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The potential role of supplementary pension institutions in the financing and sustainability of public pension systems

Thesis Supplement to the PhD Thesis

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I. Justification of the choice of the topic, objectives of the scientific research

The operation of pay-as-you-go public pension systems is based on income redistribution: between active and inactive age groups and between pensioners who are already inactive. This redistribution of income is of an order of magnitude, both in terms of scope and volume, that is outstanding among intergenerational redistribution systems. Consequently, demographic trends have a significant impact on the balance of pension systems. The ratio between the number of retired and active age groups - the so-called dependency ratio - is a key parameter for the financing of pension systems. Accordingly, unfavourable demographic trends worsen the financing conditions for pay-as-you-go pension systems. However, the financing of social security systems is not determined by demographic factors alone: employment and the size of the contribution base also play a role, and together they influence the ability to finance.

Almost all European countries are facing a demographic crisis: ageing societies are ageing because of rising life expectancy and low birth rates. This is reflected both in an increase in the number of elderly people and in a rise in the proportion of the very elderly in the older age group, combined with a sharp decline in the proportion of the working-age population. At the end of the 2010s, the old-age dependency ratio was 30.5 per cent on average in the EU Member States, i.e. just over three people of working age for every person aged 65 and over. The increase in the relative share of older people can only partly be explained by the rise in life expectancy at birth, the other important factor being the sharp fall in the birth rate: the age pyramid is thus ageing from both 'top and bottom’. There is no hope of reversing this trend in the foreseeable future: projections suggest that by 2100 the proportion of working-age people will continue to fall, and the proportion of the population aged 80 and over will double, to around 15 per cent.

The expected slowdown in economic growth, together with advances in information technologies and changing labour market needs and trends, will also pose major challenges for pension systems.

The problems of an ageing society and the decline in the number of contributors will put the legislators of the European countries under pressure to reform. In a pay-as-you-go pension system, maintaining financial equilibrium in the face of falling contributions and rising pension expenditure requires public budgetary support. To contain these subsidies, the traditional means of achieving equilibrium (e.g. raising contributions, reducing pensions, raising the age limit) may prove insufficient in the future. Supplementary pension schemes are expected to play an increasing role in providing financial security in old age, and their proper regulation and optimal integration into public pension systems is therefore a focus of attention in European countries. The European Commission's Green Paper on the Roadmap to adequate, sustainable and safe European pension systems (2010), the European Commission's White Paper on an Agenda for adequate, safe and sustainable European Pensions (2012) and the European Commission's Green Paper on Ageing (2021) confirm the future focus on the importance of supplementary pension systems in providing financial security in old age - Regulation (EC) No 2019/1238 of the European Parliament and of the Council (2019) will enter into force in 2022. Supplementary pensions is the EU terminology for all forms of pension savings outside the mandatory public pension scheme, including occupational pension schemes, voluntary savings and pension insurance. These are largely (though not exclusively) defined contribution, capital accumulation schemes, with few links to the financing of pay-as-you-go public pension schemes.

The funding and sustainability of pension systems have been at the forefront of my interest for almost twenty years. During this period, the topicality of the subject has not diminished: economic, labour market and demographic challenges are driving most states to act, and they are increasingly having to undertake paradigmatic changes in their pension systems, in addition to - or instead of - parametric reforms.

The topic of my doctoral thesis is the possible role of supplementary pension institutions in the financing and sustainability of public pension systems. Since the mid-1990s, the World Bank has been pushing for the introduction of supplementary pension schemes in Central and Eastern European countries in order to support the long-term sustainability of public pension systems. This idea is now considered a failure: supplementary pension institutions do not have such a role today. The objective of my thesis is to develop a completely new solution.

When aiming to develop and clarify the solution, it is necessary to explore all the relationships, analyse the legal institutions and examine them in detail. I will explore the theoretical background of the subject, the history of the institutions, their functioning in the world and in our country. I will review and analyse the key issues of funding and the challenges of sustainability. My main research questions are what function do/could supplementary pension institutions play, and whether and to what extent they contribute to the financial sustainability of public pension systems.

The aim of my research is to investigate the sustainability of pension systems around the world, including some typical European, non-European and Hungarian pension systems, and to explore the relationship between public and supplementary institutions as well as their role in their financial sustainability. The aim of the research is to find a solution: to develop and present a pension model that can overcome the funding and sustainability problems identified and presented in the thesis.

II. Structure and methodology of the thesis

In this thesis I have taken a systemic approach to the research topic. In doing so, the thesis touches upon several disciplines and fields of study besides law such as statistics, sociology, demography, and economics. Due to the nature of the topic, parts of the thesis are necessarily descriptive in nature, and I have used mainly analytical, historical, and comparative legal methods.

The thesis is divided into four well-separated chapters, with 5 sub-chapters and further subsections in each. I explore and describe the historical background of social welfare, the main features of the development and legal embeddedness of social rights, the development, successes, and failures of institutions other than public pension schemes during the 20th century, as well as the challenges to the sustainability of pension systems.

The first chapter of the thesis covers the theory and typology of social security systems: from the development, types and models of social rights and benefit systems, through an introduction to the constitutional understanding of social rights, to a definition of social security. The history of the development of benefit systems, their types and models, and the concept of social security have been described and evaluated by many, so I have merely summarised and organised them. In examining the theoretical foundations of social rights, greater emphasis has been placed on constitutional law approaches: in particular, how national law guarantees social rights. In doing so, I relied mainly on descriptive and analytical methods, as legal and comparative legal methods have dominated in the analysis of the fundamental rights of social rights.

The second chapter of the thesis provides a systematic analysis of the development of supplementary pension institutions and their role in financing. The main focus of this chapter is an analysis of global pension policy in the post-World War II period, including a critique of the World Bank's pension model. When examining the World Bank pension model, I carried out an explanatory analysis of a large body of international and major Hungarian literature.

The third chapter of my thesis presents and analyses the pension insurance system in Hungary: in this chapter I briefly summarise the history of Hungarian social security from its beginnings to the present day, touching also on the changes in the basic principles of social security. Particular emphasis is given to the complementary institutions: the private pension pillars, introduced in the 1990s with World Bank involvement, essentially abolished after 2010. In this section, in addition to the legal comparison method, the historical method is used.

In the fourth chapter of my thesis, I looked at the factors affecting the sustainability of pension systems, covering their financial and legal aspects, as well as the challenges of the present. In analysing these, I have sought to answer the question of whether the current functioning of the supplementary pension pillars contributes to the long-term sustainability of public pension systems. My answer is no. In fact, labour market and economic challenges, including migration/emigration, and population ageing have the same impact on the long-term sustainability of the capital accumulation pillars as they do on the long-term sustainability of pay-as-you-go public pension systems. I am not arguing that supplementary institutions are redundant, but that their relationship, linkage, and investment policy to the public pension system should be extensively rethought and reformed in order to effectively promote the long-term sustainability of the public pension system.

III. Summary of results

In the first chapter of my thesis, I examined the development, theory, typology and place of social rights and social benefit systems among fundamental rights. I reviewed the main elements of thinking about social rights, while illustrating with examples how domestic law can guarantee social rights. One solution is for the constitution to contain a general provision on the state's duty to protect institutions. Another is for the constitution to list the social rights guaranteed by the state in detail: either by defining social rights as objectives of the state (and thus depriving them of their individual enforceability), or by providing for detailed rules on social rights in lower legislation, and by allowing judicial proceedings to be brought to enforce them, but only on the basis of that legislation. The third solution would be to allow constitutional court proceedings and, under certain conditions, ordinary court proceedings to be brought in the event of a breach of the social rights enshrined in the Constitution. The Hungarian Constitution fell into the latter category. In addition to these, however, it is also a legitimate solution if a state's constitution contains neither a general rule of social commitment nor social rights. The hypothesis that the provisions of constitutions relating to social rights and social security are merely symbolic declarations cannot be justified, since they create social obligations for the state. It is also true, however, that social rights cannot be regarded as specific subjective entitlements to which everyone is entitled equally and under the same conditions, irrespective of any legislative discretion.

The first chapter also contains a history of the development and evolution of social benefit systems. The main achievement of this section is to discuss in detail the English poor relief administration of the Middle Ages and the social measures introduced by Robespierre during the French Revolution. These have been neglected in the Hungarian literature, although the former is an important early stage in the history of pensions and the latter in the history of the right to work and social security.

In the second chapter I examined the role and place of supplementary pension institutions in global pension policy. Over the past four decades, almost all countries in the developed world have been confronted with economic and demographic phenomena that have created funding difficulties for pay-as-you-go pension systems. Typically, and not independently of the World Bank's intentions, the countries concerned considered that the solution lay in a complete overhaul of the pension system, in full privatisation. Chile was the first country to restructure its pay-as-you-go pension system, replacing it with a mandatory system run by private pension funds with capitalisation. Chile's example was followed by other Latin American and then Central and Eastern European countries. The vast majority of experts now take the view that a funded system alone cannot solve the problems arising from an ageing society, nor is it necessarily suited to addressing the weaknesses that pay-as-you-go pension systems have not been able to address in the past. As I have pointed out, it may not be the case that setting up a pay-as-you-go system and a funded system as opposites will lead to a solution. Instead, it seems more appropriate to focus on the difference between defined-benefit and defined-contribution pension systems.

In a Defined Benefit (DB) scheme, the pension (annuity) of the currently retired generations is always funded by the currently active generations. The amount of the pension is calculated on the basis of a statutory pension formula. Neither the calculation nor the payment of pensions depends on whether enough contributions have been paid into the state budget in a given year. The risk cannot be passed on to the insured persons if insufficient contributions are received, the shortfall being covered by the State from tax revenues. In an ageing society, the number of contributors decreases, and the number of pensioners increases, upsetting the optimal equilibrium and increasing the political vulnerability of the system.

The Defined Contribution (DC) system is not based on intergenerational transfers, but on individual income transfers between individuals at different ages within a generation: the 'young self' invests during the active life cycle, with the benefits accruing to the 'old self' when it reaches retirement age. Unlike a defined-benefit system, there is no pension expectation promised by the state: the amount of the pension depends on how much pension capital the individual has accumulated over the years from contributions and the investments made with them. The risk is borne not by the state but by the individual: the expected pension increases in the event of a gain and decreases in the event of a loss. The defined contribution system is less exposed to the risks of an ageing population and is less politically vulnerable than a defined contribution system.

In the second chapter of my thesis, I also described how the pension system in Sweden is structured. The novelty of the Swedish model lies in the integration of the DB and DC systems, maximising strengths while minimising weaknesses: the invention of a virtual funded scheme embodied in nominal individual pension accounts and their linkage to a real funded scheme is undoubtedly innovative. Here, the amount of the pension does not depend on length of service or length of contribution, but only on the amount accumulated (actual and virtual) in actual and nominal individual pension accounts and the life expectancy of the insured age group.

The third chapter of my thesis presents and analyses the pension insurance system in Hungary: in this chapter I briefly summarise the history of Hungarian social security from its beginnings to the present day, touching also on changes in the basic principles of social security. Particular emphasis is given to the complementary institutions: the private pension pillars, introduced in the 1990s with World Bank involvement, essentially abolished after 2010.

In the fourth chapter of my thesis, I examined the factors affecting the sustainability of pension systems, covering their financial and legal aspects and the challenges of the present. In analysing these, I sought to answer the question of whether the current functioning of supplementary pension pillars contributes to the long-term sustainability of public pension systems. My answer is no. In fact, labour market and economic challenges, including migration/emigration, and population ageing have the same impact on the long-term sustainability of the capital accumulation pillars as they do on the long-term sustainability of pay-as-you-go public pension systems. I am not arguing that supplementary institutions are redundant, but that their relationship, linkage and investment policy to the public pension system should be extensively rethought and reformed in order to effectively promote the long-term sustainability of the public pension system. Such a pension scheme is presented in the last sub-chapter of this thesis.

One of the main results of the research is the presentation of a new approach to pension design in which the supplementary institution and the public pension system are optimally linked: they do not provide benefits in parallel but in a sequential way over time. The concept promises predictable and flexible benefits and has the potential for long-term sustainability. The pension model is individual and original because the public pension system's task is primarily to manage the risk of longevity, while the supplementary system's is to accumulate, primarily in human capital.

Rethinking the future role of the supplementary pension pillars and their integration into public schemes is, in my view, both socially and academically relevant. The results of this research can be used to prepare the necessary future reforms of the pension system and to develop policies.

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