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**ESS – Extension of Social Security**

**Reversing Privatization  
and Re-Nationalizing Pensions in Hungary**

Dorottya Szikra

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Social Protection Department

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## Abstract

This paper documents the reversal of pension privatization and the reforms that took place in the 1990s and 2000s in Hungary. The report analyses the political economy of different reform proposals, and the characteristics of the new pension system, including laws enacted, coverage, benefit adequacy, financing and contribution rates, governance and social security administration, social dialogue, positive impacts and other key issues of Hungary's pension system.

**JEL Classification:** I3, H53, H55, J14, J26

**Keywords:** pension privatization, pension reform, social security policy



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## Acronyms

CEE	Central and Eastern Europe
EDP	Excessive Deficit Procedure
EU	European Union
Fidesz	Fiatal Demokraták Szövetség (Alliance of Young Democrats)
GDP	Gross Domestic Product
HUF	Hungarian Forint
IMF	International Monetary Fund
Jobbik	Jobbik Magyarországért Mozgalom (Movement for a Better Hungary)
LMP	Lehet Más a Politika (Politics Can Be Different)
MNB	Magyar Nemzeti Bank
NAV	Nemzeti Adohivatal
NDC	Notional Defined Contribution
NGTT	Economic and Social Council
NMS	New Member States
OÉT	Országos Érdekegyeztető Tanács (National Council for the Reconciliation of Interests)
ONYF	Országos Nyugdíjbiztosítási Főigazgatóság
PPP	Purchasing power parity
PAYG	Pay-as-you-go
PSZÁF	Pénzügyi Szervezetek Állami Felügyelete (Hungarian Financial Supervisory Authority)
WB	World Bank
USD	United States Dollar



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## Summary of Reforms related to Pension Privatization and its Reversal

1997	<p><b>The pension system following the 1997 privatization:</b></p> <ul style="list-style-type: none"> <li>– Pillar 0: Basic pension financed through contributions and taxes</li> <li>– Pillar 1: Mandatory public PAYG DB scheme</li> <li>– Pillar 2: Mandatory private individual accounts savings scheme</li> <li>– Pillar 3: A voluntary private pillar</li> </ul>
Oct 2010	<p><b>Reversal of the privatization, re-nationalization of the pension system</b>  Act CI/2010 and C/2010: Adoption of the act on diverting 14 months of contributions and the act eliminating compulsory enrolment in private pension funds New entrants to the labour market cannot enrol in the private pillar. Appropriation of most individual account funds.</p>
Nov 2010	<p><b>Governments announcement on details of pension nationalization:</b></p> <ul style="list-style-type: none"> <li>– Private fund members lose rights to public pensions (75 per cent) if they remain in the private system</li> </ul>
Dec 2010	<p><b>Parliament adopts Pension Reform and Debt Reduction Fund Law (Law 128/2010).</b>  <b>The new model:</b> Return to the pre-1998 mandatory pension system. A public PAYG defined benefit (DB) scheme is combined with a non-contributory means-tested pension.  <b>Rights and entitlements:</b> Contributory PAYG pension benefit for men and women beginning at age 63 ½ at a replacement rate of 70 per cent assuming 35 years of contributions. Means-tested non-contributory pension is available beginning at age 62 with a monthly benefit of US\$ 79.  <b>Administration:</b> As the public (PAYG) system was still operational, no new entity was created. Central Administration of National Pension Insurance (ONYF) is the unique administrator.  <b>Transfer of entitlements:</b> Most affiliates transferred voluntarily to the public PAYG scheme. Benefits are calculated according to the DB formula. Funds of those switching to the public scheme were transferred to the Treasury.  <b>Contributions:</b> Contributions are collected by the National Tax and Custom Administration. Workers and employers contributions are 10 and 24 per cent respectively.  <b>Supervision:</b> Functions under the Ministry of Human Resources and the Hungarian National Bank.  <b>Solidarity, gender and social impact:</b> The re-reform led to increased social solidarity. Gender equity also improved with the extension of the maternity voucher from two to three years.  <b>Fiscal impact:</b> US\$ 11,000 million of the private funds were transferred to the public fund, decreasing the fiscal deficit from 5.8 to 2.75 per cent in 2011 and public debt from 81.8 to 79 per cent of the GDP between 2010 and 2012.</p>
Feb 2011	<p>Prime Minister Orbán announced the two-tier system (compulsory public PAYG and voluntary 3<sup>rd</sup> pillar).</p>
June 2011	<p>Elimination of the mandatory second private pillar. Private pension assets transferred to the government.</p>



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## Executive summary

The Hungarian pension system was based on a Bismarckian public pension system and consisted of a pay-as-you-go (PAYG) scheme, an anti-poverty tier and a voluntary private pension tier in the early 1990s. Despite its overall stability, the PAYG pension tier suffered from several problems, including a lack of transparency in calculating pensions and the sudden rise of unemployment during the transition from socialism to capitalism. While the Hungarian government developed an overarching parametric reform programme the pension privatization promoted by the International Monetary Fund (IMF) and the World Bank (WB) had come to dominate the agenda by the mid-1990s. Hungary adopted the Argentinian «mixed» model in 1997. The system reform was accompanied by parametric reforms, including the gradual increase of the retirement age to 62 years for both women and men until 2009.

Hungarian as well as international banks and insurance companies (including AXA, ING, AEGON, Allianz and Erste) entered the Hungarian private pension market in 1998. Initially, the 6 per cent employee contribution was paid into the private, second pillar, while the government-run pension fund had a employers' contribution rate of 25 per cent. The public pillar remained dominant but private pension contribution rates changed somewhat over time in response to political cycles. Future pensioners were supposed to receive 75 per cent of their annuities from the PAYG pillar and 25 per cent from their individual private accounts.

New entrants to the labour market were required to join the mixed system, while all other employees could choose to switch to the new system or remain solely in the PAYG system. Positive expectations about high yields and sustainability contributed to the surprising success of private pension funds, reaching about three million members or 75 per cent of the total labour force by 2010. A decade after privatization, it became apparent that the merits of the system had been overstated while its drawbacks (especially for older employees) had not been clearly communicated to the public during the transition.

When the private scheme matured in the mid-2000s, it became clear that the expected positive impact of pension privatization on the Hungarian economy and the sustainability of the pension system had not materialized. It had no substantial positive effect on Hungarian capital markets, employment rates or economic output. Additionally, transition costs from the PAYG to the mixed system were high and rising. Transition costs, government-financed from direct and indirect taxes, increased from 0.3 per cent of GDP in 1998 to 1.2 per cent by 2010. The funding gap also led the government to request additional IMF loans and contributed to the country's debt. Meanwhile, real rates of return of private pension funds failed to meet even conservative expectations due to high administrative costs (above 10 per cent). Furthermore, the concentration of funds created an oligopolistic situation limiting competition and choice.

Intertwined internal and external economic and political factors contributed to the reversal of pension privatization in Hungary. The sharp decline of GDP and revenues during the global economic crisis had the strongest impact. Another key factor was that the new conservative government led by Fidesz (who assumed office in April 2010) prioritized reducing Hungary's fiscal deficit and debt despite the difficult macroeconomic context. In the Fall of 2010, the new government's first measure, was to channel private pension contributions into the public system for 14 months. In December 2010, the government administration decided to tackle the issue of the private second-pillar pensions more directly, but instead of directly eliminating private pension funds, it created unfavourable conditions for private pension fund membership. As a result, by early 2011, 97 per cent of former private pension members had opted to enrol in the public scheme

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only. Accumulated assets were transferred to the newly created fund for pension reform and the reduction of the fiscal deficit.

The Fidesz administration managed to implement its reform agenda very quickly, with limited consultations. There was surprisingly little resistance against the re-reform. Only a few protests were organized and attempts by the association of private pension funds and individual fund members to modify the reform agenda were unsuccessful.

By 2012, Hungary had returned to its pre-1998 mandatory pension system, consisting of a public PAYG scheme, a poverty elimination pillar and a voluntary pillar. Despite the undemocratic processes, the overall impact of the re-reform has been positive as it improved the financial sustainability of the Hungarian pension system as well as benefit adequacy. The fiscal burden on the government budget was eliminated, and the public pension fund generated a surplus, which has contributed to the government budget since 2013. Government debt decreased by 5 per cent in 2011 and the budget deficit fell to a record low of 1.9 per cent in 2012. However, due to a variety of transactions and economic processes (including the devaluation of the Hungarian Forint), Hungary's explicit debt has not been reduced successfully. It reached 82.4 per cent of GDP in 2013, the same rate as in 2010 (Eurostat, 2013).

The overall number of pensioners decreased from 2.8 million in 2011 to 2.2 million in 2012, an 18 per cent decline due to the elimination of disability pensions and early retirement options. Replacement rates increased somewhat at the same time. Most pensioners (around 1.1 million people) retired after contributing for 35 to 45 years, with a replacement rate of approximately 75 per cent of the net average wage in 2014. Due to the high coverage and replacement rates, the share of elderly people living in poverty is low in Hungary: 4 per cent of people over age 65 live in relative income poverty in Hungary, as opposed to 23 per cent of children under age 18 (Eurostat, 2015). Concerns regarding the sustainability and adequacy of the pension system remain given that reserves for future pensions have been used for other purposes in recent years. Likewise, a negative demographic trend, coupled with continuing low employment rates, point to future challenges in terms of sustainability and equity, issues that the Hungarian government must still address.

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## 1. The Hungarian Pension System in Transition

The Hungarian pension system was based on a Bismarckian public pension system, financed on a pay-as-you-go (PAYG) basis since the end of the Second World War. The pension system, which was financed through compulsory contributions by employees and employers, remained largely intact despite social and economic changes in the early 1990s. The system remained fully contributory, along with tax-financed poverty elimination programmes. Pension coverage during the socialist era was nearly universal. The pension reform in the early 1990s included the introduction of a voluntary private savings scheme in 1992 and the establishment of a tripartite self-governing body in 1993. Table 1 shows the structure and financing of the pension system prior to the 1996 and 1997 reforms.

**Table 1. The Hungarian pension system prior to the 1996 and 1997 reforms**

Tiers/Pillars	Institutions	Finance
Tier 1. Old-age poverty elimination	Pension fund + local municipalities	Compulsory contributions + general taxes
Tier 2. Mandatory public PAYG	Pension fund	Compulsory contributions
Tier 3. Voluntary private pension savings	Private non-profit funds	Voluntary private savings

The pension system of the 1990s posed several challenges. First, a relatively complex, non-transparent pension formula resulted in some cohorts' receiving much lower pensions than others<sup>1</sup>. Second, nearly a quarter of all jobs, some 1.2 million, were lost during the early 1990s, resulting in a sharp rise in the unemployment rate. Consequently, a large percentage of people chose early retirement and disability pensions. Approximately 300,000 workers received disability pensions (Fazekas and Scharle, 2012). The number of disability pensioners under retirement age increased from 100,000 in 1990 to 200,000 in 1995 and to 350,000 in 2006 (Monostori, 2008:40). This drove the increase in the system dependency ratio, from 51.4 per cent in 1989 to 83.9 per cent in 1996<sup>2</sup>. Pension spending rose to over 10 per cent of GDP in 1992, while the pension fund deficit was around 0.4 per cent of GDP between 1992 and 1996 (Orbán and Szalay, 2005:8-9).

Parliament established a detailed reform agenda in the early 1990s to address the problems of the pension system. Experts of the Public Pension Authority argued that a parametric reform of the public system would be sufficient to overcome immediate and long-term problems of the pension system (Augusztinovics and Martos, 1996). The IMF and the World Bank (WB) recommended a pension privatization and structural reform agenda and soon dominated discussions on the pension reform (Müller, 1995; Orenstein, 1998). The country's high level of debt with international institutions contributed to its exposure to the privatization agenda promoted by the IMF and the WB.

Trade unions and some civil society organizations were consulted; in general, however, there was no wide-reaching public debate on the reforms (Müller, 2001). The government financed a market-based public relations campaign. It emphasized the problems of the old PAYG pension system and called for «self-reliance» as opposed to

<sup>1</sup> For example, those who retired in 1993 received pensions 6 per cent lower than the average, while those retired in 1990 received pensions 13 per cent above the average (Simonovits, 2009:9).

<sup>2</sup> The system dependency ratio is defined as the ratio of pensioners to contributors.

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inter-generational solidarity (Kósa, 2002)<sup>3</sup>. Social policy experts pointed out the possible drawbacks of privatization, including decreased inter-generational solidarity (Ferge, 2000), a wider gender gap in the pension system resulting from individual accounts and the lack of solidarity components in a private pillar. However, the pro-privatization stance of the Socialist Party prevented further discussions on improving the social insurance pension system.

Proponents of the structural pension reform argued that:

- **Individual savings** should be promoted instead of a social insurance pension system based on solidarity to strengthen the linkage between contributions and pension levels, and to increase transparency of the pension system.
- **The financial sustainability** of the public system was believed to be at risk. Low employment rates threatened the financial sustainability of the PAYG system (Simonovits, 2009: 10-11). It was also suggested that contributions were too high and that they could be substantially reduced only through the introduction of a privatized system (ibid: 11).
- **Economic growth:** Pension privatization was assumed to generate additional revenues through employment increases and higher economic output. Private funds were also expected to channel savings into more productive segments of the economy (Drahokoupil and Domokos, 2012:288-289).
- **Reducing the informal economy:** It was assumed that privatization and the creation of individual accounts would automatically reduce informal employment and tax evasion.
- **Demographic concerns** such as increasing longevity and decreasing fertility would pose problems. Privatization would decrease the «burden» of the working population to finance pensions of older generations (Simonovits, 2009:10). A retirement age increase and flexible retirement programmes were planned to overcome these issues.
- **Privatization would diversify the pension market** and offer the possibility of choosing between funds.
- **Private pension systems would produce better returns**, thereby strengthening the domestic financial market. Proponents of privatization assumed unrealistically high rates of return and tended to downplay the risks and costs of the reform (Simonovits, 2009: 11, quoting Feldstein, 1996).
- **Macroeconomic reasons:** Privatization would attract foreign investment and help maintain favourable relations with international financial institutions such as the IMF and the WB.
- **Political reasons:** The Communist legacy would be eliminated.
- **Privatization would «educate»** the public on self-reliance and financial responsibility.

<sup>3</sup> One of the ads, for example, depicted a grandfather with his grandchild. The narrator said “You do not want her to take care of you in your old age, do you?” (Kósa. 2002).

Hungary adopted the Argentinian, «mixed» model rather than a fully-privatized pension system, partly in response to government negotiations with trade unions (Müller, 1999; 2001). The 1997 reform package also contained important parametric elements. The private pension pillar was based on the structural features of the previously-established voluntary private pension system. In administrative terms, this meant the creation of non-profit associations led by self-governing bodies of insured employees. Although some genuine, locally organized insurance associations were created, most of these non-profit entities were simply branches of large insurance companies and banks, including international ones. While it was emphasized throughout the reform process that privatization would benefit the Hungarian economy, no limits were set on the number of multinational companies (including AXA, ING, AEGON, Allianz and Erste) entering the Hungarian private pension market (see below).

New entrants to the labour market were obliged to choose a private pension fund and enter the mixed system, while this remained an option for other employees <sup>4</sup>. The private pension tier was financed from employees' contributions deducted from their gross wages and usually paid directly by employers. Of the total 31 per cent of contributions, 6 per cent (employees' contribution) were paid into the private funds initially (gradually increasing to 8.5 per cent in 2003) and 25 per cent (employers' contribution) to the PAYG system (decreasing to 18 per cent in 2002). This meant that the public pillar remained dominant. Rather than adding an extra tier to the public pension, the private pension scheme was «carved out» of the public tier (Simonovits, 2011).

It was envisaged that future pensioners would receive 75 per cent of their annuities from the PAYG pillar and 25 per cent from their individual private accounts. Employees voluntarily entering the mixed system thus lost 25 per cent of their earlier contributions to the public system as this share was not included in the calculation of their overall contributions. It was hoped that this loss would be compensated by the high returns of the private pillar when entering retirement <sup>5</sup>. The compulsory public and private pillars were supplemented with the existing voluntary pillar, while prevention of old-age poverty through minimum pensions and the previous means-tested scheme also remained in place.

**Table 2. The Hungarian pension system after the 1997 reform**

<b>Tiers/Pillars</b>	<b>Institutions</b>	<b>Financing</b>
Tier 1. Old-age poverty elimination	Pension fund + local municipalities	Compulsory contributions + general taxes
Tier 2. Mandatory public PAYG scheme	Pension fund	Compulsory contributions
Tier 3. Compulsory private pension savings	Private non-profit insurance funds	Compulsory contributions
Tier 4. Voluntary private pension savings	Private non-profit insurance funds	Voluntary private savings

<sup>4</sup> Originally, employees above age 47 were not allowed to enter the mixed system. This was quite logical given that beginning at that age, pension levels within the mixed system would have been lower than those promised by the public system.

<sup>5</sup> This elimination of social security rights was ruled unconstitutional by Augusztinovics (2000).

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The parametric components of the 1997 pension reform included changes in the retirement age, benefit formula and contribution rates: The official pension age was gradually raised from 60 to 62 years for men and from 57 to 62 for women between 1998 and 2009. The effective pension age remained lower, however, given that the possibility of early retirement (at age 55 for women and 60 for men) remained in effect, with some reduction in pension levels <sup>6</sup>. The Swiss pension indexation formula was adopted <sup>7</sup>.

Employer contributions (directed to the PAYG pillar) were reduced from 24 per cent in 1997 to 20 per cent in 2001 and to 18 per cent in 2002, with a planned further decrease to 16 per cent until 2009 (which did not occur). Employee contributions to the private pillar were supposed to increase to 9 per cent gradually but in fact only rose to 8 per cent in 1999 and to 8.5 per cent in 2003. The share of employee contributions to private pension funds fluctuated depending on the political commitment of the government to the private pension system (see discussion below). Overall contribution rates decreased from 30 per cent to 25.5 per cent of gross wages between 1997 and 2007, which threatened the system's sustainability.

The mixed system became surprisingly popular, with around 2.4 million members in 2004 and three million in 2010, or about 75 per cent of the total labour force. Most employees entered voluntarily. Some employees, especially older ones, did not benefit from entering the mixed system. When asked to choose, they were not sufficiently informed about the drawbacks of the private system while its merits were exaggerated. The following issues probably fostered people's enrolment in private funds (even when it did not benefit them):

- Employers typically chose a pension fund for their employees, which led to mass enrolment in some of the largest funds <sup>8</sup>. Employers would enter into a contract with a fund (for a service «package») and would strongly recommend that employees enrol when establishing or modifying labour contracts. This created pressure on employees to enter that specific fund and contributed to a high number of enrollees in the funds.
- Annuities would have been inheritable in the private system. While survivors' pensions existed in the PAYG system, the possibility of choice was successfully advertised by private pension proponents.
- High-earners found the private pension system attractive because it did not include components of social solidarity and redistribution.
- Individual accounts were established in the private pillar but not in the public pillar.

<sup>6</sup> The minimum years of contribution was raised to 38 years, but workers could effectively retire with 35 years of contributions. Every "extra" year retirees received pensions was sanctioned with a 1.2 per cent loss of benefit amounts. Longer employment was rewarded with an extra 0.5 per cent monthly.

<sup>7</sup> Between 1992 and 1997, pensions were indexed according to the increase in net wages. This led to the decline of the real value of pensions as real wages fell throughout the transition crisis. Swiss indexation beginning in 1997 matched the real increase of pensions with the median of the nominal wage increase and expected annual price increases.

<sup>8</sup> Employers arranged for the direct payment of private contributions. This transfer method "has allowed employers to influence their employees in their choice of funds" (Simonovits, 2009:16).

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- Proponents of the reform stressed the low credibility and lack of transparency of the public pension system. The public pension fund and its leading experts and officials were slow to defend the PAYG system.
  - Government propaganda and information provided by sales agents overemphasized potential returns while downplaying the risks of the private scheme.
  - A minimum pension guarantee existed until 2001 for those entering the mixed system in the event the pension funds failed to achieve expected annuities. In 2001, this guarantee was eliminated.

## **2. The government decision to move away from individual accounts and the mandatory second-pension pillar**

Drahokoupil and Domonkos (2012) concluded that re-reforms in the countries of Central and Eastern Europe were a reaction both to the legacies of past choices and to the exceptional fiscal circumstances resulting from the crisis, as well as the belief that the new political economy «would no longer allow the deferral of costs to the future». The lack of extensive public debate and consensus on pension privatization increased political risks and the divide between left and right.

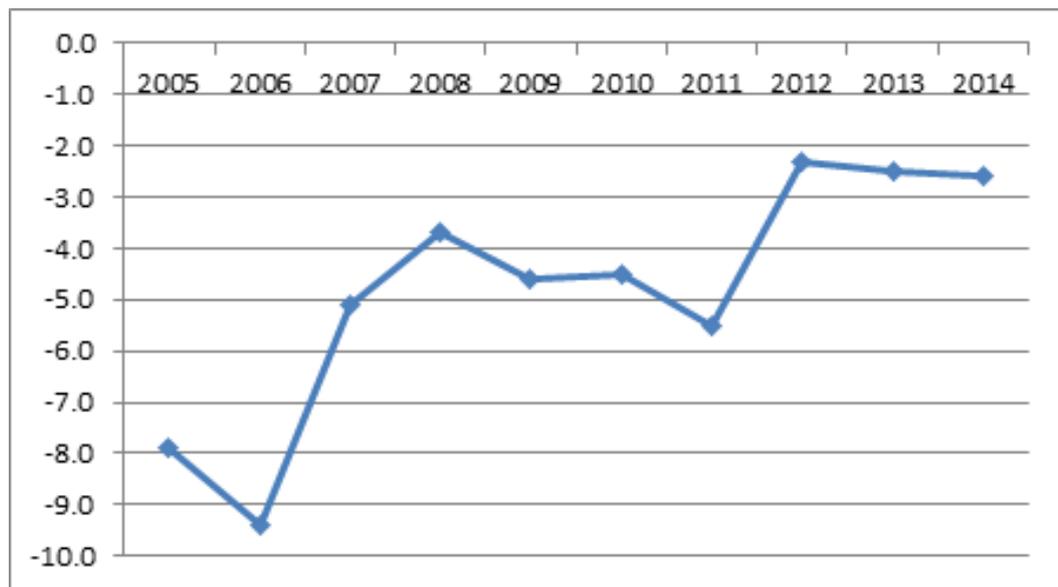
### ***Fiscal costs***

The pension privatization reform and the parametric reform in 1997 sought to increase the financial sustainability of the Hungarian pension system. Privatization had high, increasing transition costs and thus placed a fiscal burden on the government. These costs rose from 0.3 per cent of GDP in 1998 to 1.2 per cent of GDP in 2010. Decreasing shares of contributions along with increasing contributory and non-contributory pension payments have increased financial burdens (Mesa-Lago, 2014: 10).

Parametric reforms, especially the increase in the retirement age, initially contributed to the financial sustainability of the system (Benczúr, 1999), but positive effects were eroded by subsequent reforms, including the introduction of the 13<sup>th</sup>-month pension in 2002, and the gradual decrease of social insurance contributions between 1999 and 2007 (Orbán and Palotai, 2005: 10).

The Hungarian government had to face a tough choice of increasing taxes to finance additional costs or allowing government debt to increase. This challenge was a key issue in the debates concerning the modification of the European Stability and Growth Pact when Hungary joined the European Union in 2004. The European Commission finally allowed the new member states with recently privatized pension systems to temporarily deduct a decreasing share of transition costs from government deficit, which was taken into consideration in the Excessive Deficit Procedure. The budget deficit reached 9.4 per cent of GDP in 2006 and was a critical issue for the succeeding socialist-liberal government administrations in Hungary between 2004 and 2009.

Figure 1. Budget deficit as a percentage of GDP



Source: Eurostat, 2015.

When this deduction ended, the full amount of transition costs was added to the budget deficit in 2010. This was a key external factor triggering the Orbán administration's reversal of pension privatization in 2011.

## Coverage

It is important to differentiate between legal and effective coverage of insured persons, where the former refers to coverage based on the law while the latter refers to the real percentage of those insured by the pension system in the active labour force and the share of retired individuals who receive a pension of the total population above the retirement age. Both before and after pension privatization, the legal coverage of the economically active population was 100 per cent in Hungary given that the pension system has remained mandatory for all workers throughout the (re)reform processes. While there has been no substantial difference in the overall legal coverage rates, the 2011 reform changed the internal structure of the pension system. These changes were defined as «cleansing of the profile» of the pension system: Only those above age 62 could remain in the old-age pension scheme (besides survivors' pensioners). The disability pension was replaced by a «disability benefit» and a «rehabilitation benefit». Disabled pensioners above age 62 were switched to the old-age pension scheme. The number of beneficiaries receiving the new «disability benefit» decreased following the strict re-examination of former disability pensioners. The impact of the changes is described later in this report.

Effective coverage rates are much lower than the legal coverage rate. The informal economy employs approximately 22 per cent of the labour force and tax evasion is estimated at 25 per cent (Schneider, 2013). An estimated 10 per cent of the *officially* registered employed population do not pay regular social security contributions, either because they work in the «grey» economy, moving in and out of official employment, or because they are registered as so-called farm labourers [őstermelő], who are exempt from pension contributions (Augusztinovics and Köllő, 2007:556). Czajlik and Szalay (2005:3) mentioned that no payments were made to 12 to 13 per cent of private pension fund accounts, most likely because of long-term unemployment or illegal employment of the accountholders, or the failure of employers to pay contributions. Based on these estimates,

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the effective coverage rate was approximately 75 per cent. Furthermore, self-employed persons and many employees of small enterprises (with fewer than five employees in Hungary) covered under the mandatory pension system tend to underreport their salaries and therefore can expect benefits with lower replacement rates. Increasing emigration from the country since 2010 may also have contributed to a slight decrease in effective coverage rates. Between 400,000 and 500,000 people, or 10 per cent of the labour force, left the country between 2011 and 2014. While no official data are available on this issue, the Hungarian Statistical Office has suggested that migrants tend to pay social contributions only irregularly (KSH, 2014:3) <sup>9</sup>.

Given that current pensioners began working during the socialist government system, the problem of unstable employment and social insurance coverage, as well as lower pensions, will gradually become apparent over the next few years. Augusztinovics and Köllő (2007) modelled future pensions based on employment rates in the mid-2000s. They indicated that over the next 15 years, between 250,000 and 500,000 people will not reach the minimum of 20 years of contributions to the pension system needed to receive a public pension. Workers with a primary school education or no schooling are the most affected by the problem of irregular employment records and low social insurance coverage.

In Hungary, pension coverage of the female population has been relatively higher than that of Latin American countries. This is mainly due to two factors. First, while the female employment rate of 56 per cent is currently lower than the EU 27-country average of 62 per cent in 2012, most women still work full-time, resulting in higher coverage. Second, years spent on maternity and parental leaves were counted as contributory years for pension calculations of the social insurance scheme since the paid parental leave system was established in the late 1960s. Those leaves were not counted as contributory years for the compulsory private tier between 1998 and 2011. Had the private pillar remained in place, women would have received lower pensions than men. The current public PAYG system counts the maternity and parental leaves as contributory periods for pension calculations. Despite these compensatory mechanisms, women's average pensions are still about 13.3 per cent <sup>10</sup> lower than those of men due to their lower average wages and longer absence from gainful employment (KSH, 2013; 2014:14). The gross replacement level of Hungarian pensions has been better than that of many other European countries, but it is among the worst if purchasing power parity (PPP) is considered (see below).

### ***Investment performance of the funds***

In early 2005, 950 billion HUF were accumulated in private pension funds, equal to 5.4 per cent of the gross savings rate of the Hungarian population (Czajlik and Szalay, 2005:36). After increasing by more than 100 per cent in 1998-1999, the funds grew by 40 per cent annually and equalled 10.7 per cent of GDP in 2010.

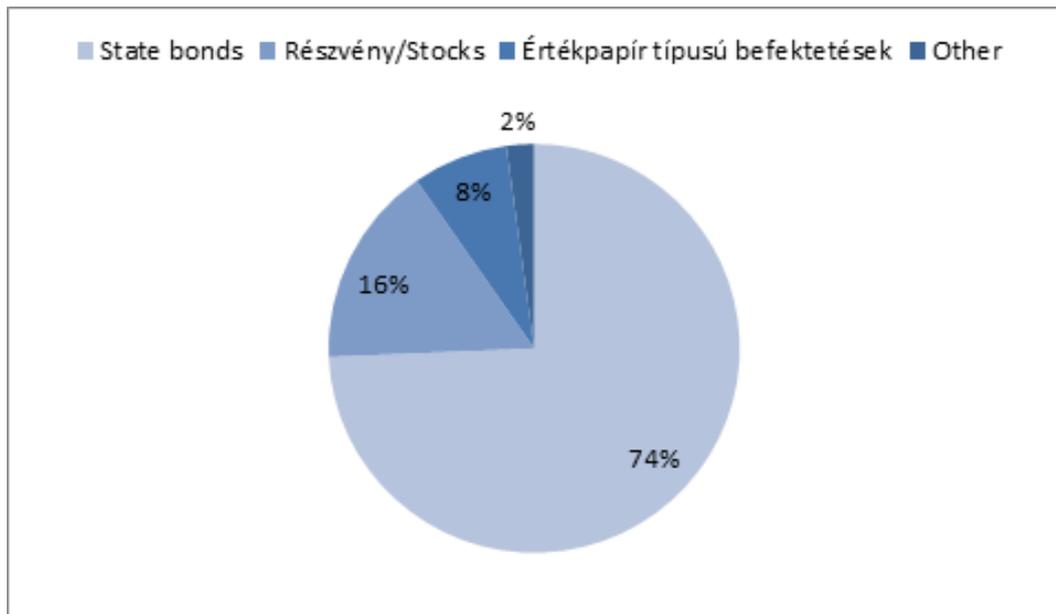
Due to high administrative costs, however, the real average rate of return of private pension funds was zero between 1998-2005, with significant variations among funds (Matits, 2008; Simonovits, 2009:19). In a context of a declining, volatile Hungarian stock market and a high budget deficit resulting in high interest rates, pension fund assets were concentrated in government bonds (Simonovits, 2009:20).

<sup>9</sup> It was mainly middle-aged men with tertiary education who lost their jobs during the financial crisis. This group was also hard-hit by the sharp cut in the unemployment insurance period (the maximum time for receiving the insurance decreased from nine to three months).

<sup>10</sup> Average old-age pensions were 122,828 HUF for men and 106,451 HUF for women (ONYF, 2013).

Czajlik and Szalay (2005:37, 52) also point out the low diversity of pension fund portfolios. They estimated that 75 per cent of the assets were invested in government bonds and the share of stocks was around 15 per cent in 2004. Besides limited investment opportunities in the domestic market, the authors mention the lack of incentives to acquire foreign investments, risk-avoidance strategies by all pension funds, and the lack of a long-term investment strategy for pension savings. They argue that banks and insurance companies opted for short-term and low-risk investments.

**Figure 2. Investment portfolio of private pension funds in Hungary, 2005**



Source: Czajlik and Szalay, 2006:37.

Mesa-Lago (2014:10) confirms these calculations and states that 70 per cent of private funds were invested in government bonds with below-inflation interest rates and that the real average annual rate of return was negative during the 13-year reform period. The real rate of return fell well below even the conservative rates estimated at the beginning of the privatization process. The author questioned whether the originally planned minimum-pension levels could have been achieved by the time the first pensions would have been paid out. The investment performance of pension funds was much lower than expected, except for in 2004 and 2005, the years when Hungary joined the European Union.

Drahokoupil and Domonkos (2012:290) concluded that investing in government bonds was, a «circuitous way to return funds to the government» so that it could cover the costs of pension privatization.

### ***Administrative expenditures and organizational problems of pension funds***

Hungarian pension funds were legally managed by mutual savings associations. In theory, this arrangement assured oversight by members. However, members did not receive sufficient information about the real costs of fund administration. Several studies found that the level and structure of the operational costs of private pension funds were not well communicated to members (Czajlik and Szalay, 2005: 52; Simonovits, 2009).

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The internal organization and administration of funds was fraught with problems. While major decisions were taken by «assemblies» [közgyűlés], members were typically represented only indirectly, through representatives elected for five years (Czajlik and Szalay, 2005:29). In the case of funds established by large banks and insurance funds, officials of the parent companies served on the boards of directors and oversight committees. Representatives employed by the respective banks and insurance companies were in the majority, including the chief executive officers of these firms (Czajlik and Szalay, 2005:30).

Given that the funds were non-profit, parent companies contracted out several administrative procedures to their own firms to earn income. No open tenders for administrative services were issued and funds «automatically» contracted services of their parent companies, resulting in higher administrative costs. These costs were hidden within the budget of the parent company and were not revealed in the pension fund accounts (Czajlik and Szalay, 2005:33)<sup>11</sup>. The overall volume and structure of administrative costs could only be identified through the careful investigation of the spending structure of the banks and insurance companies.

It is evident from the minutes of general assemblies of pension funds that there was no opposition to the decisions made and no pressure was put on the board of directors of the funds to reduce operational costs. On average, just two-thirds of all members were represented by elected representatives, a figure that varied significantly among funds. The limited number of fund members present at the assemblies suggests that members were inactive, partly due to the lack of information on the structure of expenses and rates of return (ibid: 29-20).

While ordinary members of funds were the legal owners of funds, parent companies were the real owners yet they were not legally obliged to fulfil their commitments (Czajlik and Szalay, 2005).

Private pension funds had high administrative costs resulting from the lack of effective oversight of the funds and their administrative organization, and the lack of a central office to collect and administer contributions, among others.

Parent companies of mutual savings associations did not charge trusteeship fees [vagyongkezelési költségek] in accordance with market prices. Rather, they focused on achieving a high rate of return on the initial investment as soon as possible (Czajlik and Szalay, 2005).

Operational costs were supposed to be approximately 4 to 5 per cent of contributions (Simonovits, 2009:17) but in fact these costs amounted to more than 10 per cent of contributions. According to Mesa Lago (2014:9), administrative costs totalled 14.5 per cent of contributions in 2010 and 12.3 per cent in 2014, or 3.4 and 1.2 per cent of the funds, respectively. So-called «membership fees» amounted to approximately 5 per cent of annual contributions (Simonovits, 2009:19). Czajlik and Szalay (2005) estimate that some 60 per cent of the membership fees earmarked to cover administrative costs were transferred from the funds to parent or insurance companies. Orbán and Palotai (2005:14) estimated a charge ratio of 25 per cent, calculated as the expected decrease in the future value of pensions, due to fees and levies paid by members. Membership fees did not decline despite the decreasing costs of administering the funds.

<sup>11</sup> The authors compared administrative costs of Polish and Hungarian private pension funds and found that while in the former country the largest costs arose from agents' fees, at approximately 30-40 per cent, these costs were extremely low in the Hungarian case (5 per cent) because parent companies carried them out (Czajlik and Szalay, 2005:33).

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## **Adequacy**

Given that 75 per cent of pensions would have been covered by the public pillar in the mixed system, the impact of the fluctuations in the privatized pension schemes on overall replacement rates are limited. However, several authors point out that, due to the low rates of return, estimated future replacement rates fell below even conservative estimates. Orbán and Palotai (2005) suggest that the high administrative costs would mean that a large share of new members of the mixed system would get lower pensions than those who remained in the single-tier public system. Older employees who chose to switch to the mixed system seemed to be the main losers of privatization. Assuming a real average net rate of return of 2.1 per cent, the future average pension of the mixed system would be substantially lower than that of pensions in the single-tier system (ibid. 27, Figure 9). Even with an unrealistic rate of return of 3.4 per cent, new members of the mixed system would receive only slightly better pensions than those who remained in the single-tier public system.

In addition to the average lower pensions of the mixed system, Orbán and Palotai (2005:30) argue that pension levels of the different private pension funds may vary substantially. Different pension levels for workers with the same employment record and contributions, which would have resulted from different investment returns would have led to social tensions. The question was whether subsequent governments would be willing to pay for the losses of pensioners of the mixed system.

Simonovits estimated gains and losses of the mixed system and calculated that those who paid into the mixed system for 20 years would receive pensions that were from 9.8 to 12.5 per cent lower than the pensions of those who remained in the public single-tier system. Losses would increase with years of service, reaching more than 18 per cent for pensioners paying into the system for 30 years (Simonovits, 2009:19). It is not clear whether those who chose to enter the mixed pillar were aware of this loss as this information was not widely communicated<sup>12</sup>.

A large percentage of older cohorts joined private funds given that the benefits they would have obtained from the mixed pension system were lower than those from the public one. About half of employees between the ages of 40 and 49 enrolled in the mixed system following the successful pro-private pension campaign of the government and pension fund administrators, which tended to downplay the deficiencies of the mixed pension system. The fact that employers often made the choice was another reason many people ended up in the mixed system.

## ***Issues and problems of regulation and supervisory frameworks***

The government supervised and regulated the privatization process through the Financial Supervisory Authority [Pénzügyi Szervezetek Állami Felügyelet – PSZÁF], which oversaw capital markets and insurance firms in Hungary. Most of the organizational and administrative problems could have been handled through a change of regulations, with adequate planning for implementation. Czajlik and Szalay (2005) recommended strengthening the self-governance of pension funds. The rights of fund members would have been strengthened if profit-oriented funds had complied with stricter rules on capital fund transparency.

<sup>12</sup> Taking away the gain in social security rights was ruled unconstitutional by Augusztinovics (2000).

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## ***Implicit pension debt and sustainability indicators***

Based on the long-term modelling of the sustainability of the Hungarian pension system, Orbán and Palotai (2005) concluded that pension system sustainability did not improve with the introduction of the private pillar. Net implicit pension liability increased substantially, from 60 per cent of GDP in 1998 to 237 per cent in 2004. This increase was due to the transition costs of privatization but also to parametric reforms, including decreased contributions and increased pensions such as 13<sup>th</sup>-month payment in 2002. The deficit of the mixed system of the public pension scheme is estimated to be significantly higher than that of a hypothetical single pillar system until 2050 (Orbán and Palotai, 2005:20). The authors claim that financing pension system costs with government debt, as occurred in the second half of the 2000s, turned implicit net liabilities into explicit liabilities. In the long run, increasing real net rates of return of the pension funds could have compensated for the losses of the public system. However, there was no guarantee this increase would occur, and expectations were lowered when the global financial crisis hit in 2008.

## ***Minimum benefit guarantees and minimum investment return guarantees***

A Pension Guarantee Fund [Pénztárak Garanciaalapja] was established by the 1997 legislation that provided a minimum benefit guarantee. In the event a private pension fund was unable to fulfil its obligations, the Guarantee Fund would supplement the annuity up to 25 per cent of the pension, which would be calculated by following the public system formula (Szalay and Czajlik, 2005:26). The conservative Fidesz government eliminated the minimum benefit guarantee in 2002, when enrolment in private funds was made optional for new employees. When the Socialist-Liberal coalition again rose to power in 2002 and re-established mandatory membership, it «forgot» to re-introduce the minimum benefit guarantee (Simonovits, 2009:21).

## ***Gender considerations***

The calculation method for the private pension system was clearly disadvantageous for women in term of benefit amounts because of women's longevity, interrupted employment periods, low compensation for maternal leave and lower wages. The 1997 legislation stipulates that only one year of childcare leave is counted as a contributory year. Hungarian women spend an average of five years on maternity and parental leaves, which were not counted in the private tier. Years in higher education were not counted as contributory years, which negatively affected women given that they outnumber men Hungarian universities. The fact that annuities of the private pension fund would have been inheritable might have discriminated against women as their husbands could have chosen someone other than their spouses as heirs, as in the case of survivor's pensions in the public system.

## ***Concentration of the pension industry***

Within two years of the initial diversification of pension funds, a concentration of the funds created an oligopolistic environment, with six major pension funds linked to banks and international insurance companies. Choices were severely limited (Czajlik and Szalay, 2005). The rise in the share of funds backed by multinational banks and insurance companies was striking in the early 2000s. The share of occupation-based mutual savings associations as well as other mutual savings associations declined from nearly 20 per cent of all members in 1998 to 8 per cent in 2004 despite a continuous increase in total members

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(Czajlik and Szalay, 2005:27). This was mainly due to the marketing capacities of banks and insurance companies that financed and launched intensive sales campaigns in parent companies and affiliates throughout the country (ibid: 26)<sup>13</sup>. By the end of 2004, when membership reached 2.4 million, six companies had more than 100,000 members.

The number of pension funds decreased from 60 to 21 and the largest six companies concentrated 90 per cent of all members in 2010 (Mesa Lago, 2014:8). Another assessment estimated that 80 per cent of the capital was concentrated in five large funds (Simonovits, 2009:17). High costs of establishing and operating funds that were partly hidden within the accounts of parent companies prevented the establishment of new funds in the 2000s. The oligopolistic situation contributed to rising operational costs. The funds were further concentrated when a small percentage of members, estimated at 1 to 2 per cent in 2004, switched funds. This low share was due to the lack of transparent information regarding the costs and rates of return of funds, and to the agreement among the largest pension funds, in force until the end of 2003, not to pay brokerage fees to agents when clients switched between these funds (Czajlik and Szalay, 2005:30).

### **3. The Re-Reform of the Pension System in 2011**

#### **3.1. The Process of Re-nationalizing Private Pensions**

The re-reform was initiated by the conservative Fidesz administration, whose party won an overwhelming majority in the Parliament in the 2010 elections. Fidesz had opposed privatization from the start and had severely limited the role of private pension funds during his first term (1998- 2002). In 2010, constrained by internal and external economic crises, the second Fidesz administration decided to radically modify the pension system and eliminate the private pension pillar. Drahoš and Domonkos (2012:290) claimed that the financial crisis exposed drawbacks of the private pension system and especially the «funding gap» problem; however, this by itself was insufficient for the re-reform. Rather, a combination of internal and external economic and political factors contributed to the reversal of pension privatization.

Hungary, like other new EU members, had experienced a series of crises following its incorporation into the European Union in 2004. Cumulative problems, also known as «post-incorporation crises» (Ágh, 2013; Bohle and Greskovits, 2012) included economic decline, high government debt and budget deficits, and internal political tensions, coupled with weakening administrative capacities and increased corruption and social instability (see, for example, Rupnik and Zielonka, 2013). Hungary was particularly vulnerable to the 2008 crisis. The country's GDP fell 9 percentage points between 2008 and 2009. A decline in revenues was followed by increased budget deficits. This severe fiscal constraint put the re-reform of the private pension pillar on the political agenda. Hungary's socialist government also turned to the IMF and the European Central Bank for financial assistance in 2008. The Fidesz administration had wanted to repay its debt to the international agencies to end external control over its economic and social policies.

Strict EU requirements on macroeconomic stability left little manoeuvrability for reforms. The new member states that partially privatized their pension systems had the

<sup>13</sup> The biggest funds were affiliated with the following banks (B) and insurance companies (I), in order of their share: OTP (B); ING (I); AEGON (I); ALLIANCE (I).

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opportunity to gradually deduct transition costs from their budget deficit (which were covered under the excessive deficit procedure) until 2010.

The Fidesz administration wanted to balance the budget to eliminate foreign economic and political scrutiny. The conservative government sought to end the agreement with the IMF and stop the EU excessive deficit procedure to be able to make independent economic and social policy decisions. Fidesz's programme included the introduction of a flat tax of 16 per cent and a nominal reduction of social security benefits. The IMF was strongly opposed to both measures <sup>14</sup>.

In October 2010, despite the protests of opposition parties, the Parliament passed legislation to redirect private pension fund contributions to the Treasury for 14 months (Act CI/2010). It also gave workers the possibility of returning to the public pillar (Act C/2010). Re-directing resources from private funds was thus associated with the tax reform and the EU's strict budget deficit requirements. In late November, the economics minister proposed to Parliament the more radical plan of eliminating the private pillar. By 13 December, this measure was adopted without public debate or consultation with the opposition.

Instead of directly confiscating private pension assets, the new legislation proposed extremely unfavourable conditions for those who opted to continue in the private pillar. Workers who remained in a private pension fund would be ineligible for the future accrual of a government pension (75 per cent of an individuals' total pensions) even though it was mandatory for employers to pay into the public scheme. To avoid scrutiny by the Constitutional Court for violating social insurance rights, contributions paid by employers were re-named «social taxes» to which no future claims could be attached (Act CLVI/2011). The justification for this bill was that «those who do not return to the public pension scheme will 'opt out' of the national social security system» (Bill T/1817:12). Members of private pension funds had just one month to decide. Ultimately, 97 per cent chose the public scheme. A year later, private fund members regained their rights to accruals in government pensions. By this time, however, only a small fraction of the former members remained in the private pillar.

Another important aspect of the pension reform was the separation of disability pensions from the old-age pension system beginning in January 2012 (Act CXCI/2011). The government intended to 'cleanse' the pension system from disability-related benefits.

Early retirement pensions were also eliminated (Act CLXVII/2011). The basic rule was that no one under age 62 could receive old-age pensions after 2012. Civil servants were obliged to retire at the age of 62. However, the law stipulated that women with 40 years of contributions could retire earlier. Years spent in higher education did not count as contributory years, whereas time spent on maternity and parental leave did (for eight years), reflecting the government's prioritization of women's caretaking roles.

The Fidesz administration managed to quickly implement its reform agenda through the use of procedures that were unorthodox in a parliamentary democracy. First, the government did not reveal its plans and did not consult opposition parties, trade unions, private pension funds or experts. Second, Fidesz used the method of «individual member's bill» (formerly used only in the event of catastrophe) to avoid the rule of compulsory

<sup>14</sup> As Appel and Orenstein (2012) correctly point out, the IMF was generally against flat taxes and had tried to impede the spread of this practice among post-Communist countries.

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consultation<sup>15</sup>. Third, the government left little time for (legal, social and insurance) experts to follow its measures and, let alone to analyse and react to them.

Within the government, Prime Minister Orbán and the Minister of National Economy, György Matolcsy (who subsequently became the president of the Central Bank), were the strongest proponents of the re-reform. When it became clear that the government would nationalize private pension fund assets de facto, the Socialist Party communicated its objection and argued that «the coercive nationalization carried out by the government is another milestone of the dictatorship»<sup>16</sup>. The small leftist Green party, LMP (Lehet Más a Politika -- Politics Can Be Different), compared the way the government implemented the reform with the political culture of Belarus. The extreme right-wing party, Jobbik (Jobbik Magyarországért Mozgalom), was the only political force in Parliament agreeing with the nationalization. However, it also opposed the elimination of individual accounts of former fund members<sup>17</sup>.

The rapid completion of the legislative process<sup>18</sup>, the lack of transparency and the practical absence of public debate meant that potential opponents, including employers' organizations and trade unions, were unable to influence the reform process in 2010 and 2011. Trade unions unanimously opposed the way in which the re-reform was carried out<sup>19</sup>. Several trade union confederations joined forces, but they did not mobilize against the nationalization of private pension funds. They were more effective in organizing demonstrations against the Labour Code and the elimination of early pensions in the Spring of 2011. Their main achievement was collective bargaining with the Ministry of Interior to reduce working hours for people above age 60 but failed to persuade the government to eliminate mandatory retirement at age 62. Leading employers' organizations were actively involved in negotiations concerning the Labour Code but were silent with respect to the 2011 pension reform.

A civil movement of private pension fund members organized a demonstration of approximately 3,000 people in December 2010, as well as another smaller demonstration to encourage resistance to switching to the public system in January 2011<sup>20</sup>. The harshest critic of the re-reform was the association of private pension funds (Stabilitás Pénztárszövetség), headed by the private fund unit of Hungary's largest bank, OTP, which also had the largest share in the private pension fund business.

Private pension fund members also tried to bring the nationalization process before the European Court of Human Rights. The Court refused to take the case because it stated that the situation had resulted from members «own choice» and that the members were «in

<sup>15</sup> Later, Fidesz used this method for nearly all important parliamentary decisions, including the enactment of the new Constitution.

<sup>16</sup> A nyugdíjpénztárak államosítása. Brüsszel is aggódik” [The nationalization of pension funds. Brussels is concerned].

<sup>17</sup> Ibid.

<sup>18</sup> The Hungarian parliament passed more than 700 laws between 2010 and 2014, including the new Constitution and over 10 “core resolutions” that required only a two-thirds majority to modify.

<sup>19</sup> “A szakszervezetek és a nyugdíj” [Trade Unions and Pensions].  
[http://hvg.hu/itthon/20101117\\_szakszervezetek\\_nyugdij](http://hvg.hu/itthon/20101117_szakszervezetek_nyugdij).

<sup>20</sup> Details are available at <http://azennyugdijam.blog.hu/>.

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any case entitled to future pension payments in accordance with the amendment to the act». Judges and civil servants successfully filed a case with the European Court of Justice referring to the mandatory retirement age of 62. The Court ruled that Hungary's decision to lower the mandatory retirement age violated the equal treatment rules of the EU. Nevertheless, a government order in the last days of 2012 declared that all civil servants must retire at 62 and public employees must still retire at age 62 with no possibility of remaining employed <sup>21</sup>.

The approval rating of the governing party fell sharply following the pension privatization, from 40 per cent among eligible voters when the party assumed power in April 2010 to 15 per cent by late 2011. However, given the lack of strong opposition and the re-writing of election law just before the 2014 elections, the conservative coalition managed to regain a stable majority in Parliament.

### **3.2. The new national public pension system**

In 2011, the Fidesz administration nationalized private pension assets and virtually eliminated the second, private tier (Simonovits, 2011). This section presents the basic characteristics of the new model in terms of mixed and PAYG financing mechanisms, institutional arrangements, linkages among schemes/inter-institutional coordination, previous individual account funds and new collective/solidary funds, individual fund entitlements, pension right entitlements and mechanisms to improve solidarity, governance and instruments for social dialogue.

#### ***Basic characteristics of the new model in terms of mixed and PAYG financing mechanisms***

Hungary re-built its public pension system, returning to its pre-1998 mandatory pension system, consisting of a sole PAYG public scheme, originally developed after the Second World War (Inglot, 2008; Szikra, 2009). The tax-financed poverty elimination tier and the voluntary tier, introduced in 1993, remained intact.

Within the same reform package, the government implemented parametric and paradigmatic reforms in the public tier as well, including the elimination of early retirement benefits (Act CLXVII/2011) and the separation of disability benefits from the old-age pension scheme (Act CXCI/2011). The latter two reforms were part of the neo-liberal austerity package of the Structural Reform Programme.

The reformed pension system has two contributory tiers as per the pre-1997 scheme. The public tier is a PAYG scheme in which current pensions are financed with current contributions and redistributions are included in the calculation of pensions. The current third tier, or the previous fourth tier, is a voluntary private pension scheme with substantial tax breaks.

<sup>21</sup> As young professionals increasingly migrate to Northern and Western Europe, a serious shortage of doctors and nurses is likely to occur when older professionals retire. Hungary became one of the leading countries providing doctors to Western and Northern Europe due to inadequate working conditions in the country, including low salaries, even when compared to other Central and Eastern European countries.

**Table 3. The Hungarian pension system following the 2011 re-reforms**

<b>Tiers/Pillars</b>	<b>Institution responsible</b>	<b>Financing</b>
Tier 1. Old-age poverty elimination	Pension fund + local municipalities	Compulsory contributions + general taxes
Tier 2. Mandatory public PAYG	Pension fund	Compulsory contributions
Tier 3. Voluntary private pension savings	Private non-profit funds	Voluntary private savings

### ***Institutional arrangements/reorganization***

The self-government of the pension fund, eliminated in 1998, was not re-established during the re-reform. The pension fund has remained autonomous despite having received government subsidies before and after the re-reform and having contributed to the national treasury after the re-reform. The financial and administrative roles of the pension fund and of the government budget are unclear.

The supervision of the pension system is divided among three entities: The Ministry of the Economy (Nemzetgazdasági Minisztérium, NGM), the Ministry of Human Affairs (Emberi Erőforrások Minisztériuma, EMMI), and the Central Administration of National Pension Insurance (Országos Nyugdíjbiztosítási Főigazgatóság, ONYF). The administrative tasks of the public pension system remained with ONYF as they had before the re-reform. The ONYF is controlled and supervised by the Ministry of Human Affairs, which is responsible for supervising the implementation and development of core pension legislation (Act LXXXI of 1997 on Social Insurance Pensions – Pension Act).

The Ministry of the Economy is responsible for planning and monitoring the pension fund budget. The fund is part of the national government budget and is included in the Government Budget Act (Költségvetési törvény) every year. The national Treasury manages all pension fund revenues. No other institutions are involved in managing funds of the national pension system.

Contributions are collected by the National Tax Authority (Nemzeti Adóhivatal, NAV). The elimination of self-governance of the pension fund (1998), the shifting of the responsibility for the collection of contributions to NAV (1999) and the re-naming of employers' contributions as «social taxes» (2011) have more closely associated the pension fund in Hungary with the government budget.

Both before and during the re-reform, the regulatory agency of private pension funds was the Hungarian Financial Supervisory Authority (Pénzügyi Szervezetek Állami Felügyelete, PSZÁF). This organization was merged with the Hungarian National Bank (Magyar Nemzeti Bank, MNB) in 2013.

The highest legal authority of the Hungarian social insurance system was the Hungarian Constitution until 2011. The conservative government first changed the Constitution in 2010 and a new Basic Law (Alaptörvény) was enacted by a two-thirds majority<sup>22</sup> of Parliament in 2011. While the 1989 Constitution included a reference to social insurance as a means of fulfilling social rights of Hungarian citizens, there is no mention of social insurance in the new Basic Law, and social rights were more limited

<sup>22</sup> The Basic Law of 2011 was enacted quickly (in just three months), without public debate and with only limited political debate. The opposition does not encourage acceptance of the Basic Law.

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compared with the previous Constitution (Szikra, 2014). However, paragraph XIX (4) of the Basic Law establishes the basic principles of the pension system «based on social solidarity», including increased protection for women»<sup>23</sup>.

The Pension Act (Act LXXXI of 1997), modified several times since its adoption, is the core legislation of the Hungarian public pension system. It defines the government responsibility to «operate and develop» the compulsory public pension system. The pension system administers old-age and survivors' benefits following the exclusion of disability benefits. The pension system is primarily financed from contributions, but the government plays a substantial role, defined in the act as follows: «The Hungarian government secures the payment of pension benefits from the central government budget, even in the event that pension fund expenses exceed income».

### ***Linkages among schemes/inter-institutional coordination***

Besides the nationalization of the private tier, substantial structural changes to the PAYG public tier were adopted in 2011. The most important paradigmatic and parametric modifications of the public pension system and their rationales are summarized below:

- **Exclusion of disability pensions** from the pension system («cleansing the pension system profile»): Disability pensions had been part of the public pension system since 1928. The disability component of the public pension system was shifted to the general government budget. Since 2012, the Hungarian pension system has provided old-age and survivors' pensions. The government claimed that this action was designed to «cleanse» the pension system, namely to eliminate fraud in the disability pension scheme.
- **Elimination of early retirement pensions**: Early retirement pensions were ended in 2012. No one can receive old-age pensions under the statutory retirement age of 62. The government said it implemented this measure to eliminate fraud and privileges in the old-age pension scheme and to uphold promises of the Structural Reform Programme to cut spending.
- **Compulsory retirement of civil servants**: Civil servants and judges must retire at age 62 according to the 2011 pension reforms. Although no official explanation has been given, political analysts it responds to Fidesz's anti-Communist ideology to dismantle 'clotted structures', that is, to replace the «old» elites with ones loyal to conservatives. Another explanation is that it enabled the hiring of more young professionals at lower salaries than older ones to contain budget expenditures.
- **Benefits for women** with more than 40 years of contributions: Women may receive old-age pensions below age 62 if they had 40 years of contributions by 2012. Up to eight years of maternity and parental leave periods are counted as contributory years although higher education is not included. Reasons given for this change included the financial recognition of motherhood and the increased opportunity for grandmothers to care for grandchildren while their mothers work.

<sup>23</sup> «Hungary shall contribute to ensuring livelihoods of the elderly by maintaining a general government pension system based on social solidarity and by allowing for the operation of voluntarily established social institutions. The conditions of entitlement to a government pension may be established in a law, which must ensure stronger protection for women.»

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- **Employers’ contributions are re-named»social taxes»** [szociális hozzájárulási adó] to which no future claims could be attached (Act CLVI/2011). The aim of the government was to avoid scrutiny by the Constitutional Court for threatening social insurance rights (see below).

### ***Previous individual account funds and new collective/solidary funds***

When the government decided to persuade private fund members to switch to the government-run pension system in November 2010, it promised that their assets would be held in individual accounts of the public pension system. It was also stated that the private pension annuity, transferred from the private to the public system, would be inheritable. Following the transfer of most private fund members and their annuities to the public pillar, Prime Minister Orbán declared that individual accounts would be established during 2011. These promises have not been fulfilled and the public pension scheme still has no individual accounts.

### ***New investment framework***

The public pension fund forms part of the national government budget and is included in the annual Government Budget Act (Költségvetési törvény) every year<sup>24</sup>. Since the elimination of the compulsory private pension tier, no other for-profit or non-profit entity, national or international has administered the compulsory pension system.

Domestic and foreign insurance funds in the voluntary pension system currently benefit from a 20 per cent income tax reduction. The largest and most successful funds are the international insurance companies Aegon and Allianz, while ING, Generali and Erste also have a considerable share of the market. The investment of voluntary pension funds is strictly regulated by law. All funds invest mainly in government bonds.

### ***Individual fund entitlements, pension right entitlements***

Apart from voluntary pension funds, there have been no individual fund entitlements in Hungary since 2011. Pension right entitlements of the compulsory public PAYG pension scheme are discussed below.

The official retirement age was raised and there have been limited early- and late-retirement options in some cases, such as for civil servants in the case of early retirement options, since 2011. The retirement age is being raised by six months annually, from 62 in 2015 to 65 in 2022. The table below shows the retirement age increase by year of birth:

<b>Year of birth</b>	<b>Retirement age</b>
1952	62
1953, 1954	63
1955, 1956	64
1957	65

Source: Act LXXXI of 1997, §18.

<sup>24</sup> Part 72 of the Government Budget Act refersto the pension fund.

Pensions are calculated based on average gross wages earned since 1988, adjusted for inflation in the year of retirement. Workers need to make contributions for at least 20 years to receive full pensions. Replacement rates increase in line with the number of contributory years. An 80 per cent replacement rate is reached after 40 years of contributions. An annual 2 per cent increase of the replacement rate is provided for additional contribution years. Workers may receive up to 100 per cent of their previous average wage with 50 or more contributory years. In the event of retirement above the official retirement age, an additional 0.5 per cent is added to the original monthly pension amount. Civil servants cannot work above the statutory retirement age <sup>25</sup>.

The following table shows the increasing replacement rates with increased contributory years:

Year of birth	Retirement age
15	43
20	53
25	63
30	68
35	73
40	80
45	90
50 or more	100

Source: Act LXXXI of 1997, Appendix 2.

Special regulations apply to benefit levels of former second-tier members. If they chose to join the public pension fund in 2011, as most did, their pensions are calculated as if they had always been members of the single-tier public system. If workers remained in their pension fund, as only 3 per cent of all private pension fund members did, their pension, received for the contributory years prior to 2010, was multiplied by 0.75. These members had to pay full contributions to the public pension fund beginning in 2011.

There was also an option for those who remained in the private tier to transfer their annuities to the public pension system when they retired. In that case, their pension level was calculated in the same manner as for workers who have always been members of the public scheme, for which reason the 0.75 multiplier did not apply. This was an opportunity for people who believed that their pensions from the mixed system would be lower than what they would have received from the public pillar, had they remained there.

### ***Mechanisms to increase solidarity***

The reform included conflicting elements in terms of social solidarity. As the private pension tier was based strictly on actuarial calculations, it limited social solidarity among members of the mixed pension system. Elements of social solidarity were present in the public pension system. Eliminating compulsory private pension fund membership and returning to the pre-1998 PAYG public pension system therefore increased social solidarity. The opportunity for women to retire before reaching the official retirement age

<sup>25</sup> This includes all civil servants, including judges, doctors, nurses, teachers at all levels of education, municipal and ministerial employees, etc.

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with a full pension if they had contributed for 40 years provided more retirement options for women.

Other reform elements, however, decreased social solidarity, weakened social rights and contributed to rising inequality among pensioners. The first issue was the renaming of employer's contributions as «social taxes». This may lead to arbitrary changes in pension rights.

The exclusion of disability pensions from the pension system («profile cleansing») decreased social rights of disability pensioners. While those above age 62 are included in the old-age pension system, the health status of people below the official pension age was re-examined and they were referred either to the unemployment scheme, which is primarily based on social assistance and public works («rehabilitation track») or to a tax-financed benefit scheme outside of social insurance.

Minimum pensions have remained in place throughout the re-reform process. The level of the minimum pension was frozen in 2008, however. This has weakened social solidarity. The minimum pension is 28,500 HUF, or approximately 200 USD, one-third of the net average wage.

An important though less visible change has been the gradual increase and finally, the elimination of the ceiling on pension contributions and pension levels, which contributes to increasing inequality among old-age pensioners. The ceiling was introduced in 1992; initially, it was set at 300 per cent of the gross average wage. In the decades that followed, the ceiling has oscillated between 161 per cent in 2002 and 311 per cent in 2009 of the gross average wage. In recent years, the ceiling has remained at approximately 300 per cent. When calculating pensions, each annual ceiling was applied to the annual average wage of the employee. Fluctuating ceilings created inequalities between the level of pensions defined in different years, even among people with the same number of contributory years and the same wage level. Low ceilings restricted generous old-age pensions whereas high ceilings nearly eliminated their limiting effect.

In 2013, the ceiling was eliminated and a 10 per cent contribution rate was applied to the gross wage. Beginning in 2013, pension levels were set according to the total wage whereas prior to 2013, they were calculated by applying different ceilings. A gradual increase of the highest pensions is expected over the next few years. Given that the minimum pension has not been indexed since 2008, and a growing number of people will have low pensions due to interrupted employment records, it is likely that income inequality among pensioners will increase. Men are overrepresented among high earners and women among low earners given their interrupted employment record and lower wages, indicating that gender inequality among pensioners will also probably rise.

Another method to increase solidarity within the Hungarian pension system was the degressive calculation of net income bases. Degressive accrual was substantial in the early 1990s as it included lower incomes, but it was gradually reduced to the point of virtual elimination. Only 0.5 per cent of pensions were determined with degressive accrual in 2013 due to the high level of net wages above which degressive calculation is required.

To summarize, the re-reform has mixed outcomes in terms of social solidarity. While returning to the (solely) public pension system increased solidarity, other paradigmatic and parametric reforms typically decreased solidarity.

## Governance and instruments for social dialogue

A relatively stable system of tripartite consultation was established in the early 1990s, although the legitimacy of both workers' and employers' organizations was weak (Neumann and Váradi, 2012). The tripartite body, the National Council for the Reconciliation of Interests (Országos Érdekegyeztető Tanács, OÉT), played a key role in setting the minimum wage and led collective bargaining efforts on social insurance rights. In 1998, the Fidesz administration eliminated the tripartite self-governing body of the social insurance system (Társadalombiztosítási Önkormányzat) established in 1993. Currently, no official entity exists for collective bargaining on pension system development, level of pensions and contributions.

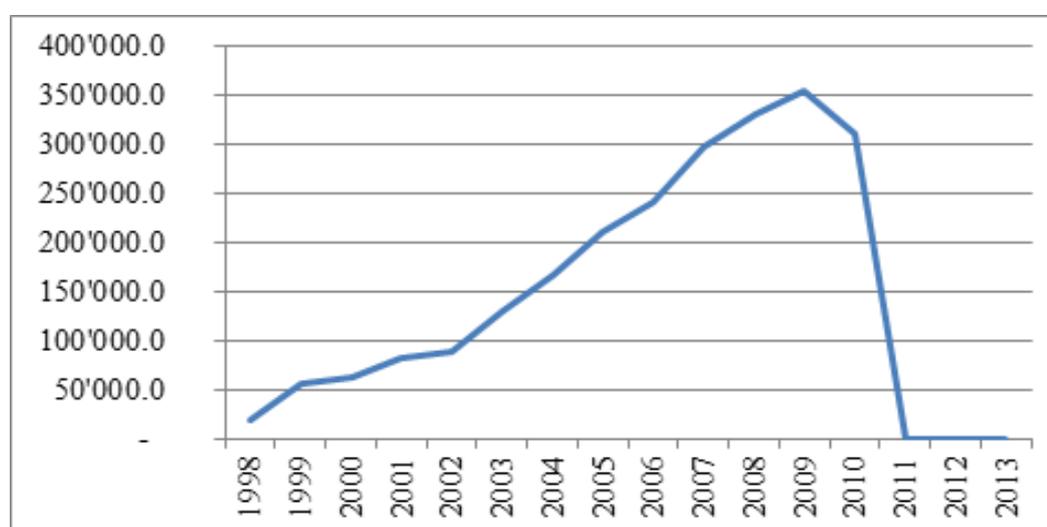
The Fidesz administration replaced the OET with the Economic and Social Council (NGTT) in 2010. This new institution does not have the same bargaining power as the previous council. Participation is not limited to workers' and employers' representatives; it is also extended to selected civil society representatives and the church (Scharle and Szikra, 2015). Declining tripartite bargaining, the hurried legislative process and the rapid adoption of a new Labour Code in 2011 contributed to the inability of opposition members, including employers' organizations and trade unions, to influence the re-reform process.

### 3.3. The Impact of the 2011 Re-reforms

#### Macroeconomic and fiscal impacts

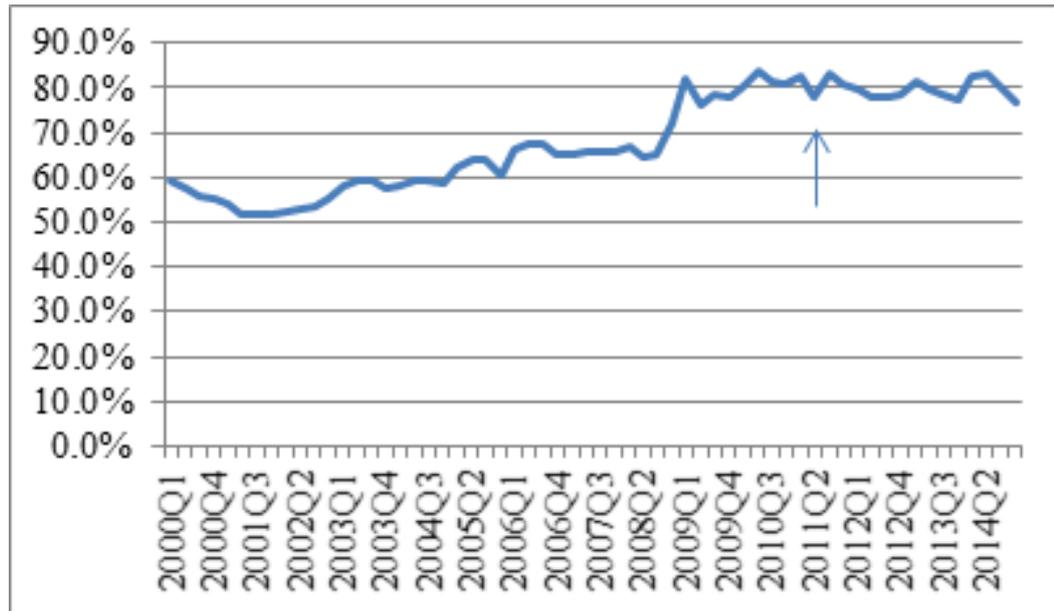
As mentioned, budgetary support sharply increased following pension fund privatization in 1997 due to transition costs and declining pension contributions at the same time pension benefits increased (from 2002) until 2009. In that year, the 13<sup>th</sup>-month pension was eliminated, immediately decreasing government support to the pension system. In 2010, private pension contributions were channelled to the public pension system for 14 months, which further eased the burden on the budget. The nationalization of private pension assets in 2011, together with the elimination of early retirement schemes and disability pension schemes (the «profile cleansing» of the pension system) helped the pension fund shift from a large deficit to a surplus, which has contributed to the government budget since 2013.

Figure 3. Nominal value of central government financing of the costs of transition to the mixed pension system in Hungary, 1998-2013 (millions of HUF)



The nationalization of private pension assets helped reduce government debt by 5 per cent between the first and the second quarters of 2011 (Figure 4). It is estimated that about half of that amount was spent on decreasing the budget deficit, which fell to a record low of 1.9 per cent in 2012, as compared with an average of 4 per cent for the EU27 countries. Nevertheless, several transactions<sup>26</sup> and economic processes (including the devaluation of the Hungarian Forint) have impeded the successful reduction of the explicit debt of the Hungarian government, which reached 82.4 per cent of GDP in 2013, the same rate as in 2010 (Eurostat, 2013).

**Figure 4. Quarterly debt levels of the Hungarian government, 2000-2014 (percentage of GDP)**

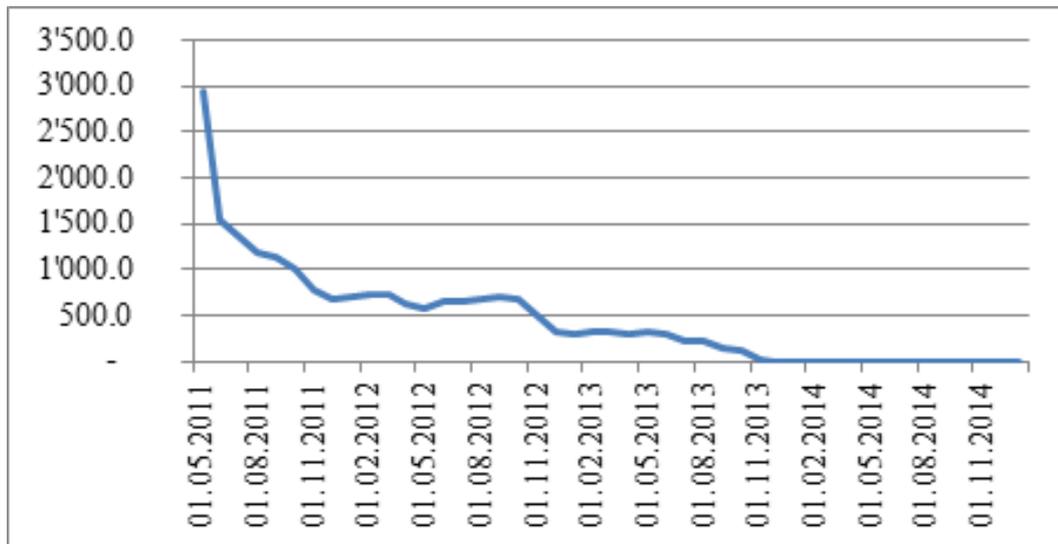


Source: Own calculation based on Government Debt Management Agency [ÁKK] data, various years.

Assets of the Pension Reform and Debt Reduction Fund, which the government established to manage incoming assets of private pension funds, decreased sharply following the nationalization of pension funds due to the withdrawal of government bonds transferred from private funds to the government (Figure 5). Half of all assets kept in government bonds were immediately withdrawn once they were transferred to the Hungarian government. The Fund used most of its assets to decrease government debt, while 243 billion HUF were used to repay the IMF loan, and a further 81.3 billion HUF were utilized to cover local government debt. In 2011, the Fund paid 95.6 billion HUF directly to the Treasury and 363.4 billion HUF to the public pension fund. It also bought shares in the Hungarian oil company MOL to acquire majority shares from Russian shareholders.

<sup>26</sup> The government, among others, bought shares in the Hungarian oil company MOL to counter the majority Russian ownership.

**Figure 5. Nominal value of assets of the Pension Reform and Debt Reduction Fund in Hungary (billions of HUF)**



Source: Own calculation based on Government Debt Management Agency [ÁKK] data, various years.

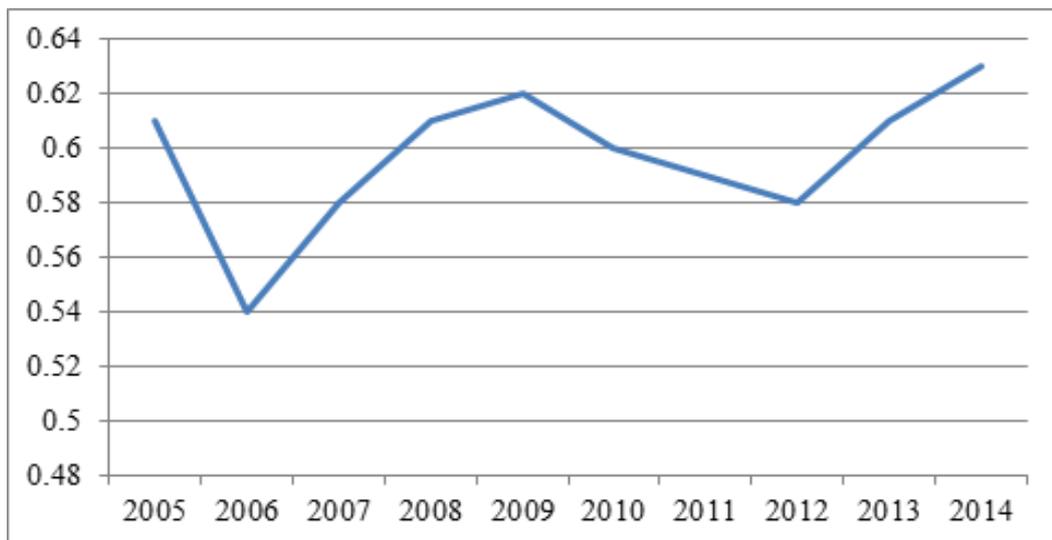
### **Coverage, Replacement Rates, Adequacy and Equity**

The reversal of pension privatization did not have any discernible effect on **coverage rates**. There was a substantial shift *within* the pension system, however, in light of the elimination of disability pensions. By removing disability pensions from the system and eliminating early retirement options, the overall number of pensioners decreased from 2.8 million in 2011 to 2.2 million in 2012, an 18 per cent reduction within a year (KSH, 2014). Meanwhile, the number of beneficiaries receiving non-insurance-based benefits tripled. The value of benefits did not change but social rights were threatened by the shift from insurance- to tax-financed benefits as there is no enforceable right attached to the latter. Some 100,000 people were removed from the two systems and transferred to the unemployment benefit system and public works programmes (with much stricter eligibility requirements) <sup>27</sup>.

**Replacement rates** have increased since the 2011 re-reform (Figure 6). However, this increase cannot be considered as an effect of nationalization; rather, the changes are due mainly to paradigmatic and parametric reforms (elimination of disability pensions, decreased degressive accruals in calculating pensions, elimination of contribution and pension ceilings and the introduction of favourable retirement conditions for women).

<sup>27</sup> For example, in 2013, 25.3 per cent of revised disability pensioners were sent to a rehabilitation programme (for a few months), after which they were eligible only for means-tested social assistance if they agreed to accept public employment.

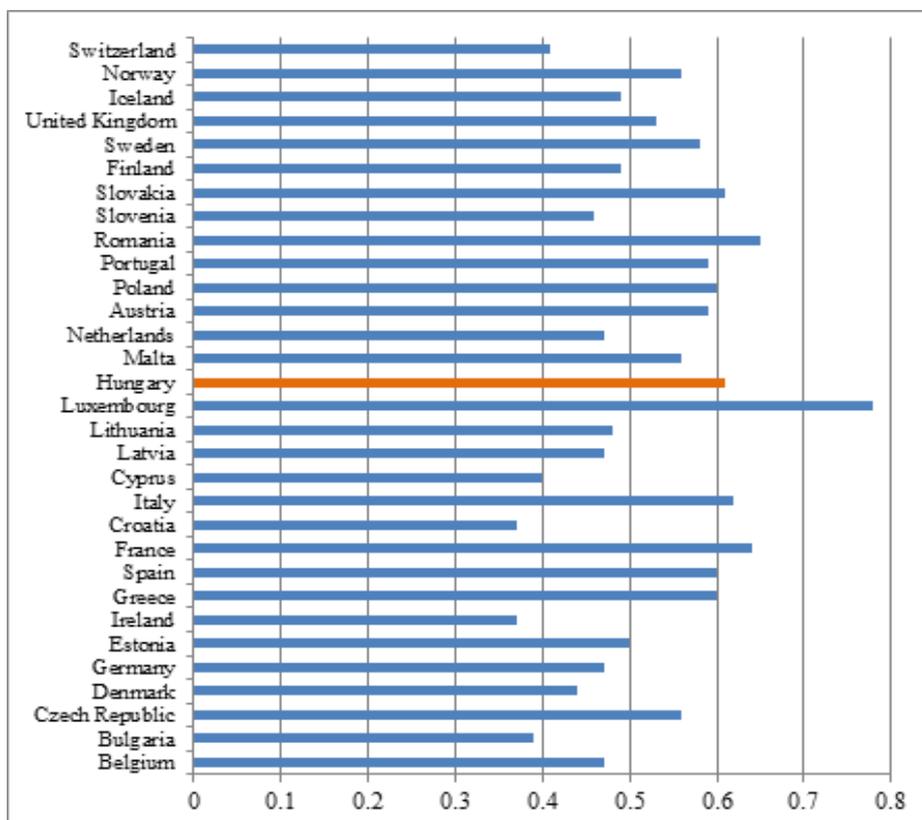
Figure 6. Aggregate replacement ratio in Hungary, 2005-2014



Source: HCSO, 2014.

Compared with other Central and Eastern European countries and EU member states (Figure 7), the **adequacy level** of pensions has been relatively beneficial in Hungary, if calculated as aggregate replacement rates. Recently, the relatively high replacement rates have led decision-makers to consider reducing them.

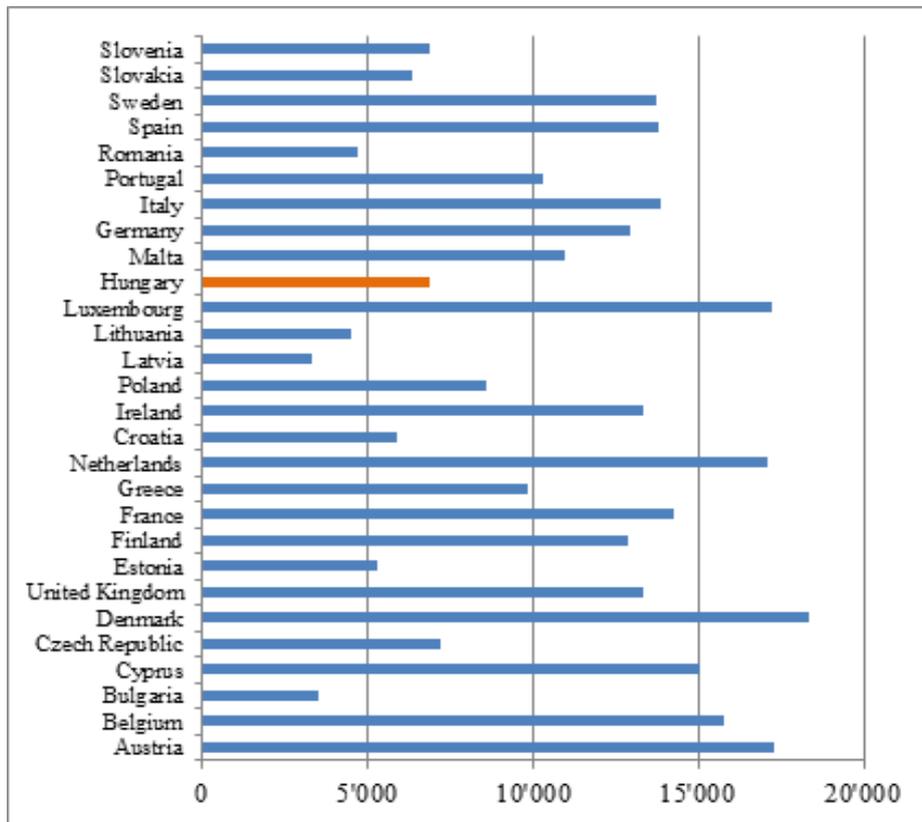
Figure 7. Aggregate replacement ratio of old-age pensions in Hungary and in Europe, 2013



Source: HCSO 2014, Figure 5.

However, when calculated on PPP (Figure 8), Hungary is in the lowest group of 25 EU member states, which supports the arguments of those who oppose reducing replacement rates.

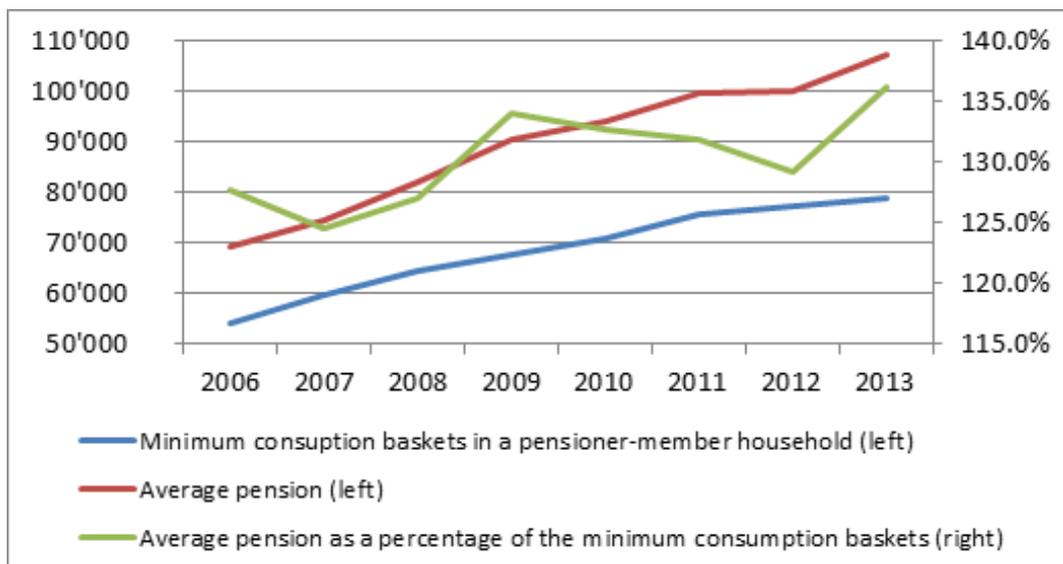
**Figure 8. The annual amount of old-age pension per pensioner, as measured by purchasing power parity (PPS/person)**



Source: HCSO, 2014.

Average pension levels have declined following the global financial crisis, but have exceeded the minimum consumption basket for the elderly even during the crisis. Currently, the average pension is 135 per cent of the minimum level, which has gradually increased since 2012 (Figure 9).

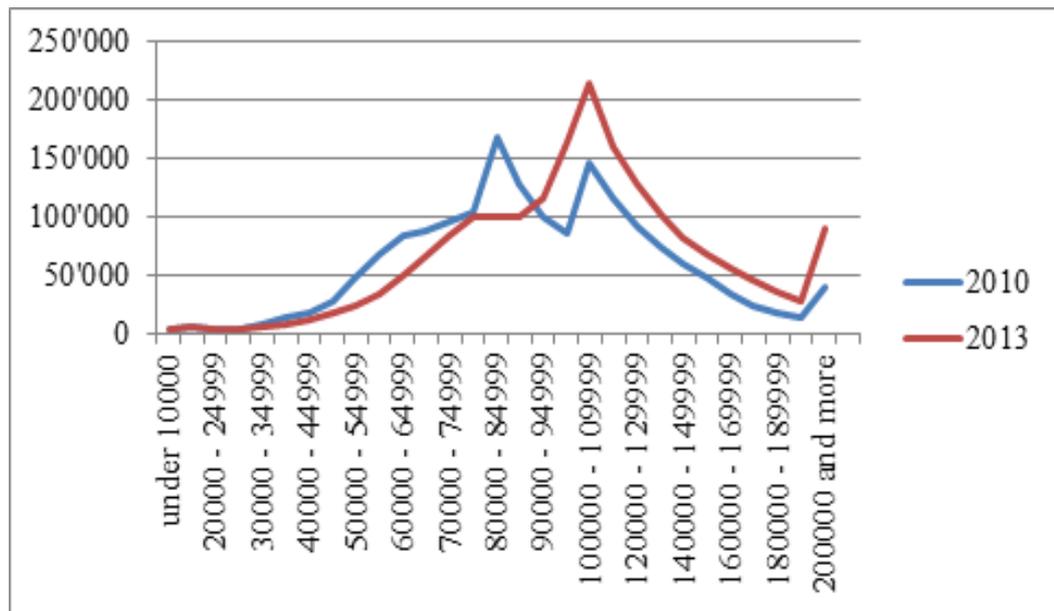
**Figure 9. Minimum consumption basket and average pensions in Hungary, 2006-2013**



Source: Own calculation based on HCSO and ONYF, various years.

Another important change was the gradual increase and elimination of the ceiling on pension contributions and levels. The ceiling, introduced in 1992, was set at 300 per cent of the gross average wage. The ceiling ranged from 161 per cent (in 2002) to 311 per cent (in 2009) of the gross average wage<sup>28</sup>. Since 2013, pension levels have been set according to the total wage without a ceiling. As the minimum pension has not been indexed since 2008, and as an increasing number of people will have low pensions due to interrupted employment records, income inequality among pensioners is expected to increase. Given that men are overrepresented among high earners and women among low earners, gender inequality among pensioners will also most likely rise. Figure 10 demonstrates the sharp increase in the number of pensioners who received pensions above the average in 2013.

**Figure 10. Number of old-age pensioners by benefit level in Hungary, 2010 and 2013**



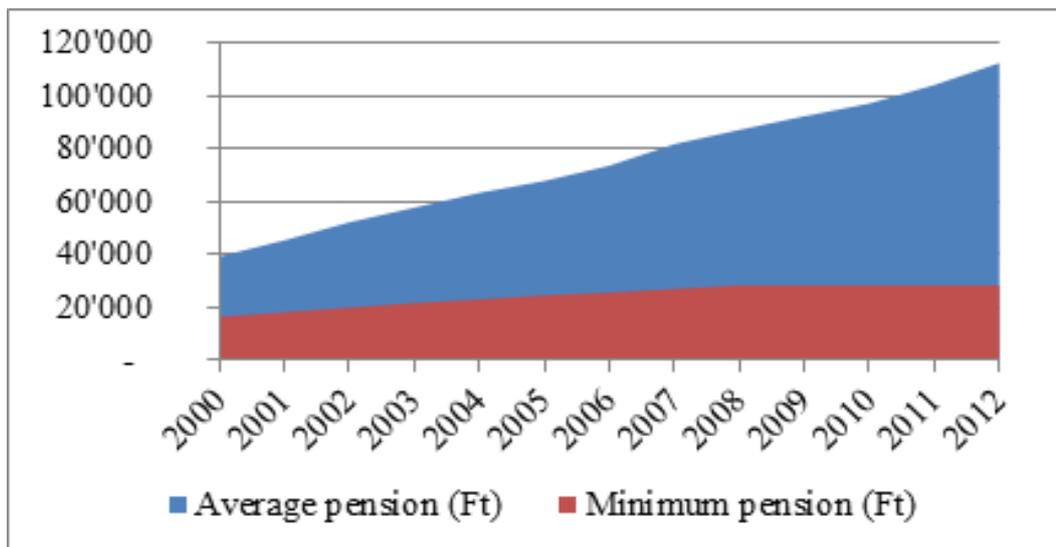
Source: Own calculations based on ONYF, 2015.

The **minimum pension** level has been frozen since 2008<sup>29</sup>. The level of the minimum pension is 28,500 HUF (approximately 200 USD), one-third of the net average wage. Figure 11 shows that while average pensions have been adjusted for inflation, the minimum pension has not been indexed.

<sup>28</sup> Recently, the ceiling has remained around 300 per cent. Each annual ceiling was used to calculate pensions (every year, a different ceiling was applied to the yearly average wage of the employee).

<sup>29</sup> The reason for this is that all social assistance levels are calculated as a percentage of the minimum pension in Hungary, including unemployment benefits.

**Figure 11. The nominal value of the average pension and the minimum pension in Hungary, 2000-2012**

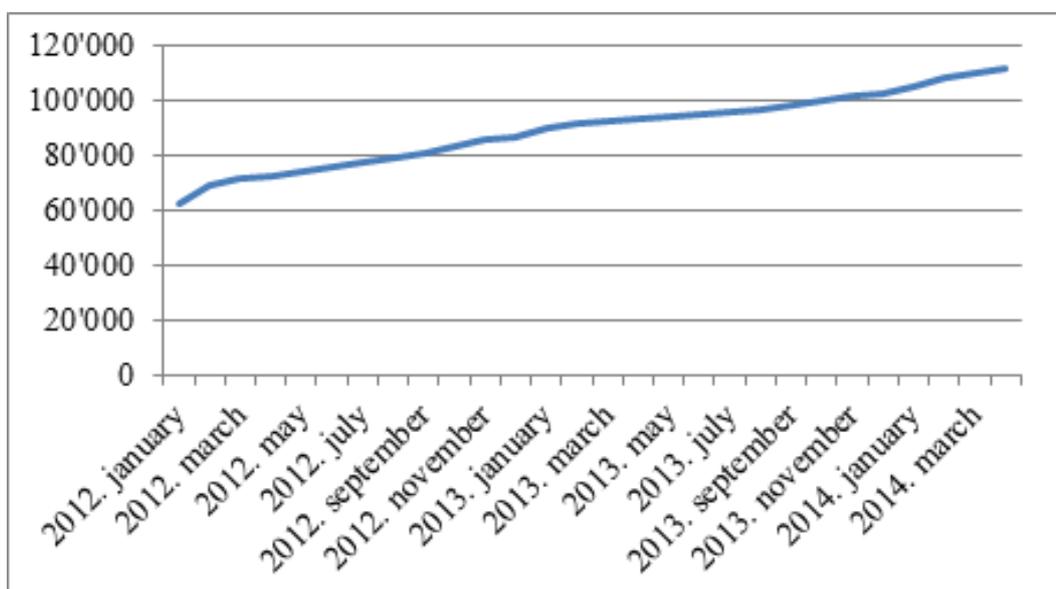


Source: Own calculations based on Országos Nyugdíjfolyósító Főigazgatóság, 2015.

Due to high coverage rates and relatively high replacement rates, only a small share of Hungary’s elderly population lives in poverty. According to Eurostat, 4 per cent of people over age 65 lived in relative income poverty in Hungary (below 60 per cent of the median income), as compared with 14 per cent of middle-aged individuals (between the ages of 25 and 54). Currently, the most pressing social problem in Hungary is the high percentage of children living in poverty: 23 per cent of individuals under age 18 lived in relative income poverty in 2013 and over one-third lived in severely deprived circumstances. This percentage is extremely high, even compared with other countries of Central and Eastern Europe (Eurostat, 2015).

The positive discrimination of women (who can retire before the official retirement age with a full pension provided that they have contributed for 40 years) had a beneficial effect on women’s pensions and thus contributed to gender equality in old age. The number of women who took this opportunity rose from 60,000 in 2012 to 110,000 in 2014 (Figure 12).

**Figure 12. Number of women who retired after contributing for 40 years**



Source: ONYF 2014.

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## 4. Final Remarks

Hungary partially privatized its pension system in 1997, making it compulsory for young people to enter the mixed pension scheme and optional for other employees. The designers of the mixed pension system overestimated its possible positive effects and at the same time downplayed drawbacks. The greatest problem arose from the increasing cost of the transition from the public PAYG to a mixed pension system. External pressures, including the global financial crisis, strict macroeconomic conditions of the EU, and Hungary's lending from the IMF, as well as the internal political and economic conditions led to the conservative Fidesz-cabinet to introduce the re-reform in 2011 and to reverse pension privatization. The most important driver behind the reform was the cabinet's intention to reduce budget deficit and public debt while getting rid of international control of the IMF and the EU to fulfil its political and economic aims.

While the reform and re-reform process was somewhat abrupt and involved only limited transparency and social dialogue, its outcomes and the overall impact of the re-reform has been positive. Most importantly, reversing pension privatization has led to improved financial sustainability, increased pension adequacy, and with the positive discrimination of women in retirement age improved solidarity and gender equality. As a result, Hungarian pensioners enjoy rather favourable conditions with regards to coverage and pension benefit levels and are much less exposed to poverty than younger generations. Yet, the pension system in the long run raises some concerns that need to be addressed in future reforms. Reserves for future pensions were used for other purposes during the past years and the demographic transition and low employment rates indicate future challenges with regards to the sustainability of the system, challenges that will have to be addressed in order to guarantee sufficient income protection in old-age.

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