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The reform of the reform
The principles of an unavoidable further reform of social security

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It is commonly accepted that a reform of the social security system has to be carried on. The changes implemented in 1998 that created the second pillar of the system are not to be considered as a true reform of the social security system. In the economy of the Hungarian aging society the change to the capital reserve system was very expensive; it was financed from government debts. However, without influencing the demographic processes, the pay as you go system inevitably becomes uncontrollable. We propose to introduce the point-based system into the state pension system. The essence of the system is that the points collected in accordance with adequate regulation – in which theoretically, for example, the performance of the mothers bringing up children can be built in – would define the pension compared to the average wage at the time of the payment, which will be the fee of the to-be retired person. The fees in this system would be shared by the employer and the employee.

It would allow us to create a social security system with an influence on demographic processes. This would incite employment and it can be supplemented by – voluntary – supplementary pension fund savings. This proposal, however, does not exempt the government from responsibility to create an economic policy that creates jobs.

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1. Introduction

It is commonly accepted that the reform of the social security system has to be carried on. We believe that the analyses of NYIKA (the Pension and Old Age Round Table, Holtzer 2010b) also confirmed this need. The question is: what is the direction the reforms should take?

There is no need to argue at length: the sustainability of the pension scheme is more than doubtful, even in its “reformed” state. It has also become clear that private pension funds do not fulfil the expectations that brought them to life.

The changes implemented in 1998 that created the second pillar of the system are *not to be considered as a true reform of the social security system* (Botos 2009). As its name indicates, it established a mandatory but private social security system which is a rather unusual construct, since if it is mandatory it should be a part of the social security system. However, the latter has two more criteria: solidarity and state

guarantee. Lacking these components, the system does not qualify as a social security system proper. In such a case we may only speak of a fund that is *like a private insurance scheme*, even if the institution has non-profit status.

Therefore, another reform of the social security system seems unavoidable – but this time, it has to be a true reform. We firmly believe that we need to return to *a reformed version of the state pension scheme*. Even though our proposal appears as a step backwards, it could open up the possibility for *revolutionary advances*.

2. Principles

What are the principles to follow when changing the current system based on several pillars based on several pillars? The essential elements are the following:

- it should positively effect the demographic situation;
- it should motivate employers to employ a larger work force;
- it should not decrease people's willingness to continuously save (pay the fees) during their career, but rather, it should increase it;
- it should contribute to the balance of the national budget, if possible, in the short run.

It appears that out of these principles, the incentives required for the demographic effect can only be provided within the mandatory system, because it allows for the realization of the element of solidarity between those who do and those who do not raise children. Therefore, we believe this to be the direction – a step back, if you wish – that is rather a step forward towards a sustainable system.

3. Why is it not reasonable to maintain the current system of mandatory private insurance?

When the new system was implemented – in close cooperation with the international financial organizations – it was advertised by showing the possible advantages of the system. What was not addressed publicly is the fact that *in the economy of an aging society a change to the capital reserve system is very expensive* (Barr 2004, 2009). The transition also required substantial state resources in Hungary. It is usually interpreted in the Hungarian professional literature as the manifestation of a latent debt. This is because the budget is required to transfer the amount missing from the pensions payable in the mature system. Since there are no financial resources to do so, it can only be financed by borrowing money. However, a manifest debt creates an *immediate* liability to pay – severe – interest rates from our budget that is already in deficit, thus contributing to the increase of indebtedness. Due to the low level of domestic savings, we may only rely upon external, foreign currency sources, and it further increases the vulnerability of the Hungarian currency.

At the same time, NYIKA itself pointed out that *the operation of the private pension fund system is expensive.* It is only reasonable to maintain if the accumulated financial resources can be used for purposes other than buying government bonds of modest proceeds. Moreover, it can only produce significant profit for the contributors if it can be invested *abroad*. Some experts claim that the private pension funds should be maintained or even that their participation should be increased in order to make them entirely independent from the Hungarian Government. They say that the income of the pensioners "cannot be exposed to the deeds of the state" (?), "to what goes on in this country" (?) (Holtzer 2010a). Therefore, we need to allow for investments in foreign countries. This line of criticism does not consider the fact that *this investment would be financed from government debts.* It is simply impossible for someone from the field of macro-economics (like ourselves) to understand such an approach within the particular Hungarian economic situation. The pension scheme cannot ever be separated from what goes on in this country (Botos 2010, Kun 2010, Matits 2010). It was the state itself – whose influence they'd like to remove – that, by increasing its indebtedness, made it possible for those entering the private pension funds to accumulate wealth. Let us not forget: the *transition affected an already mature system.* Current pensioners must receive their pension payment. In a demographically mature society, the payment of pensions is dependent upon the incoming fees. If the social security system is not able to cover its liabilities out of the fees, it has to rely on *taxes*. If there is no sufficient tax income, *the state has to borrow money for this purpose*, and that further increases its indebtedness together with the accompanying interest, as we have previously indicated. *Consequently, we would provide for an increased superannuation fund for today's contributors – possibly from foreign resources – at the expense of state debt and interest.*

This "deal", however, cannot be justified by any concept of social justice. It would raise a number of unanswered questions: how can we justify making a risky investment with the state's money for the benefit of just one segment of society. Why favour them? Why should we exclude the short-term success of the active age groups from the actions financed by debts the state undertakes? Why do we not rather support our private sector by increasing investment possibilities that produce taxes and fees for the national budget? Why should today's pensioners finance the costs of the state debts that make it possible? (Since that is what they are doing by paying VAT.)

The logic behind the proposal, however, is understandable. The investment of savings is obviously a crucial question. That is what the *state* should have *done* at the time when the payment of fees superseded the payment of pensions, that is, *when the system was not yet mature*, and the age structure of the society was much younger. Indeed, that is when the social security system should have accumulated wealth as was the case in more prosperous countries, such as in Canada (in Quebec, for instance, where these resources were used to stimulate real economic

development). However, in Hungary the social security system became mature under the socialist regime, and at the same time the number of pensioners who were not vested increased (by including the agricultural workers), and the centralized state invested or used up the fees together with the profit they produced. Most of this state wealth created back then disappeared after the change of the regime – *because it was worth nothing* – or it became private property in the hands of mostly foreign investors – *precisely because it was worth something*. According to the Hungarian National Bank, the assets of the Hungarian budget were 1.5 times the volume of the GDP at the time of the change of the regime, this ratio fell under 20% by the end of the first decade of the new Millennium (MNB 2008). Unfortunately, the democratic parliaments did not use the state's assets to create the financial basis for the social security system.

Let us suppose, however, that the regulations would exclude investments in foreign markets. The members of the parliament could consider the benefits of using this substantial capital to finance investments that would contribute to the growth of the *Hungarian economy* (in accordance with the objective of supporting the current active age groups). A government investment fund could provide the necessary resources. (That could have been financed by the state's income from privatization, but *that is a lost cause by now*. Similarly, economic development cannot be realized by borrowing from international sources because we need to decrease the high rate of indebtedness compared to the GDP, and we can hardly borrow more. For this reason, one might suggest that a part of the amounts that the society and the international organizations have accepted as debts could be "magically transformed" to provide for these purposes.) It could be realized, for example, by composing the financial investment "products" of a development agency established by the state out of the securitised portfolio of loans supporting small and medium-size companies that we sell to private investors and institutions, and the pension fund could also buy into this investment fund. Or even the Hungarian bank sector could "provide", as a financial innovation, such products for investors. We also have to see that these products would be no less risky than the innovations of the US mortgage market. They would actually be more risky, since there would be no mortgage coverage since they would be provided for financing businesses. While it is not impossible, this idea would be rather risky to realize.

The recent events of the international financial market have clearly illustrated the risks in investment. Such a hazardous way of managing assets belongs to the world of private investments. A pension fund cannot undertake such risks since it is the source of income for future pensioners. The government cannot afford to watch the possible impoverishment of its elderly voters with indifference in case these ventures failed to be successful and the investor pension fund lost on the business (as it happened in the US where – as Stiglitz (2003) claims – 8000 billion dollars disappeared from the investments of the pension funds lacking a state guarantee).

By means of providing social services the state would “contact” those pensioners that were thus forced by law to invest a part or the whole of their fees (or dues). The state should obviously provide some kind of guarantee for the proceeds of the investments in case the pension fund was allowed to participate in risky investments. Once such a guarantee is required, however, it would be more reasonable to *provide guarantee for the pension itself that one can obtain within clearly defined rules*. This would also eliminate the moral hazard that inevitably accompanies guaranteed investments.

4. The point-based system

What should the solution be? NYIKA has drawn up several versions.

Some experts argued that out of the paradigmatic reform plans of NYIKA the version of *individual accounts* would be reasonable and result in a cheaper construct compared to the current system. We may keep the approach of considering the accumulated assets as virtual or real investments. A centralized management makes the system operate at much lower cost than the costs of the current pension funds, and that alone is already a major advantage. *We may also maintain the practise of purchasing government bonds out of the amount actually paid.* This would solve the interest rating of the amounts paid (which would remain unsolved in the individual account system if we only realized virtual investments). That would also enhance the psychological effect on the savers-investors that their savings are profitable because they have their own portfolio with their savings, even if it only meant government bonds. However, in this case the *state indebtedness could not be decreased*. It would conserve the present situation in which the accumulation itself generates state indebtedness since the budget would have to transfer the amounts *already* missing from pensions. But what should be the source to do this? The income from the non-existing proceeds. While this system could work under the circumstances of reduced costs of the management of social security, it is questionable whether this system would be worth the maintaining of the state indebtedness. The maintaining of the mass of indebtedness for a long period would inevitably create a disadvantage within the frames of the Maastricht criteria. While it is true that the proceeds of the state bonds would add to the fees, thus contributing to maintenance of the value that could increase willingness to become vested (while the interests on government bonds are paid by the taxpayers), many of the changes we propose in order to reach our demographic objectives could not be implemented in this system. (For instance, this system considers a homogeneous fee paid by the employee thereby depriving us of the means of inciting and differentiating the labour market.)

There are several attainable alternatives among the proposals of NYIKA to implement such a paradigmatic reform. One of these is the *point-based system*. (It

was also received with the highest level of consensus among the participants of the round table.)

Rudolf Borlói excellently and precisely describes the reform steps grounded in the point-based system in the document provided in the NYIKA Report (Holtzer 2010b). The essence of the system is that the points collected in accordance with adequate regulation – in which theoretically, for example, the performance of the mothers bringing up children can be built in – would define the pension compared to the average wage at the time of the payment, which will be the fee of the to-be retired person. By tracing the points, people can have a clear picture any time about how much pension they can expect compared to the then workers' average wage. This solution creates the tightest relationship between the active and inactive groups, owing to that the to-be active age group will produce the actual conglomerate of products and income from which pension of the retired can be paid. Here is an example that the pension system can never be independent from the existing state of the economy.

By eliminating the currently manifest indebtedness we could decrease the state indebtedness and reduce its expenses. We could also provide momentum for the private sector by a (differentiated) reduction of their expenses based upon the saving from our expenses. That would incite the labour market and the level of fees and taxes paid. At a minimum, it would allow us to save a number of companies, which is a significant result in and of itself.

By undertaking a single and substantial state indebtedness, the objective of the private pension fund system implemented in Hungary in 1998 was to enforce strict budget management. These efforts have remained *unsuccessful.* On the contrary, it created a significant interest liability for the budget expenditure. *By "undoing" the system we would get rid of this expense and the state indebtedness.*

This solution would also require an undertaking, the successful fulfilment of which depends upon a number of factors. Whether it leads to future state indebtedness, that is, whether this latent indebtedness of the state becomes manifest, depends on the figures of demography, commodity wages and employment. It is not obvious that this undertaking leads to a future increase in manifest state indebtedness. The point-based system considers the attainability of latent state indebtedness (state undertaking) in light of a number of factors from outside the pension system. These factors, however, may turn out to be beneficial for revenues.

Our proposal presupposes the possibility of positively influencing the external conditions from within the social security system itself.

Without influencing the demographic processes, the pay as you go system inevitably becomes uncontrollable (Kovács 2010).

Taking all this into consideration, we propose *the full transition* to the point-based system as opposed to the *partial transition proposed by NYIKA*. The point based system introduced in social security has another major advantage: *it can be accompanied by proper means of inciting the labour market*. Our short term

objective is to eliminate the negative effects on child birth of the hostile attitude in the labour market towards people with children. People should not be discouraged from having children by their resulting difficulties in the labour market. The central element of our proposal is that *the fees paid* by the employer should be *differentiated* according to the number of children raised by the employee. The *employer* could be entitled to *pay reduced fees* when employing families with children or pregnant women. *The margin would be paid by the state.* It would also appear as expenditure in the budget but it would help people with several children find jobs in the labour market and also contribute to their job security, and this is a major achievement. Such a differentiated reduction of fees would result in the decrease of labour costs for the employer to the extent they employ families with children.

In addition, we should provide for more direct means to motivate *employees* to have children. One way of achieving this is by introducing certain *correctional factors* into the pension scheme based on the number of children raised and educated by the employee. This would indicate that the costs of producing "human capital" do create profit for the parents. The proposal is justified by the fact that by raising children and providing them with proper education enables them to find their place in the labour market and thus they become fee payers for the benefit of those who do not undertake these costs.

5. Arguments against the reform

There are two major considerations.

First of all, we should make it clear that ending the private pension funds and transforming to a point-based system would *not damage the interests of those vested*. (The first news about the reform created some turmoil and a fear that the state intends to nationalize people's contributions. The propaganda based on selfishness and the importance possession was very effective and able to weaken the credibility of the government's platform.)

No one in society seems to understand that *it is not their own contribution that the fund may invest*, but rather, indirectly, the resources of the budget supporting the system, thus making up for the deficit created by redirecting a part of their fees to the private pension funds. The amount one pays "themselves" is *not theirs* but rather their parents' and grandparents'. All mature systems work this way. We transformed an already mature system; therefore, large amounts of fees are due. If we did not pay from the fees, we would have to sell the state's assets that were accrued through the payments of earlier generations. As we have seen we can no longer rely on the state's assets, partially because they never existed or because they were sold by the state and the earnings frittered away.

People also find it hard to understand that payments into the present system, if it was maintained, would fare worse than in the point based system we propose even though the recent years have proved the contrary.

The argument that the ending of the private pension funds would eliminate a major purchaser of government bonds is without substance because it would *also partially eliminate the need* to issue government bonds. (As it seems a surplus budget will be out of reach for a long time, and therefore the government bonds will continue to finance the budget transfers into the pension system, the snake bites its own tail. This vicious circle can be broken by the reform of the reform. There will obviously be other factors contributing to the deficit that must be covered, but by the ending of the private pension funds, the deficit would be considerably less.)

The second consideration when discussing the proposed reform is a continuing need to manage *voluntary* contributions. The institutions of private pension funds managing the payments would obviously be negatively affected by such a restoration. They have created a (rather costly) apparatus and invested in the sector. They could, however, freely take over the management of supplementary and voluntary pension funds that will continue to be an essential, supplementary element of the reform, *but not on a mandatory and state guaranteed basis.*

5. Summary and conclusions

We propose to introduce the point-based system into the state pension system. The fees in this system would be shared by the employer and the employee – as in the present system. Both the employer and the employee should be entitled to differentiated reductions in paying their fees, and the beneficiary should be entitled to preferences in other parameters of the system (retirement age, etc.) This would incite employment and it can be supplemented by – voluntary – supplementary pension fund savings.

It would also allow us to create a social security system with an influence on demographic processes that would *truly contribute to a revolutionary change* compared to all previous reforms.

This proposal, however, does not exempt the government from responsibility to create *an economic policy that creates jobs* (Augusztinovics 2005). The economic policy of a given government has a decisive role in people's ability to find jobs and become vested. The pension system can never be independent from "what goes on in this country".

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