

Chapter 4

Pension Reform: Providing Old-Age Income Security in the Face of Population Ageing

This chapter reviews the challenges faced by the Hungarian pension system. It presents recommendations for reforms to improve fiscal and social sustainability and to strengthen the payout phase of mandatory private defined contribution (DC) pensions. Comparison with the pension-policy experience of other OECD countries reveals shortcomings in Hungary with respect to incentives for early retirement and low pension coverage of the working age population. Moreover, Hungary lacks appropriate legislation and instruments to convert retirement savings in mandatory DC plans into a stream of income at retirement. Hungary is forecast to experience one of the largest increases in public pension spending over the next 50 years, which raises serious concerns about the financial sustainability of its pension system. The public pension system exhibits replacement rates that are the same for all workers with the same career pattern, which implies virtually no redistribution from rich to poor in the system. This contrasts with the majority of OECD countries, which have systems with higher replacement rates for lower-income workers. By redistributing income, this can reduce the risk of old-age poverty while containing total public spending on old-age incomes. The chapter also highlights how the pension system affects work incentives for older workers, which helps to explain why the effective retirement age for both men and women in Hungary is the second lowest among OECD countries. It also discusses challenges faced by the Hungarian pension system with respect to governance and regulation of mandatory private pension accounts and how they can be met. This includes issues such as how pension benefits should be paid out; who should provide annuities; how the risk of unfavourable annuity conversion conditions should be spread; how performance, charges and investments of private funds can be improved; and what should be the institutional arrangements in managing the private pension funds.

Background and key policy recommendations

Hungary's retirement-income system combines an earnings-related public pension scheme with mandatory, private, defined-contribution plans. The private component is, by definition, funded while the public scheme is financed on a pay-as-you-go basis, whereby current contributions pay for current benefits. OECD projections suggest that, in the long term, around one-third of retirement incomes will come from the defined-contribution plan with the other two-thirds coming from the public earnings-related scheme (OECD, 2007, pp. 50-51; due to differences in assumptions this result differs from that of national projections). Simulating the operation of the existing pension system under conditions of predictable demographic change reveals a large increase in future expenditures resulting from significant population ageing. After analysing the various causes underlying these results, this chapter makes the following policy recommendation to secure the long-run fiscal sustainability of the Hungarian pension system:

- **phase in further gradual increases in the statutory retirement age**, starting in 2009;
- **modify pension benefit formulae** so that the effects of early or late retirement are actuarially neutral;
- **change pension indexation**, linking it to price inflation only;
- **complement cuts in public pension benefits** – if needed – by strengthening income safety nets;
- **provide a wider choice of payout options** to convert retirement savings in mandatory DC private pensions into a stream of income at retirement;
- **improve the governance and regulation of mandatory private insurance accounts.**

Details of these recommendations are elaborated in the main body of the chapter, discussing policy options in the light of pertinent experience in other OECD countries that face similar demographic trends.

Recent reforms

The new pension system was introduced in 1998. People entering the labour market after 1998 have to contribute to the new scheme. Older workers could choose between the new mixed public-private system or remain with just a public pension (on reformed rules). The proportion of earnings contributed to (mandatory) private pension plans increased from 6% initially to 7% in 2003 and 8% from 2004 onwards. Finally, workers have been able to

switch back from the mixed public-private system to the purely public pension system at various times since the reform.

Other notable elements of the reform included an increase in the pension eligibility age. For men, this has risen from 60 to 62 years, and for women it will eventually also reach 62, from a starting point of 55. The indexation of pension benefits changed from the growth of average earnings to a 50:50 mix of real earnings growth and consumer price inflation. Finally, pension benefits used to be calculated on the basis of individual net earnings, but this will change to gross earnings from 2013 onwards.

The effect of these reforms is to increase expected retirement incomes. The net replacement rate – retirement income relative to earnings, after taxes and contributions – for an average earner with a full career (from age 20 to the normal pension age) is projected to be 102.2% under the new system, including the expected value of the defined-contribution pension (OECD, 2007, Part II.1). This compares with 80% for women and 88% for men with a full career under the pre-reform rules.

However, the increase in retirement age offsets the effect of the higher net replacement rate. Net “pension wealth” – the present value of the lifetime flow of pension benefits – is projected to fall from 11.2 times annual earnings, for a man on average pay, to 10.8 times. For women, pension wealth falls from a comparable multiple of 15.1 to 13.4. Nevertheless, these reductions in lifetime benefits – 5% for men and 10% for women – are significantly lower than the average cuts in lifetime pension benefits entailed by reforms in other OECD countries. In the 16 countries that have had major retirement-income reforms since 1990, the overall effect was to cut benefits by an average of 22% for men and 25% for women (OECD, 2007, Part II.1).

More limited changes to Hungary’s pension system, focused on improving incentives to delay retirement, were enacted in 2006-07. The first of these will restrict the ability to combine working and claiming an early-retirement pension. Government figures suggest that around 15% of people on early-retirement benefits continue working, of which between a third and a half are working full time. A second change will alter the reduction in pension benefits for people taking early retirement. For retirement at age 60 rather than 62, the reduction in pension benefits under previous rules was, at most, 2.4% per year. After the changes, this will increase to 4.2% per year.¹

International benchmarking

Is the Hungarian pension system fiscally sustainable?

Hungary currently spends 10.4% of its gross domestic product (GDP) on pensions, around the same as the average for the 25 European Union (EU) member states (before the membership of Bulgaria and Romania). However, this is significantly less than in a number of EU countries, such as Austria, France, Germany and Italy.

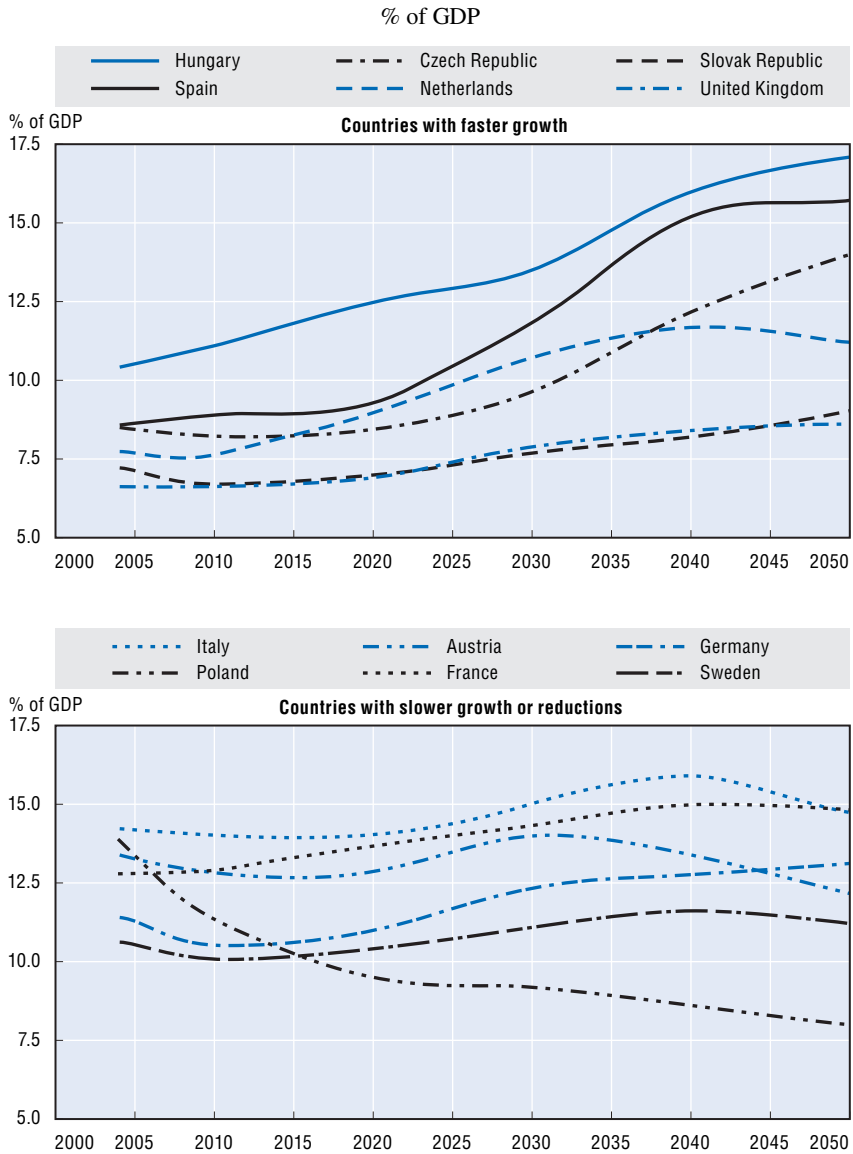
Looking ahead, public pension spending as a share of national income in Hungary is expected to rise steadily, both relative to other countries and in absolute terms. Among the countries shown in Figure 4.1, Hungary is expected to see the fastest growth in public pension spending, bar Spain. In contrast, recent reforms are expected to stabilise public pension spending in Austria, France, Germany, Italy and Sweden. With the partial privatisation of pension provision in Hungary, one might have expected that **public** spending on pensions would be contained in the long term, as in the case of projections for Poland and the Slovak Republic, which have enacted similar pension reforms; but this is not the case.

The OECD's models of individual pension entitlements shed further light on the issue (OECD, 2005a, 2007). Figure 4.2 shows a microeconomic indicator of financial sustainability. This indicator is based on "pension wealth" because this comprehensive measure of retirement-income systems takes account of cross-country differences in indexation policies, pension eligibility ages, and life expectancies. The calculation of pension wealth presented here includes all public sources of retirement income. It takes account of differences in pension benefits for people with different levels of earnings by taking a weighted average, where the weights come from data on national earnings distributions.

The average **public** pension in Hungary is larger (relative to income) than the OECD average. Nonetheless, because of the partial privatisation of retirement-income provision, it is less than in a number of other countries, including France and Italy. However, average public pension wealth is much lower in a number of countries, including Germany, the United Kingdom and the United States. At the far left of the spectrum, public pension wealth is lowest in two of the other countries that have partially privatised pensions: in Poland and the Slovak Republic, average pension wealth from public schemes is only about half the OECD average.

An important explanation for Hungary's result on these measures of pension systems is the relatively low statutory retirement age. This will remain the case even when currently scheduled increases are fully in place. OECD countries plan, on average, to have a pension eligibility age of 65 years. At that age, life expectancy (expected duration of retirement) averages 18.5 years in half the OECD countries (Figure 4.3). Hungary's planned retirement age of 62 years coincides with an unusually low life expectancy by international comparison, especially among adult men

Figure 4.1. Projected public spending on pensions, 2004-50

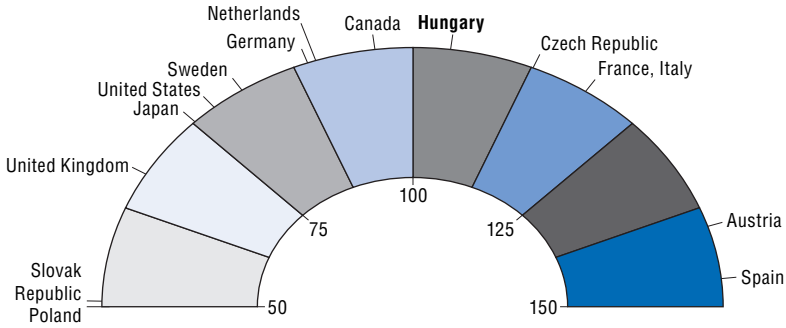


Source: European Union, Economic Policy Committee (2006), “The Impact of Ageing on Public Expenditure: Projections for the EU 25 Member States on Pensions, Health Care, Long-term Care, Education and Unemployment Transfers (2004-2050)”, European Economy, Special Reports No. 1/2006.

Figure 4.2. A microeconomic indicator of fiscal sustainability

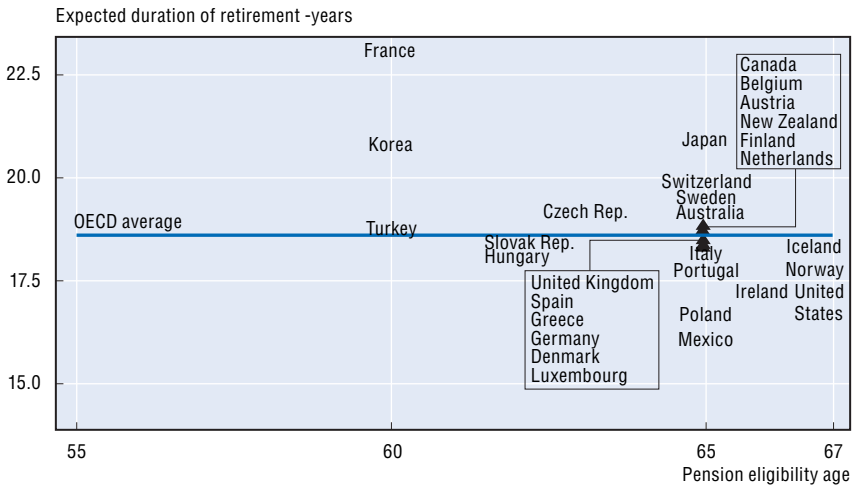
Weighted average pension wealth from public retirement-income programmes

OECD average = 100



Source: OECD pension models. For a detailed description, see OECD (2005a), *Pensions at a Glance: Public Policies across OECD Countries*, 2005 edition, OECD, Paris; and OECD (2007), *Pensions at a Glance: Public Policies across OECD Countries*, 2007 edition, OECD, Paris.

Figure 4.3. Pension eligibility age and life expectancy of men at retirement age



Source: OECD pension models. Mortality data from World Bank/United Nations population database.

Is the Hungarian retirement-income system socially sustainable?

Following the reform, Hungary’s public pension system exhibits a very strong link between earnings, contributions and pension entitlements. Replacement rates will be the same for all workers with the same career pattern, regardless of their earnings: there is virtually no redistribution from rich to poor in the system. Seven other OECD countries have retirement-income systems with similarly strong links between earnings and benefits. But the other 22 OECD countries have systems with higher replacement rates for lower-income workers. The principal objective of these arrangements is to avoid old-age poverty while containing public spending on old-age incomes.

The absence of such redistribution in Hungary may explain – in part at least – why the level of replacement rates is so high across the earnings range: if redistribution is precluded, then a very high replacement rate is needed to avoid old-age poverty among people with low lifetime incomes. Efforts to improve the fiscal sustainability of the Hungarian public pension system must be mindful of the consequences for low-income workers and those with less than full careers.

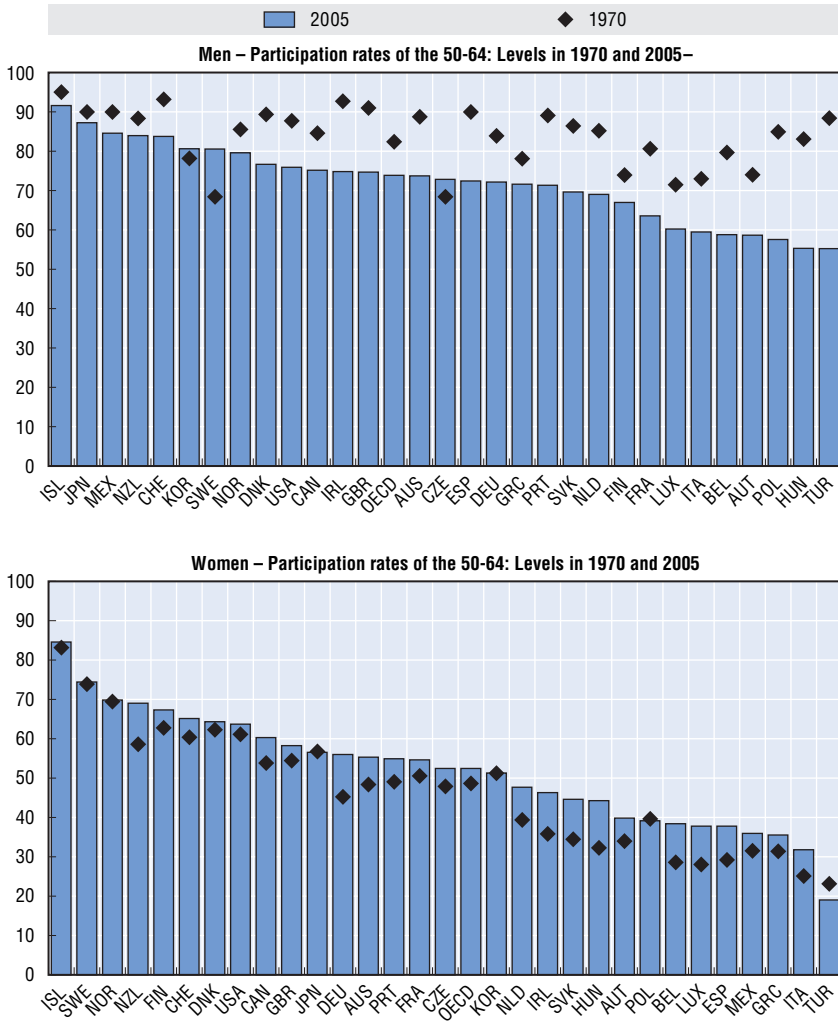
The Hungarian pension system covers a relatively small share of the population of working age. The number of active contributors amounts to 52% of the population aged 15-64 (the standard definition of “working age”). This compares with an average of 64% in OECD countries as a whole. Relative to the labour force, coverage is 86% in Hungary, the same as the OECD average. This reflects the relatively low labour force participation rates in Hungary.

How does the pension system affect work incentives?

Relatively few older Hungarians participate in the labour market (Figure 4.4). For men, the participation rate for 50-64 year-olds of around 55% is the second lowest among the 30 OECD countries, substantially below the OECD average of 75%. Only around 45% of Hungarian women in this age bracket participate in the labour market. Although this is by no means the lowest figure for OECD countries, it is well below the OECD average of just over 50%.

Part of the explanation of these findings is that the **effective** retirement age for both men and women in Hungary is the second lowest among OECD countries. For both sexes, the average effective retirement age is less than 60, well below the statutory retirement age in Hungary.

Figure 4.4. Participation rates of 50-64 year-olds by sex, 1970 and 2005

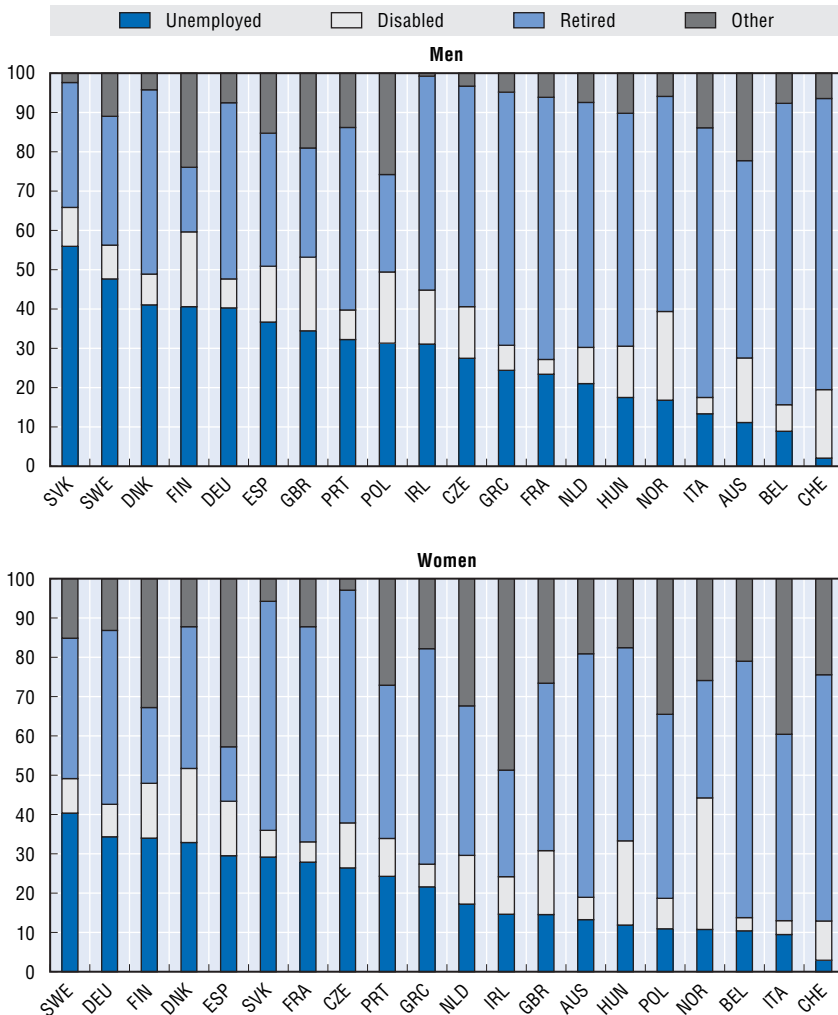


Source: OECD (forthcoming), *Pensions at a Glance: Special Edition on Retirement Incentives*, OECD, Paris.

National figures show that only 6% of pensions are first drawn at the statutory retirement age, while 82% are drawn before that under early-retirement provisions. An additional 12% are drawn earlier than normal retirement age under privileged rules for certain occupations and industrial sectors. Between 1998 and 2003, the average age of men starting to draw pensions remained steady at around 60, despite the increase in statutory retirement age from 61 to 62 in 2000. For women, the pension eligibility age increased from 56 to 59 years over the period 1998-2003, while the average age of women starting to draw

pensions rose by two years (from 56 to 58) over the same period. Women’s average retirement age increased by a further year between 2003 and 2007. There is no unambiguous answer to the question **why** people retire early in Hungary. However, there is evidence regarding **how** people retire early. Figure 4.5 shows that early retirement in Hungary occurs predominantly using the early-retirement provisions of the old-age pension system. Long-term unemployment is a relatively rare pathway into early retirement in Hungary, as is disability benefits (for men, at least). The disability benefit as a pathway into early retirement is discussed in Chapter 5.

Figure 4.5. Pathways out of employment for older workers (aged 50-64), 2004



Source: OECD (forthcoming), *Pensions at a Glance: Special Edition on Retirement Incentives*, OECD, Paris.

There is ample evidence – from both national and cross-country studies – that the financial incentives embedded in the pension system affect retirement behaviour,² and changing retirement incentives has been a central concern of recent pension reforms, both in Hungary and elsewhere. Retirement incentives matter for reasons of fairness and equity as well as efficiency. People who work more and contribute more **should** have higher pensions. Equally, those who are forced to drop out of employment early, perhaps through no fault of their own, need to have a reasonable standard of living. The aim should be to have a pension system that neither excessively subsidises, nor excessively penalises, early retirement.

Table 4.1 presents two measures of the way the pension system can affect retirement incentives. Both measures are based on the concept of pension wealth, introduced above.

The first is the **change** in pension wealth from working an extra year. This indicator – normalised to individual gross earnings – compares two flows of income. The first flow occurs when retiring immediately, the other when working (and so delaying pension receipt) by an additional year. The difference between the two income flows is earnings during the additional work year plus the implicit tax or subsidy in the pension system, measured relative to individual earnings.

The second measure of incentives to retire is based on the **level** of pension wealth relative to income. It tries to capture the “income effect”: people who are richer in terms of pension wealth are more likely to retire however large the **change** in pension wealth from working an additional year.

The results in Table 4.1 examine a retirement “window” between age 60 and 65. In most OECD countries, this age bracket represents the period when early retirement occurs. But with the normal retirement age of 62, this age bracket covers both early and late retirement in Hungary.

The level of pension wealth already achieved at age 60 in Hungary is in the highest third of OECD countries while the change in pension wealth that results from continuing to work to age 65 is in the lowest third. Thus, Hungary pays relatively high pensions to people who retire at age 60, and pension wealth actually falls if people remain in work after age 60. Along with Greece, Italy, Luxembourg and Turkey, therefore, Hungary’s public pension system embodies the strongest incentive to retire early among OECD countries. At the other end of the spectrum, there is a low level of public pension wealth at age 60 in the United Kingdom and a relatively large increase in public pension wealth from remaining in work.

Table 4.1. **Levels and changes in gross pension wealth**¹
60-65 year-old male on average earnings

		Changes in pension wealth, working age 60-65		
		Lowest third	Middle third	Highest third
Level of pension wealth at age 60	Lowest	Australia	Ireland	Germany
		Belgium	Mexico	Japan
		Canada	United States	Poland
				United Kingdom
	Middle	France	Czech Republic	Finland
		Portugal	New Zealand	Iceland
			Norway	Korea
			Slovak Republic	Switzerland
	Highest	Greece	Austria	Denmark
		Hungary	Spain	Netherlands
		Italy	Sweden	
		Luxembourg		
		Turkey		

1. Countries grouped into thirds of the distribution of both change and level of pension wealth. Mean level of pension wealth achieved by age 60 is 5.40 times individual lifetime average annual earnings for the low group, 7.98 for the middle and 11.78 for the high group. Mean change in pension wealth for working from age 60-64 is minus 34.7% of annual earnings for the low group, plus 0.2% for the middle group and plus 10.7% for the high group.

Source: OECD (forthcoming), *Pensions at a Glance: Special Edition on Retirement Incentives*, OECD, Paris.

How can the payout phase, the governance and regulation of individual accounts be improved?

There are several policy issues that relate specifically to the new privately managed, defined-contribution pension plans. Hungary's private pension funds managed assets of around 9.7% of GDP in 2006, according to the OECD's global pension statistics, two-thirds of which come from mandatory contributions. The funds have achieved cumulative average annual real gross returns of 2.3% since their establishment in 1998.³

The privately managed part of the system has experienced some "teething problems". The main areas of policy concern are the payout mode of private pension plans (particularly the development of annuities) and the governance institutions of private pension funds. It is important to note, however, that these are just a sample of the challenges faced by private pension schemes. Others, not covered in this chapter, include increasing life expectancy, individual investment choice, and administrative costs and charges.

The payout phase

Benefit payments from mandatory private pension plans will commence in 2012. Current regulations require these benefits to be paid as a single-life annuity, indexed to a combination of price inflation and average-earnings growth. There is no requirement for survivors' benefits. This raises a number of questions:

- **Should there be more choice regarding the way benefits are paid?**

Given the relatively high replacement rate provided by the public pension system, there would seem to be scope to allow some flexibility in how benefits derived from the accumulation of individual accounts are paid out. The option to vary withdrawals over time would give members greater flexibility to manage their personal finances. This could include an option of bequeathing wealth in the event of early death. To protect people from outliving their savings, programmed withdrawals could be coupled with a requirement to annuitise part of the account to cover benefits starting at a later age (*e.g.* age 75).

The current requirement for indexation to a mix of wage growth and consumer price inflation results in a relatively low benefit early in retirement, rising to a higher real level in later years when, arguably, annual expenditure – with the exception of healthcare needs – tends to be lower. Greater flexibility in indexation may be warranted. Moreover, there are concerns regarding the cost of pension indexation to price changes in the absence of inflation-linked securities in domestic currency.

Pensioner couples are not required to purchase survivors' annuities, leading to the risk of poverty among widows and widowers. Survivors' benefits arrangements should be encouraged or even mandated.

- **Who should provide annuities?**

The options are individual pension funds, life-insurance companies, or a government provider. Each of these options has broader policy implication, such as the appropriate regulatory body and regulatory framework. Pension funds are currently allowed to provide annuities, but existing reserve requirements may not be sufficient to ensure solvency. A central annuity quotation system (such as the SCOMP system in Chile) could also help individuals choose more effectively between providers and products.

- **Should the risk of unfavourable annuity conversion conditions be spread?**

It is common internationally for defined-contribution pension plans to require individuals to transform the balance in their accounts into a life annuity at the time

of retirement. This is problematic because it is a matter of luck whether the transaction coincides with favourable investment market conditions and favourable annuity rates. A way of alleviating this problem would be to require the purchase of deferred annuities over a period preceding retirement. For example, 20% of pension capital could be used to purchase a deferred annuity on each of the five anniversaries preceding the expected retirement date. Programmed withdrawals (see above) are another way of avoiding this timing risk.

Highly developed private-pension and annuity markets in several OECD countries provide a wealth of experiences relevant to these questions, including many options for increasing the flexibility of the system in Hungary (Stewart, 2007).

Performance, charges and investments

Some studies have suggested that investment performance delivered by Hungary's private pension funds has been low, compared with returns on government securities, returns achieved by pension funds in other emerging economies, and wage growth in Hungary. However, a recent OECD/World Bank study on the investment performance of privately managed pensions funds finds that the real gross returns delivered by Hungarian pension funds in the period 1999-2006, and the volatility of those returns, are within the performance range of most other countries. The study concludes that Hungary is among the countries where pension funds have "added value" over long and short risk-less instruments, both domestic and foreign, but also states that the returns delivered by pension funds in Hungary could be improved.

Another criticism of Hungarian pension funds has been over the fees they charge. Indeed, reports from both the OECD and the World Bank show that these are relatively high in international comparison, especially the charges for asset management. Lack of standardisation in the way fees and performance are reported – and the resulting lack of transparency – makes comparison between funds difficult and hinders competition. The introduction of standard performance measurement and lower caps on charges could help to remedy these problems.

Pension funds' investments have been restricted, particularly the acquisition of foreign securities. Portfolios have been concentrated in government securities, accounting for about two-thirds of investments in 2006, according to OECD statistics (excluding government securities in investment funds). Evidence from other countries suggests that a move away from quantitative investment restrictions can improve risk management and investment returns. Hungarian regulations have moved in this direction, opening up greater opportunities for diversification, although foreign investments are still fairly restricted. However, changing conservative attitudes towards investment may be equally important as regulatory changes. The recent widening of choice, with portfolios offering differing risk-return mixes, might improve investment returns by encouraging less conservative investments than the current single, bond-intensive portfolio.

Institutional arrangements

Private pension funds in Hungary, whether mandatory or voluntary, are established as not-for-profit mutual associations. These are governed by a board of directors and the board of supervisors, selected by the annual general assembly of plan members. In principle, this should align the interests of members with those of fund managers. However, most funds are established by financial institutions that find it easy to put their candidates on the supervisory board, weakening the link with members' interests. For example, a recent World Bank report shows that pension funds sponsored by financial institutions tend to charge higher fees than funds sponsored by large employers. Hungarian pension funds lack both the stronger governance imposed by boards with employer and employee representatives and the clear accountability and fiduciary responsibilities imposed on pension fund management in Latin American countries. While mutuals can work effectively, the experiment does not seem to have been entirely successful in Hungary.

One approach, therefore, might be to demutualise the funds, shifting legal capacity and responsibilities to pension-fund managing companies (as in Latin America). However, this process should avoid closing employer-sponsored funds that have performed well and have relatively low costs, or creating new conflicts of interest. Given the prevailing uncertainty in this area, it seems sensible to make demutualisation optional rather than mandatory and let the alternative governance structures compete in the marketplace.

Whatever the institutional structure, there is a need for independent board members without employment ties to service providers and an independent management committee to monitor pension-fund investments and advise on investment choices, including default funds. Allowing employers a greater role in monitoring private-pension providers and guiding their employees' choices might also be helpful. Such recommendations are in line with the OECD's *Guidelines on Pension Fund Governance*.

Can public awareness campaigns assist the policy reform process?

Hungary is not alone in facing the challenge of how to maintain sustainable pension systems in the face of ageing populations. Many OECD countries have undertaken pension reforms – which may be seen as unpalatable to parts of the population – that often involve individuals having to take more responsibility for funding their retirement income. Several OECD member countries have therefore launched public awareness campaigns to help explain the need for reforms, the policy undertaken, and the increased responsibilities which individuals face. Such campaigns have been shown to be successful in raising awareness of these issues; though translating this into a change in behaviour seems more challenging.

Through its broad Financial Education project, the OECD has surveyed a number of these national pension awareness campaigns (see OECD, 2005b). General recommendations on such programmes have been included in the OECD "Recommendations on Financial Education and Awareness". In addition, some lessons can be learned from case studies of successful campaigns. In Ireland, the Pensions Board has run an annual National Pensions

Awareness Campaign on behalf of the government since 2003. Through innovative use of the media and partnering with a wide range of organisations (often specifically targeted at women and younger consumers), the campaign successfully raised general awareness on pension issues among the adult population from 60% in 2003 to over 65% in 2006.⁴ In Australia, the Financial Literacy Foundation (a division of the Department of the Treasury) ran a highly evaluated campaign in 2005 to explain the introduction of choice into the superannuation system,⁵ while in New Zealand the government is building its campaign relating to the new KiwiSaver initiative, a more general financial project.⁶ Meanwhile in Sweden specific tools – in the form of the “Orange Envelope” annual statement – are being developed to help individuals understand what pension they can expect to receive from the public system, in order to be able to plan their private retirement savings more effectively.

Conclusions: reforming and performing

The Hungarian pension system is in need of reform for both its public pension as well as its private pension component. Comparison with pension systems of other OECD countries reveals two major shortcomings calling for policy action as regard public pensions.

- First, projections of public pension spending suggest that the system is not fiscally sustainable in the long run. One option for adjustment is to simply increase pension contributions. However, at 26.5% of gross earnings (including contributions to individual accounts), these were already significantly higher than the OECD average of 20% in 2004.⁷ Since then, contributions have increased further to 33.5%.
- Second, there remains a strong incentive to retire early, despite recent changes to the system. This is detrimental to the financial sustainability of the pension system.

The private pension component is in need of reforms as well: new and more flexible payout options need to be considered, and the governance of pension funds should be strengthened. In addition, there is a problem of low coverage of the pension system, entailed by low labour participation rates. The following recommendations address these problems.

The normal pension eligibility age for men was increased to 62 years in 2000; it will reach the same age for women by the end of 2009. However, no further increases in retirement age are currently scheduled.

- **Further increases in retirement age for both men and women should be gradually phased in to secure the fiscal sustainability of the pension system in the long term.**

One way of doing this would be to link the pension eligibility age to changes in life expectancy. This reduces the risk to the pension system’s finances from unexpectedly rapid

improvements in life expectancy. It is also likely to be politically more acceptable than various other reforms. The Hungarian pension system already has a link between benefits and life expectancy as a result of the defined-contribution component: as life expectancy increases, the annuities paid for a given pension accumulation will fall. However, this applies to a relatively small part of the overall pension package. In Finland, Italy, Poland and Portugal, for example, all or nearly all of pensions will be linked to life expectancy, compared with currently just 30% in Hungary (Whitehouse, 2007).

- **Increases in retirement age after 2009 should be linked to the growth in life expectancy at age 60, increasing both early and normal eligibility ages. This would improve both incentives to remain in work at older ages and the system’s fiscal sustainability.**

Reforms are already being introduced to tighten qualification requirements for early retirement. These changes will be fully phased in from 2013 onwards. Nonetheless, optional early retirement will still be possible starting at age 60. The pension will be paid in full to workers with 41 years’ contributions at age 60 and at a reduced rate to workers with at least 38 years’ contributions. However, the current reductions are at a very low rate: just 2.4% a year for two missing years. This will increase to 4.2% under the changes enacted in 2006-07, compared to the average cut in OECD countries for each year of early retirement by 5.2%. Even with the proposed increase, the adjustment is below the “actuarially neutral” reduction: that is, the cut in benefits that would leave pension wealth unchanged, which is currently around 7.5% for Hungary (Queisser and Whitehouse, 2006). The reduction is also well below the annual benefit increment for late retirement of 6% per year.

- **The reduction in benefits for early retirement should be increased, at least to match the 6% upward adjustment of benefits for late retirement. Ideally, any deviation from the statutory retirement age should be accompanied by an actuarially neutral change in benefits. This would make regulatory restrictions on combining work and pension receipts (as recently introduced) unnecessary.**

Another issue is the indexation of pensions in payment. Indexation of pension benefits to price inflation is found in 12 OECD countries. Indexation is linked to earnings growth in just two, while five countries – the Czech Republic, Finland, Hungary, the Slovak Republic and Switzerland – use a mix of earnings and prices indexation. For a given fiscal outlay, there is obviously a trade-off between the initial level of the pension and how it evolves during retirement. A shift from mixed indexation of pension benefits to pure inflation indexation would reduce the scale of cuts in initial benefits needed to achieve fiscal sustainability while preserving the purchasing power of pensions.

- **The proportion of pension benefits that is linked to changes in earnings should gradually be reduced so that pensions are linked to price inflation only.**

The changes proposed above, even taken together, are unlikely to be sufficient to deliver long-term fiscal sustainability to the Hungarian pension system. A cut in the replacement rate embodied in current rules governing the public pension scheme will probably also be required to stabilise public-pension finances. However, an across-the-board cut in public pension benefits risks an increase in old-age poverty.

- **Cuts in earnings-related public pensions will also be needed to contain the long-term cost of public pensions to an affordable level. Such cuts should be accompanied by strengthened income safety nets to prevent a resurgence of old-age poverty.**

Concerning the mandatory private DC pension component, the following reforms should be considered to improve the system.

- **Widen choice of payout options to convert retirement savings in mandatory DC private pensions into a stream of income at retirement.**

Programmed withdrawals combined with deferred annuities to protect against longevity risk at old age could be considered.

- **Improvements in the governance of private pension funds are needed through strengthening the independence of the oversight mechanisms.**

In order to avoid inherent conflicts of interest which arise when financial institutions manage pension funds, independent governance arrangements should be put in place, such as independent board members or management committees. The option of a mutual structure should, however, remain in order to foster current employer-sponsored funds.

Reforming pensions involves governments in taking long-term decisions in the face of numerous short-term pressures. Before the long-term benefits of reform appear, most governments will have left office. However, many OECD countries have succeeded in implementing pension reforms that should deliver retirement-income systems that are fiscally and socially sustainable. This chapter has set out ways in which Hungary can learn from their experience to achieve the same goals.

Notes

1. An average of 0.3% per month for ages 61-62 and 0.4% per month for 60-61.
2. International analyses comprise studies by the OECD (Blöndal and Scarpetta, 1998; Duval, 2003) and those by a group of national experts convened by the National Bureau of Economic Research (Gruber and Wise, 1998, 1999).
3. This number corresponds to the period 1998-2005 as provided by the Hungarian Financial Supervisory Authority (HFSA). Using the same data source, Orbán and Palotai (2005) report an average annual real rate of return of just below 3%.
4. Further information can be found on the Pension Board's website at www.pensionsboard.ie/index.asp?locID=134&docID=-1.
5. Information on the Australian financial education campaigns is available at www.understandingmoney.gov.au/Content/Consumer/AboutUs.aspx.
6. See www.sorted.org.nz.
7. Comparing total contributions with gross labour costs (*i.e.* gross wages plus employer contributions), the rate in Hungary in 2004 was 22.5%, compared with an OECD average of 18.5%.

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