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Could Fiscalisation Really Solve the Problems of the Pension System?

SUMMARY: The financing of social security, including its pension and health insurance sub-systems, is closely linked to who the recipients are and what it is that they receive from the system, although in this respect the two sub-systems behave differently. For the financing of healthcare – owing to the large number of redistribution elements therein –, the choice between contribution-based and state financing is practically free, although there may be slight differences here as well. At the same time, under state financing only a citizen-based, equal size and lower amount basic pension is conceivable for pensions. To have a differentiated work pension similar to what we have today, the current contribution-based financing is needed, which does not mean that major reforms are not required to improve the existing system. The article is directly linked to the study by László Árva and László Mádi from last year, which in terms of social security generally recommended transitioning from contribution-based financing to direct state financing, while it failed to clarify that the current pension system would change as a result. In my article, I wished to establish that such a major financing change for pension would result in the radical transformation of the whole of the pension system, which may not be desirable.

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The costs of social security services are traditionally charged to the wage of active workers in the form of a general wage-proportionate contribution. The philosophy of this solution somewhat varies between the two large social security sub-systems, namely healthcare and pension.

THE PHILOSOPHY BEHIND THE FINANCING OF SOCIAL SECURITY SUB-SYSTEMS

In the case of healthcare financing, there are two underlying principles behind the way in which costs are passed on to active workers on a wage-proportionate basis.

❶ THE SOLIDARITY PRINCIPLE: instead of all beneficiaries paying a contribution in proportion to their average wage all their lives (a 'head tax', as it were, which more or less corresponds to the principle of equal pay for equal service), load-bearing capacity is also taken into account and higher earners in part finance the services provided to lower-income workers.

❷ THE PRINCIPLE OF SMOOTHING FINANCING OVER A PERSON'S LIFETIME: workers pay contributions during their active career only, which are evenly distributed over this period but almost never correspond to actual use. At a younger

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age, we pay considerably more than we currently consume (on average, of course), while in old age this is the exact opposite, but in theory, on average, the contributions paid and the expected values of the service received are in balance for the entire life-cycle. (As a minor adjustment, it should be noted that the solution as per the first principle – that is, current wage-proportionate financing – in part serves the realisation of the second principle if we assume that our income gradually increases during our life-cycle).

As wages are highly dispersed, it would not be exaggerated to assert that healthcare is largely financed from the contribution parts collected based on the solidarity principle.

In comparison to this, the financing philosophy of the most important sub-system of the pension system in Hungary (and in most places around the world) [typically called Pillar I as used by the World Bank – see World Bank (1994)] is somewhat different, or at least its focal points lie elsewhere. According to this, in our active age we waive part of our wages for the benefit of the elderly and in exchange, when we ourselves become elderly, the proportion of annuity we receive from the total annuities offered by the active workers at the time to the elderly is equal to the ratio of our earlier contributions to the total contributions paid ['social contract between generations', *Samuelson* (1958)]. Of the two principles described above, this fundamentally corresponds to the second principle – the smoothing of financing over the life-cycle – although solidaristic elements are at times also included – to a smaller extent – in the pension system.

The philosophy outlined above is rendered somewhat more complicated by the fact that contributions are usually formally broken down into contribution parts that are charged – directly and indirectly – on worker wages. The latter is formally paid by the employer for the wage provided, and is not included in the gross wage of the worker. At the same time, from a very general perspective, we can assume that this distribution is arbitrary, and that all contributions count regardless of whether paid in full by the worker or the employer.

We should also mention that it may be possible – indeed, it happens increasingly frequently – that during the financing of either healthcare or the pension system, the second principle is not met for a given generation in the sense that the total of contributions paid (valorised) by the given generation and the annuities (healthcare benefits) received are unequal. The deficit or surplus is financed or received by other generations. According to the initial philosophy, this is not a problem, and is usually disregarded, but at the same time this is where the roots of today's problems lie.

THE CRISIS OF SOCIAL SECURITY FINANCING

Today's financing model of social security, as briefly outlined above, is in crisis in most countries where it is in place. The main cause of this crisis is that, back in the day, these models were based on unclear or flawed principles (this particular type of 'social contract between generations' is fundamentally questionable), or they were based on external circumstances existing – but explicitly disregarded – at the set-up. One of the most important external circumstances is the fact that population is on the rise; there are always enough younger active workers to take care of the rising – but proportionately still limited – number of the elderly, and to also pay their healthcare services. This implicit assumption is deeply integrated into the financing model, with no troubles observed as long as the number of active workers dynamically increased. Today, however, the situation has changed and this has been the case for some time, with no specific hope of restoring the conditions existing at the time of the establishment of the system, which means that something needs to be done. One possibility is to rethink the philosophy of financing, while another is to manage (using ad-hoc solutions) a sub-problem from a large pile of problems that seems most urgent at any given time or which has been pointed out by someone for some particular reason. I believe that the article under review is taking the latter route, while in my opinion the former should be the way to go.

ON THE STUDY BY MÁDI AND ÁRVA

The inspiration for my train of thought was an article by Mádi and Árva published on the pages of this publication last year [*Mádi – Árva* (2016), online: http://www.penzugyiszemle.hu/penzugyi-szemle-folyoirat-aktualis-szam/a-tarsadalombiztositas-finanszirozasi-reformja], which proposed the solution the authors called 'fiscalisation' as the main direction for the reform of social security (including the pension and healthcare systems). By this they mean that we should abandon the financing of these social security sub-systems through contributions added to wages as this makes labour more expensive and hence, keeps employment low. Instead, they propose to resolve the financing from general tax revenues. In analysing the study we find that it addresses numerous issues and topics; but it is also informative to see what was omitted. I wish to highlight two omissions that I consider to be highly important.

The authors fail to discuss the philosophy of social security financing – the opening subject of this paper.

They completely overlook what the desirable level of pension and healthcare is – something which of course is closely linked to the previous topic.

Although the authors do not explain how fiscalised social security would be different from today's social security, they most likely assume that it would not differ in any other respects. They argue that the form of financing is highly influenced by the service structure and level of social security and by the circle of the beneficiaries. Let us start with the level of care.

Why is it important to determine the level of care?

Both the level of pensions and healthcare – in today's Hungary, but in reality in any such state-maintained systems – could be entirely different from what we can observe today. When the question is raised what justifies the current level of pensions, the answer is more or less that this is what the contribution level permits or, from another side, by paying a particular level of contributions the beneficiary earned this particular level of pension. This stems from the fact that according to the above outlined philosophy of the pension system, contribution has a dual nature [see Borló's *(*2016) strong emphasis on the matter]: it currently finances pensions and at the same time it also creates eligibility. Based on this philosophy, in theory it can be objectively determined whether pensions are low or high (subjectively, pensions are obviously low as we frequently hear). Looking at the level of healthcare, our task is more difficult as this philosophy does not provide such a good point of reference as in the case of pension. This is because while the solidarity component is secondary for pension, it has a crucial significance in the financing philosophy of healthcare. In other words, this could also mean a wholly different service level.

Focusing solely on the source of financing, the authors fail to clarify what level of pension or healthcare would be financed down the line through reformed, 'fiscalised' financing. In reality, (international) practice has long decided this matter and the solution is also very logical: fiscalised pension financing can mean nothing other but a uniform, low-rate basic state pension available to all citizens after a certain age. It is no coincidence that the concept of direct budgetary financing was introduced by *Augusztinovics*, as quoted by the authors, in relation to the basic pension. The authors perceive but fail to recognise its significance, simply adding as a final note that they do not wish to delve deeper into the matter of the basic pension.

Why is it logical that ('fiscalised') pension financed from a general budgetary source must be uniform, low-amount and made available to all citizens (pension that can be characterised by these features together is called, after all, basic pension)? If this is financed from general taxes, there are no criteria to exclude anyone, in other words, all citizens must be eligible. Compared to the situation today, this would require the considerable expansion of the number of eligible persons, as today people not paying contributions or those not paying contributions for an adequately long period are excluded from pension. However, everyone pays some form of taxes, if nothing else then the value-added tax on boxed wine. As a result, in the case of fiscalised pension, there would be no criteria that would allow for the differentiation of pensions. The basis of differentiation could, of course, be the level of personal income tax, but if – as the authors also propose – pensions were to be financed from carbon-tax, then how much PIT a given person pays loses relevance. Pension differentiated as per the above would not survive a political fight on the matter, making the uniform pension level the only logically stable solution – as aptly demonstrated by international practice.

However, there are two reasons why the uniform pension level should not be high. Firstly, the budget would not be able to supply for a high-level uniform pension, and secondly, it would be easy to torpedo the notion that a broad range of citizens receive higher pensions from public funds than their active-age income. Another addendum: in the case of a fiscalised pension system, we might as well wave good-bye to other flexibility solutions such as varied retirement ages (although this idea – early retirement at least – should be eliminated in all other state-financed pension systems as well).

We can conclude that setting the fiscalisation of the pension system as an objective is actually – albeit implicitly – identical to the transition to basic pension, or more accurately to an arrangement (frequently encountered in Anglo-Saxon countries) where state pension exclusively means basic pension.

Of course, the Anglo-Saxon model – where the state only provides the basic pension and the part above this pension is partly paid by the employer and is partly provided by the worker's retirement plan – is a viable and good pension model and transitioning to this scheme should be taken into consideration. Its main benefit is that it requires a much lower amount of public funds in proportion to GDP than the existing 'work pension system', and that it involves a much lower share of GDP in the state pension system. But the adoption of this scheme is a problematic and lengthy process and, for political considerations, it might be more expedient to begin the transition with fiscalisation. (This is certainly not the case professionally, but pension is less of a professional and more of a political matter).

The situation is somewhat different with the state financing of healthcare, and the reason for this is the abovementioned difference in philosophy. If a large part of the contribution already has a solidarity function, then the contribution paid by the individual and the level of healthcare received have no significant relation to one another in the first place. As a result, in theory, the financing of healthcare could easily be resolved in some other form. In this regard, I certainly agree with the authors' proposition that fiscalisation should start with healthcare. I feel that the financing of healthcare through contributions is less substantiated 'philosophically' than in the case of the pension system; indeed, there is far more room for making changes in this area – even in the form of an NHS-style fiscalisation. At the same time, it should also be mentioned that the fiscalisation of the financing of healthcare in practice would mean the extension of care to social segments that currently do not pay contributions. In the case of healthcare financed from general taxes – as is the case with the basic pension – there are no criteria whatsoever for excluding anyone from the services.

Looking back, the fact that – despite the difference in financing philosophy – healthcare is financed from wage-proportionate contributions, is likely the result of a one-time analogy deduced from pension financing, which the one-time joint institutional control demanded and made rational. At the same time, of the services provided by healthcare, 'household' care – in other words, what the various individuals receive in money, the rate of which, in turn, also depends on their wage – such as sick pay or disability annuity, is closely linked to wages. For this reason, the financing of the various sub-systems of healthcare along the lines of a different logic, in other words wage-proportionate contribution – with a much smaller range than today – could be justifiable. In the case of the larger part – primarily institution financing –, wage-proportionate contribution is not self-explanatory at all.

Why is the philosophy important?

We have already touched on the issue of philosophy in relation to the level of care, but now let us take a step back and assume that we do introduce a pension system such as the one suggested (but not actually discussed in detail) by the authors. According to this, pension remains differentiated, with levels similar to those today, but financing is performed using wholly different budgetary resources and not from wage-proportionate charges.

There is one thing that is certain in relation to such a system: it will not be permanent and will certainly not reproduce itself. As in this case the level of care will clearly be determined arbitrarily – compared to the financing source –, it will be exposed to two different types of political pressure: the groups that receive pensions lower than others will 'prove' that they are due at least as much as those in more favourable positions. And they will accomplish this as care levels have been determined arbitrarily, and why should not these arbitrary levels be arbitrary in some other fashion. Fiscal government will always strive to push down the level of pensions since they represent an increasingly growing direct burden on the budget. As a result, both the care level and the differentiation will change hectically, subject to political cycles, without any brakes or guarantees built into the system. Consequently, participants will certainly be even more unhappy with it than today, feeling even less in control over their pensions – apart from 'voicing' their demands – and they will recognise pension as their own even less so than today.

Subjectively, fiscalisation – in other words the 'large basket' – communicates to individuals that their pension has no objective rate, i.e. there is nothing protecting it and it could decrease at any given moment. This is why deserting is a reasonable individual strategy;

there is no point, after all, in participating in such a system.

It is no coincidence that this proposal was drawn up by macro-economists based solely on a macro-perspective; indeed, such tunnel vision is fairly characteristic among these experts. To give an example: it was macro-economist Mária Augusztinovics – an otherwise outstanding economist much quoted by the authors – who has asserted (Augusztinovics, 2005) that there is nothing wrong with the Hungarian pension system from a macro-perspective because, even though the number of the elderly has grown (and continues to grow), the number of births fell sharply simultaneously, which means that active workers now provide for roughly the same number of inactive people as before. It is obviously of secondary importance that we give a considerable portion of our income to our children voluntarily but when it comes to giving to the elderly, the state, as it were, has to 'rip it out of our hands'.

The fact that the authors do not concern themselves with the philosophy of pension financing but treat it as a purely technical issue, renders their 'list of reforms' extremely formal, no more than a technical list of possible tasks. In reality, however, these potential sub-steps cannot be randomly attached to one another; a philosophy is needed that would legitimise the system so it may be more or less maintained across election cycles, providing a measure of guarantee to stakeholders, allowing them to believe in it rather than toying with the idea of deserting.

The concept of fiscalisation as presented by the authors (which I consider problematic primarily in respect of the pension system) is vulnerable to criticism even on the basis of their own logic. Firstly, fiscalisation does not mean savings – even though it was put forward as such – but rather added expenditures and less revenues. It means less revenues because they relinquished contributions, and more expenditures because they have given up on the possibility of setting any entry conditions to pension or healthcare.

In addition, if something is built on a tax that is unconnected to it, then it cannot be anything but a short-term solution as in the long run, the financing source would have to be changed continuously. For instance – to use the authors' example –, carbon tax is unsuitable to finance pension as it is meant to incentivise stakeholders to lower omissions; in other words, it is likely to terminate itself (along with pollution), which is the very objective for which it was created. The financing of pensions, however, is a permanent and long-term problem. In addition, factors such as the carbon tax should be spent on the things against which they are being collected – i.e. to reduce carbon dioxide emissions –, something that political voices will certainly be demanding sooner or later down the line.

FISCALISATION, OR SOMETHING ELSE PERHAPS? – A POSSIBLE ALTERNATIVE

Based on the above, in my opinion fiscalisation in respect of financing healthcare is a direction that merits consideration. It is no coincidence that the authors first reassessed this particular topic in respect of healthcare (*Árva – Giday – Mádi,* 2017). There are issues worth reconsidering even in this area: one being that the prime example of fiscalised healthcare, the NHS in the United Kingdom, is facing increasing challenges and is becoming more and more difficult to be viewed as an example to follow. Another issue, as has been mentioned above, is that fiscalised healthcare would indeed eliminate a part of the wage contribution in the first-round, but instead of cutting expenditures, this would lead to an increase through the expansion of eligibility.

At the same time, it is a 'philosophical' argument for the fiscalisation of healthcare – and the authors are right in this respect – that in Hungary the role of the budget in healthcare financing is substantial already. As a result, it does not function as a purely financial subsystem even today; that is, it fails to adhere to its own operating philosophy, opening the door – even 'philosophically' – to fiscalisation. Discussing this topic, therefore, is wholly justified and has been expected for some time.

I, however, feel that this direction should not be followed in the case of the pension system (which is why I have highlighted the word 'pension' in the title of my study), as partial fiscalisation (namely, that wage contribution is not the basis for all pension expenditures) is causing problems in this regard already. The fact that the pension system does not insist on its own financing philosophy sends the message to stakeholders to increase their pension demand as it does not depend on their own contributions. This means that the system miscalculates –overshoots – the consumption point of reference of pensioners. Admittedly, however, it is difficult for the pension system to adhere to its own philosophy – as established by Samuelson – as it is fundamentally flawed in the first place [the detailed discussion of this point is beyond the scope of this study – see *Banyár* (2014)].

The authors introduce the topic by stating that contributions are too high. At the same time, we are aware that it is not contributions that are too high in general, but rather the general budgetary charges. This problem cannot be resolved by picking out a single item, and re-labelling it. Should this happen, another item will come under attack, invariably, the one where positions are deemed to be the weakest.

Of course, there may be partial truths in the restructuring of burdens, but this needs a philosophy – and some are available already – for instance, the fiscalisation of the lion's share of healthcare is justifiable, while that of pension, not really.

At the same time, fiscalisation should be treated with caution; indeed, I would take the opposite direction: a separate financing source should be identified for each major budgetary objective, one that reflects the philosophy thereof. For my part, I would prefer to plan the specific charges based on the budget item to be financed. I would prefer to do this despite being aware that 'labelling' and 'earmarking' are traditionally subject to fierce criticism among Hungarian macro-economists. Along the lines of this principle, we may find that the financing of pension serves as a good example already, as wage-based charges are perfectly justified and correct, given that pension is similar to wage itself, and was subject to being kept on payroll after retirement. We might as well see this as the income distribution of the life-cycle during the life-cycle. The problem is that it is not because of the high contribution charges that Hungary is not competitive; contributions are high because of the ageing of the population and because we will not allow the elderly to starve to death. This cannot be changed through fiscalisation and any attempt to do this would be nothing more than sleight of hand. This pension system needs substantial changes.

However, I do agree with the authors that there is much room for improvement in the financing of the pension system. The challenge is to find a completely different philosophy to replace the current flawed solution, one that would restructure burdens and ensure the long-term legitimacy and sustainability of the system. The authors positively quote the *Botos* couple's pension concept that is linked to the number of children; indeed, this solution would help increase the number of children which in turn would assist in resolving the issue of pension financing.

On my part, I think that the new pension philosophy should be based on the reproduction of contribution payers, and that numerous sub-elements of a sustainable pension system are consistent with the Botos's conception. At the same time, I find their philosophy – namely, that the pension system should be used to encourage childbirth – to be flawed. Instead, I would retrace the pension system to the need of settlement between generations, i.e. young people provide pensions for their parents' generation by repaying the costs of their rearing (or more precisely, only for those who actively participated in rearing them), but get nothing in return; they are merely repaying the debt they have accumulated during their active years. If they wish to receive pension, they can do one of two things: invest some of their income into the production of contribution-payers (in other words, rear children) or accumulate income for future consumption, or perhaps combine the two. Such a pension system flexibly adapts to social preferences: if the number of children is low, the state pension will also be low but sufficient for those who have raised children. Meanwhile, those who opt for not having children will have to rely on their own savings, as society has nothing to 'give back' to them as pension, and the contributions they paid in their active age were merely repayment for the debts 'they owed' for their rearing. This system, this philosophy answers why pension is as much as it is, and why the people receiving it actually receive it. There are of course many details to clarify, but these can be easily addressed based on the well-established fundamental premises. Such a system is likely to provide a much better incentive for having children – compared to the existing system –, but it is merely an ancillary positive effect and not the essence of the system. Instead of the flawed, Samuelsonian philosophy that is failing before our eyes, the foundation should be a fair settlement between generations [Banyár's work (2014) and (2016) contains a more detailed analysis of this proposal which should be developed further].

SUMMARY

In my opinion, social security financing and the rate of services provided by social security and eligibility are closely linked, and cannot be arbitrarily selected independent of one another. Healthcare has fiscalised financing for the most part already, and the transition to a wholly fiscalised financing scheme can be easily justified. Whether this would truly help the country remains the subject of further investigation, but it certainly merits further discussion.

In respect of pension, we must be aware that fiscalisation is identical to transitioning to a uniform and low-amount basic pension system available to all citizens; therefore, when we speak of fiscalisation, we must also speak of the basic pension. I am not entirely confident, however, that this system – which functions well in Anglo-Saxon countries – would also work well in Hungary. For my part, I would therefore propose the introduction of a pension system based on a settlement between generations; in other words, I would gradually reform the current system in a way where eligibility for pension would not be created through the payment of pension contributions, but through the rearing of contribution-payers, who in turn would have to pay contributions which they owe in exchange for their rearing. For those who do not wish to have children, a recapitalised sub-pension system should be set up where they can set aside the funds saved on child rearing, and this would provide their pensions down the line.

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