THE ROLE AND FUNCTION OF THE PAY-AS-YOU-EARN PENSION SYSTEM IN THE HUNGARIAN PENSION SYSTEM

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„Old age is the most unexpected of things that can happen to man.” (Leon Trotsky)

Historical review

The first appearance of the development of the socially organized forms of pension insurance is related to the formation and development of industry in Hungary. The industrialization in Hungary first began in the mining sector where the very first self-help institutions were organized for mining workers as early as from the end of the 15th century.

From the mid-18th century trade associations gathered ground in the industrial manufactories. Since workers did not receive any social benefits neither from employers nor from the state, they started to organize their own self-help associations. The first such self-help association was set up by printing workers in 1837.

State bureaucracy was regarded as a privileged class within the Hungarian society, as an evidence of this, pension rights of those working in the state administration were institutionalized by Act XI of 1885 and further developed.

In addition to the pension schemes for public service employees, there were several other pension schemes provided by the state for workers in the military forces, local authorities, railways and so forth.

The first pension law relevant to society was Act XL. passed in 1928, in which compulsory insurance was introduced for industrial and commercial workers in cases of retirement, disability, becoming a widow or an orphan. This law was of European standard, it was a novelty in legislation, based upon careful preparations and calculations. However, it had a crucial shortcoming because it excluded agricultural workers from the group of those entitled to receive social security pensions. The insurance itself was based on a form of a defined benefit scheme.1 The law allowed the establishment of corporate pension funds acknowledged by the state together with the acknowledgement of the existing ones. Corporate pension fund members were exempted from the scope of state retirement

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1 The defined benefit scheme is a version of pay-as-you-earn systems. In this scheme there is a predetermined period of accumulation, the paid contributions are collected and invested. Because of this, the system is not able to provide pension services right from the start, only after the end of the accumulation period. The amount of pension later to be paid is predefined and contracted in this scheme and the amount of contributions is determined accordingly.
insurance. The compulsory old-age insurance for agricultural workers was organized in the 1930s.

The events of World War II also caused serious damages in the pension insurance institutions. A substantial part of the accrued capital in the pension system was used by the state to finance expenditures of war, other parts of it were destroyed or devaluated, the majority of registries and records perished. The effects of the ravages of war were significantly strengthened by the sky-rocketing inflation in 1945-46. Because of the war, the hyperinflation and other destructive effects, other financing methods had to be found to secure pension benefits, as a consequence, the previously existing pay-as-you-earn system was converted to a type of pay-as-you-go financing scheme.²

In the post-war years the standardization of social security institutions began, those self-insurance and social security institutions were extinguished that, in previous decades, had administered the pension provision for groups of workers belonging to various trades or professions.

After the nationalization of privately-owned companies and mines, the position of insured seniors at corporate pension funds and self-insurance funds for miners also had to be settled for, providing them pensions became the responsibility of the state. With the absence of pension wealth and private pension institutions, the organization of social security pensions at the level of society became the primary responsibility of the state, which essentially took place in the 1950s, a total of three large and two smaller, separate rule-based pension system existed that were based on separate rules. In the individual systems, the benefits, eligibility requirements, rules and the rate of contributions were significantly different from each other.

The comprehensive codification of the social pension insurance took place by passing Act II. of 1975 and implementing its regulations, which completed the consolidation and modernization of social security. Based on common principles, the law regulated the system of social security pensions for the workers and their dependents in the society. It also laid down the key principles of the state pension insurance for the Hungarian society: distribution in proportion to the years spent working; the requirement of social security; and the principle of a state guarantee as financing the pension fund was guaranteed by the state budget.

The road towards reforming the pension system

Although the law was born after a considerable preparatory work, there were some flaws in it: eligibility criteria were eased and certain retirement rules were relieved, as a result, overall pension expenditure was increased and the level of employer’s pension contributions had to be raised from the second half of the 1970s. The need for the social security pension reform arose in those years, however, the courage for implementing those reforms brought about only minor amendments that did not deliver satisfactory results.

² The pay-as-yo-go (PAYG) system does not set aside any assets, pensions and other benefits are paid directly from current workers’ social security contributions and taxes. Pension expenditures in a given year are covered by the received social security payments in the same year. This system does not create any reserves as it is fully dependent on the payments coming from the working generations.
Then the transition from socialism to capitalism gave a new impetus to demands for change.

Since 1989, the relationship between the social security system and the state budget has been changed, the social security system has been separated from the state budget and, in order to handle social security income and expenses, an independent Pension Insurance Fund was established in 1992.

The Hungarian Parliament passed a law on establishing voluntary mutual insurance funds in 1993, its obvious goal was to re-plant the idea of voluntary care and create its necessary institutional background.

Social security regulations have also been constantly modified, in 20 years the law was changed in more than 120 articles, some of its provisions were amended more than ten times, its regulations in relation to raising pensions consisted thirty different solutions. The continuous payment of social security pensions has become an oppressive burden. The second half of the 1990s saw a more radical transformation due to the increasing international pressure coming from the World Bank and the European Union as well as some internal (economic, social, demographic and regulatory) contradictions in the pension systems.

In line with the Maastricht Treaty, one of the accession criteria was that the ratio of the annual government deficit to gross domestic product must not exceed 3% at the end of the preceding fiscal year. Hungary was also expected to cut its long-term pension expenditure and reduce the paternalistic aspects of the state.

The need for repaying existing loans to and ask for receiving new ones from the World bank also encouraged pension spending cuts within the broader group of social expenditures together with correcting the actual errors in the existing pension system. Later, the introduction of the Chilean model of social security was suggested.3

The national social security pension system evolved under conditions where there was almost full employment, the vast majority of salary and wage earners worked in the public and the co-operative sector or in state-owned enterprises. The number of population steadily increased, maintaining the existing pay as you go system did not cause any particular problems. However, this almost peaceful condition changed after the post-transition period (1989): companies and cooperatives were closed down, dissolved or privatized, lots of jobs were lost, thousands of workers became unemployed or sought refuge in early retirement or in the less strict rules of disability pensions. It was this time when avoiding the payment of contributions caught on among the population. In the meantime the number of births fell and the slow process of population aging began. As a consequence, the financial balance of the pension insurance system deteriorated, the revenues (the amount of paid contributions) were not enough to cover actual pension costs any longer. The rate of pension increase remained below the actual inflation rate, furthermore the capricious nature of legislation resulted in growing injustice.

In order to transform the social security pension system, several models and concepts were hammered out. Finally, the model proposed by the Ministry of Finance - which also bore the support of the World Bank – was accepted. The targets in this model included creating the relationship between the payment of contributions and the pensions together

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3 This social security model, suggested by the experts of the World Bank, was first introduced in Chile in 1981.
with the creation of individual interests in making pension payments. In other words, the insured were allowed to see in advance that after paying mandatory pension contributions in their active age what retirement benefits they could rely on in return. The model also aimed at encouraging individual self-care, pre-saving for the old age and the transformation of the pension system had to facilitate economic development and stimulate economically efficient investments.

The three main acts providing the basic structure of the pension system reform are noted as follows:
- Act LXXX of 1997 on Persons Entitled to Social Security Benefits and Private Pension, as well as the Coverage of these Services (became effective on January the 1st, 1998);
- Act LXXXI of 1997 on the Social Insurance Pension (became effective on January the 1st, 1998);
- Act LXXXII of 1997 on Private Pension and Private Pension Funds (became effective on September the 1st, 1997).

The structure of the transformed state pension system

Apart from modernizing the pay-as-you-go pension system, the laws mentioned above allowed to add a new financial element to it.

The new private pension fund system operating on the principle of pay-as-you-earn systems has become, as a subsystem, part of the pension system. The mandatory pension system was transformed into a two-pillar system: its first pillar was a social security pension subsystem financed on a pay-as-you-go basis and requiring mandatory participation, whereas its second pillar became a private pension fund system which also required mandatory participation and it was funded on a pay-as-you-earn basis.

According to the plans, the two different pillars of the pension system would have ensured pension services in the future as three-quarters of of the pensions of those choosing the mixed system would have been paid from the first pillar and the remaining quarter would have been provided by the second pillar.

Under the new rules, those insured by the state pension scheme could voluntarily choose between two options from September, 1997 until August the 31st, 1998:
- staying exclusively in the state pension insurance scheme or
- opting for the so-called mixed system, which meant that they could remain members of the state pension system but they were also allowed to enter a mandatory private pension fund based on their voluntary choice.

New entrants to the labour market were obliged to enter the second pillar. This obligation facilitated the gradual introduction of the second pillar and it also made possible that an entirely mixed system would operate in the future.

Those who chose the mixed system were once allowed to change their mind and return to the pure state pension scheme.

The third pillar consisted of voluntary forms of individual self-care such as voluntary mutual pension funds or life insurance and pension insurance provided by various insurance companies.

Private pension fund members paid membership fees to the fund and pension contributions to the social security system. The membership fee was based on the member’s
taxable income, its actual rate was determined by the law. According to the initial statutory requirements, private pension fund members had to pay 6% of their taxable income to private pension funds in 1998, 7% in 1999 and 8% in 2000. They also had to pay a reduced contribution of 1% to the state pension fund. The contributions paid by members were transferred to their individual accounts. The payments were invested by the fund (the accumulation period was at least 15 years) and old-age pensions were supposed to be provided by using this accumulated amount. The accumulated capital on the individual account could be inherited, in other words, payments from an insured person who died during the accumulation period were awarded to beneficiaries who might take out the amount in a form of lump sum or could continue to membership in the pension fund.

Only those organizations could become the founders of private pension funds that were identified by the law: employers, professional chambers, trade associations, voluntary mutual pension funds and so on. However, among the actual founders numerous commercial banks and insurance companies could be found. In order to facilitate the independence of private pension funds, the law ordered that there could not be a direct legal relation between the founder and the private pension fund, after the establishment process, the founder would not have any rights or obligations towards the private pension fund. But it was not enough in itself to rule out the possibility of indirect relations between them. Through the operation of the pension fund and by managing its assets, the founders could realize a hefty return on their original investments.

After their foundation, private pension funds got into the ownership of members who had to operate them in compliance with the principles of local governance. Based on the principles of reciprocity and individual self-care, pension fund members jointly created the financial background for operating the fund and providing its services by putting the fund’s assets together through their compulsory membership fees.

The functions of the funds were to collect and manage membership fees, to invest the contributions made by members and, finally, to organize and provide pension services determined by the law.

The services provided by the pay-as-you-earn pillar were protected by a safety system comprising of several elements: the Hungarian Financial Supervisory Authority (PSZÁF), which controlled the operation, the management and the strict regulatory requirements on financial investments, and the Gurantee Fund, which was established to handle cases of insolvency.

Originally the government estimated that around 360.000 to 500.000 ensured would choose to enter the newly-established private pension funds. In reality, the number of fund members exceeded more than two million in 2000.

Due to the contributions paid to private pension funds, a soaring deficit appeared in the state pension system as a significant part of pension contributions were channelled into the private pension funds. Responding to this shortfall, the government earmarked 20 billion forints but the actual deficit in the state pension system proved to be much higher. State bonds were issued to at least partially cover the losses and the government started to take measures to make more and more private pension fund members return to the exclusive state pension scheme: the state guarantee was extinguished, increasing the rate of paid membership fees was forbidden, whereas the rate of the social security contribution was increased and the mandatory membership of new entrants to the labour market was suspended for a few years.
The next major intervention to the private pension fund system took place in 2008, it was mainly triggered by the financial crisis and other economic reasons. Legislators tried to reduce the existing risks of private pension funds by the means of statutory regulations. One of the results of the legislative efforts was the introduction of the yield guarantee into the system, which was designed to preserve the real purchase value of the savings. It was achieved - either by the funds themselves or, as a last resort, by using the reserves of the Guarantee Fund - by complementing the balance of the member’s individual account with the missing amount if it did not reach the state-specific rate of inflation at the time of determining pension payments. The amount of money paid for operating and managing private pension funds was also limited, determining the maximum percentage that could be deducted for these tasks from membership fee payments.

An attempt was made to the institutional transformation of the private pension fund system by taking these funds out of member ownership and allowing private companies to manage fund assets but in the end this plan failed for political reasons.

Return to the one-pillar compulsory pension system, the radical changes of 2010

Poland and Hungary, together with seven other EU member states sought to alter the way their budget deficit and public debt are calculated in the European Commission. The aim of the initiative was to be allowed by the European Union to account for the cost of overhauling their pension systems. So the amount transferred to the state pension system from the central government budget would not be part of the state deficit, the compensation for the deficit created by contributions to the private pension funds would not increase the overall deficit of the state budget.

Apart from Hungary, other Eastern European countries such as Poland, Lithuania, Estonia, Bulgaria, Croatia, Romania, Slovakia and Macedonia were forced by the World Bank and the European Union to develop mandatory private pension fund systems financed on a pay-as-you-earn basis in the last decade.

The introduction of the private pension fund system resulted in a much higher deficit in the Pension Insurance Fund and the central budget than it was previously calculated because a major part of pension contributions appeared in the private pension funds. Retirement model studies showed that the gradual increase of retirement age made the introduction of a pay-as-you-earn element possible because it reduced pension expenditures (less people could reach the age of retirement) in those years when the private pension fund system still could not provide pension services as they were only in the phase of accumulation, taking huge sums out of the state pension system. After reaching a turning point, when private pension funds are able to pay pensions on a pay-as-you-earn basis, they also help to reduce the expenditure of the state pension system and it can be financed in the longer term despite the worsening ratio of worker to retiree.

It is estimated that if the government had been allowed to account for the membership fees paid to private pension funds as a state revenue, Hungary’s budget deficit, at least on paper, would have been only about 2.4% of GDP instead of the existing 3.8% of GDP, which would also have been well below the maximum of 3% required by the Maastricht Treaty. However, the EU stated that the private pension funds must be considered private institutions and as such they did not fall within the scope of the accounts between other state-operated institutions, as a consequence the Hungarian request was dismissed.
A solution had to be found for reducing the budget deficit in order to avoid possible disadvantages posed by the European Union. The government saw the private pension fund system as the only possible area to come up with a solution. Instead of making further diplomatic efforts, the government quickly decided to pass a series of laws aimed at changing the compulsory private pension system. The two most important laws in this regard were Act CI of 2010 and Act CLIV of 2010. The latter one was the most drastic, in which seven other important laws were amended at one blow.

The members of mandatory private pension funds had to decide whether they wanted to remain in the private pension funds or return to the state pension system until January 31st, 2011. Those who did not declare to remain in the private pension fund system until March 1st, 2011, lost their private pension fund membership and automatically returned to the social security pension scheme. The accumulated capital on the individual accounts of those who decided to return to the state pension system was transferred to a fund specially created for this reason. They were free to make a decision on what to do with the real yield (their return on investment above the inflation rate), they were also allowed to keep that amount.

It was also stipulated that the individual accounts had to be introduced in the state pension system as well, making it possible for the insured to check the amount of their pension contributions. This is only a virtual account because the amounts on it are not accumulated in reality, since the received contributions are immediately spent on current pension payments in the state pension system.

From December 1st, 2011, those who did not return to the state pension system are not entitled to acquire additional service time from the social security pension system and are not eligible for receiving pensions from the state, they are entitled to get their pension solely from the private pension funds. The amount of the membership fee was raised to a 10% rate of the basis of pension contributions. Those private pension fund members whose pension benefits will not be enough to make a living could receive old-age allowances as an additional social benefit, which would hopefully be enough for them to maintain a minimum standard of living. Although private pension fund members will not pay pension contributions to the state pension system and they will not be eligible to receive pension from the state, their employers together with the insured sole proprietors must keep on paying a so-called employer’s pension contribution of 24%. The state pension system will be expanded with a new service in the future by introducing allowances for widows, it is intended to provide some form of heritability. Based on the accumulated payments on the individual account of the deceased, the beneficiary does not receive a widow’s pension (it has been an existing possibility so far) but a widow’s allowance if this amount is higher than the precalculated sum of the widow’s pension.

The amounts of money that can be deducted for operating private pension funds have been further reduced.

Judging the law amendments from a taxonomical point of view, it can be stated that the three-pillar pension system has been eliminated, which included the first pillar in the form of the mandatory state pension system financed on a pay-as-you-go basis, the second pillar in the form of a mandatory private pension fund system financed on a pay-as-you-earn basis and the third pillar consisting of other supplementary mutual voluntary funds.

The new system includes a mandatory social security pension scheme or an also mandatory private pension fund system but it is not compulsory to choose the latter one.
The system is made complete by various forms of self-invested retirement savings accounts.

Future prospects of the private pension funds within the state pension system and the factors influencing them

98% of the private pension fund members, more than 3 million people decided to return to the state pension system until the end of February in 2011. Approximately 100,000 members remained in the private pension fund system, their number is not enough to maintain the operation of the existing 18 private pension funds. This will inevitably lead to the concentration of private pension funds and some of the funds will have to cease their operation as a result of the increasing competition. According to the statutory provisions, private pension funds cannot be operated if the number of their membership falls below 2,000 persons (currently, there are five private pension funds whose membership does not reach the required number), and the market conditions in previous years proved that around 10,000 members would be needed for the efficient operation of private pension funds. This size was only reached by those five private pension funds that had already belonged to the largest ones.

Despite the shocking changes, lots of new entrants in the labour market opted for the private pension system in 2011. Now we have every reason to ask the question: who chose well?

It is not possible to give a definite answer to this question, quot capita, tot sensus. Pension services offered by the private pension funds are determined by the received contributions, they depend on the payments of the member, the length of the accumulation period and the rate of yield. The latter one is the most uncertain factor, strongly affected by the volatility of financial markets. Allowing private pension fund members to choose from several investment portfolios representing various levels of risk increases individual risks as well, whereas the majority of the Hungarian population is not mature enough yet to take full responsibility for their financial decisions.

Although the yield is guaranteed on paper (hence the institution of yield guarantee), it is not certain if the Guarantee Fund could cover the actual needs, furthermore private pension fund members cannot rely on state guarantee.

Private pension fund members can only check the accumulated amount on their individual accounts but the amount of pensions they could possibly receive in the future cannot be calculated.

There is no official estimation on the exact amount of the monthly membership fees needed for accumulating enough money to get more or less the same amount of pension provided by the social security pension scheme.

4 Even economic experts familiar with the changes of the pension system are divided over this issue. Some of them welcomed the changes while others were discontent with making the private pension fund system “paralyzed”. According to János Kun, whose views were published in several papers, it would be the best if private pension funds vanished under the current circumstances. He claims that their weak effect on capital markets, the Hungarian economy and future pension benefits does not justify their existence. Pénzügyi Szemle, Vol. 1, 2010.

5 According to an earlier study (2005), calculating with the original rate of 8%, a real yield of 2.7% is needed for achieving the full amount of state pension which consists of 75% of social security
According to the existing rules, new entrants in the labour market and those who do not acquire the necessary additional service time to receive pension from the state pension system will have to accumulate enough capital on their individual account to receive adequate pension. The current operation and the organizational structure of private pension funds are not efficient enough, which is further worsened by the limited level of operation expenses. Private pension funds cannot raise enough capital in case of temporary or constant insolvency, the reserve in the Guarantee Fund does not provide sufficient solution for such cases.

Those who choose private pension funds are likely to lose either partly or fully their right to receive pension from the state. The private pension fund system cannot handle the risk of becoming disabled, membership fees can only be deducted if the member receives taxable income. There can be various situations in life when a member does not get such income, in other words, payments are not accumulated on the member’s individual account, reducing the amount and value of the expected retirement income. Thus, private pension fund members have to take more risks and responsibility.

Although savings on the individual account are inheritable in the accumulation period (at least 15 years), this feature cannot replace the beneficiary care provided by the state pension system, and although it is also true that private fund members are allowed to choose from four different pension services, this does not compensate for the risks originating from the imperfections of the current terms of services.

With the introduction of individual account records an important step would be taken towards transparency (the exact date is still uncertain), it would be linked to the introduction of the widow’s allowance but no definite action has been taken in this respect.

The social security pension is actually a benefit-defined pension plan which means that it is determined by the amount of taxable income for pension fund and the established length of service. The rules of pension calculation are laid down by the law, making it possible for everyone to calculate the expected amount of their pension. However, some redistributive aspects of the prevailing system lead to imbalances and injustice.

The state pension system is heavily exposed to economic and demographic changes. The pay-as-you-go system is also vulnerable but its risk factors are partly different. The amount of its total revenue depends on the active age population, their employment rate, the discipline in paying contributions, the rate of deducted contributions, the number of years spent in retirement, the amount of starting pensions and the indexation of pension in payment. If there is a decrease on the side of contributors (because of economic and demographic reasons), pension payments can be reduced either by raising the official age of retirement or by limiting the amount of pensions in payment.

The state still guarantees the payment of pensions from the central budget but certain steps have been taken towards change. As it can be seen, the state pension system, does not provide full security, either.

The future role of the pay-as-you-earn scheme in the Hungarian pension system heavily depends on the retirement policy of the European Union.
The EU does not have a comprehensive legislation for various pension systems, their financing and the harmonization of pension services, the directives related to this area were accepted to ensure mobility, that is, the free flow of labour and capital. One of these directives was Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision, Hungary complied with the provisions of this directive by adopting Act CXVII of 2007 on Occupational Retirement and its Institutions. The first of these occupational retirement institutions has already been established in Hungary, if it works and spreads, it will create significant competition for private pension funds.

The member states of the EU show a varied picture of existing pension systems, pay-as-you-earn pension schemes appear in many of them but not necessarily in the form of private pension funds. This is most typical of post-Socialist states where the private pension system is contribution-defined, serving as an additional pillar. In more developed member states, the function of the second pillar is mostly fulfilled by defined benefit occupational pension schemes.

The latest green paper towards adequate, sustainable and safe European pension systems (adopted by the European Committee in July, 2010) takes an integrated approach across economic, social and financial market policies and recognises the links and synergies between pensions and the overall Europe 2020 strategy for smart, sustainable and inclusive growth.

Generating adequate and sustainable retirement incomes through pension reforms and the goals of Europe 2020 are mutually reinforcing. Its 75% employment target requires employment rates significantly higher than the present levels in the age group 20 to 65. Addressing gaps in pension adequacy, which can be a significant cause of poverty among the elderly, can also contribute to achieving the Europe 2020 poverty reduction target.

Today’s Europe faces a major demographic challenge, life expectancy has risen by about five years in the EU over the last 50 years. According to the latest demographic projections, a further rise of about 7 years could be expected by 2060. Combined with low fertility rates this could lead to a dramatic change in the age composition of the population. As a result of this, the old-age dependency ratio will be likely to double: at present there are four people of working age for every person over 65, there will be just two people of working-age for every person over 65 by 2060.

Providing an adequate and sustainable retirement income for EU citizens now and in the future is an important priority for the European Union. Providing an adequate retirement income is important because the growing number of retired age group will account for the bulk of consumer society. In order to maintain consumption, an adequate retirement income is needed but it must not increase public pension expenditure drastically. The continuous increase of the retirement age, the long-term employment of the retired, the reduction of the number of years in retirement will all appear as requirements in the future, which will result in reducing overall public pension expenditure.

It is more and more vigorously emphasized in the EU that state pension systems financed in a pay-as-you-go scheme should be supplemented by defined contribution or
defined benefit pension schemes, which can be realized either in the state pillar\textsuperscript{6} or in a second, additional pillar, thus reducing public pension expenditure.

Taking into consideration the effects of the current economic crisis hitting not only Hungary but also the other member states, the demographic trends and the requirements of the EU, it can be projected that there will be a need for an additional pay-as-you-earn system, it will play a more important role in the future. The only question is if this role is played in Hungary by the remaining private pension fund system, the emerging occupational pension schemes or perhaps other new pension institutions.

If the private pension fund system holds its position in the long term, its thoughtful reregulation will become inevitable. It is necessary to transform the current institutional and organizational structure, reduce the risks of operation and asset management, tackle or share risks more effectively, rethink the current amount of membership fees based on model calculations and strictly regulate future pension benefits.

In addition, it is essential to prepare the active age population in Hungary for the need of self-reliance, familiarize them with various forms of self-reliance to the widest possible extent and provide them with basic education on investment.

\textsuperscript{6} A good example is the Swedish state pillar, consisting of a pay-as-you-go system combined with an individual account (NDC) and a premium pension scheme financed in a pay-as-you-earn manner.