Czech It Out: Pension Pains are Global

By Editor Test *Wed, Apr 7, 2010*

Age-related spending in the Czech Republic will be 23.4% of GDP by 2060, according to European Commission data.

The U.S. is far from the only country that faces a growing fiscal burden as the result of an aging population. The same trend threatens the Czech Republic.

Unless the Czech Republic creates new policies for dealing with healthcare and retirement benefits for the aged, the country's "long-term fiscal sustainability remains a serious challenge," according to a report by the Organization for Economic Cooperation and Development (OECD).

As reported by IPE.com (Investment & Pensions Europe), the Czech Republic's own Ministry of Finance estimated that rapid population aging would increase age-related spending by 6.4 percentage points over the next 50 years.

Without reform, that demographic trend would push the country's public debt past 60% by 2040 and to more than 250% of GDP by 2060. The OECD said raising the retirement age by two years won't be enough.

"Recent legislation extending the increase in the retirement age will do much to fend of the threat of looming increases in pension spending" said the OECD, "but on current projections pension expenditure is still set to rise from around 7.8% of GDP in 2007 to roughly 11% by 2060."

"Tackling this challenge without imposing large—and possibly unsustainable—increases in social security contributions or other taxes is likely to require a combination of both further parametric adjustments to the system and structural changes," the report added.

The Czech finance ministry has predicted that projected spending will fall by 1% of GDP by 2060 following a recent move in 2008 to increase the retirement age by two years. However, age-related spending in the Czech Republic will be 23.4% of GDP by 2060, according to data gathered by the European Commission.

The country should consider phasing out the differentiation between men's and women's retirement ages and introducing partial indexation of benefits to life expectancy, the authors of the OECD report recommended.

It claimed the earlier Czech government's aim to create a voluntary but fully-funded, defined contribution plan or "second pillar pensions regime" might help the country's pension problems. On the other hand, diverting assets from the state defined benefit pension to fund a new DC pension "could undermine financial sustainability too."

A "DC carve-out" of existing pension assets would lead to a "transitional deficit" as revenue into the DB plan or "first pillar pensions regime" fell, so how much impact it would have at retirement would have to be carefully determined at the carve-out stage.

Either way, said the OECD, a simple carve-out of assets would need to be topped up with further reforms to ensure Czech workers have enough retirement income.

Instead, the OECD has proposed the Czech Republic introduce mandatory or “soft compulsion” to pensions by requiring individuals to “opt out” of a new DC plan rather than “opt into” one. In other words, the OECD recommended something similar to the “Auto-IRA” that the Obama administration is considering.

Though market turmoil may have created a sense in the public’s mind that a Social Security-type pay-as-you-go plan is safer than a market-based 401(k)-type plan, the OECD pointed out, a poor economy also hurts both types of plans.

“The crisis has reduced the rates of return on contributions to the PAYGO pillar as well, even if the decline has been less visible,” said the OECD. In that case, it might be better for Czechs to have both types of plans or “pillars,” the OECD report suggested.