

CZECH PENSION POLICY

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1. Introduction

Inflation and the low indexation of bend points in the first half of the 1990s substantially reduced the dependence of newly granted old-age pensions on previous earnings. The pension reform from 1996 created a ‘pension insurance’ with two ‘amounts’: flat-rate and earnings-related. Each pensioner receives a flat-rate basic pension, replacing the previous universal ‘state compensation contribution’ of 1990, which compensated the cancellation of retail price subsidies. Its amount is now 10% of the national average earnings (NAE). The earnings-related ‘percentage amount’ of the pension generates a partial dependence of pension on previous lifetime earnings, adjusted by bend points and reduction coefficients: the crucial earnings are reduced to just 26% once the first low bend point of 44% is exceeded. Current second bend point is 400% of NAE with the reduction coefficient 0%. Figure 1 shows these current parameters of the Czech ‘pension insurance’. The ‘progressivity’ of this system is high: a newly granted old-age pension is roughly by 30% earnings-related. Thus, 70% of it is a Beveridge type pension. This is a rarity in Central Europe as ‘Bismarck’ clearly dominates in all neighboring countries.

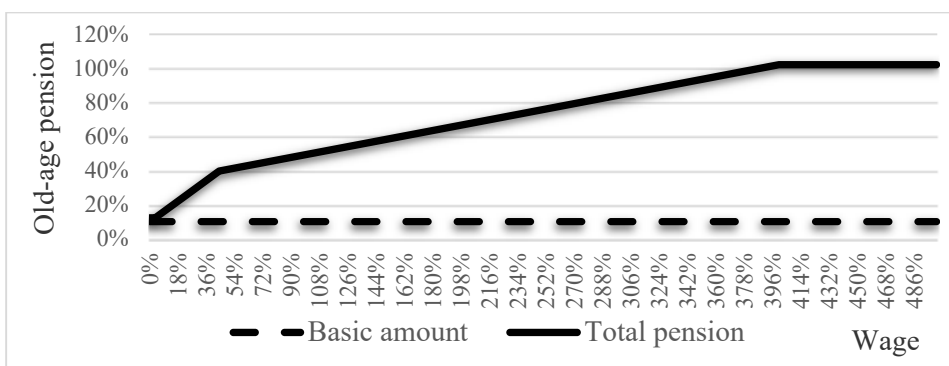


Fig. 1. Newly granted (net) old-age pension in relation to lifetime earnings, in % of NAE in 2020 (45 years of insurance)

Source: Author.

The transformation of the Czechoslovak predominantly Bismarckian pension system into the Czech predominantly Beveridgean system was influenced by the liberal policy of Klaus’ government and by the creation of a complicated and

poorly understandable calculation of both newly granted old-age pensions and indexation (valorization) of pensions. Recently, the marketing approach of politicians on these issues has also contributed to strengthening the levelling of pensions. More than half of Czechs nevertheless prefer 'Bismarck' to 'Beveridge'. In 2010, the Czech Constitutional Court concluded that 'whole complex design of the pension system is non-transparent to a degree that it is de facto incomprehensible for its addressees; and for the majority of the insureds the calculated amount of the pension benefit becomes unverifiable' (Czech Constitutional Court 2010). In addition, the court declared the provisions of the Pension Insurance Act on bend points unconstitutional, 'because in its consequences and in combination with other parameters and the existing construction of the pension system it does not guarantee a sufficiently constitutionally guaranteed right to adequate material security in accordance with ... the Charter of Fundamental Rights and Freedoms and it leads to unacceptable inequalities between different groups of pension insureds' (Czech Constitutional Court 2010). The Constitutional Court abolished the section of the Act containing the bend points and reduction coefficients and it forced the government to react quickly; the government has reintroduced the first bend point within the scope of the so-called small pension reform. Unfortunately, this reform (2011) did not increase the transparency and clarity of the pension system. The only comprehensible parameter of the Czech 'pension insurance' has been the basic pensionable age, which is differentiated for women according to the number of children raised (a remnant of the Communist pension policy). To date, it has also not been possible to establish a comprehensible system of indexing the percentage amount of pensions; after the introduction of parameterization of the basic pension amount, the indexation of the percentage amount of the old-age pension depends on the total room for increasing the average old-age pension, the increase in the basic amount being deducted; so far, no one has even tried to explain the logic of this dependence of the indexation of the percentage-based amount on the valorization of the basic pension amount.

The fundamental challenge for Czech 'pension insurance' is its paradigmatic or rather technical reform, which would lead to the clarity and meaningful combination of the Beveridge (non-insurance) and Bismarck (insurance) components of this 'system'.

2. Proposal for a small pension reform

The non-restoration of the previous second bend point in the key range from 44% to 400% of NAE in 2011 created the preconditions for a simple reform of the basic and percentage amounts of the old-age pension without fundamentally changing the total amount of the old-age pension. Taking into account that earnings up to 44% of NAE are basically an exception, we can increase the total old-age pension in this range so that the total amount curve 'straightens' according to the grade of the straight line demonstrating the dependence of the total pension amount in the 44-400% of NAE range. The result of this operation is an increase

in the basic old-age pension amount from 10% to 32% of NAE and a reduction in the pension rate for 1 year of insurance from 1.5% to $1.5 * 0.26 = 0.39\%$ see Figure 1.

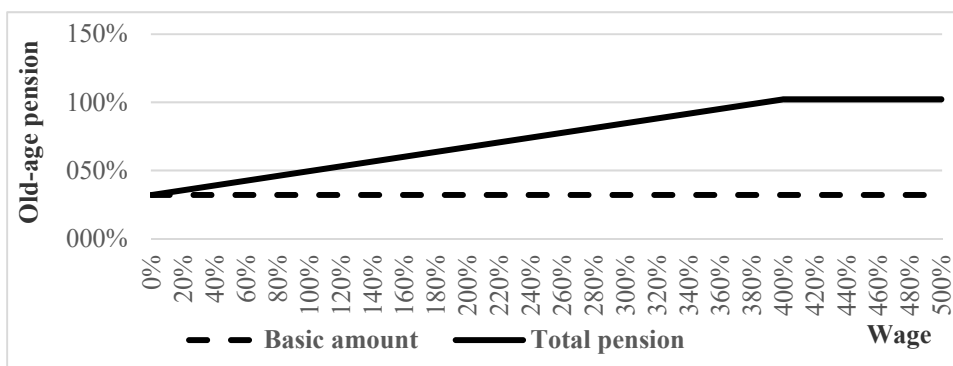


Fig. 2. Small pension reform: newly granted (net) old-age pension in relation to lifetime earnings, in % of NAE in 2020 (45 years of insurance)

Source: Author.

The outlined small pension reform does not change anything for the absolute majority of old-age pensioners. Only those whose pension is calculated from a wage lower than 44% of NAE will ‘profit’ from it. (The costs of this reform are some CZK 7 bn. only, according to the Ministry of Labor and Social Affairs.) I believe that such a small pension reform can be feasibly implemented in a span of one year. Its main effect will be a demonstration of the real ‘progressivity’ of the Czech pension system: it will be clear to everyone that ‘pension insurance’ is not, in fact, mainly a social pension insurance, but a flat-rate pension. I assume that later the interest in changing the structure in favor of earnings-related pensions will prevail. In order to facilitate this restructuring, it would be useful to cancel the parameterization of the basic old-age pension amount (32% NAE) and set a fixed sum for this amount: under the conditions of 2020, it would be CZK 11,141 per month (near the OECD poverty threshold). This redefinition of the basic pension amount will also allow for a substantial simplification of the indexation of the (new) earnings-related pension amount, which will become understandable – as well as the indexation of the basic old-age pension amount.

Disability pensions can continue to ‘copy’ the old-age pension formula after the small pension reform. For survivor pensions, it will be necessary to derive separately their basic and earnings-related pension amounts, as we have derived the rationalized the basic and earnings-related old-age pension amounts.

The key objective of the small pension reform is the ‘irreversible’ removal of the basic bend point used in calculating the earnings-related amount of old-age pension. This will significantly increase the understandability of the Czech pension system. A small pension reform can be implemented by the current Czech government, with the approval of the opposition.

3. Proposal for a major reform of public pensions

A consistent pension reform requires the division of the Czech current ‘pension insurance’ into two pension pillars: pillar 0 and pillar 1, according to the World Bank classification. Pillar 0, in its starting form a flat-rate pension at 32% of NAE, shall be financed from general taxes. On the other hand, the insurance pension (pillar 1) is to be financed from the social pension contributions, which does not exclude the financing of childcare credits from the state budget.

Significant differences should or could be made in the basic conditions for entitlement to the flat-rate pension and the insurance pension. The vesting period for (insurance) pension entitlement should be no more than 5 years. By contrast, a full flat-rate pension may continue to be subject to paying insurance premiums or, more generally, taxes (or length of stay) for 35 years – as is the case in the UK today.

Modern social pension insurance products include:

- Notional Defined Contribution (NDC) system of individual pension accounts, in which the resulting balance of the account is converted into a lifetime pension according to actuarial principles, including the application of adequate mortality tables. The NDC generic scheme has also built-in stabilization mechanisms in the valorization of individual accounts as well as in the indexation of pensions.
- ‘Points system’, where for each insurance year the client receives a fraction where the numerator is the client’s wage (up to the earnings ceiling) and the denominator is represented by the national average earning (NAE); the client accumulates the points until the old-age pension is granted, the law and the government set a point value (e.g. EUR 31.03) for each year, thus providing the actual amount of the pension paid.
- (Austrian) pension accounts system, where pension entitlements are credited every year, calculated according to the pension formula e.g. $1.78\% \times \text{annual wage of the insured}$, with the valorization of pension accounts using the wage index (amount of granted yearly old-age pension = final balance of the pension account), with indexation of paid pensions according to the law.

In 2003, World Bank expertise for the Czech Ministry of Labor and Social Affairs (Chłoń-Domińczak 2003) recommended us to move to the NDC system. Two options were recommended here as a solidarity pillar: flat-rate or minimum pension. On my recommendation, the Czech Social Democratic Party subscribed to the transition to this system. However, a simulation of the NDC system in the first Bezděk's Pension Commission was accompanied by putting a ceiling on the pensionable age at 65 years, which suggested that NDC pensions would be very low at the end of the century. Until recently, Bezděk was claiming on the basis of this ‘analysis’ that the NDC system is not suitable for Czechia because pensions would be low (Mediafax.cz 2010). The lesson learned is trivial: any pension system can be ‘destroyed’ by bad parameters.

All three products, which fit into a modern social pension insurance system, are transparent and understandable. After learning the relatively new Austrian

pension accounts system, I am in favor of its introduction in Czechia. It is a defined benefit system and its novelty consists in the fact that the insurance pension for the given year is definitively calculated after the end of this calendar year – see table 1. The Czech allowance would be calculated according to the formula $0.39\% \times \text{annual assessment basis}$, which includes not only earnings, but also the basis for calculating sickness and other benefits, as well as e.g. valuation of childcare. Such care can be valued, for example, by the average national wage – just like, for example, in the German points system. The annual calculation of pension entitlement (account balance after the end of the year) would be an important contribution to the comprehensibility of Czech social pension insurance.

Table 1. Austrian pension accounts (example)

Year	Annual assessment basis	Annual increment (1.78% * annual assessment basis)	Account after the year (valorization of account after previous year + increment)
2005	30,000	534.00	534.00
2006	31,000	551.80	1 096.48
2007	32,000	569.60	1 688.01
...			
2047	72,000	1 281.60	57 365.13
2048	73,000	1 299.40	59 811.83
2049	74,000	1 317.20	62 325.27

Source: SVS (2020).

The preparation of the major pension reform bill would take 1 to 2 years and we might implement the pension accounts system in waves, as it was done in Austria: to start with new insureds, continue with e.g. 10 following years of birth and only in the further wave extend the system to the remaining clients incl. persons of pre-pensionable age.

The major reform of public pensions will also include a reform of disability and survivor pensions. The existing Czech disability pensions use the ‘pension-type’ concept of disability pensions: their construction is parallel to the construction of old-age pensions (Browne et al. 2018); disability is conceived as a kind of premature aging, or loss of ability to work. An alternative, more modern is the ‘sickness’ concept of disability benefits, conceiving disability primarily as a prolonged illness, until resuming work (if possible). Disability benefits/compensations are part of the sickness benefit system under this concept. Norway is one of the countries which apply the sickness benefit concept of disability pensions. Since 2015, the disability pension has been provided as 66% of the final wage (average wage in the best three of the last five years before disability; earnings ceiling), with a minimum disability pension at 40-50% of NAE, applying even to persons without previous employment. The minimum degree of disability is 50% (Støve et al. 2015). Since 2011, Norway has introduced an NDC-type old-age pension system, supplemented by the ‘guarantee pension’. Pensions and other social security benefits are subject to income tax. We also recommend reforming

the Czech disability pensions (and all sickness insurance benefits) in the same manner, including the cancellation of bend points.

The old-age pension system with a predominance of a flat-rate pension is best paired with a flat-rate orphan pension, in our country up to 25% of NAE. The flat-rate orphan pension (for orphans aged 10 and over) is of similar amount in the Netherlands, where the individual's flat-rate old-age pension is equal to about 30% of NAE. Such an orphan pension may be classified as a family benefit. It is not only from the perspective of Czech pensioners that universal child benefits should replace the current refundable child tax credit), which cannot be claimed by not only low-income families but also by non-earning pensioners, because they are not subject to the personal income tax. The decisive argument for the transition from universal child benefits to child tax allowances in our country was an effort to compel 'non-adaptable' citizens living on social assistance benefits to take up employment. Apparently, advocates of these views did not even try to make a simple example to confirm their ideas; the fact is that in the universal child benefit scheme, only the final social assistance benefit (subsistence benefit) is (substantially) reduced: by child benefits paid. The very discrimination against Czech pensioners as regards the tax credit for children may, of course, be eliminated by introducing taxation of old-age and disability pensions; but this is not foreseen in the framework of the major pension reform: we are postponing the solution of this problem for the future.

The importance of widow pensions has long been declining in the western countries, also as a result of the unification of social insurance systems. The trend is to move to a 'bridging' widow/widower pension, paid for 6 to 12 months after the spouse's death – so that the surviving spouse can adapt to the new situation. (Widely conceived costs of raising orphans should be concentrated in the amount of orphan pension.) Modern systems of social old-age pension allow for the sharing of pension entitlements of couples. In any case, it is advisable to introduce into Czech law the sharing of pension entitlements of divorced couples, unless there is another agreement reached during the divorce proceedings.

The key content of the proposed major pension reform is the reform of old-age pensions: the transition to a flat-rate pension, funded by general taxes, and the transition to a modern social old-age insurance system. In the interest of this transition to the two-pillar system in a relatively short period of time, it may be advisable to postpone the solution of some other issues that we mentioned in this section of the paper.

4. Reform of personal pensions

The introduction of the 'supplementary pension insurance with state contribution' in 1994 was a relatively positive step towards the development of financial services not only in the area of pension savings – new distribution networks were established and developed. The state contribution played an important role in kick-starting the pension pillar 3. With the rapid growth in the number of 'supplementary pension insurance' contracts, a strong pension lobby was created, which led to a strengthening of the sector's fiscal stimulus. The lobby

of insurance companies was also partially successful. The result was the emergence of a segmented system of the pension pillar 3, which is unprecedented in the world. The number of the supplementary pension insurance contracts at the end of 2012 exceeded 5 million. In addition, there were 3.5 million ‘private life insurance’ contracts, of which about 1.5 million contracts drew deduction from the income tax base.

The major pension reform of 2013 increased the transparency of supplementary pension insurance and introduced cost limits for the pension companies, but it did not affect private life insurance, tax deductions and non-payment of income tax and social and health insurance premiums in the case of employer contributions to supplementary pension insurance or private life insurance. The indirect state support for employer contributions is highest in the world, accounting for 65% of the employer contribution. State support for citizens' contributions is ‘only’ above average in an international comparison (OECD 2018), since this comparison assumes contributions of 5% of wage (the products compared in other countries are occupational pensions where the situation is significantly different!). The calculation also reflects the low rate (15%) of the Czech personal income tax. The Czech state support of supplementary pension savings in the form of employer contribution is 2,4 times higher than the support of the same product in the form of a participant's contribution (if 5% of wage are to be saved). All state regulation of the state-supported pillar 3 should be – by its very nature – uniform.

The main purpose of taking out Czech supplementary pension insurance is not individual protection in old age, let alone in a form of an annuity. The main purpose is the tax optimization and getting rid of excess liquidity. The construction of the product taken out till the end of 2012 was of fundamental importance for its high penetration: it was essentially a simple savings product, with high explicit state support in the form of a state contribution, with a guarantee of a non-negative nominal yield. Fiscal illusion, based on the assumption that the state support is for free, also played an important role. All of this explains the unusually high number of participants. ‘Personal pensions have relatively wide take-up in only a few Member States (over 60% coverage in the Czech Republic, over 30% in ... Germany) while in most Member States take-up is moderate and fragmented, and in some, nearly non-existent’ (EC 2017). In general, ‘the third pillar is not really a pension scheme. It is akin to a tax-advantaged savings account. The system should not be presented to the public as a source of meaningful future replacement income’ (WB 2017). If we think this through to all its consequences, we come to the conclusion that: ‘Pillar 3 (voluntary retirement savings) should not receive tax subsidies, which are regressive and, in any case, have not been shown to have any significant effect on private saving’ (Willmore 2000). Therefore, the persistently repeated ideas of some Czech party experts that the impact of the ageing population can be solved by pension savings in the third pillar are completely unrealistic. The standard pension pillar 3 is of no practical importance to most of the population anywhere in the world.

The parallel existence of several Czech systems of generous fiscal support (state contribution, tax deductions, exemption of employer contributions from income tax and from payment of social and health insurance premiums), even for one single product (supplementary pension savings), is unconstitutional, because it significantly distorts the (oligopolistic) market and it is also a manifestation of clientelism and illiteracy. Last year, public spending (including tax expenditures) on these subsidies for supplementary pension savings and private life insurance amounted to approximately CZK 22 billion. Real investment returns for clients are increasingly negative. Due to the extreme state support and the consequent very high number of participants, this (hypertrophic and chaotic) ‘system’ can be included in the rank of ‘soft compulsion’. According to the World Bank's classification of pension pillars, this is essentially pillar 2, not pillar 3. It is a chaotic variant of the neoliberal model of private pensions/savings. More efficient systems of this kind use auto-enrolment, opt-out, auto-escalation of contributions, matching contributions, mostly in the pillar of occupational pensions.

Top managers of the pension companies (Poklop, Homolka) recommend the introduction of compulsory employer contributions, boosting of state support and auto-enrolment of citizens or employees; they like the new 2019 Polish system, which is essentially a copy of British workplace pensions. It is a neoliberal pension concept that has nothing to do with the typical pillar 3. It must be noted that even specialized pension (joint stock) companies do not belong to the third pillar. This is a Czech specificity, which arose only because public servants in 1993 did not want the new business (supplementary pension insurance with state contribution) to fall into the lap of the then almost monopoly Czech Insurance Co. (the reason were two increases in premiums for motor liability insurance – in a short time interval). The existence of special pension companies is completely unnecessary; moreover, almost all these companies outsource most of their activities to affiliated companies within their respective financial groups.

A fundamental reform of the supplementary pension insurance, supplementary pension savings and private life insurance is indispensable and, in general, we have several options for the ‘public choice’. From a technical point of view, liberal policy is the simplest solution: abolishing all fiscal support for financial products and reducing taxes. Social democratic policy could have a broader scope: the abolition of fiscal support for financial products could be linked to an increase in pensions or other social expenditure – for example based on the argument that the relative amount of old-age pensions in our country (slightly) lags behind the OECD or EU (‘pension gap’). A conservative (Christian Democratic) policy can be described as the transition to exclusive tax deductions, with the pay-out of pension savings being fully burdened by a personal income tax (EET tax regime). This is the most common practice in the world, which is especially beneficial for higher income groups, due to the usual existence of progressive income tax rates. Under the conditions of a flat-rate income tax rate (as in Czechia), this system is equivalent to the TEE tax regime, where savings

or investments are made from taxed income and the state support has the form of an exemption of capital income from taxation. In Czechia, the TEE tax regime applies to mutual and investment funds. The TEE tax regime has been increasingly recommended around the world over the last decade, at the expense of the EET regime, as it is significantly simpler and more equitable (equal approach to all income groups); notwithstanding the fact that when applying the EET regime, there is a significant risk that tax rates will be different in the future (when, for example, entire pension savings are taxed). Thus, the TEE tax regime can be unambiguously recommended for Czechia.

5. Future parametric pension reforms

The current Czech pension ‘system’ requires the above-mentioned fundamental reforms to introduce some order/system into it and at the same time to get rid of a lobbyist weed that eats up a considerable part of the pension ‘cake’ or the national income as such. It would not be surprising if, for example, the social pension insurance is to be strengthened at the expense of the flat-rate state pension in the coming period – we are not so different from the neighboring nations so that the flat-rate old-age pension would have to dominate in our country.

However, due to the ageing of the population, there will be no need for (further) paradigmatic pension reform, despite many experts (and institutions) trying to give an impression that it would. The ineffective ‘second’ pension pillar in any form will not become effective or at least economically acceptable due to ageing of the population. I leave aside the issue of occupational pensions, which are basically already past their prime in Western countries. Especially when trade unions in our country are too weak in most private sectors to negotiate pensions or savings of this kind. (Nevertheless, I recommend lifting the de facto Czech ban on occupational pensions.) Pension savings are not even a partial solution to the problem of population ageing, even if investment yields should return to the 1990s levels. In the upshot, if a miracle were to become and investment returns could be an argument for their large-scale use in the pension system, it would have to be advantageous to gradually replace taxes as such by those. But this will not happen, because the globalized world is full of savings that are difficult to utilize. And many governments prefer to borrow from elites instead of taxing them (Streeck 2014).

Retirement age is one of the essential parameters of pension systems. Flat-rate pension generally includes a different concept of the basic pension age than that in the social insurance pension. In the solidarity pillar, the statutory pension age should be fixed, and in the insurance pillar, the retirement age might be flexible. With regard to the now largely prevailing retirement just after reaching the current statutory pensionable age, it can be recommended that the pensionable age for the basic pension remains fixed (inflexible), preferably at the level of the current basic retirement age for men (including its increasing in accordance with the current law); raising of the pensionable age of women with children could be accelerated. Conversely, in the case of the insurance pension, we can afford – to begin with – to set a (minimum) pensionable age at 60-61 years – while concurrently the

‘premature’ retirement would be eliminated; the system simplifies. At present 80% of Czechs could work without problems until the age of 65.

A family policy reform can contribute to reducing the pace of demographic ageing: in particular, the integration of parental allowance into the basic maternity benefit, the payment of a new single parental benefit for up to 100 weeks (up to 150 weeks for twins) from the sickness insurance system, in the amount of the gross wage of the mother/father (however, at least 50% of NAE, at most 200% of NAE), after deduction of income tax (including the current insurance premiums). It is also necessary to introduce the right to a place for all children from one year of age in full-day preschool facilities at an affordable price or even free of charge (Vostatek 2019). ‘It is also advisable to shorten the inefficiently long periods of formal study’ (Münich 2019). ‘The current setting of labor taxation, along with parental leave setting and low availability of creches and kindergartens contributes to the highest drop in employment of Czech mothers with young children across the EU’ (Šatava 2016). This has a considerable impact also on the state budget, incl. the pension system.

6. Conclusions

The 1996 Pension Insurance Act has added a small basic amount of all pensions to the system of ‘percentage amounts’ of individual pensions, heavily levelled by bend points and reduction coefficients; ‘Beveridge’ prevailed over ‘Bismarck’ but he left the massive pension insurance premiums live. Substantial conceptual contradictions were not removed by later pension reforms. The main problem is the lack of transparency and comprehensibility of the system not only for its regular clients. With regard to the unpreparedness of the overall reform of public pensions, and also of the forthcoming parliamentary elections, we recommend dividing this reform into two steps: a small reform and a major reform. Small pension reform shall focus on simple but fundamental rationalization of the basic and percentage amounts of the old-age pensions. The new basic amount of these pensions should be at the level of 32% of the national average earnings; for the percentage amount, the valuation of one year of insurance cover shall be reduced from 1.5% to 0.39%.

The major pension reform might be a paradigm reform of old-age, disability and survivor pensions. The basic amount of old-age pension will be transformed into a separate flat-rate pension, with an independent system of retirement age, minimum residence or economic activity (35 years) in Czechia and valorization. The percentage amount of the old-age pension will become an independent pension pillar of social insurance, optimally with the construction of the Austrian pension accounts, with a separate retirement age and valorization system and with a minimum insurance period of 3-5 years. Disability pensions can be newly designed as social insurance and incorporated into the sickness insurance. Orphan pensions may be redefined as a universal, flat-rate benefit. The significance of widow and widower pensions may decrease, given the introduction of a flat-rate old-age pension and the assumed increase in the (average) orphan pension.

All these proposals are based on the pension development trends in the OECD countries.

Only social pension insurance is to be financed by insurance premiums on a model basis, which would allow for a substantial reduction in the Czech pension insurance premium rate. However, the general economic approach favors the cancellation of health insurance premiums – regarding the existing system of Czech public health care and due to the absurd conception and structure of health insurance premiums and their collection by all seven health insurance companies. Anyway, we can simply reduce insurance premiums only by integrating employee premiums (11% of gross wage) into the personal income tax – which is desirable also in view of the low capital income taxation (when compared to the western countries and the OECD average). When reforming the personal income tax, we get rid of the super gross wage taxation. This reform of personal income tax is also important in the interest of reforming pension (and building) savings: for political reasons, we need to compensate for the reduction in state support for these products by increasing the basic tax credit. An increase in this tax credit is also needed in order to increase the progressivity of income taxation.

The extremely complicated system of state support for ‘personal pensions’ is almost entirely the result of lobbying by the completely superfluous ‘pension companies’ that have a monopoly on the provision of supplementary pension savings. The rate of state support for employer contributions to these savings is 65%, which is by far the highest one in the world. State support for participant contributions is lower. More than half of the population is involved in the system, but its role in protection is as low as in other countries. The main purpose of ‘pension savings’ (and ‘building savings’) is tax optimization, coupled with the fiscal illusion that the state support is a free lunch. State support essentially ends in the overhead and profit of the providers. In accordance with the relevant social models, we recommend either a complete cancellation of state support for all financial products or the transition to a uniform TEE regime (exemption of returns from income tax) – optimally in the form of British Individual Savings Accounts (ISA) or Canadian Tax-Free Savings Accounts (TFSA), where annual deposits are limited and withdrawals are unlimited. Not only in our country the (previous) housing investments are far more important for (future) pensioners than any third pension pillar.

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