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# The Main Challenges and Risks for Social Security Systems in the European Union

## *The Essence of Reforms in Hungary After 2010*

*Summary*
In all Member States social security systems are used to help secure social goals such as protection against poverty. In the majority of European Union (EU) countries public schemes also play a core role in securing levels of pension benefits and health services that to a reasonable degree allow people to maintain the living standards from their active years into retirement. After 2010 the objective of comprehensive pension reform in Hungary was 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 former Hungarian three-pillar system which is hopelessly threatening the budget balance, and is financially unviable in the short, medium and long run. Having accomplished this transformation, the government is committed to maintaining and supporting voluntary private pension funds parallel to the state-run social security pension pillar. In the second half of 2010, as a result of the world economic crisis and the restriction measures linked to it, a major crisis evolved which required a series of immediate measures from the new Hungarian government formed in that year. How did the new government manage to consolidate the Hungarian pension system? You can find more details in this article.

**Journal of Economic Literature (JEL) code:** H55, H62, H63, H75
**Keywords:** budgetary deficit, demographic crisis, EU's Stability and Growth Pact, Hungarian pension reform, public debt

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## The main challenges and risks for social security systems

The sustainability and adequacy of social security systems depends primarily on the development of employment and employment income and savings set aside for pension purposes. Financing arrangements, the conditions of eligibility and labour market conditions must be calibrated for there to be a balanced relationship between contributions and entitlements as well as among the actively employed contributors and the number of retired beneficiaries (European Commission, 2012).

The current key challenges facing pension systems are:

1. Ensuring the fiscal sustainability of social security systems
2. Increasing the labour market participation of women, younger and older workers, inactive people of working age, those living in deep poverty, and Roma people
3. Ensuring the financial sustainability of health systems
4. Ensuring the financial sustainability of pension systems
5. Maintaining the value of the level of pension benefits
6. Implementation of Pension Reforms in the European Union

The ability to ensure fiscal sustainability means that a government is able to finance current and future obligations and liabilities into the long term. According to the baseline scenario of the latest forecasts for the period 2013 to 2060, total age-related expenditure is expected to increase to 1.3 per cent of GDP for the EU 28 and to 1.4 per cent of GDP for the Member States of the euro area (see Table 1). However, a number of significant differences are found between Member States. According to the forecast, in the baseline scenario ten EU Member States (Finland, Austria, Czech Republic, Netherlands, Slovakia, Germany, Belgium, Luxembourg, Malta and Slovenia) will see a growth from 2013 to 2060 of 2.5–6.8 per cent in the proportion of GDP allocated in the budget for age-related expenditure. EU experts forecast lower, but still significant, growth in expenditure 0–2.5 per cent of GDP in another group of Member States (Bulgaria, Portugal, Estonia, Sweden, Hungary, Poland, Ireland, Romania, Latvia and the United Kingdom). By contrast, according to the EU forecast, in the case of a third group of countries, age-related spending is expected to decrease by 0.8–2.8 per cent of GDP in Croatia, Greece, Latvia, France, Denmark, Cyprus, Italy and Spain (European Commission, 2016).

As reported by EU experts, overall no significant risks of fiscal stress appear on the the horizon for Hungary, though some variables (share of debt denominated in foreign currency, share of debt owned by foreign investors, and share of non-performing loans in the banking sectors) point to possible short-term challenges. Medium risks appear, on the contrary, in the medium term from a debt sustainability analysis perspective due to the still moderately-high stock of debt at the end of the projection (2026). A medium degree of risk also emerges due to a gap with respect to the 60 per cent of GDP Treaty reference value and the unfavourable projected cost of ageing, thus leading to an overall medium risk for the country in the medium term. No sustainability risks appear over the long run (European Commission, 2016).

*Table 1: Projected change in age-related expenditure components, baseline and risk scenarios, 2013–2060*

| | **Pension expenditure** | | **Healthcare expenditure** | | **Long-term care** | | **Education expenditure** | | **Unemploy-ment benefits** | | **Total expenditure** | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | **2013** | **2013–2060** | **2013** | **2013–2060** | **2013** | **2013–2060** | **2013** | **2013–2060** | **2013** | **2013–2060** | **2013** | **2013–2060** |
| Austria | 13.9 | 0.5 | 6.9 | 1.3 | 1.4 | 1.3 | 4.9 | 0.0 | 0.8 | –0.2 | 27.9 | 2.9 |
| Belgium | 11.8 | 1.3 | 6.0 | 0.1 | 2.1 | 1.5 | 5.8 | 0.1 | 1.8 | –0.2 | 27.5 | 2.8 |
| Bulgaria | 9.9 | –0.4 | 4.0 | 0.4 | 0.4 | 0.2 | 3.0 | 0.4 | 0.5 | –0.2 | 17.8 | 0.3 |
| Croatia | 10.8 | –3.9 | 5.7 | 1.7 | 0.4 | 0.1 | 3.7 | –0.4 | 0.5 | –0.3 | 21.2 | –2.8 |
| Cyprus | 9.5 | –0.1 | 3.0 | 0.3 | 0.3 | 0.2 | 7.3 | –1.2 | 0.8 | –0.6 | 20.9 | –1.4 |
| Czech Republic | 9.0 | 0.7 | 5.7 | 1.0 | 0.7 | 0.7 | 3.4 | 0.7 | 0.2 | 0.0 | 19.1 | 3.0 |
| Denmark | 10.3 | –3.1 | 8.1 | 0.9 | 2.4 | 2.0 | 7.6 | –0.7 | 1.4 | –0.5 | 29.8 | –1.4 |
| Estonia | 7.6 | –1.3 | 4.4 | 0.6 | 0.6 | 0.7 | 4.4 | 0.8 | 0.2 | 0 | 17.1 | 0.6 |
| Finland | 12.9 | 0.1 | 7.8 | 0.7 | 2.4 | 2.1 | 6.1 | 0.3 | 1.9 | –0.4 | 31.2 | 2.7 |
| France | 14.9 | –2.8 | 7.7 | 0.9 | 2.0 | 0.8 | 5.0 | –0.2 | 1.5 | –0.4 | 31.1 | –1.7 |
| Germany | 10.0 | 2.7 | 7.6 | 0.6 | 1.4 | 1.5 | 4.1 | 0.3 | 0.8 | 0 | 23.9 | 5.0 |
| Greece | 16.2 | –1.9 | 6.6 | 1.3 | 0.5 | 0.4 | 4.1 | –1.1 | 1.2 | 0.9 | 28.5 | –2.3 |
| Hungary | 11.5 | –0.1 | 4.7 | 0.8 | 0.8 | 0.4 | 3.6 | –0.2 | 0.3 | –0.1 | 20.8 | 0.8 |
| Ireland | 7.4 | 1.1 | 6.0 | 1.2 | 0.7 | 0.7 | 6.0 | 0 | 2.1 | –1.1 | 22.1 | 1.9 |
| Italy | 15.7 | –1.9 | 6.1 | 0.7 | 1.8 | 0.9 | 3.7 | –0.2 | 0.9 | –0.3 | 28.2 | –0.9 |
| Latvia | 7.7 | –3.1 | 3.8 | 0.6 | 0.6 | 0.1 | 3.8 | 0.8 | 0.3 | –0.2 | 16.2 | –1.7 |
| Lithuania | 7.2 | 0.3 | 4.2 | 0.1 | 1.4 | 0.9 | 3.9 | 0.9 | 0.2 | –0.1 | 16.9 | 2.1 |
| Luxemburg | 9.4 | 4.1 | 4.6 | 0.5 | 1.5 | 1.7 | 3.3 | 0.2 | 0.7 | –0.2 | 19.5 | 6.2 |
| Malta | 9.6 | 3.2 | 5.7 | 2.1 | 1.1 | 1.2 | 5.9 | 0.1 | 0.3 | 0 | 22.6 | 6.6 |
| Poland | 11.3 | –0.7 | 4.2 | 1.2 | 0.8 | 0.9 | 4.4 | –0.1 | 0.2 | –0.1 | 20.9 | 1.3 |
| Portugal | 13.8 | –0.7 | 6.0 | 2.5 | 0.5 | 0.4 | 5.2 | –1.0 | 1.5 | –0.9 | 27.0 | 0.3 |
| Romania | 8.2 | –0.1 | 3.8 | 1.0 | 0.7 | 0.9 | 2.6 | 0.4 | 0.1 | 0 | 15.5 | 2.1 |
| Sweden | 8.9 | –1.4 | 6.9 | 0.4 | 3.6 | 1.5 | 5.7 | 0.2 | 0.4 | –0.1 | 25.5 | 0.6 |
| Slovakia | 8.1 | 2.1 | 5.7 | 2.0 | 0.2 | 0.4 | 3.4 | –0.4 | 0.2 | –0.1 | 17.7 | 4.0 |
| Slovenia | 11.8 | 3.5 | 5.7 | 1.2 | 1.4 | 1.5 | 5.3 | 0.8 | 0.6 | –0.2 | 24.7 | 6.8 |
| Spain | 11.8 | –0.8 | 5.9 | 1.1 | 1.0 | 1.4 | 4.6 | –0.8 | 2.2 | –1.7 | 25.4 | –0.8 |
| The Nether-lands | 6.9 | 0.9 | 7.2 | 1.0 | 4.1 | 3.0 | 5.2 | –0.5 | 2.0 | –0.8 | 25.4 | 3.6 |
| United Kingdom | 7.7 | 0.7 | 7.8 | 1.3 | 1.2 | 0.4 | 5.1 | 0 | 0.3 | –0.1 | 22.1 | 2.3 |
| EU–28 | 11.3 | –0.3 | 6.9 | 0.9 | 1.6 | 1.1 | 4.7 | 0 | 1.1 | –0.4 | 25.6 | 1.3 |
| Euro area | 12.3 | –0.1 | 7.0 | 0.8 | 1.7 | 1.3 | 4.5 | –0.1 | 1.3 | –0.4 | 26.8 | 14 |

*Source: European Commission, 2016*

The challenges caused by an aging society will be increased by the doubling of the old–age dependency ratio (the ratio of people over 65 compared to those of 15–64 years) from 2010 (26 per cent) to 2050 (50 per cent). In fact, the real challenge is the economic dependency ratio, which is the number of working-age inactive, unemployed and retired compared to the number of active employees. The Vienna-based Austrian Chamber of Labour and Commerce calculates that if the European Union fulfils the goal of achieving the Europe 2020 strategy, with a target of a 75 per cent employment rate in the 20–64 age group, and further progress is made in the period between 2020 and 2050 then the economic dependency ratio will rise to a lesser degree, from the current from 65 to 79 per cent (European Commission, 2012). Therefore the future adequacy and sustainability of pension systems in several EU countries, including Hungary, can be improved by increasing the employment rates. And it is not only necessary to do this for older age groups but for all those groups where employment rates are currently low, such as women with small children, the young, the less educated, the elderly, those living in extreme poverty, Roma and other disadvantaged people. Achievement of the EU employment goals and convergence to the best performing countries in terms of employment can mainly neutralize the negative impact of aging on public finances in most countries. It is therefore particularly important to strive to achieve full employment and timely implementation of social inclusion programmes.

All of this requires a concerted and co-administration of several measures including, but not limited to, new jobs, stimulating the dissemination methods of work organization, improving the conditions for lifelong learning, introducing measures enabling compatibility with private and family life, measures for the improvement of the health status of the elderly, and effective and efficient action against any form of discrimination (based on age, race, gender, sexual orientation, financial situation etc.) in the labour market.

The European Union health systems are the focus of a high level of social protection and they form the cornerstone of the European social market economy. The health sector comprises about 8 per cent of the EU's total workforce of 8 per cent and creates value added (GDP) of 10 per cent. Today there are significant differences between Member States. While in the case of Austria, Denmark, France, the Netherlands and Germany the contribution of health to the country's GDP exceeds 11 per cent, in the case of Estonia, Latvia and Romania it is below 7 per cent (European Commission, 2013). The health expenditure per capita in terms of ranking is led by the United States among OECD countries, spending 17.6 per cent of its GDP on health spending, followed by the Netherlands (12 per cent), France (11.6 per cent) and Germany (11.6 per cent). The share of GDP allocated to health spending (excluding capital expenditure) in Hungary was 7.4 per cent in 2013, compared with an OECD average of 8.9 per cent. This is slightly down from 2012 but at the same level as in 2009. Hungary spent the equivalent of USD 1719 per person on health in 2013, compared with an OECD average of USD 3453. Public sources accounted for 65 per cent of overall health spending, which is below the OECD average (OECD, 2015). Some countries have introduced measures to complement their public pay-as-you-go pension scheme with private insurance systems, but the main shortcoming of this approach is that it does not reduce the formation of future poverty risks at all, even for the lower income groups; only those with higher incomes have improved future prospects for the real value of pensions. Therefore, many Member States, including Hungary, must find additional pension savings opportunities that can also help to reduce the future risk of poverty for those with lower incomes. The main obstacle to this is that lower income households are much less able to put aside further savings from income than higher earners. The financial and economic crisis has clearly shown how to substantially improve the impact on the functioning funded pension schemes to mitigate risks and the ability of the financial market to absorb shocks.

The European Commission shed lights on the details in the Annual Growth Survey (European Commission, 2015). The implementation of these objectives can ensure a far better balance between work and years spent in retirement and help encourage additional pension saving efforts. According to the White Paper on goals for setting up a sustainable pension system, the European Commission proposed the implementation of the following items (European Commission, 2012):

– link the retirement age with increases in life expectancy;

– restrict access to early retirement schemes and other early exit pathways;

– support longer working lives by providing better access to life-long learning, adapting work places to a more diverse workforce, developing employment opportunities for older workers and supporting active and healthy ageing;

– equalise the pensionable age between men and women; and

– support the development of complementary retirement savings to enhance retirement incomes.

The implementation of the pension reforms along these lines will put pension systems on a more sustainable path, thus helping Member States to ensure an adequate income in old age for their citizen despite the less favourable demographic situation.

## The initiative of the European Union

In 1998, the Hungarian government carried out a transition to the so-called Three-Pillar Pension System. The Mandatory Private Pension Scheme (MPPS), which puts the operation of public pensions in the hands of the private sector, and its organizational entity, the Private Pension Funds (PPFs), was the core of this pension reform in Hungary. In Hungarian, it is referred to as *Kötelező magánnyugdíjrendszer*. The reason that it is described as "mandatory" is simply that, as opposed to the third pillar (the voluntary pension scheme), it entails statutory membership (Iwasaki–Sato, 2005). In the structure established on 1 January 1998, the pension contributions paid by those entering the mixed system were divided. One part of the contribution was not paid into the social security pension system which operates on the basis of the 'pay as you go' principle, but it was credited to an individual fund account as a private pension fund membership fee. According to the structure, around one quarter of contributions were paid into private pension funds. Therefore, private pension fund benefits should have covered the social security benefits which are around 25 per cent lower. According to the 1998 plans, the second pillar would have gradually covered an increasing proportion of members until all of them were covered. Only career starters would have been obliged to enter the system. However, the actual legal regulations made it possible for everyone to freely decide to enter the mixed system until the middle of 1999. Nevertheless, those stepping into the mixed system had to face the fact that their future pension would decrease by 25 per cent even if they had paid the whole pension contribution into the social security pension fund system before they voluntary entered the mixed system (Magyarország Kormánya, 2012).

However, the number of people stepping into the mixed system in 1998–1999 did not live up to expectations. There were many cases of people who decided to enter the mandatory private pension fund system even though it was not a favourable choice for them. The fundamental reason for doing so was the rather single-sided information campaign related to introducing the pension reform, which emphasised only the advantages of individual accounts and inheritance and neglected the risks of entering the mandatory pension fund system. The declared purpose of establishing the funded pension pillar was to contribute to the financeability of the pension system. However, when setting the long-term objective, it should have been taken into consideration that there would be several decades of deficit in the state pension pillar following the introduction of this system. Although part of the contribution of members entering the mixed system had already been transferred to their private pension fund accounts, the expense obligations of the state pillar remained unchanged. Extra expenses would have been eliminated only gradually and over a very long time, around 5–6 decades. Following this point of time, the costs saved as a result of lower benefits would have compensated for the deficit. In Hungary, due to the high number of people entering the mixed system, the amount of the deficit – the extra burden of the social security pension system – significantly increased during a short period of time. The member list reached 50 per cent of all insured members even by 2000, the second year after the introduction of the system, and it gradually reached more than 60 per cent by 2010. The deficit of the 'pay as you go' pension pillar gradually increased as a result of the loss of return and it reached 1 per cent of GDP by 2004, while it was close to 1.3 per cent of GDP by 2009. As a result of the increasing loss of return, similarly to other countries introducing a pension reform, the accountability of the returns of the mandatory funded pension pillar as a state budgetary return also became a key question in Hungary.

Calculations published in a 2008 study revealed that introducing a more-than-two-pillar private pension fund system resulted in significant differences between each country in terms of the magnitude of state financing and its temporal distribution, considering the annual state-financing need due to the loss realised in the state pillar (see Table 2). This emerging cost exceeds 3 per cent of annual GDP in Bulgaria, Poland and Slovakia. The relevant values are 2.4 per cent in Hungary, 2 per cent in Estonia and 0.3 per cent in Lithuania. In Latvia and Sweden, this system was introduced in such a way that it did not require any extra financial support from the state budget. The introduction of the system had to be financed from the state budget for only two years in Slovakia and for three years in Latvia. Poland, Hungary and Bulgaria faced the worst situation, as the state budget had to contribute to the operation of the mandatory private pension fund system even in the 6th and 7th years following the establishment of this pillar (Center for Policy Studies PRAXIS, 2008):

*Table 2: Total financing needs of the pension reform during the seven years following the reform (% of GDP)*

| **Country (year of introducing the reform)** | **Year of reform** | **+1 year** | **+2 years** | **+3 years** | **+4 years** | **+5 years** | **+6 years** | **+7 years** |
|---|---|---|---|---|---|---|---|---|
| Bulgaria (2000) | 2.0 | 2.0 | 3.1 | 2.6 | 2.4 | 2.4 | 3.6 | |
| Estonia (2002) | 0 | 0 | 0.4 | 0.3 | 1.9 | | | |
| Latvia (2001) | 0 | 0 | 0 | 0 | 0 | 0 | | |
| Lithuania (2004) | 0.1 | 0.2 | 0.3 | | | | | |
| Poland (1999) | 0.9 | 1.6 | 2.2 | 2.9 | 2.9 | 3.3 | 3.0 | 3.4 |
| Hungary (1998) | 0.5 | 0.7 | 0.7 | 1.0 | 1.8 | 1.4 | 1.6 | 1.9 |
| Slovakia (2005) | 2.5 | 3.2 | | | | | | |
| Sweden (1999) | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |

*Source: Centre for Policy Studies PRAXIS, 2008, 16–17*

The loss generated by the pension reform is not the result of state "overspending", but of the structural reforms introduced in order to provide financeability in the future. For this reason, it was not obvious in the beginning whether the impact of the pension reform had to be taken into consideration when determining the government budget deficit or not. Eurostat, the competent EU authority, published a declaration in 2004 with regard to the presentation of public accounts (Beetsma–Oksanen, 2007). This declaration stipulated the methodology to follow in the practice of all involved countries during the presentation of public accounts. The declaration made it obvious both in the case of Hungary and other EU Member States that the return of the funded pension pillar cannot be considered public finance income according to the public finance accounting rules of the European Union. Starting from 2007, all countries were obliged to follow the points laid down in the declaration. In the spring of 2005, the Council of the European Union (ECOFIN) decided about the extent to which the return of the obligatory funded pension pillar can be accounted for from the aspect of excessive deficit procedure. According to this decision, the return of the funded pension pillar can be accounted for as public finance return to a constantly decreasing extent – 100, 80, 60, 40 and 20 per cent. With this decision, the European Union basically gave a 5-years extension to countries introducing the mandatory funded pension pillar for considering the impact of the funded pension pillar when establishing the structure of public finance. However, this decision did not make the situation of the affected countries notably simpler. Countries that introduced a pension reform were given a smaller scope for budgetary action for the subsequent period in order to implement their economy policies in comparison with countries which did not undertake the structural rebuilding of the pension system.

As a result of the capital market processes in 2008 and 2009, the value of the mandatory private pension fund savings quickly decreased. When pension fund members faced the account balance of 2008, they saw that the value of their preceding year's savings had decreased by around 20 per cent on average, instead of the expected increase. Although the processes of the subsequent period partially compensated for the losses, the 2008 processes shocked pension fund members. This practical experience was the opposite of what they had previously heard about the advantages and safety of the mandatory private pension fund system. The members were not given any unambiguous promise for the period up to the determination of the amount of the pension. As regards future processes, they only had a limited guarantee concerning the future increase of savings. This process greatly held back society's trust in the mandatory private funded pension pillar in Hungary. A significant doubt emerged in a large proportion of pension fund members about whether the savings collected within the mandatory private pension fund system would really help them in establishing the financial background for a decent old age. The decrease of the accumulated savings and the loss of society's trust also occurred in other countries operating the mandatory funded pension pillar.

There are many people in Hungary who remember that one of the main objectives in establishing the mandatory private pension fund system was to improve the lack of capital of Hungarian enterprises with their investments and to improve their competitiveness as a result. However, not one implemented investment has been reported during the last 16 years. To avoid any confusion, the current owner of Budapest Airport is not Hungarian either, but a Canadian state pension fund called PSP Investments. The question arises as to why a foreign state pension fund sees economic advantages in what a Hungarian mandatory private pension fund or the state do not. Hungarian private pension funds initially invested their capital in Hungarian funds and then in foreign stock exchanges in the hope of higher profits, which was either a successful or an unsuccessful action. However, they definitely did not contribute to the economic development of Hungary and the improvement of its competitiveness, but instead they held it back.

In Hungary, these unfavourable processes revealed several internal contradictions of the second pillar. It thus became obvious that membership was not favourable for a significant proportion of mandatory private pension fund members. Their private pension fund benefits determined at the time of retirement would not be able to compensate for the reduction of their social security benefits even in the case of a high future return. Even though social unrest resulted in the granting of the opportunity to leave the system in 2009, it was possible only for the oldest age groups (above 52 years of age), which represented only 4 per cent of pension fund members. It also became obvious that the significant risks of the private pension fund system could not be made consistent with the mandatory entrance into the system.

The economic crisis also revealed that the risks of the operation of the private pension fund system were borne almost solely by pension fund members and the state (through compensating for the budget deficit). The financial sector, which was authorised to operate the mandatory private pension fund system, was able realise a stable return independently of its successfulness as a result of the operation of funds and the performed property management activity. By erasing all limitations on purchasing shares before the economic crisis, mandatory pension fund members were encouraged to buy shares in the most unfavourable time from an economic point of view. At the same time, being able to determine the maximum property management fee without any impact assessment made it possible for trust companies to realise a return above the average property management fee (Magyarország Kormánya, 2012).

During the introduction of a 2009 study, the OECD described the high cost level of the Hungarian mandatory private pension fund system as a negative example. Of all mandatory pension fund systems, members had to pay the highest administrative and management costs in Hungary, amounting to around 2 per cent of the wealth managed by the system, while these fees were the lowest in Sweden (less than 0.5 per cent of the managed wealth). As regards non-OECD countries, the highest fees were observed in Costa Rica (2 per cent) and the lowest in Bolivia (0.5 per cent) (Tapia–Yermo, 2008).

These differences in fees are so high that they could result in up to a 30 per cent difference in return realised by members between countries operating with the highest and the lowest administrative cost. This criticism also showed that the losers of the high cost level are fund members, as this difference resulted in significantly lower sums credited to their individual accounts. This difference became a significant problem especially in view of the great losses resulting from the economic crisis which finally led to decreasing costs. However, the financial sector in Hungary still continued to generate unduly high costs in the case of mandatory private pension funds (Magyarország Kormánya, 2012). The amount of operational expenses was 137 billion HUF in the Hungarian mandatory private pension fund system in the period between 2000 and 2010. Operational expenses were limited by legal regulations from the beginning. However, their amount (6 per cent, 5.5 per cent, and 4.5 per cent) still remained high at the international level, which was shown by the related OECD analysis. This high cost level made it possible mainly for large pension funds to waste money during their operation. Larger mandatory private pension funds usually outsourced the tasks which were within their scope of activities to organisations – mostly fund services – dealing with the given duties in a professional manner. Fund services usually performed administrational and registry activities, as well as recruitment of members for private pension funds. Due to the practice of these fund services of invoicing complex administrational costs, the operational expenses of the sector appeared in a non-transparent way in the financial reports of private pension funds (Magyarország Kormánya, 2012).

Mostly as a consequence of the actions described above, the return of Hungarian mandatory private pension funds was especially low in the 13-year-long period between 1997 and 2010 and was not even on a par with inflation; they had a negative return. None of the mandatory private pension funds operating in Hungary reached the level of the index of short-term government bonds (RMAX), but they were significantly lower. Consequently, Hungarian mandatory private pension fund members would have been better off if these funds had invested the savings of their members into Hungarian government bonds (Magyarország Kormánya, 2012; KEHI, 2011).

The affected countries (including Hungary) had to face a dual problem. In addition to the narrowing scope of budgetary action as a result of the funded pension pillar, they also had to deal with its loss of popularity. All these factors made it obvious that the continuation of the pension reform would only be justified if it were carried out more carefully. The restructuring of the pension system in order to provide financeability in the long run can only be undertaken if it does not result in a more unfavourable situation.

By prescribing a maximum level of only the explicit state debt instead of the whole state debt (implicit & explicit), the EU's Stability and Growth Pact did not support reforms aiming at the recapitalisation of pension systems since the point of recapitalisation is making part of the implicit state debt explicit.

However, the framework conditions should have been reshaped, since the restructuring process endangered the benefits of a certain proportion of pension fund members in the given situation and it significantly held back the scope of budgetary action of all the affected countries. The conditions should have been changed in a way to provide tangible advantages and acceptable risk to all parties affected by the funded scheme – both society and the public finances in addition to the financial sector operating the system.

The Ministers of Economy and Finance of the nine affected Member States of the European Union sensed these dilemmas and sent a joint letter to the heads of the European Union in August 2010. In this letter, they pinpointed that the approach laid down in the Stability and Growth Pact establishes an unfavourable situation for the countries which carry out pension reform in order to provide for the long-term sustainability of the state budget. The ministers requested a modification of the points set out in the Pact in order to abolish this discrimination.

The European Union's Commissioner for Economic and Monetary Affairs responded with an understanding of the initiative. At the same time, the Commissioner declared that the EU's rules currently in force do not make it possible for the revenue of private pension fund systems to be accounted for as public finance revenue. According to the standpoint of the European Commission, the extra expenditures arising from the introduction of the private pension fund system can only be taken into account if the launching of the excessive deficit procedure is at stake.

## The need for restructuring of the Hungarian Three-Pillar Pension System

Between 2008 and 2010, the Pension Insurance Fund requested a public finance contribution of around 600–700 billion HUF each year and the deficit would have grown to around 800 billion HUF by 2011 without the subsequent measures taken by the

Orbán government. Since the Hungarian pension expenses are high by international standards, the constantly deteriorating demographic circumstances would have resulted in a further increase in the deficit. The government realised that the solution for two of the most fundamental problems of the Hungarian economy – the low level of economic activity and population decline – cannot be provided by the constant modification of the pension fund system with a "patch and mend" approach. The ageing of the population should not have been used as a pretext for discrediting and, consequently, eliminating the existing social protective systems in order to substitute them with systems which serve a different purpose, i.e. the extension of the liquidity of capital markets. For this reason, in 2010, the new Hungarian government made it clear that they wanted to solve this problem by focusing Hungarian economic policy on two areas: increasing employment and preventing population decline (NGM, 2011).

The assumption that the conversion to a capitalised private pension fund system would automatically reduce the evasion of the payment of contributions proved to be wrong. Also, after the drastic reduction of benefits, the issue of maintaining the standard of future benefits gave grounds for serious concern and the measures by previous governments resulting in the reduction of pensions and their value in real terms further increased these concerns.

During the introduction of the Hungarian pension reform in 1997, the risk of macro-economic considerations overriding social political objectives should have been taken into account; therefore it should have been clarified which values were at stake. The primary purpose of the pension reform should have been the improvement of old age income security, independently of the suggested model. No series of political steps can be called pension reform if they do not improve pension benefits, but make them uncertain, even if they have a positive effect on certain areas. In fact, it became obvious by 2010 that the pension reform of 1997 did not live up to the expectations at all and was a complete failure. Even though this reform undoubtedly contributed to the extension of international capital market liquidity, it had a very slight contribution to the improvement and growth of the Hungarian economy, the development of Hungarian investments, the growth of savings and the accumulation of Hungarian capital. Neither did the introduction of the mandatory private pension fund system make the finance of the pension fund system easier and more secure. The experts and politicians with an interest in the development of private pension funds, together with the international financial institutions, banks, investors and the media interested in maintaining and extending the system, created the false illusion that the new private pension fund system introduced in 1997 in Hungary would be capable of this task. On the contrary, this system significantly contributed to an increase in the budgetary deficit and state debt. As time went by, further limitations, weaknesses and imperfections of the private pension fund system were revealed and it eventually failed internationally in 2007 as a result of the global financial and economic crisis before it could become an orthodox system and take root in the more developed countries of the world as expected by its followers. Today, both internationally renowned financial experts and journalists ask what the point of the whole system is if no positive benefit can be expected from retirement savings (Flood, 2013). "Not only did the mandatory private pension fund system not solve the problems of the already defective Hungarian pension fund system, but it became another severe social and economic problem itself… The amount of operational costs and unrealised profits is around 850 billion HUF" (Magyarország Kormánya, 2012).

The assumption of the World Bank that capitalised private pension fund systems are of higher standard than 'pay as you go' state systems was proved to be wrong. There are many 'pay as you go' systems successfully operating in the world today without being on the brink of bankruptcy. Undoubtedly, strengthening the close correlation between paid contributions and paid pensions could improve the transparency and acceptance of non-capitalised systems, but all these can also be performed without privatising old age security. It also became clear that the solution to problems with demography and low economic activity cannot be postponed or swept under the rug on the pretext of reforming the pension system. These problems must be solved as soon as possible independently of the difficulties of operating the pension fund system.

There is a growing imbalance emerging between numbers of entrants to the labour market and those leaving (see Table 3). Fewer and fewer people entered the labour market in recent years. There are two main reasons: firstly, there were fewer and fewer people of working age and, secondly, those aged 15–24 became a smaller and smaller part of the population.

*Table 3: Hungarian total population, by age groups (thousands)*

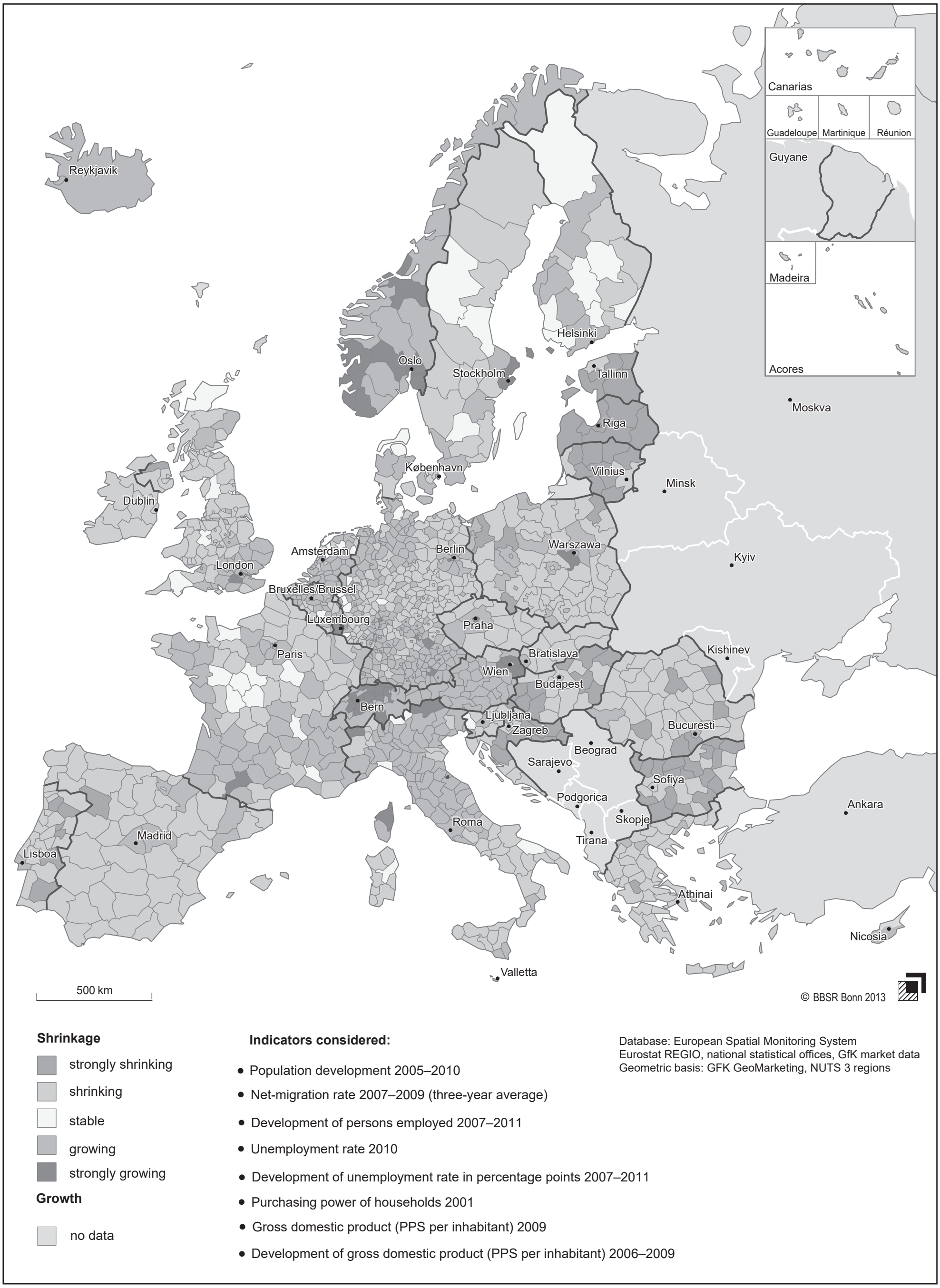
| **Age group** | **1990** | **1994** | **1998** | **2002** | **2006** | **2008** |
|---|---|---|---|---|---|---|
| Total population | 8244.3 | 8370.5 | 7755.8 | 7762.2 | 7721.8 | 7710.2 |
| 15–19 | 766.9 | 869.1 | 720.6 | 634.1 | 609.2 | 600.5 |
| 20–24 | 678.7 | 745.2 | 872.4 | 739.4 | 644.7 | 627.7 |
| 50–54 | 597.7 | 633.2 | 648.4 | 728.3 | 820.3 | 802.4 |
| 55–59 | 607.5 | 558.9 | 569.2 | 605.7 | 668.6 | 694.7 |

*Source: ILO, http://laborsta.ilo.org/STP/guest*

Similarly to other Member States of the European Union, Hungary faces a severe demographic crisis; life expectancy has increased by around 5 years during the last 50 years and it is predicted to increase by a further 7 years by 2060. The low number of birthsand a dramatic change of the age composition of the population has resulted in an ageing society. One of the consequences of these phenomena is that the old age dependency ratio will be doubled: currently, the EU average of the amount of people of active age per person above 65 years of age is four (the situation in Hungary is worse), while it is expected to be only two by 2060 (Prugberger–Barta, 2015).

A new analysis of the Federal Institute for Research on Building, Urban Affairs and Spatial Development (BBSR) reveals large disparities in the population development within Europe. The BBSR collected data between 2001 and 2011. While that might

*Figure 1: Growing and shrinking regions in Europe (2005–2010)*




*Source: The Federal Institute for Research on Building, Urban Affairs and Spatial Development (BBSR), 2015* sound slightly outdated, these are actually the most up-to-date figures Europe has to offer, as 2011 is the most recent year for which comprehensive population data is available for the whole of Europe. Shrinking and growing regions are often side by side. The results of the censuses carried out in Europe in 2011 provide the basis for a EU-wide comparison of the population development in 2011 based on the latest census of each country, which was generally carried out in 2001. The regional picture of growing and shrinking regions in Europe shows their parallel development in nearly all countries. Only a few countries reveal homogeneous national development trends e.g. Switzerland and Norway ("growth") or Bulgaria and Hungary ("shrinking") (see Figure 1).

In addition, the level of employment in the European Union was the lowest in Hungary. According to 2010 data, the Hungarian employment level was 8.7 per cent lower than the EU average. Of the new Member States of the EU, the level of employment increased by nearly 10 per cent in Bulgaria and by nearly 8 per cent in Poland between 2002 and 2010, while that of Hungary decreased (by 0.5 per cent) in the same period (Novoszáth, 2014).

## Hungary steps towards correction of the pension reform

In this new situation, Hungary was forced to take action. The central budget had to compensate for the contribution deficit resulting from the introduction of the mandatory private pension fund system by paying the amount of deficit to the Pension Insurance Fund. On this account, the state provided a total of 2043.2 billion HUF budget support to the Pension Insurance Fund between 1998 and 2009 and 372.4 billion HUF was planned to be provided in 2010 (Magyarország Kormánya, 2012). These amounts transferred from the central budget to the Pension Insurance Fund increased the budget deficit from year to year. The Hungarian state covered the deficit by issuing government bonds and taking loans which eventually increased the deficit with their interest. At the same time, Hungary declared several times and in an unambiguous way that it aspired to make its budgetary balance indexes in conformity with its obligations arising from EU membership. However, after examining the budget processes of 2010 and planning the scope of budgetary action of 2011, it became obvious that the narrow scope of budgetary action restricted the state's ability to comply. Even the measures which were indispensable for putting Hungary on a path to growth were at risk. Expectations concerning future measures also caused uncertainty in the private pension fund system.

In October 2010, in order to continue the pension reform more carefully, the Government of the Republic of Hungary initiated several steps which were adopted by the Parliament. The most important measures were the rules of free choice of pension funds as set out in Act C of 2010 which came into force on 3 November 2010. The most important rules were as follows:

– The mandatory private pension fund membership of career-starters was phased out. However, insured employees under 30 years of age and those above 30 years of age entering into an insurance scheme for the first time in Hungary can also establish membership of a pension fund.

– The opportunity of returning to the social security pension system was provided to all private pension fund members. This step gave a chance to those who voluntarily became pension fund members to rethink their previous decision, this time possessing all-inclusive information under the new circumstances. They were given fair information about the possibility of returning, with both the benefits and risks of this decision being pointed out, and they had the opportunity to weigh their experience of the operation of the private pension fund system. According to the previous rules, those who were obliged to establish a membership with a private pension fund by law also had the opportunity of returning to the social security pension system.

– The membership fee to be paid by each private pension fund member (8 per cent of their income) were accounted for as pension contribution between 1 November 2010 and 31 December 2011. Therefore, this amount was added to the revenues of the social security pension system. This step is basically the same as the crisis management measure used by Estonia between 1 June 2009 and 31 December 2010. This change did not affect private pension fund members adversely. Those who decided to return will be handled as if they had not ever established a pension fund membership when determining the social security pension benefits. In the case of those deciding to maintain their private pension fund membership, this period will be accounted for during the determination of their future pension benefits. Their benefits will be calculated by taking into consideration that not only the three quarters, but the whole amount of their pension contributions were transferred into the social security pension system for 14 months. Therefore, no pension member will lose money.

Both the returning of private pension fund members into the state pillar and the transfer of private pension fund membership fees for 14 months resulted in extra income for the social security pension system, which was partially a short-term and also long–term extra resource. On one hand, this amount reduced the increasing deficit of the social security pension system, while, on the other hand, it was spent on reducing the state debt. The extended scope of budgetary action made it possible to take the measures needed for launching economic growth and for providing stability for the Hungarian economy.

There was a significant change in the social security pension system on 1 January 2012. In accordance with the Hungarian Constitution, pensioners are defined as those who have reached retirement age and women who have obtained the right to retire after a 40-year-long eligibility period. In the future, pension benefits before retirement age and disability pensions will not be financed from the Pension Security Fund and not as pensions, but as other benefits.

In recent decades, it was possible for pensioners to obtain pension benefits and discounts based on various different allowances before actually reaching retirement age. For this reason, the actual age of becoming a pensioner was only very slowly moving closer to retirement age. In the future, anticipatory old-age pension benefits, reduced anticipatory old-age pension benefits, early retirement pensions benefits, pensions benefits of miners and artists, service pensions, the pension benefits of parliamentarians and mayors and early old-age pension benefits will not classified as pensions. At the same time, the benefits listed above will increase to the same extent as pensions and the rules of taking a job while obtaining these benefits will be the same as in the case of pension benefits obtained prior to retirement age. In the case of two special allowances, those working in underground mining can obtain entitlement to miner benefits and the artists of four special ballet companies can obtain entitlement to ballet artist annuities. However, these two benefits are not classified as pensions either and they are governed by the rules of benefits before retirement age (NGM, 2012a).

According to the Hungarian Constitution which entered into force on 1 January 2012 and the Stability Act, private pension funds are no longer part of the mandatory pension system. In accordance with Point (4) of Article XIX of the Hungarian Constitution, "Hungary shall contribute to ensuring the livelihood of the elderly by maintaining a general state pension system based on social solidarity and by allowing for the operation of voluntarily-established social institutions. The conditions of entitlement to state pension may be laid down in an Act with regard to the requirement for stronger protection for women."

After 97 per cent of previous members returned to the state pillar in early 2011, around 100,000 members remained in private pension funds, representing around 250 billion HUF. Paragraph 42 of the Act no. CXCIV of 2011 on the Economic Stability of Hungary which entered into force on 1 January 2012 stipulated that solely the Pension Insurance Fund is entitled to pension contributions (10 per cent) paid by natural persons based on statutory obligations. This provision established a new situation in the pension system.

The rule about "contracting out" was abolished; therefore, it follows from the general rules that private pension fund members can obtain entitlement the same way (100 per cent) as those entitled to pension benefits in the social security pension system from 1 January 2012 (however, specific calculation rules still have to be refined). Remaining members obtained 75 per cent pension entitlement referring to the period before 31 December 2011, which increases to 76 per cent due to the compensation provided as a result of forwarding the membership fee for 14 months.

As a result of the legislative amendment in late 2011, the possibility of returning to the state pillar was provided to private pension fund members again until 31 March 2012. The detailed rules referring to returning were mostly the same as those of the returning opportunity in 2011 (public duty exemption was also provided). Around 25.03 per cent of private pension fund members returned to the social security pension system in the second period. Therefore, the number of private pension fund members decreased below 75,000 people.

Every member had the option of remaining a member of private pension funds if they wanted to. Even today, there are numerous private pension funds operating in the country with a member list of around 75 thousand people. However, career-starters are not obliged to become a member of private pension funds and the option of previous private pension fund members to return to the state pillar is now available.

A Hungarian citizen filed a complaint on this matter which the Strasbourg European Human Rights Court dismissed on 13th January 2013 on the grounds that no rights to private property were violated. The court rejected the petition.

## Conclusion

A few years ago, it was heresy in Hungary to curb the mandatory private pension system. Today, even the IMF's former chief economist Mark Allen (Bielecki–Allen, 2014) argues for similar steps and the Czech Republic, Poland, and Slovakia have also followed the Hungarian example. It has become apparent that the low yield and high cost did not serve the interests of pensioners.

The Hungarian social security system will work in a stable and sustainable way in the long run only if the currently prevailing unfavourable proportion of active and inactive people can be altered drastically and if the number of entrants to the labour market permanently surpasses the number of those leaving the labour market. The currently declining demographic trend also needs to be reversed. None of the Hungarian governments in office before 2010 realised that extension of employment, the reduction of economic inactivity among the active population and increasing the number of births are the key factors for the growth of the Hungarian economy and the financial stabilisation of the Hungarian social security system. A radical change can only be expected from 1 million new taxpayers and 1 million more newborns in the upcoming ten years.

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