

Pension reform in Hungary

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FIRST DRAFT

1. Introduction

This paper analyses the Hungarian pension reform in a relatively simple fashion. In section two a brief discussion of the pre-reform situation is provided, followed by the presentation of the new pension system, introduced in 1998. The reformed pension system, similarly to most World Bank-sponsored pension reform projects introduced in the 1980s and '90s in Latin America and post-communist Central and Eastern Europe, consists of three pillars: a traditional pay-as-you-go pillar, a mandatory private pillar and a voluntary private pillar. Section three introduces all three pillars, describing their characteristics. Section four presents some modifications conducted during the implementation phase under two successive governments, and draws some preliminary lessons on these, comparing the Hungarian pension reform to that of Poland. It is not the ambition of the paper to come up with any new data on the Hungarian pension reform: the purpose itself was to provide a summary of the Hungarian case, the first such policy measure implemented in post-communist Central Europe. Hence no new empirical findings are presented, yet some conclusions will be hopefully drawn in a plausible manner.

2. The pre-reform situation of the pension system

The Hungarian statutory pension system was established in 1929. This scheme was fully funded, benefit defined, as opposed to the subsequent pay-as-you-go (PAYG) system. The latter was introduced only when accumulated capital of the mandatory social insurance system was lost in World War II and the following inflation in the late 1940s. A shift to PAYG was unavoidable – and the resulting social insurance scheme is still at work today. The theoretical launch of the 1998 reform began in 1991 with a resolution by Parliament and subsequent law amendments, resulting in significant changes to the system. The length of service for eligibility was raised, the number of years to be taken into account when calculating average income for the purpose of assessing pensions was increased and an insurance income ceiling was introduced. Voluntary private pension funds, the third pillar of the reformed system were introduced in 1994. Then age of retirement was raised in 1996, and mandatory private pension funds, the so called funded second pillar of today's system were established in 1998.

Because of demographic and policy changes, systemic characteristics of the PAYG scheme altered substantially in the post-war period. The system dependency ratio (i.e. the ratio of pensioners to active labour market participants) increased just as the average replacement ratio (i.e. the ratio of the average pension to the average net wage) did. However, this was not only result longer average contribution periods, but also that of more generous benefits and permissive eligibility regulations. Consequently, pension expenditures went up from about 5 percent of GDP in 1970 to above 10 percent in 1990. (This ratio has remained essentially unchanged so far.) Expenditure of pension benefits as a percentage of GDP hovered around 9-10% in the past decade. Total contribution rates to the PAYG scheme amounted to 34.5% of gross wages, constituting a rather high contribution level. Moreover,

because of reduction of the workforce during the so called transformational recession and deliberate policies aiming at the mitigation of unemployment by early retirement techniques and generous provisions for disability pension schemes the system dependency ratio worsened even more in the early 1990s, reaching 66% in the first part of the decade. At the same time, revenues decreased by as much as 3% of GDP. This would have resulted in large PAYG deficits if the government had not used some corrective measures: indexation parameters were slightly manipulated, resulting in a drop of average replacement ratio. In addition, real wages shrank by about 15% during 1995-96, the implementation of the so-called Bokros package¹, pushing downwards real value of pensions because of wage indexation. In consequence, the PAYG system suffered a significant loss of credibility and the general public became relatively opened towards the idea of a comprehensive pension reform.

3. The reformed pension system

The comprehensive pension reform was introduced in January 1998. New entrants to the labour market from that point had to participate in both the first and the second pillar of the pension system, thus they pay most of their (employee) contribution to mandatory private pension funds instead of the PAYG scheme. Those who had started paying contributions to the pension system before the launch of the new system, however, were given a chance to switch or to fully stay in the PAYG scheme.

The government initially considered mandatory switching for everyone below 40 years old age, and everybody above that to stay in the PAYG. However, as constitutional provisions did not allow for such discrimination, only new entrants were “forced” to the new system, and everybody with a contribution record could choose. Actual switching outcomes did not fall far

¹ Bokros package was a set of austerity measures including a significant one-time devaluation of the forint, the introduction of an extra import duty, the implementation of a crawling peg devaluation system and a number of fiscal restrictions.

from what the government intended, though. By the deadline set in September 1999, more than 80 percent of switchers consisted of employees below 40, and more than 80 percent of employees in their 20s and 30s had switched to the new system. Membership of mandatory private pension funds passed two million people, more than 50 percent of the labour force.

3.1. The first pillar: the reformed PAYG

Apart from introducing a second and a third pillar of pension schemes, the pension reform has substantially altered the traditional PAYG system itself. A number of changes have been initiated regarding it, most prominently concerning the backbone of the PAYG scheme, the *old-age pension* system. Reforms to the PAYG included the following elements:

- (a) A higher normal retirement age of 62 for both men and women,
- (b) increase in the number of years of service to be eligible for early retirement without penalties to 40,
- (c) increases in the penalties for early retirement and in the rewards for late retirement
- (d) changes in the benefit formula designed to eliminate its explicit redistributive elements (i.e. elimination of the penalization of higher income employees),
- (e) a new tax regime,
- (f) a shift from backward net wage indexation to the “Swiss formula” consisting of a contemporaneous price and net wage indexation with 50-50% percent weights.

Thus, as part of the reform, *retirement age* is to be raised gradually from 60 to 62 for men, and is being gradually raised for women from 55 to 62 by 2009. The new age retirement for men born in 1938 is 61. For those born earlier it is 60, and for those born later it is 62. For women born before 1940 it is 55, and for those born after 1946 it is 62. After the retirement age has been unified, from 2009, both men and women may retire 3 years before the new limit

of 62, if they have a long enough length of service. So that one can obtain a full pension until 2009, he/she needs to have at least 20 years of service for a full pension and 15 years for a partial old-age pension.

The amount of pension is calculated from the insured person's incomes (i.e. wages or salaries), which forms the basis for contributions, according to a *scale determined by the length of service*. The average salary on which the pension is based is calculated from salaries and incomes received from January 1988 until retirement. Pensions before January 2013 in the event of 15 years service amount to 43% of income calculated for pension purposes. In case of a qualifying period of more than 15 years the ratio increases by two percentage points a year up to 25 years service time, to 63%. Thereafter it increases by 1 percentage point a year up to 36 years service time, reaching 74% after 36 years. After that the proportionate increase is 1.5 percentage points for each year of service.

There is a *minimum pension provision*, applicable after at least 20 years service. The actual amount is established each year. In 2004 for old-age pension it was HUF 23 200, about 42% of the average pension.

Those retiring from the mixed system before January 2013 will get a PAYG benefit (or "social security pension") 75% of the benefits of someone who is only covered by the PAYG scheme. Thus, 25% of his/her pension will come from the second, mandatory private pension pillar. From January 2013 on, *pensions are to be calculated* on the basis of the contributory gross income. Thus, from 2013, PAYG pension is to be calculated as follows:

- (a) Those belonging exclusively to the social security pension scheme receive 1.65% of average income multiplied by the number of years of pension entitlement.
- (b) Those belonging to the mixed system receive 1.22% pf average income multiplied by the number of years of pension entitlement.

In addition, anyone with a minimum of 38 years service continuing working at least one year after his/her 62nd birthday can enjoy an *extra pension increase* of 0.5% per month. Periods of loss of earning capacity, those spent with bringing up children, with military service, and with studying at universities and colleges as well as while one was receiving unemployment benefit are considered to be service time.

Pensions calculated in the years prior to the actual increase of *pensions are increased* each January by the arithmetical average of the estimated growth of the net average incomes and the consumer prices (Swiss formula). If planned growth fails to reach the anticipated level, an additional increase shall be implemented in November and backdated to January. From 2002 the pensioners' consumer price index is taken into consideration if this is higher than the consumer price index.

3.2. The second pillar: mandatory private pension funds

The system of private pensions was designed as part of the statutory pension insurance, as the second pillar of the mixed funded pension system. The essence of the mixed funded pension system is that the insured person pays statutory pension contributions in predefined amounts partly to the PAYG scheme and partly to a private pension fund in the form of a membership fee. After reaching the age of retirement, he/she receives a social security pension from the PAYG scheme and a private pension resulting from the membership in the private fund.

In the event of disability, he/she is entitled to switch back to the PAYG scheme as the private pension system does not cover such a risk. In this case, the amount on any individual account held at a private pension fund is transferred to the state run Pension Insurance Fund that maintains the PAYG scheme, and the individual concerned is entitled to a full social security

pension. This also applies to survivors in the case of death of the insured person during his/her working life.

Until 2012 insured persons retiring can also switch back from the mixed funded pension system to the PAYG exclusively in case of not having more than 120 months membership period, provided that the benefit to be calculated on the basis of the accumulated capital would not reach the 25% of the social security pension they will be entitled.

The eventual pension of an insured person in the mixed funded pension system consists of two pension elements. First, there is a PAYG pension, calculated by social security rules and representing 75% of the pension. Secondly there are benefits calculated on the basis of the amount collected and invested on an individual account held by the private pension fund, increased by yields. The operation of the private pension system is controlled by a state supervisory body (PSZÁF).

Private pension funds were set up in 1998 to manage payments (membership fees) collected within the framework of the private pension system. Such funds can be established by employers, professional chambers, business federations and larger local governments but the largest funds are backed by commercial banks and insurance companies. Voluntary funds may also perform private fund activities. Funds are non-profit organisations formally owned by their members. Formally, control over the management is carried out at general meetings in compliance with the operational principles of local governance. In fact, however, the management of the fund is usually in position of control as ownership is naturally dispersed. Members, on the other hand, are free to pick their fund, including the right to transfer out from their choice once a year.

Private funds perform a pension service or a lump-sum payment for the benefit of members.

Types of benefit provision include:

- (a) Allowance paid to a member until his/her death (annuity),

- (b) annuity paid by the fund to a fund member or his/her heir for a time set out in advance; paid to a fund member after the specified date until his/her death,
- (c) annuity paid to a fund member until his/her death, and after his/her death to an heir until a specified date,
- (d) two or more annuities until death, paid while at least one individual is still alive.

Cases in which a private fund makes a lump-sum payment include:

- (a) If claimed by the beneficiary after the death of a fund member,
- (b) if claimed by a fund member, who has not paid a membership fee for at least 180 months before reaching retirement age.

Pension funds carry out benefit provision on the basis of approved service regulation. They may also purchase benefit provision from an insurance company. Presently no private funds plan to develop their own pension service yet.

Payments from an insured person who dies during the accumulation period are awarded to beneficiaries, who may take out the amount in the form of a lump sum or continue the membership. If the beneficiary is also entitled to social security benefits, the relevant sum may be transferred to the PAYG scheme. In this case the dependant's retirement benefit is calculated as if the deceased had paid contributions exclusively to the social security pension scheme. If a beneficiary dependant does not request transfer of the sum, a lower social security dependant's retirement benefit is awarded (and he/she may dispose of the savings of the fund member according to the rules of the private fund). If benefit provision has already started, the rights of the beneficiary (heir) depend on which of the services listed above was chosen by the member. Of the four possible basic types, selecting two annuities until death makes a widow/widower entitled to a benefit with a similar function to that of the social security widow's/widower's pension.

In 1998 1.3 million people joined private pension funds, significantly more than previously expected. By the end of 2003, the number of members was around 2.3 million. A concentration in the number of private pension funds has taken place: with a fall from 40 at the start to 18 by the beginning of 2004. However, the 6 largest funds accounted for around 87% of all fund members, with 5 of them having been set up by insurance companies and one by a bank.

3.3. The third pillar: voluntary private pension funds

Since December 1993, there has been legal provision for setting up of voluntary pension funds. The aim is to create an organised framework for voluntary savings to supplement pensions. Such savings are usually supported by employers and supplemented from their own resources. Fund members are entitled to claim tax relief on payments made to a voluntary fund. Employers may pay a monthly sum equivalent to the minimum wage on behalf of fund members, free of taxes and social insurance.

The number of voluntary pension funds and members dynamically grew and by 1999 there were about 250 funds in operation. This number had fallen to only 116 by the end of 2000, though they had 1.1 million members, representing more than 25% of all employees. At the end of 2003, however, the number of voluntary funds decreased to 80, while their membership increased to 1.2 million, and their accumulated assets amounted to HUF 434 billion, approximately 2.3% of the GDP.

4. Changes (not) enacted by the 1998-2002 right-wing government and by its left-wing successor of 2002-2006. Some temporary conclusions

In May 1998 with the somewhat surprising electoral victory of the centre right, the government that initiated the pension reform was replaced. As the left wing government of 1994-1998 had a supermajority of 72% of parliamentary seats, right wing opposition was not consulted extensively in the drafting of pension reform Acts. While this provided an efficiency gain during legislation and early implementation, now turned to be a great disadvantage as the new government did not agree on continuing the reform as its predecessor had scheduled. Consequently, employee contribution to mandatory private pension funds (the second pillar) was not raised to first 7 and then to 8 percent but remained at 6 percent of the gross wage during the government's full tenure. The reasoning behind this was that raising second pillar contributions would have increased deficit of the PAYG system, and hence would have placed an additional burden on the central budget which was (and still is) to finance the resulting gap.

Another important measure concerned the transition indexation rules: Instead of maintaining the backward net wage indexation in 1999, as it was originally planned, which would have resulted in a nominal pension increase of 18 percent, the government decided to enact a 14 percent increase in a somewhat arbitrary manner. Finally, the deadline to switch back of those participating in second pillar on a voluntary basis, i.e. not new entrants to the labour market, to the sole PAYG system was extended from December 2000 to December 2002. Despite of all these measures, however, second pillar private pension funds, as well as third pillar voluntary funds, remained popular at large among employees as actual switching results already presented has demonstrated. The centre taking office back in 2002 may have played an instrumental role in reaffirming trust in the pension reform as employee contribution to the

private pension funds has been raised to 8%, as planned at the outset, by 2004, leaving only 0.5% contribution for the PAYG scheme from those participating in the second pillar,

As a preliminary conclusion one can point to the striking difference between the Hungarian and the Polish case regarding the way of drafting pension reform Acts and subsequently implementing them. In Hungary a governing coalition, enjoying a supermajority in parliament adopted all the laws on the pension reform, and neither civil society actors nor opposition parties were consulted seriously. In Poland, by contrast, drafting and implementation both took place through a longer period consisting of two politically opposing governments' tenure and trade unions played a much more instrumental role. Thus, whereas in Hungary pension reform, as many other fundamental policy measures, was adopted in a rather exclusive way, in Poland a more diverse set of interests was included. Not very surprisingly, the reform process was more gradual and took more time to implement in Poland, but – not very surprisingly either – actors supported the process at some stage whether placed on the right or the left side of the political spectrum, exhibited more loyalty towards it over time. Hence, taking key political and social actors on board even if one has overwhelming power at a certain stage may prove to be a wise strategy in making policies on structural reforms.

