Czech Pension Reform: Expectations and Reality

Daneš BRZICA, Senior Research Fellow

Institute of Economic Research, Slovak Academy of Sciences

Background of the Issue

The Czech coalition government recently adopted some measures to stabilize the state budget. The next step is the intention to implement a pension reform. The population of the Czech Republic (CR) is aging rapidly. This is also reflected in the situation that a faster increase is in the number of people in retirement than in those entering the workforce. There are currently 5.38 million ratepayers and 2.83 million pensioners (of which 2.36 million old-age pensioners) in the country. While at the end of 2019 the average old-age pension was less than CZK 13,500, currently it is CZK 20,233. The combination of factors such as an ageing population, the widening gap between the insurance collected and the amount paid for pensions, and the increase in the average nominal pension puts pressure on the financing of the pension system and its sustainability (see Tables 1 and 2 below). This less-than-optimal situation is further complicated by relatively high inflation. It was the long-term indexation parameters that did not consider the current high inflation rates. The government is trying to correct this by reforming the entire pension system.

This situation is not unique in the world. The pension systems of most countries are facing unprecedented pressure due to a confluence of several adverse circumstances, especially population aging, rising public debt and relatively high inflation. The confluence of unfavorable circumstances means that the citizens everywhere must search their own provision in old age and can no longer rely on the state pension/social security systems.

In the second half of 2023, the president signed two amendments to the pension system. They relate to early retirement, indexation, change of pay dates and online application. However, the indexation, which will take place in January 2024, will still be under the original pre-reform conditions. The aim of planned reform is to stabilize the entire pension system, which is increasingly finding itself in a sub-optimal position. The country has been waiting for a fundamental reform of its pension system for decades. Since October 2023, the Czech government has disadvantaged early pensions and limited the future indexation of pensions. However, the submission of further changes concerning the retirement age or the calculation of pensions, has been postponed. In May 2023, the Ministry of Labor and Social Affairs (MLSA) proposed adjustments to the pension system. Originally, the MLSA was supposed to submit a draft law on pension reform in September 2023, and then the deadline was changed to October. However, a later date is now expected – the details will probably be known by the end of this year. There is a great deal of technical details related to the regulation being adopted and some of them may still be changed or refined. Therefore, they are presented in the next section only for rather illustrative purposes.

Main Causes of the Pension Reform in the Czech Republic

The main reasons for reforming the pension system are:

- life expectancy is increasing;
- the gap between the insurance collected and the amount paid for pensions is increasing;
- the number of seniors in the population is increasing;
- population development - the proportion of workers per pensioner is decreasing;
- long-term absence of reform (several pension reform commissions have failed).

Under the point "increasing the gap between the amount collected and paid", it can be stated that in 2023 this difference should reach about CZK 80 billion. In the future, the current instructional allowance should be replaced by the institute of a joint assessment base for married couples/registered partners. This would be a voluntary request by married couples/partners to have their assessment bases averaged and their pensions would therefore be at a similar level. This should bring pensions into line with those of partners with different incomes.

The regular indexation of pensions will take place from January 2025. The following changes are made to the regular January indexation of pensions: (1) 1/3 of the increase in real wages (previously 1/2) is considered; (2) only the index of the consumer basket prices of pensioners is considered; (3) changes in inflation and real wages are always surveyed from July to the following June; and (4) this procedure will be used for the first time for regular indexation in January 2025. This part of the law does not play a significant role in the real increase now, as real wages fell in 2023. Therefore, there is no reason to use this rule.

Extraordinary pension indexation is from 1 October 2023. If inflation exceeds 5% during the year, pensions (average pension) are increased by 60% of this inflation. Only the price index (inflation) of the consumer basket of pensioners is considered. An increase in the pension by means of extraordinary indexation serves to quickly compensate for inflation during the year. When calculating the subsequent regular January indexation, the extraordinary increase is deducted from the January indexation. In 2022, there were two extraordinary indexations (in June and September), and in 2023 there was one extraordinary indexation (in June).

Although many elements of the pension system reform are unknown, preparations for the reform have already begun, including in the legislative process. The internal comment procedure has already been completed and the submitted comments are being processed. The government has already pushed through several partial changes, e.g., greater regulation of early retirement or slower indexation of regular and extraordinary pensions. From January 2024, the state is to contribute to the pension savings of those who save from CZK 500 per month. The state´s contribution will increase to CZK 100 - 340 from the current CZK 80 - 230. Old-age pensioners are no longer entitled to it.

Table 1: Income and expenditure of the pension system of the Czech Republic (mid-year 2023)

CATEGORY	VALUE (in bn CZK)
REVENUES	297.03
EXPENDITURES	334.61
BALANCE	**37.58**

Source: MLSA, CSSA, 2023

There are currently 2.28 social security payers per one old-age pensioner. The minimum savings period for entitlement to the payment of the allowance will be extended to ten years. The burden on state spending is also because the average pension is constantly increasing. Here is presented the growth of the average old-age pension since the end of 2019 (year/month): 2023/6 CZK 20,233; 2022/12 CZK 18,061; 2021/12 CZK 15,425; 2020/12 CZK 14,479; 2019/12 CZK 13,468.

Table 2: Basic statistics of the pension system of the Czech Republic (mid-year 2023)

CATEGORY	NUMBER
TOTAL NUMBER OF RATEPAYERS	**5,380,231**
OF WHICH:	
- Employed insured persons	4,605,714
- Self-employed persons who are required to pay pension insurance	764,134
- Voluntarily insured citizens	10,383
NUMBER OF PENSIONERS	**2,834,958**
OF WHICH:	
- old-age (including early)	2,358,367
- disabled	410,668
- survivors (widow's and orphan's)	65,923
NUMBER OF PENSIONS PAID BY STATE	**3,417,275**
OF WHICH:	
- old-age (including early)	2,358,367
- disabled	410,668
- survivors (widow's and orphan's)	648,240

Source: MLSA, CSSA, 2023

From January 2024, there will no longer be penalties for a one-off withdrawal from pension savings. Originally, the idea of the governing coalition was that there would be penalties for one-off withdrawals to stimulate people by giving them an advantage so that they would decide to choose the option of having a regular monthly annuity paid out when paying out their pension savings. Nevertheless, the coalition government did not agree on this change. The annuity payment of savings from 3P products is not included in the amendment to the Act. Originally, it was also expected that the time worked would be reduced from the current minimum limit of 35 years to a significantly lower value of 25 years. However, this change will not be implemented as part of the reform. Nevertheless, there will be some important changes in the reform, including:

- adjustment of the retirement age;
- the sharing of pension rights between married couples;
- fictitious assessment base for caregivers.

Savings in supplementary pension savings are supported by the state through a state contribution, a tax deduction, and a tax exemption for employer contributions. Pension companies will offer dynamic investments and other institutions will provide the opportunity to choose long-term products.

Due to the greater disadvantage of early retirement, the importance of pre-retirement is increasing. Saving in supplementary pension savings, from which pre-retirement can be drawn, is becoming increasingly important. Pre-retirement is an alternative for people who do not want to work until the regular retirement age and do not want to draw early retirement. From October 1, 2023, the granting of early retirement is much less advantageous than it was. Newly, it is possible to take early retirement no earlier than three years before reaching the regular retirement age (previously five years). The reduction in the amount paid for the early retirement scheme has also increased. When choosing early retirement, it is necessary to consider a permanent – relatively high - reduction in the pension. For every 90 days before the regular retirement age, the pension will be reduced by 1.5% of the personal assessment base. Those who take early retirement by three years will have a monthly pension that is by one third lower than if they work until the regular retirement pension. In addition, indexation is limited until the regular retirement age is reached. One of other changes to early retirement after the reform is that the applicant must have at least 40 years of pension insurance (as of September 2024). Changes in early retirement will occur from November 2024 for 40 years of insurance and from October 2023 for other modifications.

Changes in the payment of pensions already approved by the Senate are: (1) the possibility to apply for the award of a pension in electronic form - effective from December 1, 2023; (2) change of the pension payment period from a rolling month to a calendar month (this will abolish the need for additional payments after the January indexation); and (3) narrowing the number of pay periods from 13 to five - effective from July 1, 2025.

Future Expectations and Implications

As was the case with the recent austerity package, many actors have criticized these pension reform steps. For example, the strongest opposition party, ANO, is against changing the parameters of the retirement age. Its representatives have announced that they want to discuss the matter with the relevant minister in mid-November. A considerable uncertainty, regarding the government´s pension reform ideas, makes it difficult to predict its final form. The volume of pensions can be influenced by a variety of factors, especially by a set of legislative measures/regulations.

Mercer's *CFA Institute Global Pension Index* assesses countries´ pension systems according to three basic criteria: adequacy, sustainability, and integrity. The adequacy criterion assesses the generosity of the pension system, in particular the replacement ratio (the volume of pensions in relation to the average wage). The sustainability criterion assesses the extent to which the pension system is set up in a financially sustainable manner in the context of population ageing, the level of public expenditure on pensions and total public debt. The integrity criterion assesses the credibility of the entire pension system, with emphasis on the credibility of the private companies (e.g., pension funds) involved in the pension system. Unfortunately, the Czech Republic is not included in the comparison. The quality of the expected Czech pension reform changes will hopefully be evaluated in the future based on the above criteria.

Although there is no penalty for one-off withdrawal of savings from pension savings, the government is counting on such a possibility in the future. The measure would then apply exclusively to new contracts, and the person concerned would lose state subsidies or tax benefits. This measure should then apply to all products in the 3P of the pension system. The constant postponement of this reform and its unclear outlines may undermine citizens' confidence in a modern, balanced, and fair pension system. From January 2024, the amendment to the law in the 3P, e.g., changes the setting of state contributions and introduces a dynamic investment product. The government is counting on adjusting the retirement age. From 2025, it is to be set for people at the age of 50 according to their life expectancy.

The retirement age should be gradually adjusted so that a pensioner spends an average of 21.5 years in retirement. The adjustment should be based on the life expectancy for each year cohort. The amount of time people spend working is thus to be extended. For those born in 1967, e.g., the retirement age would be extended from the current 65 years to 65 years and four months. Newly granted pensions should also grow more slowly than the current ones.

As part of the planned pension reform, one serious challenge should be addressed. This challenge is the already mentioned deteriorating ratio between the number of social security payers and the number of old-age pensioners. The possibility of increasing the retirement age has its limits, given by the overall health status of the population in retirement age. Reducing already low pensions is also not a viable alternative.

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