law. One can hardly imagine a better case of blame generating potential stemming from unpopular decisions in the pension reform realm and of successful threat of electoral punishment made by welfare state constituency.

The potential financial costs resulting from a shift to a prefunded system were one of the most important reasons why the Czech policy makers decided to stay with the old system and refused a fundamental reform. The implicit pension debt in the Czech pension system was estimated at the level comparable to other European countries, i.e. very high. According

[14] The Czech pension system is mature and, although the country does not belong to affluent democracies discussed by Myles and Pierson (2001), its pension scheme shares much more common features with the West European mature PAYG systems rather than with the schemes of the West European 'new family of latecomers.' The most outstanding common feature of mature PAYG systems is the responsibility of governments for meeting comparatively high future pension obligations.

to Schneider's (1999) calculations, the pension system accumulated a debt reaching 250% of GDP if the 2% valorisation coefficient is used. But if the benefits are valorised more generously by 4% in real terms, the IPD will amount to 324% of GDP, Schneider concludes. After translating these high IPD numbers into transition costs, one can see that a shift towards funding would be costly indeed, as stated by the theory. Among the Czech pension experts, there is a widespread consensus that exactly these costs represent a major reason why the fundamental reform was not even seriously considered so far by Czech policy makers—they feared their economy would not manage to cover the transition costs (Král 2006, Samek 2006). Again, this conclusion does not seem to be out of the norm of institutionalist welfare state theory.

At the end of this part, let me repeat Pierson's (2001: 413) claim that whereas benefits of retrenchment for welfare state opponents are diffuse and uncertain, welfare state clientele is concentrated to keep the status quo. A strikingly similar observation in the Czech context was made by Samek (2006), who states that people generally like the present system because it provides quite good pensions for a majority of them, whereas the rest will not be harmed that much by low replacement rates, as their working life income is high enough to ensure alternative means of provision in old-age. As in the previous cases, the Czech parametric reform provides support for the argument presented in this chapter.

Czech Exceptions and Specificities

Observing the fundamental pension reforms of CEE, many scholars tried to refine the existing welfare state retrenchment theories. One of the most notable attempts was carried out by Müller.[15] She argues that in the state of emergency (such as high levels of nation's external indebtedness and fiscal pressures of pension systems), contending political groups can be induced to agree upon painful measures. Her principal claim is that the perceived financial unsustainability of the existing PAYG schemes is an important precondition for taking radical pension reform options into account (Müller 2001: 68). Müller's general hypothesis regarding pension reforms is therefore that the countries facing economic and financial hardships are more likely to reform their pension systems fundamentally. The major actors Müller considers are ministries of welfare, ministries of finance, and the World Bank.

Let me present the situation of the Czech Republic in this respect and add some more facts. The level of external debt was lower than or comparable to those of the other Visegrad 4 states for the most of the period examined, amounting to 37.5% of GDP on average in the years 1993—2002. Many scholars accord with Müller's argument that this, together with the government's promotion of a strict fiscal policy, was the major reason why the Czech governments managed to resist the pressure from the World Bank and the International Monetary Fund (Potůček 2004: 259, Mácha 2002). Another factor was the reluctance of Prime Minister Václav Klaus to copy models created by foreign experts (Mácha 2002: 94); some observers even say that Klaus was such a strong personality that he could have afforded to "kick the International Monetary Fund out of the country" (Magvaši 2006). The Czech Republic is the second post-Communist country that graduated from World Bank borrower status[16] and the World Bank itself admits that "[t]he relationship between the Czech Republic and the World Bank was somewhat unusual, consisting solely of knowledge sharing since the Czech Republic did not borrow from the World Bank during this time [1998—2005]" (World Bank 2006: 10).

Besides the unusual relationship between the Czech Republic and the World Bank, accompanied by low external debt and strict fiscal policy, there is another feature that makes the Czech pension system specific, namely the fact that it is not separated from the state budget.[17] As the pension contributions greatly exceeded the expenditures for pensions and other social benefits in the years 1993—1995, the government pursuing a balanced budget was naturally hesitant to separate pension finances from the state budget (Mácha 2002: 94). The draft law on founding

[16] Slovenia graduated as the first one in 2004.

[17] The pensions are separated from the state budget in special pension administration institutions in Hungary (PIF), Poland (ZUS), and Slovakia (SIA). For a closer description of these institutions see Augusztinovics et al. (2002), Chłoń-Domińczak (2002), and Svorenova and Petrasova (2005) respectively.

the Social Insurance Agency failed in 2001 (Král 2004: 7), and thus even recently the pensions are channelled through the national budget in the Czech Republic. Social security experts and officials are unhappy about this situation due to the scrambles every year when negotiating the state budget legislation with the Ministry of Finance (Hofman in Ondruš 2005); however, for us the most important implication of the fact that pensions are a part of the Czech state budget is that their financing is not transparent, and therefore to estimate the extent of its supposed fiscal pressure was harder than in the case of direct financing via an institution separate from the state budget.[18]

And there are several other factors which, intertwined with the abovementioned reasons, resulted in the fact that the Czechs are parametric reformers so far. One of the major reasons is the fact that pension privatisation is not popular in the Czech Republic due to a negative experience this country had with financial institutions and privatisation. Czech pension policy experts say that the failures of almost all segments of financial markets and quick privatisation and its problems are influential factors for potential Czech pension reform (Král 2004); the experience with bankrupt banks and various funds scares also political elites who are then afraid of advocating private pension saving (Samek 2006). With a bit of exaggeration, one can thus conclude that the negative perception of private financial institutions reinforces the existing pension system.

Furthermore, there has been no government prioritising pension privatisation in this country; and this resulted in the fact that a campaign promoting reform was undertaken only by financial institutions analysts[19] and some media (Samek 2006). It is important that the country has been governed by Social Democrats since 1998[20] and I have also mentioned the strength of trade unions in mobilising against the draft law on pensions in 1995.

Present Developments

At the very end of this section, let me discuss the implications of my findings for the particular case of the Czech pension system and its prospects. I am writing these lines literally few hours before the Czech parliamentary elections will be launched (June 2—3, 2006). The preliminary opinion polls show that the conflict between the right-wing ODS and the left-wing ČSSD will be very tough. It is difficult even to guess who will form the government. If it is the ODS, an effort to pass a fundamental pension reform is far from excluded. As a matter of fact, the ODS has been proposing a liberal model of pension system with only one—mandatory public PAYG financed pillar that would pay out flat-rate minimal pension to each citizen. The rate of contribution would be thus reduced, and supplementary insurance would be voluntary. However, right before the elections, the ODS has moderated the pro-reform rhetoric, so recently not even top Czech pension policy experts and high Ministry of Labour officials were willing to share their expectations of what will happen if the ODS forms the government. One thing is clear—if it

[18] Now it is relatively easier, for in 1996 a special account within the state budget was created, in order to record the difference between pension revenues and pension expenditures. Potential surplus in this account was intended solely for the purposes related to the area of pensions. However, the surpluses were eventually the cause of decreasing the contribution rate from 27.2 to 26% in the same year—1996, and thus they very quickly disappeared. Since 1997, the Czech pension expenditures exceed the pension revenues (Mácha 2002: 80).

[19] What is more, "it seems that financial groups have toned down the lobbying activity they once pursued in favour of mandatory private insurance and are now relying on an increase in voluntary savings." (Vecernik 2004: 8)

[20] Nevertheless, one fact is worth noting—in the period 1992—1998, the Czech Republic was governed by the right-wing parties. The Civic Democratic Party (ODS) was the major party in power between 1992 and 1997. In 1997 there was a crisis in the governing coalition leading to a decision on early elections to be held in 1998. Till that time, a caretaker government was formed. Members of the Union of Freedom (US) Pilip and Volák were appointed Minister of Finance and Minister of Labour respectively. Pilip was known for his close contacts with financial and banking experts who supported the neoliberal doctrine of pension reform. Both Pilip and Volák brought to their ministries an impetus toward radical pension reform. However, they did not manage to push it through, for the opposition of other societal actors was stronger (Mácha 2002: 97—98). Let me remind that this was the period when Hungary and Poland enacted fundamental pension reforms. Nevertheless, Czechs went the other way even during this period, not only after it—when governed by the Czech Social Democratic Party (ČSSD).

proposes a fundamental pension reform and if it will succeed in enforcing it, the predictive power of this paper will, at best, lie only in accounting for the delay between adopting the pension reform in most of the CEE countries and the Czech Republic. However, I do not suppose this will happen. And, although this paper is in no way to be understood as a prediction, I nevertheless take the risk of claiming I do not expect a significant convergence between the Czech pension reform path and the fundamental way of reforming pensions many of the CEE countries opted for.

However, even if the ČSSD forms the government, the pension system is unlikely to remain untouched. The Czech Social Democrats announced their intention to introduce an NDC principle into the pension system. And according to my definition, a shift towards an NDC (public but self-insurance-based) system is considered to be a fundamental pension reform, too. However, in this case, much depends on the particular set-up of the system. If there exists a guarantee of a minimal pension benefit in the system and if the level of this benefit can ensure a decent standard of living for pensioners, then such a reform can be still considered parametric.

Grounds for Fundamental Pension Reform[21]

So far I have focused on the analysis of the Czech pension reform until now. Further I have discussed how fundamental it has been and what are its prospects, again—in terms of how fundamental it can go. The remaining part of the paper will be dedicated to answering the question what the drives behind fundamental pension reform efforts are, and what practical implications of such a reform are likely to be.

The Demographic Argument

As probably anywhere else, the pension reform proponents in the Czech Republic are keen on operating with the demographic argument—i.e. few children are born and people live longer, which means more pensioners and fewer wage-earners to finance pensions. The projected 'demographic crisis'—trend of population decrease and aging—relates to the whole Europe. The demographic dependency ratio[22] in Europe is expected to rise from 39.5% in 2000 to 79.5% in 2040. In other words, the number of working age people available to provide for a pensioner is expected to halve from the present EU average of 3.5 to 1.8 in 2050 (Dräger 2003:3).[23] This seems to be a bullet-proof argument, widely accepted as a fact calling for a fundamental pension reform.

However, there are several shortcomings to such argumentation. First, the prognoses used to justify the need for radical pension reform take demography into account ceteris paribus: that is, they underestimate the development of other relevant factors. It is thus possible to criticise the catastrophic scenarios of pension system financial unsustainability for ignoring the development of such factors as labour productivity, unemployment, and so on. Dräger (2003: 11) compares these reductionist prognoses to those of Malthus. His classical argument at the turn of the eighteenth century, based on demographic expectations, was that Britain would face widespread famine in the long run if the high rates of population growth at the very start of capitalist industrialisation prevailed. While the number of mouths to feed would grow geometrically, the amount of cultivable land would only grow arithmetically. What we are witnessing in current debates on the need to reform pension systems is the same Malthusian argument, but from the opposite perspective: that is, a society with a shrinking number of younger people (or a shrinking workforce in general) will not be able to provide for a growing number of older people. As we now know, Malthus was wrong. He did not anticipate an annual increase in labour productivity of 1.7% over the following two centuries. To avoid repeating Malthus's error, we should also consider other factors besides demography. At the same time, we should distinguish these factors according to importance.

[21] The remaining parts of this paper draw heavily on Lesay (2006).

[22] The ratio of post-productive to productive people.

[23] These projections were made in 2003 for the EU-15.

The Likely Effects of Pension Reform on the Demographic Crisis

Nevertheless, let us assume that the adverse prognoses of demographists will be fulfilled and that the growth rate and other factors remain constant. What sort of solution would a fundamental pension reform represent?

Our starting point is a future situation in which a few productive people have to finance many pensioners. The latter have been saving money on a personal account during their working lives[24] in order to purchase a pension annuity. However, as the productive generation is small in size, its economic output is also low; exactly as it would be in the case of an unreformed PAYG system. If pensioners' savings are in the form of money (for example, government bonds), desired pensioner consumption exceeds desired saving by workers. Excess demand in a goods market causes price inflation, reducing the purchasing power of pensioners' annuities and wages in the economy, too. If pensioners' savings are in the form of non-monetary assets (for example, equities), their price will fall as a consequence of insufficient workers' demand. The real purchasing power of pensioners' annuities will thus be reduced again (Barr 2000: 9). As illustrated by both cases, demography and nominal parameters are not as essential as economic output, that is, real parameters. Any pension system will be based on transferring real income from the currently active towards the no-longer-active members of the population. The elderly are always consuming only what is currently being produced for them. A reform which alters merely the form of this transfer, but does not increase the level of income available to society thus cannot solve the demographic problem (Polák 2004a: 1). The theorem 'adverse demographic development calls for pension system reform' is still presented in trivial pension reform debates, especially in the media. However, some consistent pension reform advocates already admit that the pension reform cannot deal with demographic crisis.

The experts discuss one more option by which the pension system may evade the affects of adverse demographic trends, namely investing pensioners' savings in an economy with a favourable demographic structure (Barr 1999). This argument in favour of a capitalisation-based pension system seems reasonable. However, one should not forget that population aging is a worldwide phenomenon and surprisingly holds even for developing countries. As the projected demographic crisis involves all Western countries with minimal divergence, the validity of the argument put forward in the previous paragraph can easily be applied not only at national but also at international level. The countries with a relatively better demographic structure have, by contrast, a less developed economy and are problematic regarding, for example, institutional conditions for investment. Investing pensioners' savings in an economy with a favourable demographic structure thus remains controversial.

Ideological-political Arguments

Advocates of a fundamental pension reform seek to portray it as far as possible as ideologically neutral, thereby creating the impression of its objective necessity. Here we are talking, for example, about the already mentioned financial unsustainability caused by demographic phenomena and other objective facts. As Henwood (1994) puts it: "Realism, like reasonableness, is a term often deployed to lend an air of inevitability to what are really political decisions." However, supposedly technocratic proposals often serve as a guise for deeply ideological interests. After all, many proponents of a fundamental pension reform do not even try to disguise their neo-liberal purport. They repeatedly mention earnings-relatedness, justice, and shifting power from the state to the individual.

Merit

Merit is proposed to be an essential feature of the reformed system. The old-age pension should reflect the amount of paid contributions. Strict application of the merit principle should reduce the motivation to

[24] Let us again assume optimistically that their money has increased in value or, at least, has not been devalued.

avoid paying contributions. According to the pension reform advocates, PAYG system is characterised by a high orientation towards solidarity, taking little account of merit.

The reasoning of the liberal advocates of reform sounds simple and logical: those who pay more into the system during their working lives should receive correspondingly higher pensions. This is indeed legitimate, but it is also an ideological argument and not shared universally. For the moment, we shall skip the controversial issue of whether income is distributed fairly in a society based on market mechanisms and whether there exist different criteria of merit which are socially more just than simple success or failure in the market. Significant income differences are accepted here as a fact. Nevertheless, even given this assumption it is difficult to see why income differences from productive life should be transferred to post-productive life. However much they earned during their working life, pensioners, by and large, do not work after retirement. Their merit in terms of material production is thus the same. It is true that a better paid pensioner will have paid more contributions into the system during his working life, but only in absolute terms. If we apply a relative approach, both pensioners will have contributed the same. One could even argue that the pensioner on lower wages contributed more, as flat-rate contributions for all income groups introduce a regressive element. According to the orthodox economic theory of diminishing marginal utility, contributions of the same proportion of income represent a greater sacrifice for the poor. Merit obviously has a number of facets and it is likely that the neoliberal understanding of this principle would lose at least some of its support if there was a proper public debate.

Barr (2000: 23) refers to one more problem closely connected to the issue of merit. Neoliberals are averse to solidarity-based PAYG systems in which people with very different previous earnings and contribution records end up with almost identical pensions. Such systems disregard the merit principle. However, a similar situation may arise under a reformed defined contribution (DC) scheme, when two people of different ages with identical earnings and contribution records may end up with very different pensions. The reason is that the rate of return on financial markets changes over time. There is therefore a real risk that two people with a ten-year age difference and hence also a different retirement age will receive very different pensions despite having contributed exactly the same amount to the pension system during their working lives. As one can see, the reformed system does not offer enough room even for the neoliberal interpretation of merit. This problem is also profoundly linked to the principle of inter-generational justice.

Justice

Besides justice as merit, inter-generational justice is also put forward as justification. The pension reform advocates say it would be unfair if the present generation of workers had to provide for the much larger generation of pensioners.[25] This kind of thinking perfectly exemplifies the ideological sources of the new liberalism. First, the elderly are seen here as a 'load', 'burden' or 'cost' to be covered, which illustrates the penetration of purely economic thinking into other spheres: in this case it is the economisation of a social phenomenon. Secondly, one can see a strong spirit of individualism and selfishness here: individuals may feel disinclined to financially participate in solving a social problem that does not concern them directly. Etxezarreta (2003: 10) suggests that this selfishness is inconsistent. The current generation that refuses to provide for a larger number of pensioners ignores the fact that it enjoys a much better life because previous generations paid for the investments that led to present wealth. Again, even inter-generational justice has a number of possible interpretations and the neoliberal one should not be taken as dominant.

[25] Baker (2003: 11—12) questions this logic. According to him, economists usually consider after-tax income as the prime measure of living standards. However, the proponents of pension reform have developed a new method, 'generational accounting,' which explicitly takes the lifetime tax burden as the sole measure of inter-generational justice. By the logic of generational accounting, an age cohort would appear worse off if it had a 5 percentage point increase in its lifetime tax burden, even if it saw a 100 percent increase in its after-tax income compared with a prior age cohort.

The State's Derogation of Responsibility for Pensions

The neoliberal concept of the minimal state allows for the smallest possible state interference in the lives of individuals. The responsibility for their pension has to be therefore principally shifted to individuals. Nonetheless, as I will try to demonstrate, attempts to derogate responsibility for pensions need not always be due to ideological motives. It can be politically convenient not to take responsibility for citizens' pensions, no matter what political, philosophical or ideological orientation a particular party may have.

Assuming the future insolvency of the PAYG system in consequence of adverse demographic or economic developments, and assuming we still want to sustain it, any government will have to either (a) reduce pension levels, (b) raise the contribution rate or (c) postpone the retirement age, or combine the three measures. All of them are highly unpopular. The demographic section tried to demonstrate that the pension reform does not improve citizens' situation—in the case of adverse demographic or economic developments, it will remain as bad as without the reform. However, what the reform can solve is the problems of politicians, at least in the short term. Whereas under the PAYG system the government would have direct liability for unpopular decisions, it cannot be blamed for low pensions under the reformed system, since pension levels are determined by the performance of pension companies and financial markets. The degree of risk from future developments remains the same—it is merely shifted from the state to the individual (Polák 2004b: 12).[26] The reform should therefore be seen rather as a clever accounting trick by politicians (whether social democrats, conservatives or liberals) who naturally prefer that others be the bearers of bad tidings. In the case of a fundamental pension reform, it will be the market. In the welfare state literature, especially concerning strategies to minimise the political cost of retrenchment, this technique is called 'passing the buck' (Weaver 1986: 386—387). Politicians will always try to avoid unpopular decisions. However, if a decision has to be made which is likely to incur blame, they will try to pass it on to someone else or to introduce an apparently automatic mechanism that (meeting certain input conditions) will take the decision as it were of its own accord. This is how things stand with fundamental pension reform.

Efforts to Expand Financial Markets

It seems clear that the supply of a regular flow of funds for the financial markets and of profits for financial capital and the financial players involved (insurance companies, pension funds, banks, unit trusts, etc.) are the paramount objective of this transformation [pension reform], regardless of the economic cost for the countries involved and of the increased risk and deterioration of the welfare of European citizens. (Etxezarreta 2003: 19)

I use this telling quotation straight away to point out to another ground for reforming pensions fundamentally. Pension reform promotes the interests of the groups mentioned by Etxezarreta, thereby providing a partial explanation for their efforts to promote the reform (privatisation) of public pension systems, so redirecting public finances to capital markets where the money can generate profits. Even now, pension funds are the main institutional investors in capital markets (Staněk 2003: 52). Their power and influence, both in international financial institutions and in national governments, should not be underestimated.

The fact that institutions in which pensioners' welfare is secondary to profit would be responsible for a significant part of pension income raises many questions. According to Minns (2003), the central questions relating to the pension system are: who controls delivery, how is it accomplished and who gets most out of it, the deliverers or the supposed beneficiaries? If it is a welfare issue, it should be the latter. If not, it will be the former. The central objective of financial institutions is not the delivery of

[26] As the reform has no impact on total economic *output*, it can only change its redistribution. Pensioners can thus have lower or higher pensions than under PAYG, but if they are higher, it will be at the expense of someone else. The situation of individuals is therefore the same as if the contribution rate had been raised or pensions reduced under PAYG.

welfare, but the production of a sufficient margin to make the delivery of welfare profitable. The potential welfare of beneficiaries (pensioners) is likely to be at best only a side effect of profit making. None of perspective pension funds offering services under the second pillar are charitable or mutual organisations. All are primarily profit-oriented and if they had not anticipated gain, they simply would not have entered the sector.

Efforts to Build Up an Integrated European Pension Market

The current reform-trend towards pension capitalisation is thus beneficial for institutional investment. Institutional investors in Central and Eastern Europe—as well as within the rest of the EU, because of the ongoing integration—will benefit from pension privatisation in post-communist countries due to an enlarged clientele and access to their savings (Wehlau 2003: 7).[27]

The issue of European integration is important here for another reason. As Etxezarreta (2003) points out, besides profits for institutional investors, the expansion of capital markets also serves to further the EU's politico-economic ambition to create a new 'European financial architecture' to achieve homogeneity of capital markets and so boost their competitiveness. The logic of these efforts is simple: the more privatised pension systems there are in the EU, the more capital will flow into the (single) European capital market, making it more powerful and better able to compete on equal terms with Wall Street[28] and Tokyo.

The EU's own statements can be adduced in support of this thesis. According to a 2002 internal EU paper entitled 'An Integrated European Pension Market' (cit. in Staněk 2003), the EU has developed an integrated European pension market scheme which is to constitute the fundamental pillar of all EU countries' pension system reform. It contains the design of the so-called second and third pillars: the second pillar is mandatory and prefunded, while the third consists of voluntary and supplementary insurance, exactly as in the World Bank model. Staněk says that the use of the so-called long-term resources obtained by means of the second and third pillars will be crucial for financing enterprise development. In another paper, the European Commission (2001) calls for a comprehensive approach which will involve continuing pension reforms in member states, including allowing private pension schemes to take full advantage of the EU internal market.[29]

Political Irresponsibility in PAYG schemes?

The pension reform advocates often argue that under the PAYG public system there is a major risk of politically irresponsible behaviour, ignoring the real state and financial position of the pension system. By contrast, the new system with private ownership of a part of contributions reduces the room for political manipulation, as politicians cannot touch the private savings. This argument is certainly relevant.[30]

Nonetheless, one should not forget that politically responsible behaviour is necessary even under any

[27] These investors have hitherto tried to sell their services within the framework of voluntary supplementary pension insurance (under the World Bank model known as the third pillar). However, the participation rate was very low despite several tax breaks. In Slovenia for example, only 0.02% citizens a year participated. In Slovakia, the third pillar accumulated assets amounting only to 0.6% of GDP, whereas PAYG system expenditure totalled 8% of GDP before the fundamental reform. That is why institutional investors are trying to promote a reform that will redirect as much of the revenue flow as possible from the PAYG to the capitalisation system and make prefunding mandatory.

[28] Concerning the USA, I should add that this country faces similar trends. Social Security in the United States is under serious threat. This is not a result of its financial situation but, as in Europe, the power of the financial interests which stand to gain by its dismantling and the fact that these groups have largely been able to control the flow of information to the public on this issue (Baker 2003: 11).

[29] For more detailed documentation and analysis of the EU's attempts to influence its member states to reform their pension schemes see Dräger (2003).

reformed system, especially as regards regulation. According to Orszag and Stiglitz (1999: 32), it is difficult to believe that a government that is inefficient and corrupt in administering a public benefit system would be efficient and honest in regulating a private one. Considerable government regulation is essential to avoid investments that are overly risky and managers who are fraudulent. In the CEE context, it is important to mention that this kind of risk is especially acute in countries with poorly developed capital markets.

Risks and Social Impacts of Fundamental Pension Reforms

After having presented and analysed both alleged and real grounds for fundamental pension reform not only in the Czech republic and CEE, but also all around the world, let me now proceed to identifying possible risks and consequences of such a move.

Risk of Capital Market Fluctuations

The major difference between the unreformed and fundamentally reformed pension schemes is that whereas the former is 'defined benefit' (DB), the latter is only 'defined contribution' (DC). Under the defined benefit system, the pension benefit formula is laid down by law; everybody knows what their pension payment will be. The state undertakes to make up the difference if contributions are insufficient to cover costs. That is, the risk is borne by the pension programme's 'sponsor', namely society as a whole (or, strictly speaking, its productive part). The system of DC predetermines only the level of contribution. The level of pension benefit to be paid out depends on the performance of pension companies and general financial market conditions. Payments may be higher or lower than total contributions. No one guarantees anything and the risk is borne solely by individuals.[31] Staněk (2003: 54) warns that:

the problem is the real state of pension funds in the European Union. At present, 92% of all pension funds are in a solvency crisis. Massive investment in technology stocks in 1995—1999 and the ensuing financial market crash led to a striking fall in real liquidity in an overwhelming majority of pension funds. This is confirmed by the OECD study on pension funds. The study states, for example, that there is an annual deficit in the financing of the PAYG system in Great Britain (this country also has a capitalisation pillar valued at over GBP 70 billion). This situation has arisen despite the control mechanisms designed to monitor the activities of European pension funds.

[30] Of equal relevance, however, is the counterargument that the risk of the reformed system lies in financial market volatility. It is irrelevant for an individual whether she loses money due to irresponsible politicians or unfavourable financial market conditions. In fact, a publicly run system has at least two important features. First, politicians can be monitored and if the citizens are not satisfied, they will not re-elect them. Despite all the shortcomings of representative democracy—for example, insufficient awareness and involvement, even apathy, an opportunity to cast a vote only once every four years, and so on—there is at least a possibility of influencing the course of events. Nevertheless, the behaviour of private companies and capital market developments cannot be influenced by individuals even theoretically. Second, the state can use the collected contributions 'irresponsibly' in two ways. Besides the widely discussed corruption and other forms of misappropriation, the state may manage contributions irresponsibly (in the sense that it does not use them for the original purpose of paying out pensions) in a positive way—money can be used, for example, to help the situation in an economic depression, but only on condition that during the following period of economic expansion it is 'returned'. In the case of private pension companies and capital markets, there is no evidence of similar situations of using collected funds for a purpose beneficial to all citizens.

[31] The risk of capital market fluctuations was mentioned in the subsection on merit. To repeat and summarise, under a reformed DC scheme two people with identical earnings and contribution records may end up with very different pensions. The reason is that rates of return on financial markets change over time; whatever the current state of the market, in ten years' time it could be very different. In consequence there is a real threat that two people with a ten year age difference, and hence also retirement age, will receive totally different pensions despite the fact that they contributed exactly the same amount of money to the pension system during their working

Management Risk

The last sentence in the quotation points to another risk to which we should direct our attention. The uncertainties of a fundamentally reformed system are not confined to capital market fluctuations. Even in a favourable situation, a pension fund management can fail. There have been noteworthy scandals in countries with much more effective regulatory mechanisms.[32] For example, eleven investment banks, mainly from the USA, were fined over USD 1.3 billion for manipulating research and information about corporate clients in order to retain lucrative banking business. The investment clients (pension funds and private clients) who were duped into following the investment advice, based on questionable intelligence about investment ratings, lost millions. The banks included Citibank, Merrill Lynch, Credit Suisse-First Boston and Goldman Sachs. The well-known Enron case is also relevant here, since it involved the placement of millions of dollars of employees' pension funds in its own shares, which then became worthless due to its failed financial engineering. Similar cases can be documented also in Great Britain. Of the top ten pension fund management companies in the UK, four were fined USD 470 million, namely Merrill Lynch, Union Bank of Switzerland, Goldman Sachs and Deutsche Bank. Then there was the failure of major insurance companies, such as Equitable Life, to deliver on their promises to endowment holders and pension savers, unilaterally changing the rules of policy entitlement (Minns 2003). As these examples show, regulatory mechanisms do not guarantee honest behaviour on the part of financial actors operating in the capitalisation pension system.

Questionable Rate of Return

Saving in the so-called second (prefunded) pillar is risky. There are reasons to believe that the replacement rate will keep on falling and that pensions from the second pillar will be no higher than PAYG pensions in the long run. One of the arguments presented by the advocates of a fundamental pension reform is that for decades investing in capital markets has been bringing higher real returns than those of the public PAYG scheme. They claim that this trend is likely to continue in the future and should provide for higher pensions. However, as the following will aim to demonstrate, it is not so cut and dried.

The first question that arises in relation to rate of return is why stocks, which are just a claim on the present and future profits of the so-called real sector (corporations, and so on), should bring higher returns than the real sector itself. The answer is that stocks may have higher prices. In such a case, however, the stocks are overvalued. Such overvaluation is commonly estimated by means of the price-earnings (PE) ratio, which is the value of a company's stock divided by its profits. Historically, in the USA, for example, the ratio averages about 14, but today it is about 20 (Krugman 2005). Therefore, it is true that investing in stocks can bring higher returns than PAYG. However, a number of experts doubt that the current trend can adequately guarantee that the rate of return from investing in stocks will continue to grow. In their view, stock overvaluation is a bubble that might easily burst. Henwood (1994), for example, considers it economically unwise to bet on financial asset prices indefinitely growing more rapidly than the value of the underlying real assets. This argument has its logic and is certainly in accordance with the conclusions of this paper. However, it is currently no more than a prognosis and awaits more detailed economic justification.

The lively debate currently ongoing in the USA can help us analyse future rate of return estimates. In his second term, it is a priority for President Bush to privatise Social Security (a franker term for what the World Bank calls 'pension reform') (VandeHei and Allen 2004). Despite the complexity of the issue, it will be helpful to sum up the basic points.

[32] The issue of underdevelopment of financial markets in the CEE countries is discussed in more detail by Wehlau (2003). The financial markets of these states are characterised by low capitalisation (the sum of accession countries' market capitalisation together is broadly comparable to that of Ireland, which is the fourth-smallest stock market in absolute terms within the euro-area) and by insufficiently developed regulatory mechanisms.

The Social Security Administration's Office of the Actuary (OACT) has generally used a 7% real return on stocks (based on a long-term historical average) throughout its 75-year projection period. The real return on Treasury bonds is estimated at 3%. However, some critics say that these estimates are inconsistent with other estimates on the basis of which OACT projects the unsustainability of the PAYG system, namely the GDP growth rate projected as 1.5% for the 75-year period. Assuming an adjusted dividend yield of roughly 2.5% to 3% and projected GDP growth of 1.5%, the stock return implied by the so-called Gordon Formula[33] for stock return calculation is roughly 4% to 4.5%, not 7%! To make the equation work with a 7% stock return, assuming no change in projected GDP growth, would require an adjusted dividend yield of roughly 5.5%—about twice today's level (Diamond 1999). If the OACT estimations are to be consistent, they must take into account either a higher growth rate or a lower rate of stock returns. DeLong (2005) introduces different options wherein the OACT estimates might be valid. The options qualified by the author as unlikely will not be mentioned. Assuming slow economic growth, equity returns could reach 6.5%[34] only in the case of a substantial decline in the stock market in the near future that would push dividend yields back up to the necessary levels (lower absolute values of returns will mean higher percentage values).[35]

To sum up what follows from this discussion in the Czech context would lead to the conclusion that the pension reform proponents who assume the extrapolated continuation of the development of equity returns hitherto should recall the GDP growth rate estimate which serves as a basis for predicting the crisis of the PAYG system. If the equity returns have been high so far, it is due to faster GDP growth in the past. If economic growth is to slow down in the future, equity returns cannot be as high as they have been. However, if it does not slow down, the PAYG system should avoid the crisis and reform is not needed.[36]

Transition Costs

Orszag (1999) offers another critical angle of comparison between the capitalisation (prefunded) and PAYG pillar rates of return. He says the returns cannot be compared seriously if the reform transition costs[37] are not subtracted from the capitalisation pillar returns. Redirecting a part of the contributions of those who decide to save in the second pillar to their personal accounts will create a deficit. Any deficit affecting the pension benefits of those who remain exclusively in the first pillar will have to be made up by the state or, to be precise, by the productive generation.[38] According to Orszag, this money can be borrowed by the government. However, the extra returns would be clearly offset by interest payments in such a case.[39] In any case, if the government borrows the money, it will have to repay it; if it does not borrow, it will have to cover the deficit directly from other sources. Wherever the money comes

[33] This formula says that stock returns equal the ratio of adjusted dividends to prices (or the adjusted dividend yield) plus the growth rate of stock prices.

[34] DeLong uses slightly different parameters from Diamond—1.9% for GDP growth rate and 6.5% for equity returns.

[35] Diamond (1999) estimates that the capital markets would have to decline about 35—45% in real terms over the first decade of this century. In a similar line, Krugman (2005) points out that stocks are much more expensive than they used to be, relative to corporate profits (they are overvalued); that means lower dividends per dollar of share value.

[36] For a more detailed discussion of the relationship between economic growth and equity returns see Baker, DeLong and Krugman (2005).

[37] The transition costs of the switch from the PAYG to prefunded pillar represent one of the major argument against a fundamental pension reform. They can amount up to tens of billions of EUR.

[38] This constitutes the so-called double payment problem—see the discussion in the chapter "CEE Pension Reforms—A Challenge to Existing Theories ."

[39] With an interest rate of 10%, the return will be 10 cents on the dollar, but these 10 cents will be used for interest payments. The capitalisation pillar's net return will thus be exactly the same as in a PAYG system: 0%. Orszag's model is theoretical and to make calculations simpler, does not take into account GDP growth.

from—privatisation of state enterprises, government bonds, introduction of new taxes or spending cuts—in the end the reform will be paid for by the citizens, for the state does not have its 'own' money. Such measures are always at the expense of the working generation and, indeed, they work out the same as if the government had increased the contribution rate to the PAYG system (the only difference being that they are politically more feasible). Orszag says that the rate of return can, in fact, be higher in this case. However, it will not be the result of the reform, but of extra money infused into the system. The higher rate of return could equally be achieved in a maintained PAYG system if extra money were made available.[40] It was decided in the past to start paying out pension benefits to generations of people who had not contributed or had contributed very little to the pension system and so enjoyed super-normal rates of return. This is also the essence of Orszag's argument: the decision was made and the 'gift' to the first generation needs to be repaid. Reform towards capitalisation does not permit us to renege on this. In this connection, Orszag (1999: 35) quotes Diamond to good effect:

[t]he reason the rate-of-return [for Social Security] remains below the market return is the presence of an unfunded liability ... current workers must receive a lower return from Social Security to pay for the higher returns received by earlier generations. The same analysis holds for individual accounts. The creation of individual accounts does not change the history that leaves Social Security with unfunded liabilities. The rate-of-return [under such a retirement system], including both individual accounts and the financing of the transition, is not increased by the creation of individual accounts per se.

Administrative Charges

The previous section demonstrated that, despite the propaganda of pension reform advocates, it is unlikely that returns under the second pillar will be significantly higher than under PAYG. A fair comparison of rates of return in both systems also requires that their administrative charges be considered. Experiences from abroad confirm that this is one of the most problematic issues of reform. In Chile, for example, such charges reached approximately 20% of contributions. In the UK, the level of charges was even more alarming, climbing to 40—45% (Murthi, Orszag and Orszag 2001: 308).[41]

A charge for purchasing an annuity from a commercial insurance company (commercial insurance companies have to make a profit) is another item that will reduce the total sum of money saved. Besides the charge mentioned, so-called selection costs are also likely to reduce the sum of saved money. The annuity pensioners can buy with their lump sum depends on their life expectancy at the time they retire, as well as on the interest rate the insurance company expects to earn over the lifetime of the annuity. There is significant uncertainty about both variables. The life expectancy of the population can be extended, for example, in consequence of medical advances, and the interest rate is very sensitive to economic cycles (Barr 2000: 24). The insurance companies can resist any unfavourable developments by raising charges. They will be able to do the same in the case of losses caused by so-called adverse selection. In the context of the annuity market this term is used to describe the situation of people who expect to die younger or live longer than average and who, on the basis of this private information, choose a different type of annuity than might be available to them if the insurance company had the same information. If, in this situation, insurance companies paid annuities based on average life expectancy, they would lose out

[40] Orszag supports his conclusions with an analysis carried out by the Advisory Council on Social Security in 1994—1996. The members of the Advisory Council were unable to reach agreement on the role of individual accounts, so they split into three groups. The first group proposed a system with almost half of contributions redirected to privately managed personal accounts; the second suggested that 1.6% of contributions be redirected to publicly managed personal accounts; and the third did not take on board personal accounts at all, proposing the investment of a portion of the Social Security Trust Fund reserves in the stock market. Despite the sharply different treatment of individual accounts in the three proposals, the rate of return of the first system was 2.6% and in the case of the third it was 2.2—2.7% (depending on the share of the Social Security Trust Fund invested in equities).

[41] Including charges for changing pension companies and for purchasing an annuity (see below).

on people with longer than average life expectancy. Insurance companies consequently price annuities on the basis of longer life expectancies. A typical person of average life expectancy must therefore pay a higher price for an annuity than would be justified on the basis of average life expectancy (Murthi, Orszag a Orszag 2000: 4). It is difficult to estimate the level of costs connected to annuity purchase or the percentage share it would represent of the whole saved sum[42]; however, it is certainly possible to say that there would be annuity purchase costs in a fundamentally reformed privatised system, whereas there are none under public PAYG system.

Conclusion

The ambition of this paper was to critically asses the Czech pension reform and to estimate its prospects. Particular attention was focused on how fundamental it has (not) been, how fundamental it might go in the future, what being fundamental means, and what risks and social impacts a fundamental pension reform, if enacted, would likely engender.

My major conclusions were the following: unlike most of the CEE pension reforms, the Czech pension reform has not been fundamental so far, meaning that there has been no significant shift from collective risk sharing towards individual self-insurance in the financial provision for old age. Among the reasons for this exceptionality, I identified negligible influence of international financial institutions, negative experience with domestic financial institutions and privatisation, the comparative strength of trade unions, and quite banally—the lack of political and financial actors who would push for a fundamental pension reform forcefully and consistently. However, this is likely to change in the near future. The major Czech political parties envisage reforming the current pension scheme. Liberal ODS wants to curb the public PAYG system and promote voluntary saving for pensions; whereas Social Democratic ČSSD plans to introduce an NDC system, which, if not accompanied by decent minimal pension benefits, will still constitute a fundamental move towards individualism; and Conservative KDÚ-ČSL would like to go for the World Bank model, embodiment of a fundamental pension reform. As each party considers more or less fundamental pension reform, I proceeded to identifying the grounds for such a reform and the greatest risks of reforming pensions radically in the last section.

In the course of writing this paper, many things have happened. The Czech parliamentary elections of June 2006 ended in a strange draw—the left and right blocks won 100 seats each. For a long time, no government could be formed. Then the ODS, which got the most of the votes, formed a government but only for a short time—it resigned recently. This means that right now, in October 2006, the Czechs have no government again. This also means that not many of my estimates from the time just before the June elections could have I changed. It is still not clear who will govern and even if it were, it would be very hard to predict the course of pension reform developments. The dice was cast—all the conceivable calculations, analyses, and econometric modelling have been carried out already. Nowadays, it is all rather a question of convincing other parties and public, it is a question of political will and abilities to push for the desired pension reform. Policymakers will necessarily have to make a cost benefit analysis on what their proposal of pension reform will bring politically and socially. One of the messages of this paper is to warn about what is at stake, what practical implications a fundamental pension reform might have for citizens, and what political implications it might have for the policymakers.

[42] For more detailed information for example from the United Kingdom see Finkelstein and Poterba (1999) or Murthi, Orszag and Orszag (2000). The authors for example warn that charges for an inflation-indexed (real) annuity purchase are significantly higher than charges for purchasing a nominal annuity in the United Kingdom.

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