MINISTRY
FOR NATIONAL ECONOMY

The reform of the Hungarian pension system

(A reformed reform)

Focus

The objective of the comprehensive pension reform currently under way in Hungary is to return to the two-pillar pension system, based on social solidarity on the one hand and voluntary contributions on the other, which is in place in eighteen EU Member States, from the current three-pillar system which is hopelessly threatening the budget balance, and is financially unviable in the short, medium or long run. Having accomplished this transformation, the government is committed to maintain and support voluntary private pension funds parallel to the state-run social security pension pillar.

In order to reach the targeted balanced budget required from the social security pension system, pension benefits must be separated from non-pension or welfare benefits which should be accounted as government budget items. As part of the transformation of the Hungarian public finances system, a principle will be laid down in the new law on public finances that pension benefits can only be financed by pension contributions without utilizing other budget resources.

The costs of this reform must be financed by the merging of the state and quasi-state pension pillars without additional resources from the government budget.

Background

There have been several changes in the Hungarian pension system during the past twenty years. Out of these, two significant modifications should be emphasized:

- **the implementation of compulsory private pension fund membership** as from 1 January 1998, the establishment of voluntary private pension funds, and
- the **increase of the retirement age** in 2009.

At present, the Hungarian pension system is **based on three pillars**:

- First pillar: state system (pay-as-you-go)
- Second pillar: compulsory private pension fund system
- Third pillar: voluntary private pension fund system

1. The first key problem is that due to the modifications on the Hungarian pension system the **financing of the state pension pillar has become questionable**. In the 2011 budget revenues (contributions) of the first pillar of only 2100bn HUF stand against the benefit payment obligations of over 3000bn HUF. As a result, in 2011 the state pension system would incur a deficit of 900bn HUF, thus not complying with the legislation on pension expenditures.
2. Another structural problem of the Hungarian pension system is that there are both solidarity and social care type obligations in the state pension pillar. Solidarity items are related to old age pension liabilities and social items to disability allowance and early retirement benefits. **Due to this duality** of solidarity and social care items within the first pillar **the Hungarian pension system is not transparent.**
3. The third problem of the Hungarian pension system is that it gives insufficient incentives for voluntary pension savings, resulting in **sub-optimal accumulation of long-term savings** in the voluntary private pension funds.
4. The last but most pressing problem of the Hungarian pension system is that there is **a shortage of one million legally employed workers paying contributions in the short and medium term**, and one million children who could make the system sustainable in the long run.

'Cornerstones'

To correct the above structural anomalies of the Hungarian pension system, the Hungarian government has decided to conduct **a 4-step pension reform** in order to ensure solid financing of the system in the short and medium term, and create a sound basis for the pension system becoming sustainable by 2050.

The questions concerning the pension reform are the following:

1. In order to establish the funding of the state pension system in the short and medium term, the government **will close the gap in the pension fund's budget**. This will be achieved by rechanneling the compulsory private pension fund contributions into the state pension fund (a suspension of contributions for 14 months, CI./2010 law) as set in the budgets of 2010 and 2011, as well as by using part of the funds of those opting back to the state run system. The government will use 530bn HUF of these resources in 2011 and 250bn HUF in 2012 on correcting the deficit of the state pension system.

2. Participation in the second pillar will no longer be compulsory and **the government will offer a free choice between pension systems** (C/2010 law). The members of the no-longer-compulsory private pension funds (second pillar) will be offered the opportunity to opt back to the state pension system (first pillar), while they will also have the liberty to opt for staying in the now voluntary private pension fund system. In case of the latter, upon decision by its members, the second and third pillars can be merged in the long term.

3. According to the government's decision, as from 1 January 2013 there must be a balance between contributions and expenditures. To this end, the government will replace contributions paid by employers by a pension tax of the same extent, and, with employee's contributions, the state pension fund must be break-even. Solidarity and social care liabilities will be separated, and will be financed by the state pension fund and a new state-run social care fund, respectively. **From 1 January 2013, there will be an individual account** for the accumulated pension savings for each citizen registered at the state pension system.

4. According to the government's decision, the Hungarian pension system will be **based on two pillars**: the state pension pillar and the voluntary private pension pillar. In order to stimulate long-term financial self-provision and the payment of contributions to the private pension funds, the government will work out the relevant programmes until 30 June 2011.

The sustainability of the country's pension system largely depends on two factors: the long-term employment rate and the demographic situation (mortality, life expectancy, birth rate, etc.). There is

no pension system which could handle the unfavourable changes of these factors in a sustainable manner or compensate for their damaging impact on the society or financial policies. Accordingly, besides the stimulation of sustainable economic growth, the government has made it a priority of its economic policy to improve employment and stop the demographic decline.

1. To support job creation, the government **has reduced the burden of the small and medium-sized private companies,** the sector with the highest number of employees, by abolishing some minor taxes, cutting the corporate tax rate from **19% to 10%** and by rationalizing excessive administrative burdens (i.e. notification requirements for short term work), and by rearranging the utilization of EU funds within the framework of the **New Szechenyi Plan.** One of the key elements of the economic policy aimed at boosting employment is the transformation of the personal income tax system. By introducing a **uniform flat-rate tax system**, the marginal tax rate will be significantly reduced. In addition to reducing the marginal tax rate, the most important result of the transformation of the personal income tax system is that it decreases the tax wedge for employment in the medium or higher income brackets whose tax wedge is the highest compared to regional peers, making their employment more competitive. At the same time, this measure does not decrease the net income of those in lower income brackets. To further support **job creation**, the government is also committed to transform and modernize the entire system of vocational training.

2. The **new system of family tax allowances**, focusing on the number of children, will be effective from 1 January 2011 as part of the personal income tax package, and is also aimed at improving the demographic and employment situation. The promotion of part time employment, the support of day care services and the increased state allowances for families with children are also the government's tools to serve these ends.

Besides certain positive elements, **the implementation of the multi-pillar pension system in 1998 brought about many negative consequences as described above**. The Government's key concern is to create and operate/sustain a pension system designed to correct those negative features and preserve and reinforce the beneficial ones. From an economic policy viewpoint, the current three-pillar system's **negative features are as follows**:

Most importantly, the transition from a pay-as-you-go system to a multi-pillar system had serious financial implications in countries undertaking such reforms. As long as not everyone retired receive a certain part of his/her pension benefits from the private pension fund savings accumulated in his/her active years, pension liabilities put an increased pressure on the state budget. Therefore, the **pension system reform's macro-financial impact will deteriorate the Hungarian budget situation until the 2040sof.** Another negative feature of the multi-pillar system is that it provides **solution only for the segment of the population** entitled to old-age pension benefits, moreover, exclusively for those having been able to accumulate sufficient savings during their active years. It is again the state budget that has to cover the old-age pensions of those with insufficient or no savings at all. Yet another disadvantage of the multi-pillar system is that **the guarantee and prudent management of the portfolio by private funds represent significant risks** -- as the ever-spreading financial crisis since 2008 well demonstrates. Even by appropriate regulation, the reduction of such risks requires additional resources and their elimination is impossible. The operation of private pension funds is also costly, especially in Hungary as experience shows.

The introduction of a multi-pillar pension system has, no doubt, **also positive consequences**. The most important of them is probably the promotion of citizens' self-provision and its promotion by the state. Furthermore, a positive development has been an increase of the long-term savings rate parallel to the development of domestic capital markets with higher liquidity.

Consequently, the Government aims to create a two-pillar pension system.

Having completed the pension reform, **the first pillar** will be managed and monitored by the state and financed from the central budget. The paramount objective of the reform is to secure the old age pension of the population by securing adequate living standards and optimal financial security compared to the general living standards and the financial capacities of the country. The government must achieve this goal so that at the same time the maintenance of the pension system does not cause financial damages for the generations to come. The base of calculating a proportionate and fair old age pension benefit will be individual accounts to be set up in the state pillar on which pension contributions of each employee will be kept. The establishment of the necessary legal and technical framework is can be inherited, which requires further preparation. In

the current state pillar, widows or orphans can be entitled to obtain (inherit) the right to pension benefits. After the reform, an individual account can be inherited too, that is, the pension savings of a deceased will be added to the account of the surviving spouse (or the descendent) to contribute to his/her benefits. However, the would-be inheritance regulation on pension savings must adhere to the principle of a balanced state and pension fund budget.

The **second main pillar** created by the reforms will be a system, supported by the state and managed by the private sector alongside the guidelines set by the state to promote the interest of members, which will enable the accumulation of voluntary pension savings. This new pillar will keep the advantages eliminate the disadvantages of the current compulsory private pillar. Voluntary pension savings and self-provision provision can be encouraged only by means of giving the freedom of choice. Thus the second pillar must cease to be compulsory. In the future, the government also intends to stimulate citizens' self-provision and consequently boost long-term savings rate to a greater extent than before by the help of the tax system and indirect incentives, and at the same time improving domestic financing capabilities of the country.

The next, most pressing task for the government will be now **to elaborate the measures necessary** for the implementation of the bills passed by the Parliament. To this end, the legal background of keeping individual savings accounts and the compensation for the 14-month suspension of private pension fund contributions must be worked out. This compensation will be realized by the modification of pension benefits' calculation, which means that the 14-month pension benefit liability will be funded by the social security pension system.

If a private pension fund member voluntarily decides not to opt back to the social security pension system, **after 31 December 2011 he/she will be allowed to contribute 100%** of the employee's pension contribution to the private pension fund system. In this case, however, he/she will exit the social security pension system and will not accrue further pension rights for future service years.

The key objectives of the proposed measures is **to improve the budget balance** having been gradually deteriorated year on year since the implementation of the multi-pillar system**, to reduce budget financing requirements and to cut explicit public debt relative to GDP** in order to minimize the country's exposure to external shocks. These goals must be achieved by maintaining or possibly improving the viability of the pension system in the medium and long run. The

government also intends to find a solution for the active legal workforce considering that their accumulated savings in a private pension fund are insecure and the guarantees offered for limiting risks are insufficient. The costs of the comprehensive pension reform will be covered by the revenues from the merger of the state and the compulsory, fully-funded -- quasi state-run -- systems, no other budget resource will be made available for this.

Conclusion

As demonstrated above, Hungary has been carrying out a comprehensive pension reform recently. The country is about to return to the two-pillar pension system, operated by eighteen Member States and based on social solidarity, from the three-pillar system destabilizing the budget and unviable in the short, medium and long term. **This new phase of the Hungarian pension system's reform is also a reform's reform, which keeps the positive elements from earlier reforms but corrects** the shortcomings inflicted on the state pension system by the implementation of the second pillar, i.e. the compulsory private pension fund system.

Annex: Characteristics of the Hungarian pension system from a European perspective

Comparing the Hungarian pension system to others in Europe, it becomes obvious that our system is sustainable and has the appropriate parameters.

1. Considering the paradigm of individual systems, in some (big) Member States there are pay-as-you-go systems with voluntary fully-funded pillars to complement them; whereas in the new Member States compulsory private pension fund systems are prevalent.
2. The parameters defining how stringent the system is (i.e. age limit, replacement ratio for the recently retired, indexation rules) are in line with European standards.
3. The future rate of pension expenditures to GDP, the indicator of sustainability, is not above that of most EU Member States.

There are twelve Member States without a compulsory second pillar parallel to the state-run pay-as-you-go system, and there are six other countries with partially compulsory systems. Among others, there are some big Member States like Germany or France without, and there are a number of new Member States with a compulsory second pillar. The financial crisis had a devastating

impact on the fully-funded pension pillars, and as a consequence, in Slovakia for example the compulsory element of the system has been temporarily suspended, and in Estonia private pension fund contributions have been also temporarily suspended.

There are, however, alongside the pay-as-you-go systems, voluntary fully-funded systems (private pension funds, corporate pension schemes) in each Member State encouraging private savings. The rate of membership and the size of these voluntary pension funds complementing the compulsory systems are different from country to country, depending also on the relevant regulations.

The **Hungarian pension system provides pension benefits in line with EU standards relative to average wages.** The average replacement ratio, the indicator comparing average pension benefits to average national wages, was 77.9% in 2010.

As pension benefits are not subject to taxation in Hungary, this indicator actually compares pension benefits to average net wages. The indicator, used by the EU and hardly interpretable in case of Hungary, comparing average net pension benefits to national gross wages, was 38.9% in Hungary in 2007 for all pensioners which is below the 49.7% average in the EU; and, similarly to the EU average, it will decrease by about 9% points during the period of 2007-2060.

Furthermore, **our indexation rules are of average strictness relative to the EU**. There are a number of countries with more stringent rules (i.e. pension benefits are only increased by a price index), and there are some with less strict ones (i.e. wages are more important).

Compulsory retirement age for men, 62 years, is lower than the EU average: it is 65 years in most Member States, only in Malta (61 years) is lower than in Hungary. For women the Hungarian figure is in line with EU standards. Considering, however, that life expectancy for 65 year olds was 2.7 years less in Hungary than the EU average in 2008, the difference in retirement age can be considered as proportional.

In Hungary, the sustainability of pension benefit expenditures is expected to show a more favourable trend than in most Member States. In 2007, old age and early retirement pension expenditures to GDP were 9.0% against the EU average of 9.1%, and somewhat above the region's average (EU10: 8.1%). According to EU forecasts, considering current regulations, in 50 years these expenditures will be well below the EU average, at around the EU10 figure. As a whole,

there will be a slightly smaller rise in net expenditures between 2007 and 2060 than in the majority of Member States.

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Ministry for National Economy