Zsuzsa Kékesi and Gábor P. Kiss:
The reversal of the pension reform 1998[1] from a short-term perspective*

The private pension pillar established in 1998 has generated equally important short-, medium- and long-term effects. This article addresses the short- and medium-term time horizons, which differ from one another. In the short term, the government lost contribution revenues, while its pension expenditures did not decrease. However, since this shortfall in state revenues did not influence the consumption and savings decisions of households, in this analysis the short-term indicators of fiscal impact on demand disregard the impact of lost revenues. In the medium term, however, the rechanneling of contributions increased public debt and household savings. Consequently, similarly to official statistics, our household indicators and our medium-term fiscal indicator (augmented SNA deficit) take into account the effect of lost revenues. As the vast majority of members returned to the state pension pillar in 2011, for the purposes of our analysis, we could well assume that the private pension pillar never existed. Accordingly, the difference between our medium-term fiscal indicator and the short-term indicator disappears. As a result, we have changed our household indicators retroactively in such a way as if the contributions and the returns they yielded had always belonged to the state. This was necessary because the official statistics do not spread this amount over time, but account for it in full for 2011 as a capital transfer between households and the general government, which renders evaluation of the developments extremely difficult.

INTRODUCTION

The funded private pension pillar was established in 1998 in Hungary. In 2011 members were offered the option to return to the pay-as-you-go pillar of the state. The conditions for the choice were defined in such a way that only 3 per cent of private pension fund members decided to stay; thus the entire private pension fund pillar was essentially abolished.

Similarly, in 1998 contribution payers were given the choice of remaining in the state pillar or switching to the mixed funding system, i.e. they were allowed to become private pension fund members by relinquishing one-fourth of their future state pension. Switching, however, was mandatory for new entrants to the labour market. A portion of contributions collected previously by the state was rechanneled, constituting the revenues of private pension funds. Had this been carried out over a transitional phase of several decades, it would have certainly deteriorated the general government balance, as the contributions transferred and

the interest burden on the resultant debt accumulation would have increased the deficit, while the savings on pension expenditures would only have materialised very slowly. While this deterioration would have turned into improvement in the deficit once the system "had matured", it is hard to estimate the long-term net effect. In this respect, estimates made at different times yielded different results (Benczúr, 1999; Orbán and Palotai, 2005). Indeed, whether the contribution payer or the government benefited from the mixed system largely depended on how large the contribution lost by the state would have been, versus the size of the future pension amount the state would have been exempted from in return. The lost contribution was 6 per cent instead of 8 per cent for several years, and the pension commitment of the government also changed over time (increased by the 13th month pension and decreased by its reversal, and affected by changes in the retirement age and the replacement ratio). This study is not intended to determine what the long-term impact of the mixed system would have been; i.e. it does not address the impact of the return to the pay-as-you-go pillar.

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[1] For the purposes of this article, the 1998 pension reform merely refers to the establishment of the funded second pillar; the impact of simultaneous parametric changes is excluded.

The rest of the article focuses on short- and medium-term aspects. Firstly, we examine the statistical implications of the abolition of the mixed pension system. Next we discuss the adjustments we made to the household and general government indicators presented in the MNB's Report on Inflation for analysis purposes.[2]

SHORT- AND MEDIUM-TERM EFFECTS

First we present the short- and medium-term effects related to pension funds. Over the medium term, the pension reform deteriorates both the public debt figure and the ESA-based general government deficit through the rechanneling of contributions. Indeed, from the point of view of statistical accounting, the redistribution system of the government only includes the state pillar, i.e. where expenditures are paid from actual revenues. In any case, the category of financial wealth could not have considered the decline in the implicit liabilities deriving from pension commitments as a factor offsetting the increase in public debt, because estimating its stock is extremely uncertain (Benczúr, 1999; Orbán and Palotai, 2005). Similarly, the wealth accumulated in pension funds is recorded as household savings; however, the net present value of the state pension commitment under the pay-as-you-go pillar may not be recorded as a receivable. Accordingly, the returns on the rechanneled contributions and savings can be considered as household income; in other words, the net financing capacity of households has improved.

On the other hand, the short-term effect is significantly different, given that each contribution payment has an effect on households and corporates. This also entails that even though the contributions paid under the fully funded private pension pillar disappear from general government revenues from a statistical perspective, their short-term effect on taxpayers remains similar to those exerted by taxes. As such, the contributions lost by the state to the benefit of the second pillar cannot deteriorate, for example, the external balance either, having no immediate impact on it. Namely, individuals cannot use the contributions and the yields generated by them before they retire, not even as collateral for loans. In this sense, households' consumption and savings expenditures are the same with or without the pension fund system.[3] The demand effect indicator published by the MNB since 1998 has been adjusted for this reason by the additional deficit caused by lost contributions. Another occasional paper published by the MNB (P. Kiss, 2011) proposes that one of the central bank indicators used for analysis purposes should not only be adjusted by changes in deficit across the years but also by deficit levels, which would be consistent with capturing the short-term effect. In order to separate the indicators capturing medium-term and short-term effects, the above study refers to the former as "augmented financing requirement", and to the latter as "augmented deficit". Meanwhile the mixed system has in effect been eliminated; therefore, the practical significance of this theoretical distinction has disappeared, as the difference between the two fiscal indicators is in the range of 0.1–0.2 per cent.

THE IMPACT OF THE PENSION SYSTEM REFORM ON STATISTICS

On 13 December Parliament adopted Act CLIV of 2010 on the Pension Reform and Debt Reduction Fund and the modification of certain acts relating to the free choice of pension fund, which allows individuals to return to the state pillar of the pension system. Those returning to the state pension pillar acquired an entitlement to state pension, parallel to which the wealth they accumulated in private pension funds was transferred to the state.

It is necessary to deal with the transfer of wealth stemming from the pension system reform in the statistics. Currently we have no information on the savings remaining in pension funds. According to data provided by the Central Administration of National Pension Insurance, as of the expiration of the deadline at the end of January, around 97,000 individuals had chosen to remain in the private pension fund system, which constitutes 3.1 per cent of members. Since those remaining in the private pension scheme presumably have larger average portfolios, the wealth for which private pension funds remain responsible may be greater than that proportional amount. Our indicators are based on the technical assumption that the assets remaining in private pension funds constitute around 10 per cent of the total portfolio.

Statistics are also affected by the fact that those returning to the state pension system are entitled to withdraw the real yields of their payments, as well as any supplementary amounts paid by them or their employers (the estimated value of which is close to HUF 220 billion). Although it is a one-off item, the payment of real returns is handled differently than the transfers relating to the switch.

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[2] See: MNB (2011) and P. Kiss (2011) on the general government indicator.

[3] However, minor indirect effects cannot be ruled out on either side. Some individuals may have saved less as a result of the inheritability of the funds, while others may have prepared for their retirement years more consciously, having seen their wealth being accumulated in pension funds.

From the aspect of households, the processes can be captured by three different indicators, each with its own advantages and disadvantages.

1. Net lending recorded in the statistics of the financial accounts

The transformation of the private pension pillar brought about a restructuring between the household sector and the accounts of the general government. The restructuring will significantly improve the balance of the general government in the financial accounts, while there will be a corresponding decline in household savings.

The measures adopted in 2010 essentially eliminated the second (funded) pillar of the pension system; therefore, household data for 2011 – especially the financial accounts for the first quarter – are extremely difficult to interpret. As a result of the transformation of the pension system, the assets of those returning to the pay-as-you-go pillar will be transferred to the state, which will have a profound effect on the financial savings of households. The statistical accounting will be similar to that applied for the transfers at the end of 2009.[4] The transfer of assets will be recorded statistically as a transaction; reducing both the financial savings and the net financing capacity of the sector in line with the size of the assets transferred, i.e. by approximately HUF 2,800 billion, corresponding to 10 per cent of GDP. As a result, the net financial savings of households will turn markedly negative in the first quarter of 2011 and, owing to temporarily re-channelled contributions – disregarding other factors – their level may remain well below the typical levels in quarters to come.[5] This translates into a significant level shift in balance data, while transaction data, *ceteris paribus,* will persistently reflect a minor growth in receivables.

The statistical balance of the general government will improve by private pension fund assets less real yields, corresponding in size to the adjustment of the household sector, only in the opposite direction.

2. Net lending capturing basic trends

In order to ensure comparability of data and capture economic developments better, in addition to examining the time series published in official statistics, the data appearing in the financial accounts should also be adjusted. The simplest way to perform this correction is to adjust the original data included in the financial accounts by the precisely quantifiable, one-off items related to private pension funds. In this approach, the transfer of assets and the portion of the real returns which increases savings are considered one-off factors.[6]

The advantage of this method is that it does not alter historical, factual data, and it distinguishes between the propensity for consuming out of current income and the capital revenue from accumulated real yields. At the same time, it has the disadvantage of not being consistent with the general government indicator that the MNB used for analysis purposes, namely the augmented (SNA) deficit. Indeed, in the latter indicator the official balance is adjusted by the reversible effects in such a manner that they are accounted for on the date when they actually triggered an economic effect. By contrast, based on historical factual data, it appears as though the rechanneled contribution was household income, but households were not able to use those funds – neither then, nor later. Therefore, another adjustment will be necessary to ensure that developments in the household sector are presented consistently with the augmented (SNA) deficit.

3. Net financing capacity consistent with the augmented (SNA) deficit

Based on the decision of Parliament last December, changes in the private pension fund pillar should be considered permanent. For the sake of the comparability of time series data, both as regards the general government and households, we have made corrections to the indicators used in this analysis retroactively to include the private fund transactions effected by those leaving the private pension pillar. This technique will yield a smoothed time series, which reveals how the balance of these two sectors would have evolved if those deciding to return to the state-run pension pillar had never been private pension fund members in the first place. The above adjustment corresponds to the assumption that the introduction of the funded pillars did not affect households' consumption and savings decisions; in other words, the general government balance, *ceteris paribus,* is improved by the amounts involved in the transactions (revenues from contributions and owners' revenues), while household savings suffered corresponding losses.
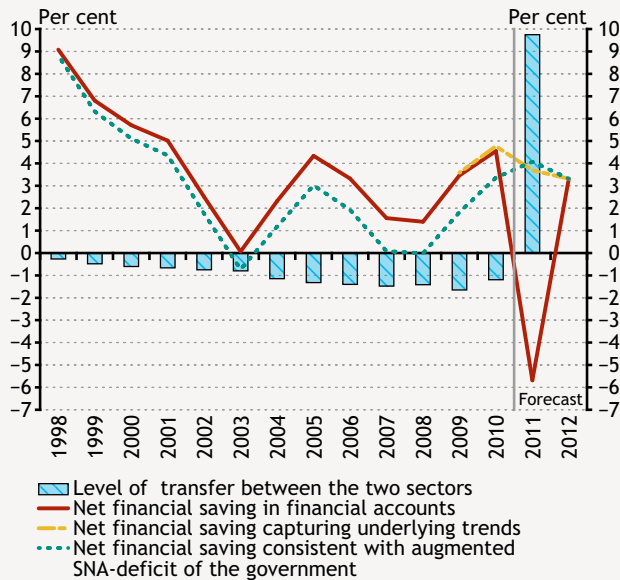
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[4] At the end of 2009 pension fund members of over 52 were allowed to return to the state system on a voluntary basis. In the financial accounts this reduced the net financing capacity of households by nearly HUF 30 billion in 2009 and by HUF 60 billion in 2010.

[5] Loss of pension fund contributions will reduce the financing capacity of households at a rate of more than 1 per cent of GDP each year on a permanent basis.

[6] We assume that half of the real returns received by households will be saved, while the other half will be used for consumption.

Chart 1

Household savings consistent with the official and the augmented SNA indicator

(as a percentage of GDP)

Legend:
- Level of transfer between the two sectors
- Net financial saving in financial accounts
- Net financial saving capturing underlying trends
- Net financial saving consistent with augmented SNA-deficit of the government

Chart 2

Net lending of households

(seasonally adjusted data as a percentage of GDP)

Legend:
- Difference between direct and indirect adjustment
- Financial assets excluding private pension funds
- Liabilities
- Net financial saving (indirect seasonally adjustment)
- Net financial saving excluding private pension funds

By contrast, the capital revenue from the accumulated real yields is expected to affect both households' consumption and their savings decisions. Thus, as an expenditure, this will increase the augmented (SNA) deficit, since we also take it into account as revenue for households.

The indicators derived in this way have the advantage of ensuring that individual transactions are accounted for on the date when the actual economic effect took place. This approach ensures comparability between the past and future data included in the official financial accounts, and at the same time presents a more consistent picture of fiscal developments.

As Chart 1 clearly illustrates, returns from the private pension pillar generated large fluctuation in financial statistics. The indicator consistent with the augmented (SNA) deficit can capture, in terms of both level and dynamics, how the net financing capacity of households would have evolved if the pension reform had not taken place. By comparison, the indicator describing basic trends can reveal additional information only in the dynamics for 2011, as, to a certain degree, it smoothes out the one-off effect of the disbursement of real yields.

It should be noted that changes to the pension system may also affect the seasonal adjustment of the household time series. Not only did the uncertainty of seasonal adjustment increase markedly due to the crisis, but it may also be affected by the corrections described above. Owing to returns to the state pillar at the end of 2009 and the suspension of private pension fund contributions in the fourth quarter of 2010, the seasonal adjustment of the official net financing capacity indicated in the financial accounts would show a distorted picture of the actual developments in savings. Consequently, among the time series presented, only the two corrected series should be seasonally adjusted and used for analysis purposes, as they are the only reliable indicators of the actual savings behaviour of the sector.
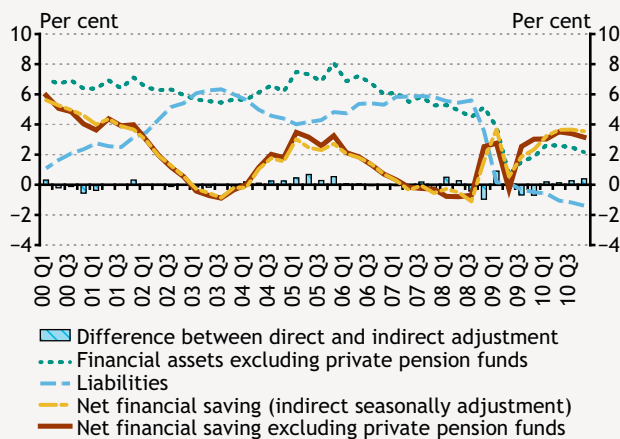
CONCLUSIONS

The changes affecting private pension funds (transfers, suspension of payments) render the analysis of data pertaining to the household sector and the general government extremely difficult. Since historical data have not been adjusted in the official household statistics and the financial accounts, for analysis purposes it could be important to perform a retroactive correction. This article presents possible methods for performing this correction.

Of course, we cannot rule out the possibility that the behaviour of households and the general government would have been different if the private pension scheme had not been introduced in the first place. While in the case of households this may have entailed only marginal effects which, in part, offset one another, fiscal policy may have evolved in a markedly different way. In this respect, our adjusted household and general government indicators may be interpreted as measures adequately capturing the

behaviour of households; however, as regards fiscal policy, they do not offer an answer as to how the deficit would have evolved without the pension reform.

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