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SOCIAL SECURITY REFORM

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Chapter 1:

Problems and Experience of the Social Security Reforms

Some unsolved problems of the Hungarian pension reform

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1. Introduction and summary

The Hungarian pension reform is an ongoing process. From our point of view it is enough to go back to 1991, when the present institutional framework of the pay-as-you-go PAYG system was set up and, however imperfect, valorization of contributions and indexation of pensions were introduced. A second important stage occurred in 1996 when the long delayed but unavoidable rise of pensionable age was enacted. Currently we are arriving at the third stage: the partial and smoothed privatization of the pension system. Since there are several good descriptions of the process, there is no need to dwell on it. Rather, I try to highlight several unsolved problems, most of them connected with the general conflict between insurance and efficiency: link between contribution and benefits, flexible retirement age, annuatization of funded pensions. In addition, I shall discuss the operational costs and the combined indexation.

2. The link between contribution and benefits

One of the most difficult problems of any public pension system is that it should be attractive to the participants (individual rationality) and at the same time help those in need (the poor, the disabled, the long-lived, etc.). Most public pension systems achieve strong income redistribution, assuming that this does not affect the degree of participation. The critics of PAYG systems claim that these systems generally achieve the perverse redistribution from the poor to the rich, because of longer life expectancy and steeper earnings careers of the rich, the latter phase of which get excessive weight in the rather short assessment period. I think that this view neglects the countervailing tendencies, at least in the First and the Second Worlds: the poor are overrepresented among the disability pensioners and the actual pension is often a strongly regressive function of the estimated earnings and years of service of the individuals.

Anyway, both types of redistribution weaken incentives. Experts, favoring the privatization and funding of public pension systems, argue that there will not be any redistribution in privatized systems.

At this point I only want to make the following remarks:

a) The Chilean privatized system also displays income redistribution, namely strongly limiting the yield differences between different pension funds and perversely providing higher rates of returns to the rich than to the poor.
b) There is a tendency to make room for a redistribution-free second (private) pillar, by weakening the earning-benefit link of the first (scaled-down public) pillar. Some materials of the World Bank go even further when it is recommended to the transitional countries to scale down the public pillar and transform it into a flat-rate pension. The idea of a private pillar with strong incentives and a public pillar without incentives is very curious since for decades a huge part of the population will remain in the old system and in the foreseeable future everybody will receive a significant part of his pension from this public pillar.

3. Flexible retirement age

As is well-known, in Hungary, like in other European socialist countries, the pensionable age was rather low: 55 years for women and 60 for men. The only factor that made such early retirement feasible was the equally low and stagnating life expectancy. During the Transformational Depression a large part of the would-be unemployed or workers of the hidden economy chose early retirement, adding to the difficulties of the pension system.

Unlike in the case of privatization of the pension system, there is a general consensus among the experts that the pensionable age in the public pillar should be drastically increased. (The private pillar is a separate case.) After several years of hesitation, in 1996 the Hungarian parliament decided on a relatively fast but smooth transition to higher and uniform pensionable age, namely by 2007 it will be raised to 62 years. Roughly speaking, every other year the pensionable age for women will be raised by one year.

There is, however, a strange absent-mindedness among certain experts. When they speak about the necessity of higher pensionable age, they generally fail to mention that in practice the actual retirement age has been strongly declining all over the industrialized world. Nobody knows what will happen to the labor markets after the baby boom generation retires, but it is clear that a large part of the cohorts between the old and the new pensionable ages will not find work.

Here enters the flexible pensionable age as it is known, for example, from the US practice. Within limits, anybody can retire before and after the pensionable age, but his monthly pension will be downward or upward adjusted, respectively.

However, it seems to be excessive to require that these adjustments follow actuarial fairness. There are at least two difficulties with actuarial fairness in this context:

(i) There are people who can simply not work longer and it would be the denial of insurance to punish them dollar for dollar for early retirement. It would be most unwanted to push even more people toward seeking of disability pension.

(ii) It seems to me highly probable that those people who decide to work longer (shorter), on average have higher (lower) life expectancy and because of adverse selection, they will gain (lose) more than what is actuarially fair.

4. Annuatization of funded pensions

One of the frequently overlooked advantages of public pension systems is that they defend against longevity risk by providing annuities. It was shown on the example of US private annuity markets, which are very underdeveloped, that the implicit interest rate for annuity is much lower than the corresponding market rate. One reason for that is adverse selection: insurance companies are afraid that only people with better than average life expectancy buy annuities, and thus they charge higher fees than they would under a comprehensive plan.

Although the Hungarian government will have about a decade to finalize the details of how private pension savings can be amortized by their owners, it would be important to outline the plans as soon as possible. Knowing the less than perfect information of the Hungarian public, it would be important to dispel any misconception.

Up to now we have only the Chilean experience for a nationwide privately-run compulsory annuity-market. The Chilean system offers two solutions to the retiree:

(i) Either he buys an inflation-indexed annuity or (ii) he annually withdraws an amount which is consistent with his remaining capital and the remaining life expectancy. On the one hand, this dual system may please the partisans of "free choice", on the other hand it creates a double danger: (a) via the adverse selection, it may incite only people with high life expectancy to buy annuities, making the purchase more expensive than would be without free choice; (b) people not understanding the quite involved notion of conditional remaining life expectancy, may end up with a rapidly decreasing pension. Strangely enough, the same perverse income redistribution appears with privatized annuities as with public pensions, because statistically, richer people live longer.

It is also of interest that the most ardent critics of public pension systems object the growing annuitization of the income of the elderly. Among other things, this otherwise beneficial tendency is blamed for the dramatically falling US savings ratio.

5. Operational costs

Until now we have not mentioned the operational costs. The present pension system operates at a too low cost, about 1% of the total revenue or expenditure is spent as operating cost. (Too low cost means low quality and incomplete record keeping.) If the public pillar gets be modernized and every contribution and benefit be recorded on a computer on an individual account, then its cost may easily be doubled.

This modernized system could also be used for the private pillar. However, it is obvious from the Chilean and British data that the emerging private pillar will cost much more than the would-be public pillar. The formulation of the official plan is rather tricky: the cost consists of two parts, namely 3% of the contributions and 0.5% of the accumulated stock. To give an underestimation of the latter, calculate the accumulated stock as the sum of 20 years of contributions (i.e. with zero real interest rate and growth), then we end up with 13% of annual private contributions. Using the planned ratio of 1:2 or 1:3 between private and public pillar, this would amount to another 3-4%. In sum the modernized pension system will use up 5-6% rather than 1-2% of the revenues.

International experiences foreshadow a much higher figure. And the start of such a system requires a huge initial investment and recruiting and teaching of the clerks. I only hope that its functioning will not be as messy as that of the personal income taxation and the value added taxes about a decade ago.

6. Combined indexation

In this section I would like to touch upon an apparently minor problem: the connection between indexation of benefits and replacement rates. In the old system, where – at least in principle – not only the valorization of the contributions, but also the indexation of benefits followed the wage-dynamics, the replacement ratio for different cohorts are comparable. However, with the combined (Swiss) indexation to be introduced in 2000, any discrepancy between wages and prices differentiates among retired cohorts. For example, calculating with an annual 3% real wage increase, each retired cohort loses 1.5% each year with respect to the workers. I would like to know whether the calculations on replacement rates in the new system take into account this problem or they simply consider the newly retired. The calculations give the impression of the latter. Anyway, if one has to reduce the benefits, why not reduce the accrual rates but maintain wage indexation. Of course, such indexation is almost impossible with a private pension system, thus maintaining wage-indexation would increase the share of the public pensions with age. But do we want more relative deprivation in old age than will occur automatically?

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