The Hungarian pension reform – the way forward ?

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No pension reform can be neutral. All those who have a stake in the pension system – present and future beneficiaries, bureaucracies, economic actors – are moved by interests and values that may or may not be conscious and well articulated. The reconstruction and the evaluation of the process can not therefore be fully neutral or fully value-free.

The Hungarian reform process started in 1990. There were two stages with two different reform scenarios. In the first phase efforts were directed mostly to the improvement of the public system. In the second stage the hegemony and legitimacy of the public system were questioned in the name of more individualised solutions. The second stance won.

The paper attempts to uncover some values and interests underpinning the conflicting reform proposals as well as some techniques that promoted the acceptance of the ›new‹ value system. Finally some social consequences will be mentioned that make the privatisation of pensions hard to accept for those committed to balanced power relations and an integrated society.

The background of the Hungarian pension reform

The Hungarian public pension system took off in 1912 with a scheme for civil servants, followed in 1928 by a more general scheme. Before 1945 it covered about one third of the labour force. The scheme was funded and governed by a tripartite board. Because of war losses and the will to broaden eligibility the scheme was transformed into a pay-as-you-go system soon after the war. The dictatorial system coming into power in 1950 abolished the former Governing Board. The social insurance fund became state-managed, an indistinguishable part of the state budget. Yet the scheme broadened and matured. In 1989 it covered practically the whole labour force and reached relatively acceptable levels. The system worked well enough to protect pensioners relatively well in the years of crisis after the transition.

Meanwhile incremental and haphazard changes blurred the transparency of the scheme. Its sustainability was jeopardised since long because of demographic changes. After the transition the difficulties were compounded by the structural changes in the economy and on the labour market. The long overdue reform became unavoidable.

The first stage of the reform- the attempt to overhaul the public scheme

In 1991 the Parliament adopted a decision determining the orientation of the would-be pension reform. It projected a three-tier system, namely a basic flat-rate scheme, a compulsory public earning-related scheme, and a voluntary, private tier (called later pillar). The citizen's pension was meant to assure basic security, and the second tier relative security.

The reform started slowly, with incremental and hesitant steps. Comprehensive reform work took off only in 1995. Yet, one can uncover some principles that underpinned also the early reforms. Three principles of reform agenda will be mentioned here, namely the striving for

- more democracy;
- more absolute and relative security for the aged;
- more ›market conformity‹.

The reform was meant to serve the economic and social sustainability of the public PAYG scheme.

More democracy

The movement for more civil control, the re-establishment of an independent Board started in the eighties. The realisation took some years. The Social Insurance Fund was separated from the state budget in 1989. In 1992 a law (re)created the Insurance Boards that were elected in 1993. The Pension Board did not work as well as expected, but it helped to defend the interests of pensioners. In any case it disturbed governments not too comfortable with countervailing powers. The third government in 1998 finally abolished it. The topic of democratisation disappeared from the reform agenda.

More security

A Law introduced the compulsory yearly indexation of pensions, a practice completely absent under state socialism in 1992. Pensions had to be indexed to wages, a solution representing solidarity between generations. The reform enacted in 1997 opted for the less solidaristic and (in a growing economy) less costly solution, Swiss indexation. Before 1997 there was one deviation from the indexation rule: lower pensions were increased disproportionately to prevent the utter impoverishment of the worst-off pensioners.

A step serving the security of masses threatened by unemployment was the relaxation of the rules of early retirement and disability pension. Over half a million people took refuge in the solidaristic schemes. This became later a debatable solution. The sustainability of the scheme could have been served by the law that ordered the transfer into the pension (and health) fund a large part of the still unprivatised state assets. The implementation of this law almost totally failed.

Also for the stake of sustainability the Parliament proposed the increase and flexibilisation of the pension age. Because of the resistance of many groups, particularly the Trade Unions, the legislation was postponed until 1996. Then the age limit was increased from 60 and 55 years (men and women respectively) to 62 years for both sexes.

More market-conformity

All social insurance schemes represent a mixture of principles of access. The so-called ›equivalence principle‹ follows the logic of market contracts. The so-called ›reciprocity or solidarity principle‹ answers needs and risks that would create socially difficult situations if left only to the market. The mixture creates a ›messy contract‹. Some approaches reject the combination of principles. In the World Bank's view »any attempt to achieve both intertemporal insurance and interpersonal distribution in a single ›pension pillar‹ involves messy and dynamically unstable compromises«. (World Bank 1995:31).

By contrast I argue elsewhere (Ferge 2000) that the combination of principles is an adequate instrument to accommodate diverse, often conflicting purposes and interests. One of its main advantages is that it may serve the interest of the weaker partners, too, better than pure market contracts.

Nonetheless, the Hungarian scheme had become too ›messy‹. On the contribution side it continued to be strictly proportional to earnings, while on the benefit side it became increasingly compressed. This alienated the higher earners, and threatened thereby the integrated scheme. The ›cleansing‹ of the scheme or more ›market conformity‹ was meant to improve the relationship between contributions and benefits, while maintaining many solidaristic elements, too.

The ›cleansing‹ of the insurance schemes was often arguable. For instance the family allowance that was made universal was rightly shifted back to the budget. However it seemed less acceptable to squeeze out from the solidaristic insurance scheme the allowance for funerals, and shift it to the local authorities in the form of a means-tested assistance.

It was in the name of cleansing that some economists and the supranational agencies censured the increasing usage of early retirement and disability pensions as a means of handling lasting unemployment. Despite the rationality of these objections this solution was seen by many as a lesser evil than condemning ageing and unhealthy people to turn to the uncertain and inadequate unemployment assistance schemes. The cleansing of the disability pension rolls is on the agenda, though, since 1998, without offering a viable solution for those eliminated from the rolls.

The main objective on the agenda of ›market conformity‹ was to adopt less opaque rules for calculating the pensions. It was planned to abandon the regressive scales in calculating the pension base, and to create a more correct relation between contributions and pensions by means of a scheme akin to the German system of ›points‹. A relatively high ceiling (2.5 or 3-times the average wage) was supposed to yield an acceptable replacement rate. With the help of micro-and macro-simulation models it was demonstrated that the public system was sustainable with some adjustments and with the citizen's pension tier at least in the next fifty years.

The increased inequality of pensions was foreseen, but it was argued that a basic pension pitched at a relatively high level would mitigate this problem.

The law allowing the creation of voluntary private pension funds with very important tax breaks was enacted in 1993. This move was positive in the sense of increasing the freedom of choice of people in the building up of old age security. It was also the first move towards the privatisation of pensions.

The comprehensive reform proposal moved very slowly ahead probably because of institutional inertia. When it was completed in 1995/96, it was already too late. In 1995 the ›second phase‹ already started with massive political and economic support.

The second stage of the reform

The new pension paradigm

The World Bank (and the IMF) correctly identified many failings of the public pension schemes in place. At first the Bank supported the efforts of improving them. Its approach however changed with time. In 1994 the Bank published a major Policy Research Report entitled ›Averting the Old Age Crisis‹. The public schemes were heavily criticised for being overgenerous, ›offering a dismal performance, and hurting the economy‹ (p.289).

The way forward was seen in private funded schemes that would serve economic growth. It was accepted that a complete shift was not necessarily warranted. The model offered was ›multipillar‹ system. The ›pillars‹ consisted of a mandatory pay-as-you-go public pension system designed to provide an income floor for all elderly persons, or in some versions a means-tested assistance scheme playing this role (Pillar 1); a mandatory funded and privately managed pension system based on personal individual savings accounts (Pillar 2); and, as Pillar 3, a voluntary system (also funded and privately managed) to provide for additional savings and insurance.

There are by now many accounts about the implantation of the ›new pension orthodoxy‹ (Müller 1999). The process started in Chile in 1981 under Pinochet on the advice of Chicago economists: there was a radical switch from a public scheme to a fully privatised funded scheme. The Bank's role became crucial thereafter, from the early nineties on in Latin America, and from the late nineties on in Central-Eastern European countries. An expert of the Bank summarised the role of the Bank in the following way:

»We are providing a broad program of assistance on pension reform – supported by lending and nonlending instruments – across most of the advanced countries, (including) the design and implementation of multipillar reforms, the drafting of private pension and insurance legislation, and the setting up of prudential regulatory and supervisory authorities. The Bank connects interested partners in the Czech Republic, Hungary, Poland, Slovenia and countries working on the same issues in Argentina, Australia, Chile, Switzerland« (Koch-Weser 1996).

The Hungarian version

While the reform of the public system was under way, the Bank presented the ›new orthodoxy‹ at a regional seminar in 1992. The first encounter seemed to lead nowhere: most Hungarian experts dismissed the World Bank plan as a costly lunacy foreign not only to the Hungarian, but also to the European tradition. Gradually, however, a group of new converts emerged. Neo-liberal economists, politicians from different convictions, as well as the staff of the Ministry of Finances were converted to the private-funded solution. The conversion may be explained by the personal contributions of the Bank, the invisible pressure of the lobby of home and foreign private insurers and by the fact that the country had huge foreign debts and was therefore vulnerable.

The debate between the protagonists and the opponents of the private scheme that lasted several years was almost a dialogue of the deaf. ›Almost‹, because some arguments were heard. The harshest market elements were abandoned. For instance the privatised tier was scaled down from 100 to about 30 percent; more guarantees were built into the scheme; a unisex benefit formula was adopted instead of lower benefits for women. And it was a ›dialogue of the deaf‹ nonetheless, because vital questions of the opponents to privatisation – requiring for instance exact calculations about the potential costs, about the potential losers and winners, forecasts based on micro-and macro simulation models – were never answered.

There may be good reasons for privatisation. Yet, in these debates one has the impression that the protagonists of the private scheme were moved more by a strong ideological commitment to the ›cause‹ than by economically or socially rational arguments. Despite the defective professional underpinnings the reform camp won the battle.

The new orthodoxy could win because its proponents had a much stronger power position; much more resources to present their project as the single reform proposal; and because the banking and insurance lobby could – more or less – indirectly influence the process. The opponents remained unconvinced. But the majority of those deciding about the reform – the MPs for instance – did not have any thorough knowledge about the pension systems and the stakes of the reform, and tacitly accepted at the end the ›There Is No Alternative‹ argument.

The laws were enacted in July 1997. The system has four pillars. The ›*zero*‹ pillar is a means-tested benefit for those who did not acquire sufficient pension rights. The *first* pillar is a slightly reformed, compressed, state managed PAYG scheme. The *second* pillar is a private funded defined contribution scheme that is mandatory for first entrants to the labour market, and optional for everybody else. The *third* pillar is the voluntary private pension. (For more details see e.g. Müller 1998, Augusztinovics 1999)

Value clashes and undue influences

The persuasion through economic arguments – the ›obfuscation strategy‹

It seems to be a characteristic of the privatisation process that information is withheld, truncated, or biased. There is of course nothing new in that. The powers that may be are never keen on imparting information if they can help it. However, in democratic politics there exist ›codes of behaviour‹ requiring that rules of ›Öffentlichkeit‹ be observed, and there are institutions, the media in the first place that control whether the rules are observed.

In case of the pension reform the situation is slightly unusual. The private pension scheme may be presented as a very complicated design. The interests pushing towards concealment or curtailed information are very strong. Meanwhile the public at large, most politicians, and the media are forcibly ignorant on the issue, and they may be easily misled. Many have observed since that an ›obfuscation strategy‹ (Pearson 1994, quoted by Müller 1999) was used in the pension reforms, obscuring or falsely representing many issues.

The main arguments for privatisation were couched in economic terms. The Ministry of Finances firmly asserted that the funded pillar will be a means of strengthening individual responsibility; of deepening and developing the capital- and stock-market; of boosting economic growth by a higher rate of savings; that it will create an incentive not to evade payment; that the private pillar was safer than the public one; and that nobody would lose with the switch.

All these statements had been contested. It is shown for instance by Orszag and Stiglitz (the latter at that time vice-president and chief economist of the World Bank) that many of these affirmations are just *myths:* individual accounts do not necessarily raise national saving; rates of return are not necessarily higher under individual accounts; labour market incentives and compliance are not necessarily better under individual accounts; or public trust funds may be managed as well or as badly as private trust funds. Nicholas Barr (1999) argues that the diversification does not mean that risks are better distributed. On the contrary, some shocks threaten both pillars, but the private pillar is exposed to additional risks (of inflation, of investment, and so forth). Also, it is much less flexible than the public PAYG scheme and therefore less able to recover from any shock.

Winners and losers

The last affirmation of the Ministry – that nobody will lose – is proved to be wrong already on the short run. The contributions of the joiners are missing from the public tier. The estimated deficit in 1998 is at least USD 150 million a year. The Hungarian government signed a new loan of US 150 million with the Bank in 1998 to fill part of the hole. Thus the next generations will have to pay. Cutting back the pensions filled the other part of the hole. The statutory increase for 1999 was by 6% lower than prescribed by the 1998 law. This harmed all the pensioners. A further compression of the public scheme is foreseen in order to finance the missing contributions.

The concealment of increased costs

The costs of private schemes are high. The administration of the huge public system amounted to about two per cent of the total outlays. The administrative costs of the private funds may absorb 10 to 25 per cent at the start, and cannot be much lower than 15 per cent even after maturation (Simonovits 1998). There is no information about these costs.

The costs of the intricate state apparatus required to support, to oversee, to monitor and if need be, to sanction the private pension market are also high. These costs – similarly to the costs of the PR campaign – have not been made public. Orszag and Stiglitz (1999) warn about the costs that a bad management can impose on the affiliates of the fund, and about some costs that will become manifest only decades later, for instance the possibly very high cost of converting the savings into a life-long annuity. The new entrants are practically never informed about these costs.

The social consequences of the reform

The mandatory privatisation of a small part of the pensions does not seem to warrant the strong feelings one encounters in Hungary and elsewhere. Yet, there are some, maybe only potential consequences that explain them.

The Trojan horse

The agenda of the privatisers is ultimately much more than partial privatisation. Mark Boléat, Director General of the Association of British Insurers is explicit on this point:

Insurance companies have a particularly keen interest in welfare state reform. There is an inevitable overlap between the products they offer and what the state offers through the social security system... It may well be that there will be new business opportunities for insurance companies...(*Insurance ...1998*).

There are pull and push factors that may drive the system in the above direction. The extension of the ›new business‹ is helped when the institutions, the private funds are already in place. They will be ready for a ›gradual phasing in‹ of privatisation as advocated by the Bank (World Bank 1994:285). The push factor is the more or less deliberate downgrading, and the verbal abuse of the public scheme. If and when the public system is cut back and delegitimated, a flight from the public scheme may occur starting with the opting out of the better off. Indeed, the arguments about unsustainability ›may prove a self-fulfilling prophecy‹ (Augusztinovics 1999:29).

The push and pull factors are strengthened by direct pressure coming from different quarters. An authoritative source declares for instance that ›...it would make sense if (...) East-Central European governments (were) to phase out most (and perhaps eventually all) state pensions in favour of a viable, privately funded system (Kramer:86).

The history of the pension reforms in Latin America and Central-Eastern Europe suggests that there may be ›contagion‹ effect. When one of a group of countries adopts the reform, the neighbouring countries will be more easily ›conquered‹, to use the expression of a World Bank officer (Rutkowski, 1998).

The promotion of selfish individualism

Right after the enactment of pension laws the Treasury started a PR campaign that was geared to build up confidence in the private scheme and destroy confidence in the public scheme. Quarter-page advertisements appeared in all major newspapers. The central figure of the publicity stunt was a charming little boy walking ahead on a road leading apparently towards a radiant future. The headline and the legend were changing. A small sample of them is worth quoting:

July 1997: Headline (**H** in what follows): ›***Who is paying the bill?***‹ A quotation from the legend (**L** in what follows): ›When there is a multi-pillar scheme *the elderly are not forced to be burdens on others*‹.
September 1997: **H:** › ***The old pension system goes on pension***‹. The **L** is about the huge amount of money Tom Smith, an everyday young man will earn when skilfully choosing a fund. ›From January a new pension system will be introduced in Hungary. Its aim is to assure that the pension of Tom Smith will cover more than his mere survival ...He may pay a part of his contribution in a private

fund to earn more money...not only for himself, but for his children...Because this money will be inherited, together with the interests‹

February 1998: **H:** ›***My grandfather is the cleverest pensioner***‹. **L:** He says among other wise things that ›Once upon a time they said that people would get what they deserve. Today they get what they can obtain from their economies‹ by skilfully using the market opportunities.

April 1998: **H:** ›***My dad sees the future***‹. This wise father gathers all the information from the funds, asking them about everything including their experience with money dealings at home and abroad. ›My dad says that it is better to clarify everything in advance to prevent that, at the end, I had to support him.‹

The values underpinning this campaign encourage in a more or less subtle way selfish individualism, the rejection of supporting the parents, and the devaluation of desert or merit or work. It also devalues the former pension scheme. This message that ›the old pension system goes on pension‹ forms part of the efforts of deligimating the public scheme.

The dismantling of collective structures – social integration in jeopardy

Concerns about social integration are missing from the agenda of the new orthodoxy. The only country offering some information on the issue is Chile with 20 years experience. The outcome is not reassuring from this perspective. Only about half of the affiliates are contributing regularly, so that half of them may not acquire sufficient pension rights.

The private saving schemes harm also in other ways the unwritten contract between generations. Indexing to prices is difficult and requires costly clauses, and indexing to wages is impossible. Disability may not be adequately handled. The fate of survivors depends much more on the length of the affiliation than in case of solidaristic arrangements.

Perhaps the most important loss is the weakening of the virtual social capital of the public funds, and of the collective structures that emerged under the former arrangements (Castel 1995). The labour and social rights attached to the funds represented an empowering structure for all those belonging to the scheme. They assured a status, protected the weaker partners, and reduced the risks of direct economic or political influence on the schemes.

The consequence of these changes is not only the further increase of income inequalities and poverty among the elderly because many will have to fall back on assistance. Another likely outcome is the withering away of the idea of equal citizenship.

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