Country Report

HUNGARY

Current pension system: first assessment of reform outcomes and output

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The Institutional Architecture

Even though the pension system that Hungary inherited from socialism did not generate excessive deficits, mainly due to insufficient, *ad hoc* indexation (spending peaked at 10.4% of GDP in 1994 and then fell to 7.3% by 1997), its complexity made prominent scholars quip: *"The prime inadequacy of the existing system was its design. It embodied an almost impenetrable mix of social assistance* […] *and social insurance* […]. *Pensioners had little idea why their pensions were exactly what they were or how they related to their previous contributions".* Hence, Hungary was among the first in Central, Eastern and Southeastern Europe to introduce a multipillar system (in 1997). However, extreme political budget cycles, which accompanied a decade of implementation, render a fresh overhaul necessary.

Hungary has a universal **social assistance** scheme to ensure a minimum level of income for the elderly. To be eligible, applicants have to be 62 and able to demonstrate that their total income falls below 80% of the minimum old age pension (95% for couples). The allowance is means-tested and tax-financed, i.e. the budget tops up the difference to the minimum threshold. In 2003, the allowance was paid to less than seven thousand individuals.

The **first (mandatory) pillar** is divided into two tiers: i) the first tier is public, earnings-related, financed through social contributions on a pay-as-you-go basis; ii) the second tier is private, earnings-related, financed through social contributions and is fully funded. Old-age pension contributions have been changing constantly. Long-term decreases were reversed in 2008. Contributions amount to 33.5% of the gross wage and are split between employers (24.0%) and employees (9.5%). Of the latter part, 8.0% is devoted to the private tier. There is a contribution ceiling for employee contributions, which is set annually by the Government and amounted in 2007 to circa eight times the minimum wage.

Eligibility rules (retirement age) for a *first tier*, public pension are: age 62 for both women and men with 20 years of qualifying period. (15 years under strict conditions). Early retirement age increases by 2013 to 60 for both men and women and the vesting period from 33 to 37 for all (there are many other early retirement venues though). There are bonuses and decrements. Bonuses amount to a 0.5% monthly increase (since 2004) if the person is 62 with at least 20 years of qualifying period. Decrements are calculated on time missing until 62: 1 - 365 days, the reduction is 0.1%; 366 - 730 days, the reduction is 0.2%; 731 - 1095 days, the reduction is 0.3% for each 30-day period, that is 7.2% maximum.

The 1997 reform led to a reduction of pension entitlements through a completely redesigned assessment base, defined-benefit formula and less generous indexation. Since 1998, the assessment base is based on average valorised wages earned since 1988. The degressive benefit formula is bound to become linear in 2013 and differentiated between those participating to the funded tier and those staying in the public tier only. The latter earn an accrual rate of 1.65% per year of service and the former 1.22%, thereby losing some 25% of public benefits. These, of course, receive as well an annuity from the funded pillar, however, the Guarantee Fund that was established to guarantee an adequate level of returns was abolished in 2002 and never reintroduced. Finally, indexation became effectively Swiss (mixed price-wage) in 2004. Again, Hungarian policymakers distorted this measure by introducing *ad* hoc benefit hikes, a 13th pension, levelled benefits across cohorts in 2005 etc. Reversals to these budget-consuming measures happened in 2008, when employee contributions are excluded form the assessment base of the newly retired, thereby decreasing pension benefits by 8% circa.

The establishment of the *second tier* was even more convoluted.

The market is rather consolidated and consists of 19 mandatory pension funds. These insured almost 3 million members (71% of the economically active) and collected HUF 1,766 billion (6.8% of GDP) by mid-2009. The operational structure of these pension funds is a uniquely inefficient feature of the Hungarian pension system. The funds are mutual associations where the members are co-owners, which disguises for-profit organisations into a non-profit governance structure. Employer associations, banks and insurance companies, sponsor the funds. Big financial holdings (the Big Six) dominate the market. The irrational decentralised contribution collection, introduced in 1998, was finally shed in mid-2006 and delegated to the Tax Office. Payment of annuities is inadequate as well: life expectancy tables are unisex, thereby leading to adverse selection problems, and indexation is Swiss, making forecasting impossible for these funds. Finally, all these flaws led to spectacular losses during the global financial meltdown: all the contributions of 2008 and 13% of all assets were wiped out. Ameliorating the general picture, a few novelties were recently introduced. Since 2009, the funds are required to offer a selectable portfolio system, consisting of three different portfolios – conservative, balanced and dynamic – with varying risk profiles. The assignment of members depends on the remaining time until retirement. Participants are able to choose among portfolios, however, the dynamic portfolio is restricted to younger workers. Moreover, to diminish operational costs, the *Hungarian Financial Supervisory Authority* (HFSA) capped asset management and front-end operational fees.

The **second and third (private and voluntary) pillars** consist of individual or occupational savings in Voluntary Mutual Benefit Pension Funds. Despite a total exemption of employer contributions and a generous tax credit, these schemes never really took off. The market remained fragmented, participation stagnated, contributions were low and mainly paid by employers. By mid-2009, less than one third of the 250 funds licensed in the mid-90s operated on the market. Concentration is high, as the 15 largest companies attracted more than 80% of the 1.365 million members (one third of the labour force, declining) and HUF 749 billion assets. If participants are relatively numerous, the per-capita contributions are modest. Being the precursors of the mandatory pillar, voluntary funds display identical problems with respect to performance, operating costs and return volatility. Due to deficit concerns, tax exemptions and credits have recently been limited. Since 2008, employers can contribute only up to half the minimum wage. These ceilings will probably discourage further participation. Recently a 'second' third pillar was added in order to increase long-term, domestic private investment in the Budapest Stock Exchange. These saving schemes have no portfolio limits and allocation is based on individual choice. Similarly to the third pillar, members receive a tax credit and capital gains are exempted from taxes. Yearly front-end fees and asset management costs are capped. Notwithstanding, initial membership fell short of expectations. By the end of 2006, instead of the projected 70,000, only ten thousand new members opted for the scheme.

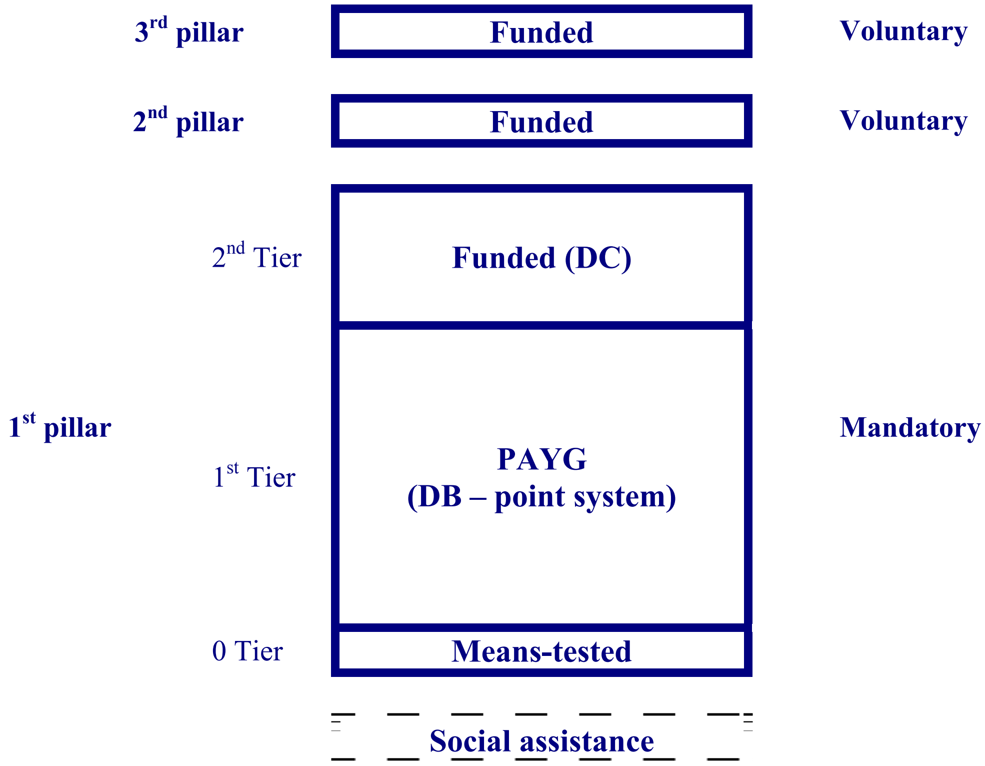
The Administrative Structure

The *Central Administration of National Pension Insurance* (CANPI) manages Hungarian public pensions. The *Ministry of Social Affairs and Labour* is responsible for policy-making and legislation. The *Hungarian Financial Supervisory Authority* (HFSA) regulates the funded mandatory tier and the *Ministry of Finance* legislates in the field. The *Tax Office* collects social security contributions for both the public and private tiers (since mid-2006).

Assessment and Future Challenges

The Hungarian pension system is one of the most troubled in the region, as it has three main flaws: i) an amateurish reform of public PAYG pensions instilled them with several design flaws (some authors attribute this to excessive fatigue after passing second, funded tier legislation); ii) the governments that followed the 1997 reform, introduced so many amendments that the future fiscal balance of the pension system has rapidly deteriorated to pre-reform levels; iii) the funded tier has governance problems that may be addressed only through a thorough systemic reform, i.e. by de-mutualising the current funds. Probably no piecemeal reform steps are enough to restore the Hungarian pension system’s sustainability. The linearization of the benefit formula in 2013 may be conducive to delayed labour market exit (94% of employees retire before the statutory age), however, a renewed structural overhaul may be a much wiser solution.

The Main Pillars in the Hungarian Pension System



1st Pillar, universal coverage (0 tier tax-financed, 1st tier public, 2nd tier private);
2nd Pillar, occupational schemes;
3rd Pillar, individual programmes.

Annex 1

Key Data about the Pension System in Hungary

Contribution rates	
Total (1st pillar)	**33.5%**
1st tier	**24.0% (employer)** **9.5% (employee)**
2nd tier	**8.0% (employee)**

Supplementary schemes	
Contribution rates	**Variable, depending on scheme**
Coverage (of employees)	**circa 31%**
Assets in EUR bln (2009)	**2.72**
Taxation	**Exempt Exempt Exempt**
Investment principles	**Quantitative Restrictions**

Theoretical replacement rates	**Gross**			**Net**
	1st pillar	**2nd pillar**	**Total**	**Total**
2005	**65.8%**	**0.0%**	**65.8%**	**101.9%**
2050	**58.5%**	**18.7%**	**77.2%**	**98.1%**

SILC income 2004	**Total**	**Male**	**Female**
Relative income of 65+	**1.009**	**1.071**	**0.971**
Aggregate rep. ratio	**0.611**	**0.600**	**0.638**

Eligibility – retirement age	**62 for both women and men with 20 years of qualifying period (15 years under strict conditions)**
Early retirement	**60 for both women and men and with 37 years of qualifying period**
Deferred retirement	**No provisions**

Indexation	**mixed prices and wages**

Public pension spending (as % of GDP)	**2004**	**2020**	**2050**
	10.4%	**12.6%**	**20.3%**

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