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HOW NOT TO IMPLEMENT: HUNGARIAN PENSION REFORMS IN AN INSTITUTIONALIST PERSPECTIVE

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How Not to Implement: Hungarian Pension Reforms in an Institutionalist Perspective

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Abstract:

After 1989, Hungary inherited a pension system characterised by an unfair and impenetrable mix of social insurance and social assistance. Widespread public dissatisfaction and the near drift into a financial crisis in the mid 1990s cleared the path for the first paradigmatic multipillar reform in Central and Eastern Europe (CEE), thereby attracting major international attention. Implementation, however, did not live up to the very high expectations. Ten years down the road, the new Hungarian pension system stands indeed as a model, but of partial failures and unintended consequences.

Applying a historical institutionalist framework, it will be shown that Hungarian pensions underwent both agency-based and structural institutional degeneration. These two phenomena, which recent events have shown to be common for newly legislated multipillar pension schemes, capture those situations where structural transformation takes place, but where, in practice, the old institutional structures 'contaminate' the new institutional arrangements, thereby enabling the blending of old and new logics of action. In the worst-case scenario, degeneration may lead to the demise of the new institutional arrangement.

In the case of Hungary, its retirement system is a paradigmatic case of poor and hasty institutional design. The expectations of involved actors failed to adapt, as neither policymakers nor private pension providers play by the rules of the game. The former indulge in extreme political budget cycles and the latter cannot self-regulate, thereby distorting competition. Furthermore, institutional complementarities are not gainfully exploited, since unfortunate policy solutions rendered the mandatory funded pillar costly, inefficient and disadvantageous with respect to the public scheme.

As a consequence, Hungarian pensions are once again in dire need of a structural overhaul. However, at the time of writing, October 2007, a coherent solution is still nowhere in sight and the many weaknesses of PM Ferenc Gyurcsány's government do not bode well. Policymakers shall learn a lot from the Hungarian experience, since it clearly shows that correct implementation may be every bit as problematic as a successful legislative phase.

Keywords:

Hungary, institutional change, multipillar pension systems, pension reforms, populism

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1 Introduction[2]

In a landmark International Labour Office (ILO) publication, Augusztinovics et al. (2002: 33) wrote the following to describe the Hungarian pension system prior to the 1997 reforms:

> *"The prime inadequacy of the existing system was its design. It embodied an almost impenetrable mix of social assistance (solidarity through redistribution) and social insurance (partial but fair replacement of previous income, based on contributions). Pensioners had little idea why their pensions were exactly what they were or how they related to their previous contributions".*

These considerations, underpinning wide disaffection with the Hungarian social security system, coupled with near drift into a financial crisis in late 1994, cleared the path for the first paradigmatic multipillar reform in Central and Eastern Europe (CEE), thereby attracting major attention and direct involvement of the World Bank's top brass.

The legislated three-pillar structure was undeniably innovative. The first, public Pay-As-You-Go (PAYG) pillar underwent major parametric reforms, such as higher and equalised pensionable age, the elongation of the calculation period and a stop to degressivity via the linearisation of the benefit formula. Hungary, decidedly inventive even before 1997, retained the highly subsidised, but mildly developed voluntary pension schemes introduced in November 1993. The major novelty in 1997 was, however, the introduction of a mandatory privately managed fully funded second pillar, financed by roughly one fourth of total contributions, that is 8%. Again, implementation did not live up to the expectations, which were in the case of Hungary particularly high.

Ten years down the road, the new Hungarian pension system stands indeed as a model, but of partial failures and unintended consequences. Using a historical institutionalist framework, it will be shown that this impenetrable mix of path-dependent and path-departing elements – some of the former hinging on principles *en vogue* during as far back as the interwar period – underwent both agency- and structure-based institutional degeneration, which render further reforms simply unavoidable (cf. Guardiancich, 2007).

Structural flaws were mainly instilled during the hasty legislative phase as a result of the ideological row within the Hungarian Socialist Party (MSzP). First, there are persistently inefficient public pillar features, which were carried over from the old system, supposedly due to excessive energy spent by the Socialist coalition on funded schemes (Simonovits, 2007). Second, a number of inadequate modifications will kick in by 2013, such as insufficient yearly accrual rates or the switch of pension insurance from the 'net' to 'gross' principle (Augusztinovics et al., 2002: 39). Third, the disastrous annuities law is in dear need of thorough adjustment (Impavido and Rocha, 2006: 39-42); and finally, the unique mutualist structure of Hungarian mandatory pension funds resulted in the funded pillar's performance being consistently inferior to that of the public PAYG scheme (Orbán and Palotai, 2005: 24-28).

As for actors' behaviour and on top of structural problems, policymakers continuously tinkered with pension parameters during implementation. Populist adjustments to the public pension scheme – the introduction of the 13th pension to counterbalance less favourable indexation – as well as a steady decrease in employers' contribution rates to gain in competitiveness are responsible for the deterioration of confidence in the new system. The mixed scheme is disadvantaged with respect to the old one and the fiscal balance of the Pension Insurance Fund (ONyF) is worsening.

[2] I would like to express my gratitude to Prof. András Simonovits for his extremely useful comments and insights. A very special thanks goes to Beáta Huszka and Balázs Apor for all their help.

In light of the above, it becomes clear that Hungarian pensions were hit hard by the inadequacy of their institutional design. The latter was unable to cope with the aspirations of Hungarian political leaders and with the deficient supervision and regulation of the private insurance market. At the time of writing (October 2007), a coherent solution is still nowhere in sight, yet, reformers garnered some strength: the consciousness that major problems subsist pushed structural reforms back into the agenda of PM Ferenc Gyurcsány's government.

The essay will be structured as follows. A brief sketch of the theoretical framework will be followed by the chronological analysis of the events leading to the 1997 pension reforms. The subsequent section will unveil the troubles of a decade of implementation, first, by investigating the structural flaws that burden the Hungarian second pillar and, second, by examining the political budget cycles that characterised the last three electoral rounds. The dissection of the institutions and actors involved will follow. The main elements of the institutional degeneration of Hungarian pensions will be highlighted throughout the text and their implications for further policy change will be explored in the final part of the chapter.

2 Theoretical framework

The institutionalist theory developed by Streeck and Thelen (2005: 4-9) showed how a rigid dichotomy between typically path-dependent incremental adaptation and radical transformation fails to capture important transformative processes common to advanced political economies. In order to complement their framework, the concept of institutional degeneration was proposed (Guardiancich, 2007). Degeneration captures those situations where structural transformation takes place, but where, in practice, the old institutional structures 'contaminate' the new institutional arrangements, thereby enabling the coexistence of old and new logics of action.

The idea lying behind the concept is that successful institutional replacement requires a number of conditions to be fulfilled in order for the new institutional arrangement to enter a stable reproductive cycle. Failing this, a degenerative process may occur in which old and new logics of actions blend and which may, in the worst case, lead to the demise of the new system. These conditions are drawn from the literature on increasing returns in economics (Arthur, 1994; for their adaptation to political science cf. Pierson, 2000) and comprise among others the adaptation of involved actors' expectations and coordination effects in the existing institutional matrix. The resulting phenomenon is multifaceted, but can be intuitively separated into agency-based and structural institutional degeneration, as conceptualised in Guardiancich (2007: 6).

Table 1 Institutional degeneration conceptualised

	Definition	Mechanism	Elaboration
Degeneration	New institutional rules get contaminated by old norms, new practice by old logics of action	Blending or deformation	**Agency** Long-term institutional maturity clashes with short-term returns to power for policy-makers, opening space for reversal, capture or modification Adaptive expectations of policy-takers fail to materialise, marginalising the institution or binding it to the same logic of action it was intended to substitute **Structure** Incompatibility with existing institutional complementarities leads to adaptation to existing structures, decreasing returns or collapse

Recent events have revealed that both processes may be affecting newly legislated multipillar pension schemes. Among these, the Hungarian retirement system stands out as a paradigmatic case of poor and hasty institutional design. Expectations failed to adapt, as neither policymakers nor providers play by the rules of the game. The former indulge in political budget cycles and the latter cannot self-regulate, thereby distorting competition. Furthermore, institutional complementarities are not gainfully exploited, since unfortunate policy solutions (centralised contribution collection and the mutualist structure of mandatory pension funds) rendered the funded pillar costly, inefficient and disadvantageous with respect to the public scheme.

Less than a decade after reforms, the Hungarian pension system is once again in dire need of a structural overhaul. This shall warn policymakers everywhere that implementation is every bit as important as the legislative phase.

2.1 Developmental phases

Post-1989 events, leading to the 1997 pension reform and its subsequent degeneration, defy a clear-cut repartition into distinct phases. Conversely, the period is rather organically characterised by the Hungarian government's insufficient consultation with civil society, opposition parties, and social partners. Notwithstanding, three different chronological junctures can be discerned, and maybe a fourth is eventually emerging.

At the onset of post-socialist transformation, Hungary found itself in a slightly different position than most other transition economies. Already during the 1980s and due to its 'progressive' attitude, the Hungarian Socialist Workers' Party (MSzMP) acknowledged the need to fundamentally reform the area of social insurance. The real value of higher pensions was constantly eroded during the last days of Kádárism, thereby leaving the pension bill at around 10% of GDP, an alarming but not critical level. After 1989, however, the worsening ratio between pensioners and contributors initiated the first phase of reforms, characterised by half-baked organisational changes, some unfair, but nonetheless effective retrenchment measures, and the introduction of voluntary pension schemes. This motley of *ad hoc* measures, legislated during a period of policy paralysis (Müller, 1999: 71), proved a heavy burden for all subsequent attempts at reform.

The Minister of Finance (MoF), Lajos Bokros, with his proposal to fully privatise the pension insurance system, started the second, structural phase of reforms, which witnessed a bitter intra-party fight within the MSzP on whether the 'new pension orthodoxy' – financially, technically and logistically sponsored by the World Bank – should be applied to Hungary. Initial proposals were radically watered down (privatisation slid from 100% to 25% of the PAYG system) and concessions were granted for the acquiescence of the social-democratic component of MSzP, represented by the Ministry of Welfare (MoW) and the National Confederation of Hungarian Trade Unions (MSzOSz) through the control of ONyF. The very unfortunate corporate governance structures of newly established Mandatory Pension Funds (MPF) and of the Pension Insurance Fund, directly brought into question the World Bank's leverage when a hard-nosed two-level game is being played (cf. Putnam, 1988).

Notwithstanding all these shortcomings, most liberal commentators acclaimed the reform as a breakthrough and the financial community even upgraded Hungary's credit standing, thereby implying that structural reforms may be as important as macroeconomic stability (BBJ, 15-21 September 1997; James, 1998: 285). However, rejoicing was short-lived. The vote into power of the Alliance of Young Democrats (Fidesz), in May 1998, set off a third, populist, or better plainly irresponsible phase, where electoral politics dominated. Fidesz opposed from the outset Socialist reforms and enacted a spate of countermeasures. They, however, never materialised in a coherent plan for the new system's demise. Thus, smooth implementation resumed only four years later, in 2002, after MSzP seized government again. The multipillar system was PM Péter Medgyessy's personal hobbyhorse, since he served as MoF during the previous Socialist administration. Yet, electoral promises and a number of scandals prompted once more a drift into populism.

Seriously damaging amendments were legislated. These, together with the rotting fruits of previous compromises, a spiralling budget deficit and PM Medgyessy's own resignation in 2004 urged an U-turn in social policy. The newly appointed and later re-elected PM Gyurcsány took some steps in this direction after the alarm had been set off by the Hungarian National Bank (MNB), the World Bank and various independent consultants (Holtzer, interview). However, after a number of minor reforms and further misdemeanours, his weakness became manifest and the concern that all these appeals may just be *vox clamantis in deserto* is great.

3 Evolution of the pension system[3]

3.1 The Bismarckian roots of path-dependence and the socialist period

Most accounts of the evolution of Hungarian social security explicitly deal with pre-socialist insurance arrangements, which put Hungary at the forefront of industrialised countries, directly competing with Austria and the Czechs. The Bismarckian features of the first social insurance act, legislated in 1891, of the first pension insurance act of 1912, aimed exclusively at civil servants, and of the 1928 Act on Pension, Disability, Widows' and Orphans' Insurance were all – excepted the last one – intended to thwart the burgeoning labour movement, which staged a (failed) communist revolution in 1919 (Szikra, 2007: 3-8). The organisational elements of these schemes are important for this study, since they were faithfully replicated once the socialist period was over in 1989.

First, the very schemes that a compulsory and centralised social insurance was supposed to dismantle, that is the mutual voluntary insurance funds, which lied at the heart of the working class movement, were exhumed in November 1993 by Act XCVI/1993, when voluntary mutual benefit funds were introduced. The differences were minor: while the pre-war schemes were occupational, Defined Benefit (DB) and their boards consisted of both employer and employee representatives; in post-socialist Hungary the structure was applied to Defined Contribution (DC) schemes with boards consisting of participants' representatives only (Erdős, interview). Moreover, an identical non-profit, mutualist corporate structure was retained for the mandatory private fully funded pillar which started operating in January 1998.

Second, the 1928 Act unified the fragmented insurance system and placed it under the aegis of a National Insurance Institution, headed by an independent expert appointed by the Welfare Ministry and a self-governing board, equally split among employer and employee representatives. Again, the similarity with the self-government of the Health and Pension Insurance Funds, regulated by Act LXXXIV/1991, cannot be dismissed as random.

Finally, the abovementioned institutions may in some respect share a common fate. The funded component of Hungarian social insurance was swept away during WWII and the 1946 hyperinflation folly, whereas the corporate governance of ONyF crumbled under its own inefficiency and the clearly inadequate mutualist structure of the second pillar ought to be soon overhauled.

3.1.1 Setup, expansion and retrenchment

Like other People's Democracies, socialist Hungary partially acknowledged previous pension entitlements by setting up a PAYG pension system after 1949. Szikra (2007: 10) distinguishes three periods of social security evolution during state socialism: 1) 1940s-1950s – setup of the new social

[3] I am particularly indebted to Prof. Mária Augusztinovics for the clearness of her exposition of the Hungarian pension system and reforms.

insurance system after the war; 2) 1960s-1970s – development of social rights in the aftermath of the 1956 revolution and expansion of coverage to include agricultural workers; 3) 1980s – coverage nearing 100% and wider set of risks insured, the system reaching maturity. Act II/1975 crystallised the pension system, which developed the following characteristics.

The low retirement ages of 60 for men and 55 for women were retained, the minimum pension and accrual premia for longer employment were merged into a function of years served and earnings. The pension base was calculated from the wages of the best three out of last five years in employment and the entry ratio's upper limit (the entry pension net replacement rate with respect to the base) was 75% with 42 years of service.

However, due to economic deterioration and increasing worries about foreign indebtedness, the Hungarian authorities decided to covertly enact internal saving measures (Augusztinovics, 1993: 309-312). First, the entry ratio started to decrease since 1982, when entry pensions were made step-wise degressive, with successive income brackets contributing less than proportionally to the entry benefit. These same brackets were not indexed, thereby steadily worsening the entry ratio for middle- and high-income employees. Second, insufficient compensation represented an increasingly progressive tax, which eroded continuing pensions and aggravated relative as well as absolute poverty among the retired population. Indexation for inflation was set at 2% in 1968, a clearly overoptimistic assumption required by law between 1975 and 1991. Only lowest pensions were fully compensated (Máté, 2004: 120).

So, retrenchment of the Hungarian pension system started almost a decade before transition. The stagnation of the country's middle class prevented pension expenditures from exploding. They amounted to 8.8% of GDP by 1990. The increasingly reformist environment in Hungary required improved flexibility and swifter responses. Hence, the Council of Ministers took charge of the pension system's management in 1984, thereby freeing it from the Central Council of Trade Unions (SzOT), which was packed with conservative diehards (Szikra, 2007: 16).

3.2 From goulash socialism to inequality

The Kádár era was chiefly characterised by a *panem et circenses* tactic to appease the working population. A paternalistic bargaining system was in place since the 1960s and was accompanied in the 1980s by a thriving and partly institutionalised second economy (Bruszt, 1995: 265). The New Economic Mechanism sowed the seeds of future market reforms. By 1988, Hungary developed a two-tier banking system, introduced the income tax, had significant corporate legislation and joined both the IMF and the World Bank. Hence, the transformational recession was here milder than in the rest of the Eastern block (see Table 2).

Table 2 GDP growth 1991-2006

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000*
GDP growth	-11.9	-3.1	-0.6	2.9	1.5	1.3	4.6	4.9	4.2	5.2
1990 GDP=100.0	88.1	85.4	84.9	87.4	88.7	89.9	94	98.6	102.7	108

	2001	2002	2003	2004	2005	2006
GDP growth	4.1	4.4	4.2	4.8	4.1	3.9
1990 GDP=100.0	112.4	117.3	122.2	128.1	133.4	138.6

Source: Central Statistical Office (KHS). * In 2000, the methodology used for the calculation of GDP was harmonised with that of Eurostat, hence most of the data are not directly comparable.

However, outdated legislation and the fearful gradualism of the first freely elected government delayed a healthy recovery at least until 1997. Formal employment and participation rates stopped declining and they stagnated ever since (see Table 3). Many experts argue that this is Hungary's current most pressing challenge.

Table 3 Participation, employment and unemployment of +15-64 during 1998-2006

	1998	1999	2000	2001	2002	2003	2004	2005	2006
Participation	58.2	59.6	59.9	59.6	59.7	60.6	60.5	61.4	62.0
Unemployment rate	7.8	7.0	6.4	5.7	5.8	5.9	6.1	7.2	7.5
Employment rate	53.6	55.4	56.0	56.2	56.2	57.0	56.8	56.9	57.3

Source: KHS.

Politically and economically, the Hungarian regime of the 1980s was a variant of 'perverse corporatism', where special interest groups enjoyed priority over systemic maintenance (Bruszt, 1995: 272). Not only did managers secure a privileged position in 'spontaneous privatisation', but also the political elites maintained immunity during the National Roundtable Talks of 1989. The coalition led by the Hungarian Democratic Forum (MDF), which governed during 1990-1994 under PM József Antall and Péter Boross, introduced strict bankruptcy laws and attracted foreign capital, but, at the same time, it exploited the recentralisation of state control over a shrinking public sector for short-term political purposes. The majority of structural reforms were postponed. Unsurprisingly, reformed Socialists seized power already during the following electoral round.

3.2.1 Early pension reforms

As it was shown in previous paragraphs and as Ferge notes (1999: 231), even under socialism it was an open secret that the pension system was unsustainable. However, the Hungarian old-age crisis was unrelated to demographics. The Age Dependency Ratio (ADR) was lower throughout the 1990s than a decade earlier. The two baby boom blips will pose problems only after 2015 (World Bank, 1995: 33-34). Transition generated the disaster. The number of insured – and of contributors even more – dramatically decreased with respect to the number of pensioners, especially the disabled. As Table 4 indicates, the System Dependency Ratio (SDR) declined until 1999, thereby drifting far out of line with Hungary's age structure.

Table 4 Changes in insured, pensioners and SDR

	Old-age pensions	% change	Disability pensions*	% change	Total**	% change	Insured ***	% change	Inverse of SDR
1990	1,461.7	n/a	542.8	n/a	2,586.8	n/a	5146	n/a	1.99
1995	1,600.3	9.5	718.0	32.3	3,009.6	16.3	4232	-17.8	1.41
1996	1,621.4	1.3	745.4	3.8	3,059.3	1.7	4080	-3.6	1.33
1997	1,646.8	1.6	766.6	2.8	3,104.5	1.5	3889	-4.7	1.25
1998	1,652.4	0.3	777.6	1.4	3,138.6	1.1	3886	-0.1	1.24
1999	1,664.7	0.7	758.8	-2.4	3,183.8	1.4	3818	-1.7	1.20
2000	1,671.1	0.4	762.5	0.5	3,145.1	-1.2	3843	0.7	1.22
2001	1,667.9	-0.2	772.3	1.3	3,115.7	-0.9	3836	-0.2	1.23
2002	1,664.1	-0.2	789.5	2.2	3,103.2	-0.4	3845	0.2	1.24
2003	1,657.3	-0.4	800.0	1.3	3,093.1	-0.3	3900	1.4	1.26
2004	1,637.8	-1.2	806.5	0.8	3,068.1	-0.8	3879	-0.5	1.26
2005	1,643.4	0.3	808.1	0.2	3,063.3	-0.2	3881	0.1	1.27
2006	1,658.4	0.9	806.1	-0.2	3,053.2	-0.3	n/a	n/a	n/a

Source: CANPI (2006). *Both above and below retirement age. **Beneficiaries from social insurance funds (ONyF and OEP, the Health Insurance Fund) and other funds. ***It includes employees, self-employed as well as entrepreneurs and persons receiving unemployment benefits

Despite the worsening of the replacement ratio, an increasingly flatter structure of pension benefits and a slide into absolute poverty of a significant number of pensioners, expenditures continued to rise or at best stagnated up until 1994, both as a percentage of GDP and in absolute terms. Palacios and Rocha (1998: 180-189) correctly imputed the financial distress to substantial revenue losses, deriving from state-owned enterprises' arrears, the fixing of the nominal value to the ceiling to employee contributions, a greater number of self-employed underreporting income and especially to a worsening SDR, which was let slip due to lower participation, unemployment, early retirement and lax disability criteria.

Table 5 Pension expenditures in billion HUF and as % of GDP*

	1970	1980	1985	1990	1995	2000	2001	2002	2003	2004	2005
Expenditures	13.0	56.0	91.7	202.1	582.2	1,228.5	1,420.1	1,696.3	1,849.2	2,052.7	2,294.5
As % of GDP	3.5**	6.9**	7.9**	8.8**	10.37	9.08	9.30	9.87	9.76	9.91	10.40

Source: CANPI (2006: 22). *Benefits financed from social insurance funds and others funds. **Data from Simonovits (2007) on benefits financed from social insurance funds.

The government did not have a clear plan to solve the impasse. Hence, the legislated measures amounted to a jumble, which Müller (1999: 63-70) broke down to modifications to the organisation, financing, eligibility, benefits as well as to the basic design of the pension system, that is the establishment of the voluntary pillar. None of these amendments were sweeping enough to fundamentally reverse the declining situation.

As for the National Insurance Institution's emancipation from the government and hence from non-insurance based expenses, two key organisational changes played a role. First, in January 1989, the Social Insurance Fund was separated from the central budget. From 1991 it was given own resources, an administration and a self-governing board to let both contributors and beneficiaries participate. Second, the Fund was eliminated in 1992 and split into the Health and Pension Insurance Funds (OEP and ONyF, respectively). The self-governing experience represents the nadir of Hungarian social insurance. The main trade union, MSzOSz, won a landslide at the May 1993 nationwide elections for the two boards and got progressively entrenched in mismanagement, cronyism and a series of scandals that provoked widespread outrage. Additionally, ONyF's opposition posed a major obstacle to structural pension reforms and had to be bought off at a high price (see 3.3.4 for the abandonment of electoral representation and 4.3.2 for the boards' demise).

With respect to financing, a coherent contributory structure was created between 1988 and 1992 (Máté, 2004: 106-125). Before 1988 both the employee and employer contributions varied, the former between 3% and 15%, depending on monthly salaries, and the latter between 0% and 40%, depending on the sector of activity. In 1988 and 1989, respectively, employee contributions were fixed at 10% of the entire wage up to a ceiling, and employer ones at 43%. Later, they were split between ONyF and OEP (see Table 14). Hence, recalculating for average gross wages, total contributions were circa 37%, and contributions for pensions stood at 20.7% (cf. Augusztinovics, 1993: 314).

The contribution base was gradually expanded to all sorts of earnings: self-employment, various types of benefits etc. A 1996 law equalled the contribution with the tax base, but was later found to be unconstitutional. Additionally, a conspicuous amount of state-owned assets was promised to enhance ONyF's autonomy vis-à-vis the state, an unrealisable pipedream (see 4.3.2 for details). On the positive side, the Pension Insurance Fund underwent some 'profile clearance', which entailed the separation of health care (another ticking bomb) from pension-related expenditures. ONyF was left with some 80% of total pensioners and related spending. The Health Insurance Fund was charged with financing both partially and totally disabled persons below retirement age.

The changes in benefits and eligibility were clear attempts at retrenchment and, apart from further complicating the system, they played a decisive role in the drop in ONyF's expenditures to an all-time low of 7.3% of GDP in 1997, when the fund recorded a tiny surplus. The main adjustments that rendered this possible were: i) the contribution base was elongated from the three best of the last five working years to all years since 1988; ii) valorisation of past earnings – to net wages two years prior to retirement – was truncated for the last three years before retirement; iii) forward-looking indexation of continuing pensions to net wages was introduced in 1991 and became backward-looking in 1995 and 1996; iv) digression factors in the calculation of entry pensions were steepened and brackets were never adjusted; v) income counting towards pension calculation was capped and this ceiling remained nominally constant from 1992 to 1996, hence its ratio to average gross earnings slid from 3.36 to 1.63. Therefore, at a time of high inflation and real wage contraction, these modifications implied substantial inflationary savings, see Table 6, and resulted in a skewed distribution of pension benefits. Those who retired between 1986-1990 earned on average 20-25% higher pensions than those retiring between 1992-1995 (Augusztinovics et al., 2002: 33-34).

Table 6 Wages and prices 1990-2006

	1990	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**
CPI	28.9	35.0	23.0	22.5	18.8	28.2	23.6	18.3	14.3	10.0
Average wage	n/a	n/a	22,294	27,173	33,939	38,900	46,837	57,270	67,764	77,187
Real wage growth	n/a	n/a	1.7	-0.5	5.1	-8.9	-2.6	3.4	3.5	5.5
	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**			
CPI	9.8	9.2	5.3	4.7	6.8	3.6	3.9			
Average wage	87,645	103,553	122,482	137,193	145,520	158,343	171,351			
Real wage growth	3.4	8.1	12.3	7.0	-0.7	5.0	4.1			

Source: KHS.

In addition, not negligible were the restrictions to eligibility. After years of bickering, pensionable ages were gradually increased to 62 for both sexes. This change was introduced in 1996, taking full effect in 2000 and 2009, respectively. As early as in 1982, instead, the minimum pension-qualifying period was raised from 10 to 20 years over the following decade (for details, see Máté, 2004: 116-121 and Augusztinovics et al., 2002: 30-32).

3.2.2 The creation of a third pillar

Amid a dearth of paradigmatic reforms, the introduction of voluntary pension funds was an acceptable compromise to keep bread buttered on both sides. Not only fiscal problems of the PAYG system had not to be tackled, but also lip service was paid to capital market development through institutional investment (cf. Müller, 1999: 68-70; and Orenstein, 2000: 32).[4] Despite being supported at a cost greater than either Exempt-Exempt-Taxed (EET) or Taxed-Exempt-Exempt (TEE) arrangements, by freeing employer's contributions from both taxes and social security payments and by granting a 50% tax credit to the scheme, up to HUF 200,000 *per annum*. Voluntary schemes only trivially affected the public-private mix in Hungarian pension provision. In fact, the market remained fragmented, participation stagnated, contributions stayed low and were mainly paid by employers (for a thorough discussion, cf. Vittas, 1996; and Matits, 2004). Only lately, the situation improved.

In 2006, 70 licensed funds operating on the market (down from 250 in the mid-1990s) had 1.36 million members and managed HUF 661 billion in assets. On average, employers contribute 2.4% of the gross wage and employees 1.2%. Concentration is high, with the 15 largest companies accounting

[4] The voluntary scheme is what remains of a three-pillar pension system proposed by Parliament in 1991 (Gál, 2006: 187).

for around 80% of members and 85% of assets (Allianz, 2007: 59). Thus, the overall experience is mixed, not least because a fourth voluntary funded pension pillar was recently added to spur domestic long-term investment.

Within the frame of this study, the voluntary pillar is interesting for its governance structure and for the players it empowered. These had in fact a determinant role in the shaping of later events. Although no account exists on the genesis of the mutual saving principle, most experts (Fehér and Párniczky, interviews) agree that it was the result of two factors: a) the lack of experience with modern corporate governance structures, which led to the reprisal of pre-war models (see 3.1); b) the affinity with the mutual assistance, self-reliance ethos as a bulwark against capitalism unbound.

Regarding the former, policymakers exhumed Hungarian pre-war trust law, which regulated genuine occupational schemes with boards of trustees who were responsible for governance, but who were not in a position to generate (administrative or investment) risks, other than making wrong policy decisions. With respect to the latter, PM Antall's government advocated a self-helped mutualist structure to deny multinational companies another foothold in the economy and to replace the paternalistic socialist welfare state. According to György Németh (BBJ, 4-24 August 1997), the problem laid not so much in the funds lagging some 100 years behind contemporary corporate governance structure, but in the institutions' exclusivity; as if the government closed down all banks and let only savings cooperatives operate. Notwithstanding, the very fragmented initial picture, where hundreds of employer-sponsored funds with tiny memberships operated, rapidly cleared up. Matits (2004: 9-11) notes that voluntary funds sponsored by financial institutions (insurance companies and banks *in primis*) had the highest chances to survive and gathered the most members and assets. Having tens of thousand of members, they of course did not function as mutual funds any longer; they just implemented a for-profit business into a mutualist frame.

As for the players that emerged from the voluntary pension schemes, they did not form a homogeneous lobby for the retention of mutualism. As a matter of fact, larger financial institutions openly favoured demutualisation or at least freedom of choice in corporate governance. However, the vast majority of voluntary funds saw in mutualism their *raison d'être* and were soon flanked by their supervising institution, the Supervisory Authority of Voluntary Mutual Benefit Funds (controlled by the Ministry of Finance), which developed a strong vested interest in keeping that corporate governance structure intact for as long as possible.

3.2.3 The return of the Left[5]

The May 1994 parliamentary elections witnessed the return to power of the reformed Hungarian Socialist Party (MSzP), under the leadership of new premier Gyula Horn. MSzP totalled 209 out of 386 seats, that is 54% of the vote. Notwithstanding, the party struck an alliance with the liberal Alliance of Free Democrats (SzDSz), thereby totalling 72% of the vote, in order to assuage public concerns over the return of ex-communists and gain a two-thirds majority in Parliament. MSzP's commitment to market reforms, political pluralism and to the compensation for the victims of Communism, the sorry state of the economy and the incompetence of Antall's cabinet were among the causes for the breakthrough. Incumbent MDF collapsed from 165 to 37 seats, while Fidesz failed to capitalise on the previous government's unpopularity.

One of the sectors, where the Hungarian Democratic Forum fared particularly badly was public finance. From the very beginning, tensions mounted between the Parliament and the Social Insurance Fund, which indulged in major overspending. Little expertise and lack of alternative solutions determined the quasi-continuity in Hungarian legislation. The latter was regarded as very progressive in

[5] The return of ex-communists elicited an enormous amount of research; see Grzymała-Busse (2002) and Cook, Orenstein and Rueschemeyer (1999) for some of the best studies describing the phenomenon.

the 1980s, but it was entirely mismatched with a full-fledged market economy (cf. László, 1998). Table 7 shows the disastrous state of Hungarian finances.

Table 7 Public debt and twin deficits 1990-2006

	1990	1991	1992	1993	1994*	1995	1996	1997	1998*	1999
Public debt (% GDP)	67.6	74.1	78.5	90.0	87.1	77.3	71.2	64.2	61.9	61.2
Budget deficit	0.0	-2.1	-6.0	-4.2	-8.4	-6.6	3.1	-6.0	-8.0	-5.6
C/A deficit	0.4	0.8	0.8	-9.0	-9.4	-3.7	-3.9	-4.0	0.2	-7.8

	2000	2001	2002*	2003	2004	2005	2006*
Public debt (% GDP)	55.4	52.2	54.0	58.0	59.4	61.7	66.0
Budget deficit	-2.9	-3.4	-8.2	-7.2	-6.5	-7.8	-9.2
C/A deficit	-8.4	-6.0	-7.0	-7.9	-8.4	-6.8	n/a

Source: KHS. *Electoral years. See 4.4.3 for an account of political budget cycles.

Despite the fiscal imbalance in 1994 – public expenditure stood at 61% of GDP, public debt at 87.1% and the twin deficits, respectively at 8.4% (budget) and 9.0% of GDP (current account) – Horn's government did not provide any solutions for as long as nine months. Employers and trade unions did not reach an agreement on wage increases, the deadlines for the 1995 budget were too tight and the impending local elections contributed to the omission of sensitive issues from the agenda (László, 1998: 138-140).

At the end of 1994, devaluation and speculation expectations mounted, as the crisis in Mexico cast long shadows over the sustainability of Hungarian deficits. Both MNB president Péter Ákos Bod (appointed by MDF) and MoF László Békesi were forced to resign. However, widely shared fears that PM Horn would designate yes-men did not materialise. Instead, the 'dynamic duo', MoF Lajos Bokros and MNB president György Surányi, were appointed to office on 14 February 1995.

3.3 Kádárism's last stand: the Bokros package

"The Kádár era is over", declared Surányi when the austerity package, named after MoF Bokros, became law on 12 March 1995. Three of its immediate consequences are important for Hungarian pension reforms: a) the consolidation of public finances required major structural reforms, and by appointing a radical thinker, such as MoF Bokros, who advocated a Chilean solution, the early consensus among Hungarian pension experts faded away (Müller, 1999: 72-73); b) while its core measures were hardly challenged, the Constitutional Court dealt heavy blows to the package by arguing that the preconditions of economic transition, which allowed earlier governments to unilaterally modify established rights, were in 1995 absent (BBJ, 27 November - 3 December 1995); c) the strength of the 'dynamic duo' implied that the liberal faction gained the upper hand within the MSzP, thereby unleashing a bitter intra-party dispute, which deeply affected reforms to come (Orenstein, 2000: 32).

Last but not least, Horn's government partially embraced the aversion to dependency culture. A clear exemplification of this worldview was the PR campaign launched in the wake of the successful conclusion of the legislative phase.

What follows is a short description of the dilemmas and trade-offs that led to the 1997 pension reform. For exhaustive accounts of the legislative process, refer to Müller (1999), Orenstein (2000) and Czúcz and Pintér (2002); for details on the reform package, see 3.4.

3.3.1 Disagreement over the basic design

Existing literature emphasises the deep disagreement on the basic design of the Hungarian pension system. Müller (1999: 75) and Orenstein (2000: 35-36) confront the contrasting positions of various proposal actors. On the one hand, Hungarian social security experts who followed the

Bismarckian tradition (e.g. Augusztinovics and Martos, 1997), the Ministry of Welfare (at least initially) and the Pension Insurance Fund's self-government elaborated a series of proposals within the Bismarckian-Beveridgean paradigm. Notwithstanding minor differences, the suggested three-pillar structure combined a basic pension and an actuarially stricter, income-related PAYG scheme with privately managed voluntary arrangements (Czúcz and Pintér, 2002: 296-297).

On the other hand, the Ministry of Finance under Bokros, until his resignation in February 1996, and after that under Péter Medgyessy, was strongly committed to structural reforms. MoF Bokros initially supported a Chilean type of privatisation, which was, however, deemed to be fiscally – owing to an Implicit Pension Debt (IPD) of 263% of GDP (World Bank, 1995: 36) – and culturally unsalable in Hungary. The financial and ideational backing by the World Bank implied that privatisation, a three-pillar design and a lower contributory burden to boost competitiveness – as advocated in the country study 'Hungary: Structural Reform for Sustainable Growth' – became firmly entrenched in the agenda. The same report depicted an apocalyptic no-reform scenario.

Simonovits (2007) discerns three types of proponents of a private pillar: those who have a vested economic or other interest in setting up the private schemes, those who genuinely believe in the schemes' superiority vis-à-vis the public pillar and those who understand the transition problems involved, but favour privatisation as an obfuscation element to simultaneously reform the PAYG system. Owing to the latter, privatisation was substantially watered down during the legislative process. At first, one-half of contributions were to be diverted to the second pillar. These were diminished to one-third in order to reach an agreement with the Ministry of Welfare, and finally to one-fourth to assuage the ONyF, and MSzOSz with it. Hence, the public pillar retained its dominant position in Hungarian pensions and as a result of further compromise its parametric reform (a down-to-earth linearisation of the formula) was postponed until 2013.

Apart from the ideological disputes over the basic design, the debate concerned various technical aspects of the private pillar and ended up in a quixotic effort to simultaneously avoid not only unfettered markets, but also big government. The choice whether private funds should become for-profit or non-profit as well as the organisation of contribution collection elicited a considerable lobbying effort by the parties involved.

On the one hand, the proponents of a for-profit corporate structure claimed that it guaranteed greater transparency, comparability, competition and professionalism in the business. Sociologist György Németh advocated a mixed approach, where mutualisation is optional and warned against excessive fund fragmentation (BBJ, 14-20 October 1996). On the other hand, the opponents – for example György Radnai and Tibor Parniczky, respectively president and vice-president of the Supervisory Authority – preferred a non-profit approach, which would fit Hungarian democratic values, prevent the worst abuses by sales agents, and ensure competitiveness at asset management level through compulsory yearly tenders (BBJ, 30 September - 6 October 1996).

Following the dispute, the inter-ministerial pension reform committee led by István Győrffy, Commissioner of the MoF, had to change the proposal drafts a number of times, to finally settle with a mandatory non-profit structure for all. Most authors agree that this was a concession to the Supervisory Authority, which retained and reinforced its functions. However, and as it turned out later, the defeat of the financial lobby was only apparent.

This uninspiring outcome casts doubts on the effective capacity of the World Bank to impose its conditionality when tough two-level games are being played. In this case, the Bank was caught off guard at least three times. First, Hungary was at the centre of attention due to its pioneering role in CEE. The World Bank consistently advocated pension privatisation and had already had a dismal experience with the 1993 Pensions Administration and Health Insurance Project (PAHIP), which yielded meagre results. Concessions were thus acceptable and were supported by a governance structure that values the disbursement of a loan above its objectives (cf. Kotlikoff, 1999). Second, the

Bank underestimated the problems associated with a mutualist structure, despite several external warnings. Third and most important, there were simply too many fires burning at the same time for Roberto Rocha and other experts not to give in (Fehér, interview).

If the funds' mutualist character hints at the appeal that 'anti-capitalism' had in Hungarian politics, the opposite was true for contribution collection. For the sake of hiding contributions from the grabbing hand of the state, Hungary ended up with a very inefficient and bureaucratically overburdening decentralised collection structure (Párniczky, interview). It was recentralised in 2007.

3.3.2 Constitutional fears

Another source of watering down of the original design was the Constitutional Court's aversion to the unilateralism brought by the Bokros package. PM Horn was as a consequence forced to hire independent lawyers to assess constitutionality and withdraw suspicious laws (BBJ, 27 November - 3 December 1995). Two rules that were particularly affected were the cut-off age above which opting out of the old system was disallowed and the use of gender-differentiated mortality tables as well as price indexation for the provision of second pillar annuities.

In the former case, the initial mandatory cut-off age of 40 was raised to 47 and later eliminated altogether. This decision triggered a series of collateral modifications. In order to discourage those close to retirement to switch – a decision, which would have increased the contribution fallout and worsened the income position of pensioners, as switching entailed the renunciation to circa 25% of accrued rights – annuities were to be provided only after a minimum of fifteen years of membership. In addition, a triple guarantee was installed: a) in case of death, assets were to be inherited by the designated successor; b) in case of disability, switching back was allowed; c) in case of poor performance of private funds, that is returns covering less than 75% of the renounced monopillar benefits, the budget would guarantee a minimum benefit amounting to 94% of the public pension (cf. Simonovits, 2007).

In the case of annuities, excessive concerns over discrimination between genders and between participants to the public and mixed systems resulted in the drafting of very poor regulation. Not only does Swiss indexation show the government's failure to understand the difference between a PAYG DB and a fully funded DC scheme, since annuities are then simply discounted, but it also gives actuaries a hard time, as forecasting changes for two stochastic variables is practically impossible. Of course, using unisex mortality tables renders the situation worse for annuity providers (Impavido and Rocha, 2006: 40-42), however, it may have beneficial redistributive effects.

The Hungarian case is noteworthy, because it shows how the expectations of an intervention by the Constitutional Court may produce identical results as the intervention itself. Regrettably, it has to be noted that most pre-emptive action resulted in unsatisfactory regulation.

3.3.3 Whither debate?

Hungarian policymaking lacked a comprehensive public debate on the content of reforms. Such paradigmatic shift should have entailed an open renegotiation of the social contract, which did not take place. Kósa (2002) carried out a content analysis of part of the 'debate' and came to the following conclusions:

- the time devoted was too short. On 13 December 1996, the government accepted the reform proposal of the Ministry of Finance and opened the floor for public deliberation: five weeks altogether, including the Christmas holidays. Later that month, a minor scandal broke out when a governmental note on the need to 'create the illusion of a public debate' was published in the daily Népszabadság;

- insufficient information was supplied and no attempt was made to provide a concise informative campaign. This resulted in general disinformation, recorded by a Szonda Ipsos poll in May 1997 (which focused only on city dwellers): 45% of those surveyed never heard of reforms and 20% of those who did, could not list a single aspect of them. Only some 20% were aware of the reforms' structural character;
- the government's plan was distributed to six to eight civil organisations, according to unintelligible criteria;
- no procedure was set up to process criticisms, hence, the government was simply not prepared to receive feedback from 'outsider' institutions or individuals.

Against this backdrop, neither civil society, nor opposition parties significantly contributed to the shaping of policy. The former lacked adequate resources, which remained concentrated in the hands of the MoF (Ferge, 1999: 237-238). The latter opposed the creation of a mandatory pillar (see 4.3), but completely avoided a constructive dialogue, either in Parliament or through the press. As a result, the Hungarian pension reform was an internal affair of the governing coalition, or better of the Socialist Party itself.

3.3.4 Family matters

The Bokros package created major turmoil within the Hungarian Socialist Party. The resignation of Minister of Welfare Pál Kovács and Minister for National Security Affairs Béla Katona, in protest against welfare cuts, marked the ascendancy of the liberal over the leftist faction within the MSzP (Orenstein, 2000: 32).[6] MoF Lajos Bokros himself (and his successor Medgyessy), backed by PM Gyula Horn and externally reinforced by MNB governor György Surányi, consistently supported the reform package, in the face of growing austerity.

Several Socialist MPs, former MSzOSz chair Sándor Nagy and the Minister for Privatisation Tamás Suchman – representatives of the more anti-liberal and pro-nationalist side – claimed that MSzP failed to explain the meaning of the Bokros package to the public. They deplored the excessive power concentration in the hands of the Finance Ministry and the drift of the Socialist Party away from traditional leftist values (BBJ, 27 November - 3 December 1997).

The squabble culminated in an internal crisis. During 1995, PM Horn intended to appease MSzP's left wing by appointing a strong competitor to the Ministry of Finance, that is an 'economic committee' chaired by Sándor Nagy and directly responsible to the premier. Horn backed off at the last moment, thereby sidelining Nagy and terminating the aspirations of MSzP's leftist faction (BBJ, 4-10 December 1995). In light of this, the continuing influence of MSzOSz during 1997 is rather surprising, especially since Horn and its liberal block firmly held the party's reins.

A plausible, albeit paradoxical explanation lies in the positive economic effects of the Bokros package, which started to bear fruits roughly one year after its implementation. Before that, the popularity of MSzP, in general, and of PM Horn and MoF Bokros, in particular, slumped. Notwithstanding, as the situation improved towards the end of 1996, the public started to appreciate the benefits of the austerity measures and PM Horn sensed that a second mandate was not entirely out of reach.

Continuous delays – mainly due to the unabated opposition by ONyF – protracted legislation well into 1997, when full support of the leftist wing became, once again, a precondition for MSzP to retain power in 1998. As part of the *quid pro quo*, one of the most controversial concessions, the last of a long series granted by the liberal wing of the MSzP to its more radical socialist fellows (cf. Orenstein,

[6] According to Miklós Haraszti (BBJ, 23-29 April 2001), MSzP is divided into three ideological platforms: a) the 'social-democratic' anti-nationalist and pro-liberal faction; b) the 'leftist' anti-nationalist and pro-liberal group; and c) the 'socialist' pro-nationalist and anti-liberal bloc.

2000: 41-42), was the retention of the autonomous, self-governing structure of the two social security boards.

Their plain inefficiency materialised in a multitude of scandals, persistent and growing deficits and the unyielding stance towards any reform that threatened their control over as much as HUF 1.1 trillion, that is roughly one-third of the 1997 budget. Notwithstanding, the Socialist Party rushed through parliament a law in June 1997, which not only preserved the structure of the boards until mid 1999, but also increased their ‘undemocratic’ autonomy by eliminating nationwide elections and allowing trade unions and employer association to directly appoint the 96 members (BBJ, 9-15 June 1997).

The law was opposed by coalition partner SzDSz and the opposition alike. In response, the Békés County unit of the Workers’ Council (a right-wing trade union) and opposition MPs appealed to the Constitutional Court, claiming that the practice of appointing members to the boards was plainly antidemocratic, as the insured were inadequately represented. Just before the elections, on 5 May 1998, the Court ruled that both boards lacked the democratic legitimacy and accountability required by the Constitution and indicated 2000 as the deadline for Parliament to amend this (BBJ, 18-24 May 1998).

The fate of the two boards was thus fully dependent on the electoral result. MSzP would have probably preserved the status quo in order not to jeopardise the alliance with MSzOSz, while in the case of Fidesz’s victory, a rapid overhaul of the disputed boards would have topped the agenda.

3.3.5 A denigratory campaign

Ferge (1999: 239-240) offers a brief overview of the intense PR campaign that preceded implementation. It was launched by government in July 1997 and sponsored with taxpayer money. The *leitmotiv* was a reinterpretation of equality as individual responsibility, in opposition to solidarism, which leads to dependency. The campaign aimed at creating an asymmetric perception between the public and private pillars. Slogans, such as ‘the old pension system retires’, were not only self-contradictory, as three-quarters of the PAYG pillar were retained, but they also fuelled popular distrust in what remained of the public scheme. The campaign was probably one of the cornerstones in building a ‘negative consensus’, which led to widespread rejection of the state as legitimate pension provider (see 4.1).

3.4 The 1997 pension reform

On 28 May 1997, four pension reform draft laws replacing Act II/1975 were submitted to Parliament. They became law on 15 July 1997, after only six weeks of debate.[7] The reforms were scheduled to take effect in January 1998, hence, all parties involved were granted less than six months to prepare.

Table 8 contains a schematic representation of the reform package. It is followed by a short summary of the criticisms it attracted.

Table 8 Changes in the public pillar

Retirement age and min pqp	The minimum retirement age increases from 60 to 61 in 1998 and to 62 in 2000 for men and by one year every two for women, to reach 62 for in 2009. The pqp remains 20 years for a full pension and 15 for a partial one.
Early retirement	The minimum retirement age increases by 2009 from 57 to 59 for both men and women and the pqp from 33 to 37 for both genders.

[7] Act LXXX/1997 on eligibility and contributions to social security and private pensions; Act LXXXI/1997 on social security pensions; Act LXXXII/1997 on private pension and private pension funds; Act LXXXIII/1997 on mandatory health insurance.

Maluses/bonuses	Bonuses amount to a 0.3% monthly increase (0.5% since 2004) if the person is 62 with at least 20 years pqp. Maluses are calculated on time missing until 62: 1 - 365 days, the reduction is 0.1%; 366 - 730 days, the reduction is 0.2%; 731 - 1095 days, the reduction is 0.3% for each 30-day period, that is 7.2% maximum.
Pension formula	There are significant differences between PAYG-only and mixed-system participants.
Pension Base (PB)	Average gross wage from 1988 on. Before 2013, earnings have to be netted by deducting the PIT. After that, a rather unclear shift to the gross principle will occur. Degressive wage calculation will be phased out by 2009.
Min/max base	Contribution floors apply. The maximum is 200% of the average monthly average wage (250% since 2002).
Valorisation	Partial valorisation to net average wages: 4 years before retirement are not valorised, previous years are revalorised to the level of the second year before retirement.
Determination	Two completely different formulas apply. The new ones enter into force in 2013.
Before 2013	Pension = 0.43 × PB (for 15 years of pqp) + 0.02 × PB × Y (for each additional year of pqp up to 25 years of pqp) + 0.01 × PB × Y (for each additional year of pqp up to 35 years of pqp) + 0.015 × PB × Y (for each additional year of pqp) Those participating in the mixed system who retire before 2013 receive 75% of the amount above, which is what participants to the first pillar only receive.
After 2013	Participants to the PAYG pillar only – Pension = 0.0165 × PB × Y (years of pqp) Participants to the mixed system (to which 2nd pillar benefits are to be added) – Pension = 0.0122 × PB × Y (years of pqp)
Income brackets	In order to eliminate the degressive elements of the formula, income brackets are annually increased by 8% above net income growth. Only the lowest bracket survives in the medium term.
Contributions	See Table 14 for rates and ceilings.
Indexation and valorisation	Indexation gradually becomes Swiss (soon discontinued, see later paragraphs). 1998: net wage – 2.5% (to finance increased survivor pensions) 1999: net wage 2000: 70% net wage + 30% price 2001: 50% net wage + 50% price
Disability pensions	Calculation and eligibility did not change. The responsibility for those under statutory retirement age who entirely lost their capacity to work was shifted back to ONyF from OEP.
Survivor pensions	The ‘one-pension-for-one-person’ rule was abolished. A survivor is entitled to two benefits; however, the benefit was decreased from 50% to 20% (30% after 2002) of the deceased person’s pension. The Constitutional Court reinstated 50% for those not eligible for a pension in their own right.

Source: Augusztinovics et al. (2002: 39-40), HU NSRASP (2005: 24) and Palacios and Rocha (1998: 194-198).

As it becomes instantly clear, most of the changes to the public pillar were postponed until after 2013, when degressive and other redistributive elements will be eliminated. This does not mean that the reform did not have its merits. In fact, both the proponents of generational accounting (Gál, Simonovits, and Tarcali, 2001: 14-22) and of budget deficit calculations (Orbán and Palotai, 2005: 21-23) agree that the 1997-1998 base reform scenario ensured, if not the long-term sustainability of the system, at least a burden considerably easier to manage for future generation.

The main demerit of the PAYG reforms was that they were not systemic and did not introduce sufficiently strong commitment devices to prevent structural or agency-based institutional degeneration. Simonovits (2007) is very clear on the point. So much effort was devoted on the private pillar, that the public one was not simplified by, say, transforming it into a Notional Defined Contribution (NDC) scheme or German point system. The mandatory private pillar did not fare much better, as it was imbued with a series of amateurish flaws. Table 9 enumerates its main characteristics.

Table 9 Funded pillar's characteristics

Affiliation	Mandatory only for new entrants in the labour force as of 1 July 1998. All the others had the choice to join between the last quarter of 1997 and 31 August 1999, with contributions diverted from January 1998 on. The insured who opted in had the possibility to switch back to the public scheme until September 2000.*
Regulation of mandatory funds	
Legal status	They are non-profit organisations owned by their members, similarly to mutual funds. They can be founded by employers or chambers of trade, professional associations, employees' interest organisations, regional self-governments and by the ONyF's administration. Membership can be open or close. The general assembly appoints a board of directors and a board of supervisors.
Operation	Outsourcing is mandatory for banking and custodian services; it is optional for administrative tasks, record keeping and registration, asset management, actuarial tasks and payment of annuities.
Capital and membership requirements	25,000 members if it intends to provide annuities in-house. 2,000 members if annuities are contracted out. Pension funds that manage assets in-house must establish an own activity reserve amounting to at least HUF 100 million.**
Guaranteed Rate of Return (RoR)	RoR target set each year by the Hungarian Financial Supervisory Authority (PSzÁF) and based on a basket of long-term government securities. The band's lower limit is 85%, the upper limit 140% of the RoR target. What exceeds 140% is charged to a liquidity reserve. The liquidity reserve is used to increase the RoR if it falls under the lower limit.
Financing the guarantee	1) liquidity reserve – it cannot be larger than 4% of assets. In case of liquidation of a fund, losses are covered by: 2) a guarantee fund – every fund pays in 0.35% of contributions, 3) the state budget.
Investment limits	Hungary did not adopt the Prudent Person Principle, but opted for quantitative investment limits. However, these are very permissive and are being eliminated over time. A 30% limit on foreign currency exposure is in line with pre-Euro standards. The 50% listed equity limit was eliminated in 2005, investment in hedge funds was introduced the same year. Private equity was admitted in 2006. Adequate hedging is possible.
Administrative fees	At the beginning, the up-front (admission) fee amounted to up to HUF 4,000, that is 5-6% of contributions; the asset management fee was unlimited. Changes were introduced in 2006, see 4.6.2.
Switching	There was a small exit fee of 0.1% on assets, abolished in 2006. Switching is permitted twice a year; at least three months of membership are required. There are administrative barriers.
Tax treatment and subsidies	It follows the TEE concept. 25% of contributions are tax deductible, investment returns are not taxed and benefits are tax-exempt.
Regulation of annuities	
Provision	Until 2013 the insured have the choice between annuities and a lump sum. After 2013 annuitisation is mandatory.
Legal status	Annuities can be provided by the funds themselves (under certain conditions) or outsourced to a life insurance company.
Retirement age	As in the public pillar. 15 years of membership in a fund are required.
Annuity type	Single and joint life annuities are possible, as well as combinations with fixed term annuities to cover the spouse or other beneficiary.
Longevity risk	Unisex mortality tables are used. There is a service and a demographic reserve; the liquidity reserve may be used as well.
Indexation	Swiss, as in the public pillar.

Source: Allianz (2007: 55-61); Chłoń-Domińczak (2003); Dobronogov and Murthi (2005: 36); Impavido and Rocha (2006). *See 4.3.1 for subsequent changes. **However, if asset management is contracted out to an investment company, financial institution or investment fund licensed by the PSzÁF, the capital of the asset manager has to amount to at least HUF 50 million if it manages a pension fund with assets of less than HUF 2 billion. Exceeding that, the required capital is HUF 250 million and it increases by 1% of the pension fund assets, up to a maximum of HUF 1 billion.

The second pillar's regulation was criticised from the outset and disapproval intensified after the first years of operation. By 2003, the sector's five-year average investment performance was zero in real terms and economies of scale were not exploited (cf. Matits, 2004). Competition based on asset management did not materialise and prospective membership was not given the tools to avoid active mistakes. These developments threaten the funded pillar's long-term sustainability, especially in light of increasing populism in the public scheme.

The unfortunate state of affairs elicited widespread analysis, which provided important feedback for later regulatory improvements (see 4.6.1). Nonetheless, it is not yet clear whether parametric changes are alone sufficient to improve competition and reduce segmentation, or whether a structural overhaul of governance is needed.

4 Implementation and degeneration

4.1 Underperformance of the funded pillar[8]

By December 2006, second pillar funds counted more than 2.6 million members, roughly 25% of the population and two-thirds of the workforce. Assets under management amounted to HUF 1.68 trillion, that is more than EUR 6 billion. Out of the initial 38 pension funds established in 1998, 18 survived by 2006. Two are entering the market in 2007. However, neither the funds' performance nor their organisation reflect the designers' initial expectations. Actor-based and structural degeneration took place during the funded pillar's development. To account for the various anomalies, the following paragraphs will separately treat the affiliation of members, the segmentation and performance of the funds, their organisation and business practice.

4.1.1 Membership and compliance

At the beginning, membership skyrocketed to circa 1.5 million, overshooting the official forecasts by half a million. This immediately forewarned that active errors would be common (for details and a regression analysis, cf. Augusztinovics et al., 2002: 54-58) and that diverted contributions may generate higher-than-expected transition deficits. Rocha and Vittas (2002: 11-12) argue that the insured shared a 'negative consensus' that the political risk of the PAYG scheme was higher than the market risk of the funded system, in light of multiple manipulations during the 1980s and 1990s. This explanation for massive switching seems more plausible than, for example, the inheritability of assets, as members was allured by overoptimistic assumptions and the propaganda of both government and private funds (Orbán and Palotai, 2005: 12).

During the Fidesz era, affiliation stagnated, probably due to the government's disinclination towards the funded pillar. After 2003, the positive trend resumed and new members (roughly) correspond to new labour market entrants.

Table 10 Total members and opt outs 1998-2006

	1998	1999	2000	2001	2002	2003	2004	2005	2006
Total members	1,338.90	2,020.58	2,279.69	2,250.63	2,192.33	2,303.97	2,403.01	2,511.11	2,655.34
Opted back to PAYG	6.77	11.08	20.82	18.55	51.33	11.50	1.53	2.38	2.82

Source: PSzÁF.

[8] I have to thank Csaba Nagy, managing director of OTP Private Pension Fund, and Gábor Borza, managing director of ING Mandatory Pension Fund, for their useful insights on the evolution of the private pension fund market in Hungary and on the functioning of the Association of Pension and Health Funds Stabilitás, of which they are, respectively, the chairman and a member of the presidency. Furthermore, I feel obliged to István Czajlik of the MNB for comments on regulatory issues.

Further investigation, however, blurs the idyllic picture. Simonovits (2007) posits that well-designed pensions should encourage compliance and delay retirement and that the current Hungarian system has yet to fulfil this task. Máté (2004: 139-141) shares the pessimism. Since 1988, when the Personal Income Tax (PIT) was introduced, the tax and contribution bases, which differed until then on principle grounds, started to converge. The contribution-paying morale abated to the same extent that contributions came to be regarded as a tax. Many efforts have been spent to increase compliance (see 4.3.2), however results are mixed and data difficult to disaggregate. Most indicators started to improve in 2001: the covered wage bill (as percentage of GDP) recovered from an all-time low of 24.1% during 1999-2000, and the effective contribution rate (average contribution paid on average gross wage) exceeded 80% for the first time since the beginning of transition. However, it is impossible to say whether these results are attributable to increased compliance or simply to a general economic upturn.

4.1.2 Segmentation, concentration and performance

Of the 18 funds that endured initial selection, insurance companies sponsor six, banks founded four, big employers established five and three are independent. Augusztinovics et al. (2002: 67-70) show that the chances of survival of funds linked to the financial industry were highest. Table 11 contains an overview of the segmented Hungarian pension fund market on 31 December 2006.

Table 11 Pension funds by founder in 2006

Founder	MPF	Member share		Asset share		Average members	Average yearly contribution*	Average account value*
		2000	2006	2000	2006			
Insurance co.	6	57%	59.0%	52%	55.6%	260,943	84,568	596,864
Bank	4	32%	34.7%	41%	30.2%	230,421	116,560	551,350
Employers	5	10%	2.6%	6%	4.0%	13,866	153,760	961,907
Independent	3	1%	3.4%	1%	4.1%	30,561	58,280	751,905

Source: Matits (2006: 26) and PSzÁF. *All values are in HUF. Average yearly contributions refer to 2004.

In addition to segmentation, private pension providers underwent major concentration. The Big Six garnered 87.6% of members and 79.2% of assets (cf. Allianz, 2007: 58). Apart from the largest fund, run by commercial bank OTP, the others are sponsored by insurance companies.

Table 12 The Big Six in December 2006

Fund	Members	% share	Managed assets	% share
AEGON	495,986	18.7	275,448,358	16.4
Allianz Hungária	352,190	13.3	165,448,172	9.8
AXA	193,242	7.3	130,716,000	7.8
Évgyűrűk	113,988	4.3	59,866,905	3.6
ING	397,537	15.0	285,316,897	17.0
OTP	771,985	29.1	414,369,423	24.7
Big Six	**2,324,928**	**87.6**	**1,331,165,755**	**79.2**
Total	2,654,941		1,680,508,894	

Source: PSzÁF.

The main characteristics of Hungarian pension funds are their excessive administrative costs and underwhelming performance (cf. Matits, 2006). During 2004, the private pension sector recorded a total cost of 2.54% of average asset value, which is high according to international standards. A cost decomposition individuates in decentralised contribution collection a chief offender.

Unlike operating costs, asset management outlays declined only marginally, from 1.17% to 0.98%, against the backdrop of a six-fold increase in invested assets between 2000 and 2004. There is huge variance between single funds. During the period, per capita operating expenditure was similar in the smallest (less than 10 thousand members) and largest funds (more than 700 thousand members). Such blatantly irrational result implies that economies of scale were simply not exploited. The fee structure is anomalous and market overregulation is partially responsible. Back-office costs amount to 51% of total operating expenses. The Hungarian Financial Supervisory Authority and the Guarantee Fund make up for an additional 8%, again prompting a revision of the underlying financing strategies.

The funds' average annual net real rate of return was 2.1% during 1998-2004 (Orbán and Palotai, 2005: 12-13) The reasons for such poor performance were a wildly swinging Budapest Stock Exchange, which got seriously shaken by the Russian, American and other crises, excessive conservatism (see Table 13) on a very sharp market, and disclosure requirements, which prompted herding behaviour and short-termism. This generated much criticism and lately prompted a series of partial reforms (see 4.6.1 for an exhaustive discussion).

Table 13 MPF portfolios by asset class (HUF billion and % shares)

	2002		2004		2006	
		% share		% share		% share
Total portfolio	413.6		876.0		1,590.7	
Money on account and cash	16.6	4.0	8.5	1.0	38.3	2.4
Debt securities (bonds)	298.8	72.2	656.3	74.9	1096.3	68.9
Of which: Govt securities	280.9	67.9	639.1	72.9	1069.9	67.3
Shares	36.8	8.9	68.0	7.8	152.8	9.6
Investment fund units	29.2	7.1	75.4	8.6	224.4	14.1
Other	32.1	7.8	67.9	7.7	79.0	5.0

Source: PSzÁF.

Notwithstanding poor yields, structural degeneration of the funded pillar is best reflected by the variation between returns of individual funds. The five-year average difference between the best and worst performers amounted to 3%, a very significant figure, which may, after 30-40 years, translate into a 50-60% difference in disposable assets for participants in the two funds (Matits, 2006: 22).

Two factors account for this. Volatility of the market, and hence risk allocation, may explain the variation in gross returns. However, and most importantly, Matits distinguishes between asset managers who were chosen competitively on the market and those who were not. The latter, overwhelmingly employed by funds sponsored by financial institutions, charged much higher asset management fees than the market (and than the same asset managers charged to other clients) and sometimes generated, probably out of neglect, lower gross returns than the average. By 2004, anticompetitive management covered 91.05% of the funds' assets. Thus, it might be concluded, lack of competition and regulatory loopholes explain low net returns of the whole sector as well as their variability between funds.

4.1.3 Business approach: An employer-mandated market for big business

Neither concentration nor herding behaviour is exclusively characteristic of Hungary. The defining features of the Hungarian second pillar are its mutualist structure and decentralised contribution collection (up to 2007). These are responsible for radical modifications to the nature of the mandate and for the segmentation of the market, which, in turn, encouraged completely different approaches to sales, marketing, lobbying and collusion.

From the very beginning of implementation, the private pillar's mutualist velleities as well as the decentralised contribution collection helped overturning two basic tenets on which the new system was hinging: a) the nature of the mandate imposed on individual workers; b) the non-profit (or better self-managed) character of corporate governance (cf. Vittas, 1996: 24-25, 29).

In both cases, the drivers of the unanticipated reinterpretation were precisely those banks and insurance companies, against which mutualism was aimed. The nature of the mandate became employer-based or at best hybrid (worker and employer alternatively). The pre-existing ties between enterprises with banks (holding their accounts) or insurance companies (insuring property) influenced the employers' preference to stipulate a single pension insurance contract for their entire workforce, thereby avoiding the disbursement of contributions to more than one fund and the paperwork related to decentralised contribution collection (BBJ, 19-25 January 1998). A 2007 survey showed that 44.4% of those polled followed the employer's or accountant's advice when choosing the pension fund and only 8.6% heeded the recommendation of a sales agent (cf. Ágoston and Kovács, 2007).

An employer-based mandate has thus the positive side effect of curbing marketing costs. It also limits the number of new labour market entrants who do not opt for a fund and are hence automatically assigned to a default or random fund. In Hungary, each region was responsible to set up a default fund by either establishing a regional player or by selecting via public tender an existing provider. Were the number of undecided workers higher, this would generate a serious anticompetitive pressure, since OTP won 17 out of 19 such tenders (Erdős, interview).

As for the initial run-up for members, insurance companies had a fair advantage over banks, since their sales agents were numerous, unbound from local branches and trained to lengthily explain people the available offers (thus a supply-driven as opposed to a demand-driven marketing approach). The whole financial service industry, banks in particular, resorted to multi-level marketing, an option unavailable to smaller funds. This consists in linking the pension insurance to other services provided by the same financial group, such as offering free credit cards or providing lower interest rates. Within the insurance sector, it is useful to further differentiate between life-insurance companies, which lacked a direct contact with firms, and those insuring property, which could simply extend their services to their clients.

In addition, and similarly to what happened in the voluntary pillar, financial institutions circumvented the formal mutualist structure by only pretending that their boards were democratic. Sponsoring companies, through careful delegation manoeuvres, *de facto* controlled these boards. While the motivations for doing so are very sensible, the practical result falls short of good business practice.

On the positive side, the investments and professionalism required to run a pension fund with hundreds of thousands of members imply that the sponsor has to be fully in charge of its business. The need to offer clients the highest operational standards and lowest risk is fully correlated with the reputational capital that the financial group is defending. On the negative side, the embedment of a for-profit business logic into a mutualist structure leads to undesired side effects, which can be probably only annulled through demutualisation. The main problems affect two domains: a) transparency and hence responsibility; b) competition among funds (cf. Impavido and Rocha, 2006: 30-33).

Members own the pension fund and provide all the capital. This is simply the wrong institutional structure for anything that is not a closed employer-based fund. Consequently, accounting is almost impossible to follow, since, formally, there are no investments or capital requirements. The sponsor bears no legal responsibility for the institution, neither for downside risks nor for operational fraud. The company enjoys upside risk benefits, without sharing any of the costs, apart from putting at stake its reputational capital. Furthermore, the law stipulates that these are non-profit organisations; while in reality they have a business plan, make a profit and cash it in. However, from recordkeeping this does not transpire.

With respect to competition, instead, mutualism violates it three times. First, competition based on asset management does not emerge. Tenders, which should exert a downward pressure onto asset management fees, are intransparent and invariably lead to the selection of the financial group's internal asset manager. Second, performance-based competition fails to materialise. Lack of comparability and weak disclosure requirements prevent members to 'vote with their feet' and migrate to funds applying lower fees. Third, the mutualist structure is also an effective barrier to entry, as a market for acquisitions simply cannot develop.

4.1.4 Lobby, oligopoly or both?

Due to segmentation in Hungarian private pensions, a deep cleavage emerged between funds sponsored by financial institutions, on the one side, and smaller, firm-based or independent funds, on the other, with respect to their preferences on both market regulation and organisation. Since the funds operate on entirely different magnitude scales, this is unsurprising. A good illustration is that OTP, the biggest player, has to deal with 220 thousand employers, while Villamosenergia-ipari Társaságok pension fund, the electricity sector fund, with 50.

As for regulation, the six largest funds would like to streamline administrative procedures, reduce costs and turn the business into mass production, possibly through demutualisation. Smaller funds are, instead, genuine mutual benefit associations and are thus lobbying for specific regulatory advantages. By the same token, funds sponsored by the financial sector want to stabilise the market, prevent poaching of members and keep marketing costs low. Quite to the contrary, the survival of smaller players is dependent on the preservation of their niches; hence the provision of tailor-made services is their strength. As a consequence, the players founded two sets of associations, both of which are split along the abovementioned cleavage.

The first set, whose objective is the stabilisation of competition, emerged as soon as the initial recruitment phase was over. This resulted in the effective control of the market by the so-called Big Five cartel. Lately, however, the alliance started to be torn apart by strong centrifugal forces. The second set reflects instead the growing maturity of the young institutional arrangement, whose correct functioning requires a lobby responsible for interest representation and intermediation. After an initial period of stagnation, which witnessed the emergence of competing associations, the latter set is becoming increasingly consolidated. The leading group, Stabilitás, is gradually building homogeneous representation in the industry. The evolution of the two sets will be discussed in the following paragraphs.

Starting with the stabilisation of competition, it is notable that private pension markets lacking sufficient competitive pressure, provided by a strong regulatory and supervisory structure, display a tendency towards concentration and oligopolisation. What again distinguishes Hungary from the rest is that here the cartelisation of the largest MPFs was publicly announced, transparently carried through and openly endorsed by the Competition Office (GVH).

As early as in the fall of 1998, the four largest Hungarian mandatory pension funds – all backed by financial conglomerates – stipulated a competition-limiting gentlemen's agreement, ironically called 'ethics code', which consisted of two elements: i) a 'quantity-fixing' part, which hindered the switching of members by annulling the sales agent's commission in case the new member was poached from one of the funds forming the cartel; ii) a series of restrictions to negative advertising, that is the direct comparison between the performances of the contracting pension funds (BBJ, 12-18 October 1998). The agreement was originally signed by ÁB-Aegon, Hungária Insurance (Allianz), Nationale Nederlanden (ING) and OTP. Winterthur (AXA) stepped in only later.

Most analysts, including, at first, the Competition Office's head Zoltán Nagy, condemned the agreement as being aimed at curbing competition. Until the very end of the Competition Office's investigation, started, oddly, at the funds' proposal, it thus appeared plausible that the cartel be dissolved and the funds heavily fined. To understand the anomalous decision that let the cartel stand (Hungarian Competition Office, 10 June 1999), the arguments of the proponents and opponents of the pension pact have to be evaluated.

A strenuous opponent, Árpád Skrabski of the Pension Fund Association (an association of smaller funds), strongly criticised the agreement, because it empowered larger funds to employ agents selectively to poach members from independent funds. However, the proposed cure was probably worse than the disease, as it envisaged the drafting of an alternative ethics code to extend the anti-poaching practice to the whole sector, ban negative advertising and limit the possibility to offer perks to attract members. Of course, larger funds simply refused to sign the agreement on grounds that their founders' interests differed.[9]

Moreover, the signatories of the pact provided two counterarguments. First, they claimed that the agreement did not in reality infringe competition, as members were still able to voluntarily switch. They were simply not encouraged to. Second, and in light of other countries' dismal experiences, it was argued that limiting unnecessary switching saves on marketing costs and thus increases individual members' benefits (BBJ, 14-20 June 1999).

Apparently, the large funds' line of reasoning was convincing enough for the Competition Office to ignore the negative recommendations of its own investigators and bless the agreement. The three-member court, chaired by Mrs. János Fógel, ruled in June 1999 that the pact indeed breeches Competition Law, but that by reducing marketing costs it could be granted an exception. Consequently, instead of setting an example for the financial service industry as a whole, the Competition Office let go, thereby probably contributing towards the funds' underwhelming performance.

While the cartel survived antitrust censorship, internal disagreements were sufficient to destabilise it. Aegon, first, and AXA, recently, stated that they could not keep their operations within the limits of the agreement. Aegon withdrew by the end of 2005 with the objective to increase its market share. The fund raised the commissions to its sales agents and quite effectively climbed from third to second place the ranking of funds with respect to membership (Erdős, interview). As AXA issued during 2007 two warnings that it may break off, the fate of the agreement looks grim. Its dissolution could, however, unleash a major marketing campaign, which would probably lead to even further concentration.

With respect, instead, to the industry's lobbying activity, as soon as the more pressing 'economic' issues were settled, the funds sponsored by banks and insurance companies realised that their individual capacity to influence regulation was very limited. The necessity to lobby arose out of a heavily regulated market, whose administrative requirements were often suffocating. Notable examples are yearly statements to clients, which show the opening and closing balances as well as intermediate movements. While all assets are valued marked-to-market, book values have still to be shown. Their representation is both irrelevant and costly, thereby increasing the burden borne by members.

The creation of an interest group association for the pension fund market in Hungary followed a very uneven course. While most financial sectors – banking, asset management, mutual funds – are homogeneously represented, it took almost ten years to reach a cooperation agreement among all funds, listed into three distinct associations.

The Big Six (see Table 12) created, on 29 May 2000, the Hungarian Association of Pension Funds Stabilitás with the exclusive mandate to deal with second pillar issues at the national and international levels. The European Federation for Retirement Provision (EFRP) accepted Stabilitás as a member with observer status in January 2004. Apart from one significant exception, the association underwent constant expansion and consolidation, as its members perfectly understood that only a unified front could maximise lobbying results.

The exception was Aegon, which left the association in December 2005, because it refused to reduce its asset management fees. As it was confirmed by later events, Stabilitás was right to recommend individual members to exert some self-restraint on costs, in order to avoid centralised setting of maximum fees, which was inevitably introduced in 2007. The perceptible incapacity of the

[9] Only much later, during the spring of 2006, the pension fund association Stabilitás endorsed an ethics code on the conduct of its members' business and published by PSzÁF.

market to self-regulate is a cause for concern. Its main consequences were the abovementioned failure to abate administrative costs and the top-down imposition of most important innovations, as opposed to a bottom-up feedback process. These defects indicate that the providers' expectation failed to adapt to the original design, which in fact requires a corrective action.

Failures notwithstanding, the association expanded by recruiting a number of voluntary pension funds, to begin with, and subsequently concluded two cooperation agreements: the first one with the Nationwide Association of Domestic Pension Funds HNyOSz in June 2006 and the second with the Nationwide Association of Health Funds EPOSz in October of the same year. Stabilitás encompasses circa 76% of mandatory funds and 60% of voluntary ones (BBJ, 5-11 June 2006).

Apart from regulatory ameliorations, such as the steady relaxation of investment limits, the association's utmost exploit and a notable improvement was the agreement struck with the Tax Authority, APEH, in February 2007. When contribution collection was centralised in mid 2006, the larger funds convinced smaller players that only the standardisation of their communication procedures with APEH, which is not renowned for its flexibility, would ensure the operation's success. Stabilitás sponsored a number of meetings, which led, in November 2006, to the signing of a multilateral agreement among all Hungarian private pension funds and, later, to a satisfactory compromise with the tax administration.

Stabilitás thus emerged as a rather successful organisation, which again confirms the importance played by structured interest representation in the development of young and unstable institutional environments. However, its limited capacity to impose self-discipline on members raises the question whether clients are confronted with simple market imperfections or with a worrying market failure.

4.2 Failure to adapt: The rule of Fidesz

4.2.1 The 1998 elections

After Fidesz's dismal performance in 1994, when the party got only 7.02% of the national vote, the year 1998 marked the culmination of its transformation from a youthful, libertarian, anticommunist party into a nationalist, conservative one. During 1996-1997, the political spectrum right of the centre changed dramatically. A faction of the severely weakened Hungarian Democratic Forum broke away in 1996; the Christian Democratic People's Party collapsed, owing to infighting, and its centrist members joined Fidesz ranks. Hence, the latter became the largest opposition party by overtaking the conservative and populist Independent Smallholder's Party (BBJ, 22-28 September 1997).

Despite the premises, the 1998 electoral campaign was tepid and chiefly pro-European. Even Fidesz's largely populist manifesto did not cause serious concern, as it was believed that its rhetoric would not be followed by action (BBJ, 18-24 May 1998).

The Parliamentary election, its two rounds held on 10 and 24 May 1998, witnessed a radical change in government as the incumbent MSzP and SzDSz were defeated by a relatively narrow margin. The coalition formed by Fidesz, Smallholders and MDF captured 213 out of 386 Parliamentary seats. The main surprises were the spectacular 22 percentage points gained by Fidesz with respect to 1994, the collapse of SzDSz and the discomforting voting into Parliament of István Csurka's ultranationalist Hungarian Justice and Life Party (MIÉP).

The debacle of MSzP occurred during a period when both the economy and Hungary's international standing were at their apogee. The Bokros package started to bear fruits through sustained growth, lower inflation and shrinking deficits; NATO and EU memberships seemed to be nearing fast and, for the first time since 1982, the country was not indebted with the IMF. Notwithstanding, some analysts as well as Fidesz's leader and new PM Viktor Orbán, agreed that three reasons determined the incumbent government's demise (BBJ, 1-7 December 1997; 1-7 June 1998). First, the Socialist-led coalition unnecessarily dragged its feet for nine months after the 1994 elections, before appointing MoF Bokros and launching the austerity package. Second, the four years of Socialist rule witnessed the deterioration of public security and an escalation in violence. Third and chiefly, MSzP was not punished for its pro-liberal economic views, but for all the scandals and internal corruption that gave Fidesz, which portrayed itself as a clean party fighting political dishonesty, an enormous advantage.

4.2.2 On the Threshold of a New Millennium

"Less than a change in the system, more than a change in government" was Viktor Orbán's slogan during the electoral campaign. This 'quasi-systemic' change involved a significant redrawing of both Hungarian economics and politics.

According to the electoral manifesto 'On the Threshold of a New Millennium', basic public finance tenets were to be disproved by a visionary fusion of Reaganomics with Keynesianism. The pamphlet envisaged spending increases worth HUF 600 billion, generous tax incentives and a cut in social security contributions from 39% of gross wages to 10-15% in just four years, to be achieved by introducing private health insurance (BBJ, 13-19 April 1998). These measures would, as a result, miraculously generate economic growth of up to 7% of GDP *per annum*, without either increasing overconsumption, aggravating the twin deficits or spurring inflation. Not unexpectedly, analysts were sceptical. On the political front, instead, Orbán's aim was to create a Westminster-style two-party system where the winner takes all, in order to strengthen his rule over the country. While the original intentions were perhaps benign, the final result fell little short of creating systemic illiberality. Intuitively, Fidesz's mandate underwent three distinct phases marking the party's involution.

During the first months in government, the allegiance of Fidesz's most powerful Ministers to macroeconomic stability dispelled investors' fears that the centre-right coalition would indulge in overspending. MoF Zsigmond Járai and Economic Minister Attila Chikán soothed markets as they teamed with MNB President Surányi to keep fiscal policy strict, thereby avoiding the stalemate between MSzP and governor Bod that happened four years earlier (BBJ, 20-26 July 1998; Csaba, interview). Up until 2000, spending was kept under control, however, it is unclear whether Fidesz was at the time truly committed to fulfilling the Maastricht criteria, or if it was just paying lip service to the idea.

The second phase started after a major reshuffle weakened the incumbent coalition's liberal wing. In December 1999, a dissatisfied PM Orbán substituted the Economic Minister Chikán with György Matolcsy.[10] Being the mind behind the economic sections of Fidesz's electoral manifesto, Matolcsy remained committed to the 7% GDP growth promise. Soon after taking office, he called for a Keynesian 'new deal' that materialised in the 'Széchényi Plan' (BBJ, 1-7 October 2001; 31 January - 6 February 2000). This was topped up by audacious minimum wage increase promises and a bitter dispute with the MNB, which almost led to the resignation of President Surányi.

Expenditures started to run amok during the acrimonious 2002 electoral round. By then, any velleities to rein in the budget deficit were set aside and a spending spree accompanied the global economic slowdown. At the end of 2000, a two-year electoral budget was legislated, which included wage hikes for 667 thousand workers (BBJ, 23-29 April 2001). Soon after, in March 2001, MoF Járai followed Surányi at the head of MNB, thereby raising doubts on the Bank's independence from government. The continuous practice to put expenditure items off budget drew heavy criticism from the IMF. The apotheosis was Fidesz's 2002 electoral manifesto, 'A Contract with Citizens', which significantly contributed to the electoral year's budget deficit skyrocketing to 8.2% of GDP.

[10] His previous exclusion from government signalled that Fidesz, at least initially, backtracked on excessive promises.

During the centre-right coalition's rule, few sectors of the economy and polity failed to undergo a shake-up, and in spite of just three paragraphs of Fidesz's 1998 electoral programme devoted to retirement, the pension system represented no exception.

4.3 Fidesz's incoherent crusade

Rather surprisingly for a (self-professed) liberal party, the newly established multipillar system captured from the very beginning the attention of Fidesz's policymakers, whose contempt for Medgyessy's pension reform was undisguised. While Fidesz MPs voiced throughout the brief parliamentary debate concerns over transition financing and doubts on alleged private pension advantages (Orenstein, 2000: 42), the reasons for later hostility remain undisclosed. A common explanation is that, in principle, Fidesz objected to any measure endorsed by MSzP. However, a more nuanced answer is needed.

On the one hand, there were major fiscal concerns. Coherently with the 'negative consensus' on the public pillar's unreliability, most Hungarian workers switched to the new system, largely surpassing the outgoing government's predictions. As a result, ONyF's projected deficit for 1998 triplicated (BBJ, 23-29 November 1998). At a time of high hopes of swiftly joining the EU and the Euro, Fidesz drafted a very ambitious deficit (and inflation) reduction schedule, the target for 1999 being a decrease from 4.6% to 4.0% of GDP. Consequently, the excessive popularity of the new schemes was a thorn in Fidesz's side to be extracted as soon as possible.

On the other hand, there was an aprioristic aversion against anything enacted by the Socialists, be it even a neo-liberal artefact. The opposition was almost entirely left out of the legislative process and was hence convinced that MSzP's reforms were not born out of commitment to private markets and individual responsibility, but in view of tunnelling benefits out of the new system (Hamecz, interview). It can be noted, in fact, that earlier drafts of Act LXXXII/1997 on pension funds contain the option for Hungarian regions (19 counties and the capital, Budapest) to establish each its own mandatory fund. Párniczky (interview) contends that this provision served to guarantee the existence of providers in case no one applied for a license.[11] However, the HUF 3 billion cost of the operation as well as the possibility of employing a conspicuous number of political appointees on managing and supervisory boards do point into an altogether different direction. Ultimately, all the legislation related to state-run pension funds was repealed (except the option for ONyF),[12] but the distaste of Fidesz for the mixed system persisted. Although it never materialised in a coherent alternative, talks on how to overhaul the new arrangements intensified as the 2002 elections neared.

4.3.1 A tale of policy reversals

Fidesz's derogatory approach resulted in growing uncertainty to both the insured and providers. The centre-right coalition legislated an array of measures aimed at lessening transition costs, thereby increasing the system's complexity, and aired intentions to fundamentally reform or even rollback the freshly implemented second pillar. Due to the trendsetting status of Hungarian reforms in the region, these policy reversals triggered a wave of criticism, which resulted in a flurry of analyses (Palmer, 2007: 13).

In order to 'fiscally sustain' the excessive popularity of the private pillar, Fidesz resorted to distortionary internal financing measures, which included: a) changes in contribution rates; b) less favourable indexation; c) disincentives to join the mixed system. The first amendments to the 1997 reforms were already passed on 12 November 1998. This early package infuriated both the fund

[11] In light of the rather well developed voluntary pension market, this justification is weak.
[12] This was possibly a concession to the financial service lobby.

managers, who basically had to change their business plans, and pensioner associations, since many of their members pulled the short straw.

First, the contribution rate diverted to the second pillar, scheduled to stepwise increase during the following years, stayed at 6% in 1999 and continued to be frozen during Fidesz's entire mandate. Since the public pillar was not corrected to indemnify mixed system's participants (Simonovits, 2002: 13; 2007), this measure resulted in a not so spontaneous donation of 2% of the switchers' contribution to ONyF. Hence, the cut-off age, above which participation to the new schemes becomes disadvantageous, was significantly lowered, i.e. from 36 to 28-30 (Rocha and Vittas, 2002: 13). Concomitantly, a long-term decrease in employer contributions started and continued the descent in 2002, after MSzP returned to power (see Table 14). These reductions endeavoured of course to increase Hungary's competitiveness abroad, at the expense, however, of ONyF's future self-sustainability.

Table 14 Old-age pension contributions 1989-2007

	1989*	1990*	1991*	1992	1993	1994	1995	1996	1997
Employer	43	43	43	24.5	24.5	24.5	24.5	24.5	24
Employee	10	10	10	6	6	6	6	6	6
Total	53	53	53	30.5	30.5	30.5	30.5	30.5	30
Ceiling (HUF/day)	-	-	-	2,500	2,500	2,500	2,500	2,500	3,300

		1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Employer		24	23	22	20	18	18	18	18	18	21
Employee	**PAYG only**	7	8	8	8	8	8.5	8.5	8.5	8.5	8.5
Employee	**PAYG**	1	2	2	2	2	1.5	0.5	0.5	0.5	0.5
	MPF	6	6	6	6	6	7	8	8	8	8
Total		31	31	30	28	26	26.5	26.5	26.5	26.5	28.5
Ceiling (HUF/day)		4,290	5,080	5,520	6,020	6,490	10,700	14,500	16,440	17,330	n/a

Source: Orbán and Palotai (2005: 10), Máté (2004: 118) and CANPI (2006: 27). *Up until 1992, year of the establishment of ONyF, contributions were paid to the Social Insurance Fund and therefore included the health insurance part, later diverted to OEP. In addition, there was no upper ceiling for employers or employees. Employers still pay contributions on the entire payroll.

Second, the gradual introduction of Swiss indexation was suspended as well, and substituted by the inadequate practice of defining flat sums, lower and upper limits. In fact, all benefits had to be increased by at least 11%, while low benefits were allowed to rise up to 25.5% (Augusztinovics et al., 2002: 49-50). Hence, instead of using wage indexation with a one-year lag, which would have resulted in an 18.4% increase, forward-looking indexation was reintroduced. The average 14.2% raise coincided with the actual rate of inflation. This again implied substantial savings for the public pillar and a worsening of pensioners' relative income status. Given that all fiscally stringent policies were reversed as the elections approached, the ONyF announced a 9.7% increase to continued pensions, substantially above year-on-year inflation level, projected to be 5-6% by December 2002.

Third, the government sought to lower transition costs by creating an asymmetry between incentives and disincentives to join the mixed system (Orbán and Palotai, 2005: 12). In fact, while the provision that members of the PAYG pillar could not switch to the new system after August 1999 was retained, the same did not apply to the option to pull back from it. The originally planned December 2000 deadline was duly extended until the end of 2003.

In November 2001, a second reform package reinforced the trend, by introducing some structural changes. The multipillar structure was adulterated. Participation to the mixed system, mandatory since July 1998 for new entrants to the labour market, became optional from 2002 and the public pillar regained its default status. Of course, this shift to voluntary participation had an impact on the insurance against downside risk guaranteed to members of the mixed system. In fact, the obligation of the Guarantee Fund to top up total benefits in case of inadequate returns was abolished. The Fund survived as a safeguard against fraud and mismanagement. Understandably, this undermined one of the fundamental motives that convinced risk-averse employees to switch. Claims that they were given the means to make an informed choice were *a posteriori* demolished.

In addition to this short-lived measure – MSzP reinstated mandatory participation from 2003 – the package also introduced changes in accounting rules and contribution ceilings, thereby improving the original reform. Since January 2002, asset valuation is reported on a quarterly basis, daily assessments are required for large funds and assets are marked to market. The responsibilities of custodians and asset managers were clarified. Finally, the ceiling on employee contributions was raised from 200% to 250% of the average gross wage (cf. Palmer, 2007: 11-12).

Apart from rather limited concrete actions, Fidesz's rhetoric became a cause for concern. Even though attempts at reversing the 1997 reform were no more than a nebulous plan, just mentioning change undermined confidence in the multipillar system. Criticism against the new schemes was fierce at the beginning of the coalition's mandate. László Mádi, Fidesz's MP and deputy chairman of Parliament's budget committee, repeatedly lamented the mounting deficits of the Pension Insurance Fund, while Gabriella Selmeczi, a political state secretary at the PM's Office who supplanted the ousted OEP and ONyF boards (see 4.3.2), accused the past government of excessive and irresponsible haste (BBJ, 14-20 September 1998).

Among others, the concepts supported by sociologist and former advisor to SzDSz and ONyF, György Németh, started to influence Fidesz (Banyár, interview). He abhorred pension privatisation for being a bad deal for the Hungarian state, which had to transform part of its implicit liabilities (leased at submarket rates) into explicit debt (yielding market interest), thereby endangering compliance with the Maastricht criteria (BBJ, 8-14 June 1998). While the polemic somehow abated during 1999 and 2000, PM Orbán caused a wave of outrage by unveiling, in April 2001, a plan to hurl people back from the funded into the PAYG pillar. Opposition MPs described the manoeuvre as a foul election ploy and pension fund managers cynically warned against knock-on effects across the real economy (BBJ, 23-29 April 2001).

According to Orbán, the public pillar was to adopt the NDC concept in order to directly compete with private pension funds – and possibly phase them out. Consequently, career starters would not be any longer obliged to join the funded pillar and the minimum pensionable age would be abolished, as benefits would be automatically adjusted to the qualifying period. However, nothing other than these few reform details were spelled out. The working group dealing with the issue was established only 13 months before the 2002 elections and continued meeting until then. The group, chaired by József Mészáros, head of ONyF, was split between supporters of a pure NDC pillar and those in favour of a German point system and thus all its proposals, like most initiatives of Fidesz, came to naught (Banyár, interview).

The working group's concept was later developed by some of the involved experts (cf. Banyár and Mészáros, 2003), who favoured the idea of introducing NDC schemes in order to slowly prefund the public pillar – this being quite a rupture with Németh's original intentions.

4.3.2 The anti-labour offensive and regaining control over the ONyF

During the mandate, Fidesz distanced itself from the previous government's consociational stance. Relations with labour soured to the extent that MSzOSz president László Sándor called the new Labour Code, legislated in April 2001, a *"110-year step backwards in the history of worker's rights in Hungary"* (BBJ, 23-29 April 2001). The *divide et impera* approach led to the exacerbation of conflict in a number of areas.

Negotiations within the Interest Reconciliation Council (IRC), the country's highest institution for industrial relations, were all but discontinued. The IRC was dismantled and substituted by an internationally recognised body, the National Labour Council (NLC). The tripartite forum's task was to check the compliance of all Hungarian labour legislation with the *acquis communautaire* (BBJ, 31 May - 6 June 1999). In reality, the institution was consulted only in relation to the Labour Code; other legislation directly concerning labour – social security included – was simply rammed through.[13]

In light of the above, regaining control of the social security self-governed boards was one of Fidesz's top priorities, and the 5 May 1998 Constitutional Court's decision (see 3.3.4) was the *deus ex machina* that rendered a wipe-out possible. PM Orbán's plan was to eliminate the two boards in July 1998 and substitute them, by January 1999, with two financial directorates consisting of nine representatives each. MSzOSz officials as well as Pál Kovács, chairman of the Health Insurance Fund, labelled the move as undemocratic. In their opinion, it violated both the legal security and representation of the insured (BBJ, 1-7 June 1998; 13-19 July 1998).

Notwithstanding, the decision to oust the two anti-democratic, scandal-ridden and overpaid boards was fully justified. The State Audit Office (ÁSz) reported *post factum*, in November 1998, that the social security funds' continued to perform dismally after the reappointment of their boards in mid 1997. Their combined deficit ballooned to HUF 55.8 billion. The imbalance was entirely ascribable to OEP, since ONyF recorded a HUF 5.2 billion surplus, however, experts agree that ONyF was somewhat more disciplined just owing to stricter regulation (BBJ, 9-15 November 1998).

After the ousting, the funds' reserve assets were returned to state ownership and used to pay for pension outlays (Máté, 2004: 123). As a temporary measure, before creating the directorates, Gabriella Selmeczi was designated commissioner in charge of the two funds, only to resign in an unrelated scandal in mid 1999. This event induced Fidesz to simply shelve the directorate plan and put the two funds under direct ministerial control. Since June 1999, the Ministry of Finance became responsible for the two funds' budgets, health care policy was fully delegated to the Health Ministry, while the Ministry for Social and Family Affairs was put in charge of pension-related issues (BBJ, 14-20 June 1999). By then, the self-government adventure was unconditionally over.

Another way of tightening the grip on social security financing was the transfer, effective as of January 1999, of contribution collection from OEP and ONyF to the Tax and Financial Control Administration. The latter was entrusted with a number of tasks: collection of contributions, inspections, record keeping of contribution obligations, payments, and debts; legal action in cases of serious breaches. On the one hand, these measures improved the quality and supervision of submitted data. The cooperation with Tax Administration inspectors proved beneficial and late payment charges were raised to fight evasion. On the other hand, greater involvement of the public institution strengthened the view that social security contributions are just another form of payroll tax (Augusztinovics et al., 2002: 49).

Even though improving compliance was a major objective, most efforts were vain or mishandled. From the very beginning, Fidesz backtracked from the much-needed introduction of individualised record keeping. Hungarian employers and self-employed have to transfer first pillar contributions to their ONyF account held at the Hungarian State Treasury and submit an aggregate report to the Tax Administration. The latter does not contain data on individual employees and is thus unfit to serve as a basis for detailed record keeping. The Kafkaesque twist is that legislation enacted during 1995-1996 obliged employers to hand in all their documents related to pension insurance and to annually submit data on individual workers' pension rights to ONyF's Central Administration. These

[13] A notable example is Fidesz's decision in October 2000 to override the NLC on wage concertation, if employers and employees failed to agree by 25 November (BBJ, 23-29 October 2000). This led to the unilateral fixing of the minimum wage for 2001 and 2002.

reports, however, are not checked against the aggregate figures reported to the Tax Administration and thus cannot constitute the basis of a national system of contribution records either (Máté, 2004: 128-132).

In order to fill in the lacuna, Act LXXX of 1997 included a requirement for individualised record keeping as of January 1998, but the deadline was postponed until 1999. Scarce IT resources, bureaucratic resistance and the dreadful state of past Hungarian contribution records played a significant role when the plan was definitely dropped in 1998 (Fehér, interview; Máté, 2004: 131). As a result, the need for this level of detail in the computation of benefits was eliminated and the opportunity to perform crosschecks with the funded schemes was lost (Palmer, 2007: 15).

In a further attempt to increase compliance, ONyF tried to raise the awareness of employees during 2001-2002. Based on the records provided by employers, ONyF informed workers of the pension rights they acquired during those two years and invited them to verify the data against their employers' statements. Feedback was so scarce that the campaign was discontinued by 2003. Disillusionment, indifference and lack of confidence in the public schemes – all major elements of the 'negative consensus' – were probably to blame for the low response rate (Máté, 2004: 149-153).

4.3.3 The International Financial Institutions (IFIs) as *personae non gratae*

The last months of the MSzP government coincided with a substantial lessening of IFIs involvement in Hungary. IBRD Executive Directors discussed a Country Assistance Strategy in January 1998 and a month later, on 14 February, the 23-month stand-by agreement signed in 1996 with the IMF expired, thereby marking the first time after 1982 that Hungary was not indebted to the Bretton Woods institution. A final one tranche Public Sector Adjustment Loan (PSAL), which granted US$ 150 million for implementing a complex policy matrix in the area of pensions, was disbursed in April 1998 and was verisimilarly the last say of the World Bank in the Hungarian pension reform.

These developments, coupled with investment status credit rating and abundant Foreign Direct Investments (FDI) financing part of increasingly moderate deficits, strengthened PM Orbán's disregard for the two international organisations. The premier brusquely asserted that Hungary did not need or consider borrowing from IFIs any longer, when, during the pre-electoral period, the IMF dared to rebuke the government for excessive spending (BBJ, 4-10 June 2001). As a result, the country's outstanding obligations towards the IBRD stood at only US$ 0.5 billion by 2001, down from US$ 2.4 billion in 1995. The World Bank agreed to start the graduation process in the run-up to EU accession and decided not to propose any further lending programs (World Bank, 2 April 2002). However, and apart from these positive developments, Fidesz's unconstructive stance provoked some (avoidable) repercussions.

Of the US$ 132 million originally granted by the PAHIP, whose deadline was extended until December 1999, only 34 were spent and even these with unsatisfactory results. Having Fidesz abandoned the idea of individual record keeping, the PAHIP loan appraisal remarked that, by 2000, the IT infrastructure had not been yet developed and that a confirmed database of all the insured had not been produced. Ultimately, most of the remaining PAHIP budget, mainly earmarked for planning, was never spent and follow-up projects to the PSAL were all but discontinued (Palmer, 2007: 37). In light of this, the Bank simply ceased to play a significant role in Hungarian politics after 1998.

4.3.4 Genesis of PSzÁF

The Socialist government considered the unification of financial market supervision as early as 1996, when the banking and capital market supervisory bodies were integrated. Numerous failures related to the monitoring function of the State Financial and Capital Markets Supervision (ÁTPF), the increasing integration of the financial service industry and a drive towards cost containment, spurred

Fidesz to unearth MSzP's plan during 1999. The supervision of financial markets was as a consequence merged and placed under the aegis of the Ministry of Finance (BBJ, 15-21 February 1999).

Fidesz's intention was to combine the ÁTPF, the State Insurance Supervision (ÁBiF) and State Pension Funds Supervision (APF) into the Hungarian Financial Supervisory Authority (PSzÁF) and delegate the MoF to appoint its leadership. This proposal was criticised by ÁTPF chairman and designated future president of PSzÁF, István Szalkai. He maintained that, like other monitoring bodies, such as the Competition or the State Audit Offices, the Financial Supervisory Authority should be responsible only to Parliament. He rejected the post in protest and was replaced by Károly Szász, the CEO of Konzumbank Rt (BBJ, 17-23 April 2000; 27 March - 2 April 2000). The merger was finalised in April 2000. The novel structure of PSzÁF consisted of four functionally separated departments (controlling; coordination, IT and analysis; licensing; and complaints) employing some 450 staff. The new institution covered the whole financial sector, except for credit cooperatives, and applied a unified set of rules. The endeavour was a relative success.

While staffing and financing are considered to be adequate (PSzÁF levies a supervisory fee on market participants, which grants relative independence to the institution), excessive government intervention is still a cause for concern (Impavido and Rocha, 2006: 37-39) In fact, both the cabinet and Parliament have the right to appoint PSzÁF top officials and this has the potential to generate frictions at leadership level. Additionally, the Supervisory Authority has no regulatory power outside the area of money laundering. Drafted regulations are submitted to the Finance Ministry and issued by the Council of Ministers, a procedure, which may again be a significant source of interference. However, the lacuna is partially filled by the wide range of resolutions and guidelines issued by PSzÁF, which *de facto* constitute a body of binding secondary regulation.

4.4 The populist implosion and the run-up to the 2002 elections

The 2002 electoral bout will be remembered in Hungary for its brutality. The uncertain polls, which until the end assigned a lead to Fidesz-MDF, only exacerbated the two coalitions' populism and reciprocal scorn. On the one hand, Fidesz's involution reached a climax, thereby bringing about a mixture of economically unsustainable promises, the consolidation of a Westminster-like dictatorship of the majority and a rhetorical escalation against the enemies of the nation. On the other hand, MSzP could not but play the populist card to allure voters and therewith transformed the 2002 vote into a proper race to the bottom. The irresponsibility of resulting policies jeopardised the country's hard-fought macroeconomic stability and foiled its plans to adopt the Euro.

4.4.1 Fidesz's triple transition

The illiberal, conservative and nationalist metamorphosis involved radical steps in the party's professed economics, politics and rhetoric.

On the economic front, the appointment of Economic Minister Matolcsy started the charade. In December 2000, a two-year 'electoral' budget was passed involving increased government spending by 12% to rekindle the economy, a theatrical raise in minimum wages from HUF 25,500 in 2000 to HUF 40,000 in 2001 and HUF 50,000 in 2002, and a 12% average salary hike during 2001 (BBJ, 4-10 December 2000). The Széchényi Plan's estimated costs ballooned, similarly to the promises contained in the Contract with Citizens. In a populist paroxysm, PM Orbán earmarked HUF 606.8 billion to healthcare; guaranteed to join the EU, introduce the Euro and simultaneously double average wages.

Institutionally, things were at least as bad. The majoritarian grip tightened around the country. On the one hand, the government's influence over the economy increased through a wave of renationalisation, the strengthening of the Ministry of Finance – the appropriation of OEP, ONyF and PSzÁF were just examples of a generalised trend – and the running of gargantuan projects off-budget, in order to circumvent public procurement laws, thereby attracting major criticism on behalf of the IMF (BBJ, 22-28 October 2001). On the other hand, Orbán started viewing government as a four-year Churchillian dictatorship. The Prime Minister's Office was strengthened and assigned to a separate Ministry, the parliamentary schedule was overhauled, in order to limit question times, and the Parliament's controlling role was downplayed by putting off the agenda all hearing committees proposed by the opposition (BBJ, 15-21 October 2001).

Politically, PM Orbán tried to achieve the emotional unity of the domestic right wing. After MDF swore allegiance and scandals swept away the Smallholders, Fidesz got stuck between an unyielding centre, which it did not represent any longer, and the far-right, nationalist and openly anti-Semitic Hungarian Justice and Life Party. As a consequence, PM Orbán never stopped fishing for extremist votes and his rhetoric became increasingly radical and nationalist. Fidesz simultaneously accused Socialists of being 'traitors of the nation' for having abandoned ethnic Hungarians abroad and continued to stress that if MSzP won, it would put Hungary under the heel of 'big business' (BBJ, 4-10 March 2002; 15-21 April 2002).

4.4.2 MSzP raises the stakes

The vicious campaign dictated MSzP's 'fight fire with fire' electoral strategy. Former MoF Medgyessy was the party's official PM candidate at a time when MSzP was deeply divided into three ideological platforms (see note 6). The party's leading posts were also shared: whereas MSzP president László Kovács was liberal, parliamentary caucus leader Sándor Nagy and the party's council chairman György Jánosi were hardcore leftists. In addition, a coalition with SzDSz was far from granted, and it took the resignation of newly elected president Gábor Demszky (the long-standing major of Budapest) to definitively team up.

In a populist competition with Fidesz, MSzP drew the '100-day program', which fell little short of the Contract with Citizens. The program envisaged a substantial reduction of PIT rates and the total exemption for minimum wages, a lump-sum compensation for insufficient pension benefit indexation, the introduction of the 13th pension, some HUF 150 billion annually for healthcare and an almost immediate 50% hike in the salaries of teachers, healthcare and other public sector employees. Some institutional oddities were promised as well, such as the reinstitution of an upper chamber for interest group representatives.

In view of the above, MSzP's electoral campaign elicited two sets of expectations. First, most pollsters attributed Fidesz a consistent 5% advantage. Second, prominent economic analysts viewed Socialist promises as a bluff to win the election, and believed that former banker Medgyessy would renege on them once in government. Both proved to be totally wrong.

4.4.3 *Rien ne va plus*

According to Gál (interview; cf. 2006: 185-187), certain peculiarities of the Hungarian party system exacerbate the country's political budget cycle. Hungary employs a constructive vote of no confidence[14], which radically diminishes the chances of forcing out an incumbent government before the mandate is over. This is further aggravated by historical contingency. It would be unthinkable that the two coalitions' junior partners (SzDSz and MDF) change sides to topple their respective governments. Hence, end of term elections are the norm in Hungary and these generate severe pre-election fiscal policy distortions (cf. Rogoff, 1990: 31-32). Last but not least, the electoral margin between the two coalitions has substantially narrowed, thereby increasing the cost of the winning votes. Table 15 shows that irrespective of the outcome, the 2002 electoral bill would have been very dear.

[14] The *konstruktives Misstrauensvotum*, a German invention, allows for the removal of the prime minister from office by majority vote of Parliament, only if a prospective successor also has the support of a majority.

Table 15 2006 economic targets of Hungary's two biggest parties

	MSzP	Fidesz	Actual
GDP growth	5-6%	6-7%	3.9%
Inflation	5%	less than 3%	3.9%
Central budget deficit (% of GDP)	2%	less than 3%	9.2%
Average wage increase	25%	100%	39.9%
Planned date of accession to the EU	2005-2006	2004	2004
Planned date of introduction of the Euro	2008	2006	no planned date

Source: (BBJ, 25-31 March 2002)

4.4.4 The 2002 elections

The first electoral round in April 2002 produced a narrow lead of MSzP (42.05% of the vote) over Fidesz (41.6%). The result took political analysts by surprise, as polls were consistently pointing to the opposite direction. Three reasons may account for voters turning their backs on PM Orbán: the lack of transparency of his government, its unmitigated nepotism and unabashed propaganda. The socialist candidate, Medgyessy, instead, identified the electorate's fear that Fidesz would have to ally with the far right to govern over a split country (BBJ, 15-21 April 2002).

The translation of this narrow margin into a ten-seat majority in Parliament – MSzP elected 178 MPs, SzDSz obtained 20 and Fidesz-MDF gained 188 seats – is instead characteristic of the Hungarian dual-ballot mixed-member electoral system (cf. Kenneth, 2001). A roughly even number of representatives are elected in both majoritarian single-member districts and in proportional representation lists. The first-past-the-post race witnesses smaller parties withdrawing their candidates in favour of their senior partner. During the second round, SzDSz agreed to pull out 70 of its men for MSzP, while Fidesz refused a similar offer from MIÉP (BBJ, 1-7 April 2002). The government headed by PM Medgyessy was sworn in on 27 May.

4.5 PM Medgyessy's era

The Hungarian pension reform was Medgyessy's brainchild and its resumption was rationally expected. It was as well assumed that the Socialists, whose new MoF László Csaba promised a leaner and glass-pocketed budget, would have reneged on some of the promises contained in the 100-day program. However, less than one month in office, a huge scandal involving PM Madgyessy broke out (see following paragraphs), thereby engendering a short crisis and threatening the coalition's success at local elections in October. Hence, in an attempt to regain popularity, the proposed populist measures were carried out, dealing a heavy blow to Hungarian public finances for the years to come.

4.5.1 Pension reforms restored

Most of what Fidesz undid during its four-year rule was restored already in 2002. The stepwise rise in second pillar contributions resumed (7% in 2003 and 8% in 2004). Swiss indexation was reintroduced in 2004 and before that the window for opting out of the new system was definitely closed. For one year, during 2003, those under 30 years of age were again eligible to voluntary opt into the mixed system.

However, MSzP 'forgot' to reintroduce the guarantee that was abolished by Fidesz. This created a huge problem for second pillar participants, mainly for those with jobs that enjoy particular early pension privileges (policemen, miners). These would retire before having contributed for the mandatory 15 years. Such short accumulation period cannot compensate for the renunciation to 25% of accrued rights. Therefore, the government gave in to pressures during 2004 and reinterpreted the original guarantee. The insured whose losses are greater than 6% of their potential monopillar benefit are allowed to return to the PAYG pillar until 2013.

4.5.2 Appeasing the crowds

In June 2002, PM Medgyessy was accused of having served between 1978-1982 as a spy for the Interior Ministry. He was in reality a member of the counterintelligence, which successfully prevented Moscow from interfering with the Hungarian early bid to join the IMF. Notwithstanding, the crisis was dealt with clumsily and SzDSz shortly withdrew its support, thereby provoking a severe loss of credibility (BBJ, 24-30 June 2002). In order to regain some popularity in view of the Hungarian local elections, which follow the parliamentary ones with a six-month lag, Medgyessy kept all the campaign promises.[15]

The political result was nothing short of spectacular. Pollster Szonda Ipsos soon proclaimed Medgyessy the most popular politician in Hungary, the first time a serving premier held that position. However, the cost of achieving this was extremely high. Among others, minimum wages became tax-exempt from September, the wages of around three-quarters of public employees, in particular healthcare workers and teachers, were raised by 50% in October, and Personal Income Tax brackets were widened. The populist wave did not spare the pension system. The new measures aggravated the scheme's fiscal imbalance and increased discrimination between participants to the public and the mixed systems.

Apart from further lowering contributions, MSzP introduced a *una tantum* increase in pension benefits to compensate for uneven indexation during the Fidesz years. It amounted to a flat lump sum of HUF 19,000 for all pensioners (even for new ones), which cost the budget HUF 52 billion. In order, instead, to offset the decrease in pensions relative to wages, the Socialists gradually phased in the 13th month pension over a four-year period, starting in 2003 with one week, two in 2004, three in 2005 and four in 2006. The Net Replacement Rate (NRR), calculated as the ratio between the average pension and the average net wage, rose instead of falling, thereby annulling the beneficial effects of Swiss indexation.

Table 16 Average pension benefits and NRR

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Benefits	15,904	17,903	21,482	26,646	30,503	34,077	39,647	46,028	52,360	58,520	65,563
NRR	61.4	58.6	56.3	59.0	60.9	61.1	61.1	59.3	59.0	62.4	63.6

Source: CANPI (2006: 22).

These measures upset the forecasts of the costs of transition from the PAYG to a multipillar system. In an early study, Palacios and Rocha (1998: 199-200) assessed the revenue loss at 0.8%-1.3% of GDP *per annum*. The financing strategy envisaged debt financing in the first years of transition, followed by tax financing during the following decade – via Swiss indexation, tax regime and retirement age changes. However, the higher-than-planned number of switchers, the cuts in employer contribution rates and *ad hoc* hikes implied that internal savings could hardly materialise. The inevitable consequence was that ONyF recorded a deficit amounting to HUF 93.5 billion, circa 4.24% of GDP, in 2005.

[15] Further distancing of the two electoral rounds from each other is a source of debate in Hungary. The narrow time span is very counterproductive: it fosters policy immobility and it may affect the post-electoral budget.

4.6 Gyurcsány's tough mandates[16]

Notwithstanding continuous warnings by the IMF, OECD and the EU against lax fiscal policy, an uncontrollable spending spree begun in 2002, thereby engendering spiralling twin deficits, the rise of public and external debts (see Table 7) and wide fluctuations in base interest rates. Starting with Fitch, major rating agencies downgraded Hungary's credit worthiness. The European Commission started an Excessive Deficit Procedure against Hungary on 5 July 2004 and required sound macroeconomic stabilisation to reach the 3% deficit target in the medium term (OJ L 389). However, by 2006, the country missed all but one Maastricht criterion and its revised Convergence Plan failed to even mention a possible date for Euro adoption (BBJ, 28 August - 3 September 2006).

With hindsight, PM Medgyessy's short-lived government can be held responsible for most of the damage. The continuous reshuffles in the cabinet, which were either aimed at avoiding the blame for alarmingly poor economic performance – the substitution of MoF László by Tibor Draskovics in January 2004 – or at strengthening MSzP's liberal wing, dramatically increased factionalism and lowered the popularity of the coalition. PM Medgyessy pre-emptively resigned after SzDSz threatened to again withdraw its support (BBJ, 23-29 August 2004).

The crisis lasted only 117 minutes and Ferenc Gyurcsány, a prominent Hungarian businessman and a champion of liberalism, was appointed premier in September 2004. However, the new PM knew that time to the 2006 election was short and that thus no structural reforms could be put on the agenda. Hungary entered once again a period of policy paralysis, which elicited harsh criticism on the state of its public finances in general and of the country's pension system in particular.

4.6.1 Criticisms... and damage

In the face of mounting problems with the Hungarian pension system, the supervisor's failure to individuate the sector's problems – this triggered a reorganisation of PSzÁF in 2004 – and the incapacity of the funds to self-regulate, various authoritative players entered the deliberative arena. The World Bank (Impavido and Rocha, 2006) and the Hungarian National Bank (Czajlik and Szalay, 2006; Orbán and Palotai, 2005) published various studies; independent experts, such as former MoF Lajos Bokros, World Bank senior economist Csaba Fehér (BBJ, 24-30 October 2005) and financial specialist Ágnes Matits (2006), voiced their concern; and former OTP Fund Management CEO Péter Holtzer (interview) inaugurated a high-level forum on portfolio.hu (an on-line financial magazine).

In a nutshell, the resulting analyses pointed to two types of malfunctioning, which roughly coincide with the agency-based and structural degenerations of the system: a) the continuous tinkering of past governments with pension parameters, which generated unfair competition between the public and private pillars; b) the funded pillar's underwhelming performance, which, most alarmingly, did not trigger a spontaneous corrective action by market participants. These, in turn, generated three problems that required an immediate response.

First, the long-term fiscal sustainability of the public pillar was seriously undermined with the combined effects of benefit hikes and contribution rate cuts. Orbán and Palotai (2005: 22) calculated the dramatic increase in the IPD, following the wave of 'corrections' during 1998-2005.

Table 17 The development of net implicit pension liabilities

Discount rate	1997 reform	1998-2002 contribution cuts	13th month pensions	2007-2009 contribution cuts*	Levelling of benefits across cohorts
2%	-150%	-314%	-398%	-469%	-475%
3%	-59%	-152%	-198%	-237%	-243%

[16] I have to thank Gábor Orbán of the MNB for useful comments on the budgetary consequences of pension overspending.

4%	-28%	-90%	-120%	-145%	-150%

*Discontinued in 2007, see 4.6.3.

The debate revolved around the means to prevent policymakers to abuse the system for short-term political advantage. Disagreement remains whether a structural overhaul is needed, for example the introduction of NDC, or whether tougher parametric changes are sufficient.

Second, the uninspiring performance of mandatory pension funds as well as excessive administrative costs rendered participation to the mixed system disadvantageous with respect to continued membership in the PAYG pillar. Again, Orbán and Palotai (2005: 24-27) estimate a break-even return, that is a rate of return able to ensure level playing field between the two systems in the long run, of 3.4%, a rather undemanding benchmark. Encouragingly, the funds' performance significantly improved in 2005 and 2006, thereby creating the impression that the studies were perhaps too precipitously prepared.

Notwithstanding, two issues still stand out. The past couple of years saw the Budapest Stock Exchange perform extremely well: the BUX index ended 2005 at 20,784, up 6,044 points or just over 40% compared to December 2004. This may mean that good results are only temporarily masking deeper systemic inconsistencies and that thus the imposed rationalisation, which followed shortly after, was all the more justified. In addition, a boost in returns did not solve the problem of older switchers, who are still bound to lose out. On the argument, two contrasting opinions exist. The one often supported by pension fund managers is that these members made a rational, informed mistake and that thus they have to bear the consequences. The proponents of the other argue instead that most switchers were imperfectly informed and that thus adverse selection took place. In the latter case, these people should be granted yet another opt-out period (Párniczky, interview).

Finally, as the countdown for 2013 is ticking away, the issue of unreformed annuities has been raised several times. Impavido and Rocha (2006: 49-50) provide a series of recommendations to overhaul the payout stage. No progress has been registered yet.

In addition to these theoretical qualms, the pension system's difficulties already caused some tangible damage. Both the European Commission (2006) and the EcoFin voiced their disapproval. This was conveyed through the evaluation of Hungarian efforts to fulfil the Maastricht criteria leading to the inclusion of the forint into ERM II. As a result of the surveillance mechanism, Hungary had to resubmit its Convergence Plan by September 2006. However, the decisions to first exclude virtuous pension reforms from current deficit statistics[17] (Eurostat, 2 March 2004) and later to relax the SGP as a whole seriously undermined the efficacy of EU conditionality (Csaba, interview).

4.6.2 Reactions... and improvement

The avalanche of criticism induced the second Gyurcsány government to form two (not one) reform committees: the State Reform Committee (SRC) in July 2006 and the Pension reform roundtable soon after. However, both proved to be rather ineffective. The SRC met only a few times and upon government's demand. The roundtable was more consistent, however, no programmatic framework was produced and its chair, Júlia Király, left the post in mid 2007 and was replaced by Péter Holtzer. Despite the unfavourable circumstances, a bunch of promising reforms have been enacted between 2005 and 2006. Again, however, either to pre-empt confrontation with the pension funds or to avoid discussion altogether, consultation was insufficient. Reforms are ordered by pillar in the following paragraphs.

Starting with the public scheme, two minor changes are worth mentioning.

[17] The exemption was scheduled to linearly decrease by 20% annually, starting in 2005.

Act CLXXIII of 2005 provided for the correction of the most glaring discrepancies between pensioner cohorts who retired after the year 1988 and had seen their entry pensions fluctuate arbitrarily due to inconsistent valorisation of past benefits. From a macroeconomic perspective, the manoeuvre is innocuous for two reasons: i) it is a decade late and thus most eligible pensioners have died out; ii) its implementation is stepwise between 2006 and 2010.

The willingness to convert pensions from the net to the gross principle resulted in counting retirement benefits towards the calculation of the tax base as of 2007. Pensions are still tax-exempt – this should change in 2013 – but extra income is more likely to enter higher PIT brackets. Some authors (wrongly) claim that this already equals to double-taxation.

Continuing with the second pillar, this was the object of most critiques, which in the majority of cases concerned the excessive costs of running mandatory pension funds. As a result, three significant regulatory improvements were legislated during 2006.

Given the funds' limited capacity for self-regulation, PSzÁF reduced in 2006 both the annual fees payable for asset management services (excluding trading expenses) and maximum front-end operational fees. The former may not exceed 0.9% of assets in 2007 and 0.8% in 2008, while the latter decrease from 6% of total contributions in 2007 to 4.5% in 2008. Some experts, however, argue that any such mechanistic imposition – maximum rates were set at average fees for the industry – should only be used as last resort. It does not lead to a long-term fee reduction, but rather to convergence to the upper limit, thereby fostering more herding behaviour. In the Hungarian case, there is some correlation between the fund's size and fees; hence the move may be welfare-enhancing after all.

In order to further relax quantitative limits and end overinvestment in government bonds, pension funds will offer, mandatorily from 2009 and voluntarily from 2007, a simplified life-cycle portfolio structure, that is three different portfolios (growth, balanced, conservative) with varying risk profiles. The assignment of members will depend on the time left until retirement:

- members with five years until retirement will be allocated to the conservative portfolio with a maximum equity share of 10%;
- members who have between 5 and 15 years until retirement are assigned to a balanced portfolio with an equity share between 10% and 40%;
- members who will retire in more than 15 years time are assigned to the dynamic portfolio, which has an equity share of at least 40 %, with the possibility of putting 5 % in derivatives and a maximum of 20 % in real estate.

Members will be able to choose among portfolios, however, the growth portfolio will be restricted to those with more than five years left until retirement (Allianz, 2007: 58). Only OTP decided to introduce life-cycle portfolios already in 2008.

Since 2007, and most important, the collection of contributions was centralised in the hands of the Tax Authority, APEH, thereby finally transforming mandatory pension 'paper mills' into investment funds proper. Notwithstanding the authority's initial coordination and data delivery problems, many predict that centralisation will save costs – the pension fund industry predicts a whopping 150-basis-point fee reduction – and that it will be the first step towards the creation of a central clearinghouse. Then again, the current arrangements can be ameliorated. APEH does not charge for its services, which are financed by taxpayers. This redistribution is of course unfair and it does not create incentives for cost effectiveness.

Concluding with the voluntary options offered within the Hungarian pension system, the third pillar underwent some regulatory amendments. In addition, at the explicit demand of the Budapest Stock Exchange's chief, Attila Szalay-Berzeviczy (BBJ, 3-9 October 2005), who lamented the lack of long-term, especially domestic private investment, a 'second' third pillar – known as the fourth pillar – was attached to the Hungarian pension scheme.

In particular, tax exemption for third pillar contributions is since 2006, due to deficit concerns, granted only up to the minimum wage, that is HUF 62,500 per month. The tax credit limit was reduced to 30% of savings, up to HUF 100,000 per year for younger and HUF 133,000 for older workers. In addition, the direct withdrawal of 30% of the invested amount has been discontinued.[18]

In order, instead, to encourage people to save more for retirement, no portfolio limits were set for fourth pillar savings, whose allocation is a matter of individual choice. Similarly to the third pillar, members receive a tax credit of 30% on savings, up to HUF 100,000 *per annum*. From 2007 onwards, capital gains on investments will be exempted from taxes. Yearly front-end fees are limited to HUF 2,000 and asset management costs follow second pillar rules: maximum 0.9% of assets in 2007 and 0.8% in 2008 (Allianz, 2007: 59-60). In the same study, Allianz reported that initial membership fell short of expectations. By the end of 2006, instead of the projected 70,000, only 10,000 new members opted for the scheme.

4.6.3 Lame duck

In contrast to the abovementioned regulatory advances, the political landscape did not improve. The 2006 electoral campaign was a replication of the 2002 one, with the roles of MSzP and Fidesz inverted. The latter tried to conquer government using the Socialist's tactic to promise more. The two main measures were a radical one-off cut to employers' pension and health contributions by 10 percentage points, from 29% to 19% in July 2006, and phased-in introduction of a 14th month pension. The argument hinged on a one-to-one correlation between tax cuts and the whitening of the economy, which is a misinterpretation of the Laffer curve (BBJ, 13-19 February 2006).

The strategy did not pay out. The first round witnessed a narrow lead of MSzP over Fidesz. The surprising twist was that MDF demanded its coalition partner to jettison some excessively populist plans in order to be granted support during the second round. MDF's leader Ibolya Dávid claimed that a right-wing party cannot be against capital, private ownership, banks and that it should not flirt with extremists. She was irremovable even in the face of Orbán's offer to withdraw his bid for premiership, thereby condemning Fidesz to defeat (BBJ, 17-23 April 2006).

Hence, Ferenc Gyurcsány became Hungary's first post-1989 PM to serve two consecutive terms. After stepping in office, he revealed that the economic situation was worse than reported and used this as pretext to renege on various promises and to launch a mild austerity package. The contribution reductions scheduled for 2007-2009 were discontinued. Employer contributions increased from 18% to 21% for pensions and from 4% to 7% for healthcare. In a display of machismo, the government renounced to the exclusion of transition costs from the budget deficit and signalled a strong commitment towards structural reforms.

However, PM Gyurcsány's honeymoon period with the Hungarian population was extremely short-lived. In a now legendary secret address to MSzP party members and MPs in May 2006, he admitted how the government lied 'morning, noon and night', thereby probably securing the victory for the unexpected second mandate (BBJ, 25 September - 1 October 2006). The speech leaked out to the public and triggered the violent reaction of protesters in Budapest. This left a very strong institutional position in the hands of a politically very weak PM. Although the coalition closed ranks around Gyurcsány, it is now very unlikely that badly needed restructuring may be carried through (Csaba, interview).

[18] Notwithstanding the cuts, Simonovits (2007) still condemns this as an excessive and irrationally redistributive policy.

5 Actors and institutions

5.1 Political parties

With the exception of MDF's relative independence, Hungary is progressively evolving towards a two-party system. This has further split a country in dire need of consociationalism and translated into markedly unilateral policymaking. As Orenstein (2000: 15-16) profusely pointed out, the exclusion of veto actors from one deliberative forum implies their increased activity in the next. Fidesz's aversion, during 1998-2002, to Socialist reforms clearly stemmed from their single-handedness. However, the exclusion of opposition and civil society from deliberation is just part of the story.

At least three characteristics of the Hungarian party and electoral systems exacerbated the political budget cycle that accompanied the alternation between Fidesz and MSzP in the four electoral rounds between 1994 and 2006: a) the constructive vote of no confidence; b) the narrowing balance between Young Democrats and Socialists, fostered by the electoral system and the contingent role of smaller parties; and c) the timing of local elections, scheduled six months after the general ones. The populist paroxysms of the two coalitions verisimilarly reached a climax during 2002, which cemented Hungary's involution in public finance management.

Gyurcsány's unexpected second term in office turned to be a wasted opportunity to rationalise a runaway budget, after scandals squandered the PM's political capital. As of 2007, some commentators still believe that not all is lost. Since Gyurcsány will not run for re-election, he might as well gather the remaining strength and push for some structural improvements. But these are called high politics and they are in Hungary particularly scarce.

5.2 External actors

So long as Hungary was the first to embark on the pension privatisation path in CEE, most international organisations were involved and had their regional offices *in situ*.[19] In order to sell reforms as domestic products, the World Bank skilfully pulled out of direct intervention and avoided references to Chile (cf. Müller, 1999). The end result is telling, however, of great corporate governance problems in loan disbursement and limited capacity to efficiently manage multilevel bargaining during the legislative phase.

As for the implementation of reforms, it marks the phase when the conditionality exerted by international organisation, including the EU, flatly failed the test. All of them, with no exceptions, were almost entirely ignored once the country achieved its objectives. Fidesz repaid most of the outstanding debt at the beginning of the 1998-2002 mandate, thereby sidelining both the IMF and the World Bank. In addition, all subsequent governments systematically flunked SGP requirements. Instead of taking a tough stance, the EU first excluded transition costs from deficit calculations and then, under the pressure of bigger noncompliant states, it relaxed the Pact altogether.

Even if no definitive answer can be given, a substantial failure of external conditionality points to the practical superiority of internal, policy-specific commitment devices to prevent the abuse of rulemakers or providers. However, as events following implementation made clear, the latter were missing in Hungary as well.

5.3 Trade unions and the social security funds

Hungarian trade unions, some of the weakest in transition economies, consistently favoured office-seeking over policy-seeking or vote-seeking goals. The creation, in 1993, of the self-governed

[19] The latter is not a proxy for intervention. ILO's Sub-Regional Office for Central and Eastern Europe is in fact located in Budapest but the organisation was almost absent during policymaking.

funds presiding over social security gave them a rent-seeking position to fight for. The strongest union, MSzOSz, opposed privatisation more out of fear that resources would be taken from its control, rather than out of some ideological belief or mandate.[20] The union gave in only when MSzP offered the preservation of ONyF's amazingly inefficient governance structure as counterweight. This 'dialogue' was unconstructive at best, and it reduced the foundation of the country's new social contract to an intra-party squabble over power resources. Newly elected Fidesz effaced trade union's influence from Hungarian politics. MSzOSz did not rise above insignificance level ever since.

5.4 The Constitutional Court

The Court hardly ever stepped in the disputes surrounding Hungarian pensions. Notwithstanding, the tough stance taken against governmental unilateralism, after the critical transition phase was over, rendered the executive extremely cautious during the legislative phase. This created major future inefficiencies, as the most controversial (and usually effective) solutions were withdrawn. The Hungarian experience shows that the Constitutional Court's threat of direct intervention can be as effective as the intervention itself. Whether rent-seeking groups have exploited this position is a question that exceeds the objectives of this dissertation.

5.5 Financial actors and public sector agencies

The underdevelopment of Hungarian regulatory and supervisory agencies rendered the second pillar vulnerable to agency capture and other rent-seeking pressures, not only during implementation but also during legislation. The Supervisory Authority of Voluntary Mutual Benefit Funds had a strong vested interest in retaining control over the expanding private pension market and thus influenced nascent legislation. The successor, PSzÁF, proved incapable to timely spot the flaws hampering the funded pillar's performance. Other, more authoritative actors had to step in to signal the looming crisis.

The Hungarian pension fund market developed a number of idiosyncrasies as a result of its unfortunate corporate governance as well as thoughtless regulatory flaws. The market's segmentation implied that the funds coalesced in two fragmented sets of associations. On the one hand, large financial conglomerates cartelised the market, thereby curbing competition and deepening the rupture between them and smaller players. On the other hand, the slowly emerging unbalanced lobby was unable to impose self-discipline on its members. Both associations inhibited the smooth functioning of the private pension market.

Only lately, the situation is improving. The cartel is starting to disintegrate and the interest group to reunite. This, coupled with an assortment of regulatory innovations – curing a crisis rather than pre-empting it – has probably put the market back on track.

6 Conclusions

Unilateral policymaking, extreme political budget cycles and structural, mainly path-dependent inconsistencies lie at the core of the Hungarian pension system's institutional degeneration. Widespread analyses of the legislative phase, the one that paved the way to the first multipillar reform in Central and Eastern Europe, show the lack of consultation, representation or deliberation in key decisions regarding the future of the new Hungarian social contract. Ferge (1999: 241-242) goes as far as to say that while formal aspects of a parliamentary democracy were in place, its substance had still to be learned by all partners.

[20] A notable inconsistency is MSzOSz's simultaneous and incongruous representation of both contributors and pensioners on the self-governing boards.

Thus, the reform of an unjust system that suffered from *ad hoc* adjustments since the early 1980s and witnessed the well-known deterioration related to a transformational recession was born under an unlucky star. Financial interests and ideological beliefs played a powerful role and resulted in far from optimal policy solutions. MSzP's propaganda and unilateralism that only allowed an internal debate with its leftist wing triggered both the aversion of Fidesz, which reversed and abused the system from the very beginning, and a negative consensus of the population, which fled the public schemes *en masse*.

The objective to create a system that would swiftly generate increasing returns through the positive adaptation of the participants' expectations was flatly missed. Persisting inconsistencies, whose elimination was postponed for some fifteen years, prevented compliance from improving. On the contrary, according to Simonovits (2007), the system as it is neither attracts workers to fully contribute nor delays retirement. The lack of internal commitment devices and the peculiarities of the Hungarian electoral and party systems exacerbated the political budget cycle surrounding pension benefits. Just one 'race to the bottom' between the two main electoral coalitions resulted in a greater current Implicit Pension Debt than that at the onset of reforms.

With respect, instead, to coordination effects in the private pension fund market, these are materialising only one decade after implementation started. The mutualist governance structure, lobbied for during the legislative phase, aggravated all the negative traits of segmentation. Self-evidently, big financial conglomerates exploited regulatory loopholes to conquer the market at the expense of smaller providers of 'occupational' schemes. The two fragmented sets of associations that emerged were neither conducive to increased competition nor to self-discipline. As late as in 2005, just before the Hungarian stock market started a spectacular recovery, all those who joined the mixed system were worse off than those who remained in the PAYG pillar only. As a response to the crisis, the regulator issued a series of cost-saving ameliorations.

These represent, however, only the tip of what has to be done. According to many, the hasty and amateurish 1997 reform put so much effort in pushing through the funded pillar that too many aspects of the public scheme were ignored or left unchanged; hence the renewed need for a structural adjustment to the whole pension system. The latest Socialist government, led by PM Gyurcsány, signalled a commitment to change. However, its political weakness – the product of yet more amateurishness – is far from reassuring.

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