

Pension reform in Hungary



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Presentation outline

- The pre-reform situation of the pension system
- The 1997-98 pension reform
- The politicisation of the pension reform
- Conclusions



I. The pre-reform situation of the pension system

- Statutory pension system was established in 1929 as a fully funded, benefit defined, NOT pay-as-you-go (PAYG) system. The latter was introduced after World War II and the subsequent very rapid inflation only.



1. Structural changes in the PAYG system in the post-war period

- **Demographic and policy changes:**
 - Longer average contribution periods;
 - more generous benefits and permissive eligibility regulations.
- **Consequences:**
 - 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;
 - expenditures on pensions went up from about 5 percent of GDP in 1970 to above 10 percent in 1990.



2. The pre-reform situation in the 1990s

- Reduction of the labour in consequence of transformational recession: contributions decreased by 3% of the GDP.
- Deliberate policies aiming at the mitigation of unemployment by early retirement and generous provisions for disability pension schemes
- As a result, the system dependency ratio worsened even more in the early 1990s, reaching 66%.



3. The policy response

- Indexation parameters were manipulated so that replacement ratio could be reduced
- Real wages went down by about 15% in 1995-96, as a result of the 'Bokros package,' pushing downwards the real value of pensions because of backward wage indexation.



4. Factors pushing for a pension reform

- Policy makers became conscious about the shortcoming of the old PAYG.
- As a result of the corrective measures implemented so that the system could be maintained, the PAYG system lost credibility and the public became increasingly opened towards the idea of a pension reform too.
- Pension reform in the air: the World Bank was also pushing for it.



5. Major structural changes in the 1990s

- Voluntary private pension funds – the third pillar of the would be new pension system – were introduced in 1994.
- Age of retirement was raised in 1996.
- Mandatory private pension funds – the funded second pillar of the new system – were introduced in 1998.

II. The 1997-98 pension reform



- Regulation was adopted in 1997, and the new pension system was introduced on January 1st, 1998.
- New entrants to the labour market had to participate in both the first and the second pillar, i.e. the PAYG and the funded private pension funds. Most of their contribution (initially 6%) went to the private pension funds instead of the PAYG.
- Those who had already had a contribution paying record could choose whether to switch to the new system or to stay in the PAYG exclusively.



1. Switching results

- By the deadline of September 1999, more than 80% of switchers consisted of employees below 40, and more than 80% of employees in their 20s and 30s had switched.
- Membership in funded private pension funds passed two million, more than 50 percent of the labour force.



2. Reform of the PAYG

- A higher normal retirement age of 62 for both men and women.
- Raising in the number of years of service to 40 to be eligible for early retirement without penalties.
- Increases in the penalties for early retirement as well as in the rewards for late retirement
- Changes in the benefit formula designed to eliminate its explicit redistributive elements (i.e. elimination of the penalization of higher income employees).
- A new tax regime.
- 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.

3. Funded private pension funds



- Statutory pension contributions are paid in predefined proportion partly to the PAYG scheme and partly to a funded private pension fund in the form of a membership fee.
- After reaching the age of retirement, the beneficiary 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, the beneficiary is entitled to switch back to the PAYG scheme as the private pension system does not cover such a risk.



4. Two elements of the pension in the mixed system:

- First, there is a PAYG pension, calculated by social security rules and representing 75% of the pension he/she would receive has he/she not joined a private pension fund.
- 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.



5. Forms of pension service

- Private funds perform a pension service or a lump-sum payment. Forms of pension service:
 - Annuity paid to a member until his/her death.
 - Annuity paid to a member or his/her heir for a time set out in advance; or paid to a member after a specified date until his/her death.
 - Annuity paid to a member until his/her death, and thereafter to his/her heir until a specified date.
 - Two or more annuities until death, paid while at least one individual is alive.
- Cases in which a private fund makes a lump-sum payment:
 - If claimed by the beneficiary after the death of a fund member.
 - If claimed by a fund member, who has not paid a membership fee for at least 180 months before reaching retirement age.



6. Institutional questions of private pension funds

- Funds are non-profit organisations owned by their members.
- Formally the control over the management is carried out by members at general meetings.
- However, because of very dispersed ownership, in effect the only way of controlling the management is to transfer out, possible once a year.

7. The institution of voluntary pension funds



- Since December 1993, there has been legal provision for setting up voluntary pension funds.
- The aim is to create an organised framework for voluntary savings to supplement pensions. Such savings are usually supported by employers.
- Fund members are entitled to claim tax relief on contributions 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.



8. Development of voluntary funds: growth and concentration

- The number of voluntary pension funds and their members had both dynamically grown and by 1999 there were about 250 funds in operation. This had fallen to 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, 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.



9. Growth and concentration in funded pension funds too

- 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. The number of funded private pension funds fell from 40 in 1998 to 18 by the beginning of 2004.
- The 6 largest funds accounted for about 87% of all members, with 5 of them having been set up by insurance companies and one by a bank.



III. The politicisation of the pension reform

- As the governing centre-left had had a supermajority (72%) in the parliament (1994-98), opposition views on the reform played a marginal role.
- In May 1998 the centre-right took power from the centre-left. The new gov. was generally inclined to centralisation of resources.
- Employee contribution to funded private pension funds was not raised to 8 percent but remained 6 instead. (Raising contributions to funded pension funds would have increased the deficit of the PAYG system to be compensated from the central gov. budget.)
- Deadline to switch back to the PAYG was extended until December 2002.



Developments in recent years

- The centre-left came back to office in 2002, and employee contribution to funded private pension funds has been gradually raised to 8%, as planned at the outset, leaving only 0.5% contribution to the PAYG.
- The EU allowed for adjusting the ESA'95 deficit by pension reform costs until 2008.



IV. Conclusions

- The new pension system has been institutionally stabilised. Funded private pension funds expand.
- Performance of private pension funds (both funded and voluntary) has been generally modest. They exhibit very conservative investment policies.
- Systemic characteristics (implicit pension debt, dependency ratio) have been improved.
- Yet there's a striking difference between the Hungarian and the Polish reform regarding the way of drafting new pension Acts and implementing them subsequently.
- Efficiency of the Hungarian legislation turned to be a liability when a new government was to implement the reform in 1998.
- Consensus around structural reforms is an asset on the long run.