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Dear Emergo Reader,

This is the first non-thematic issue of Emergo and the first issue not edited by a Guest Editor. Until now, most issues of Emergo have focused on a single aspect of the transforming economies and societies. Normally, the articles in most of the previous issues of Emergo reported on the findings of a research group that had been meeting for several years or they presented the main results of a relevant conference. The head of a research group or the convenor of a conference functioned as Guest Editor. They were usually responsible for selecting and compiling the articles. The topics covered until now included fiscal policy (No. 2/1), industrial markets (No. 2/3), labour market (No. 1/2), political economy (Nos. 1/1 & 2/4), privatisation (No. 2/2), real estate (Nos. 2/2 & 3/3), regional policy (No. 2/4), social insurance (No. 4/2), environmental issues (No. 4/3), etc.

This issue has a different, and in one sense more normal content. It brings together several disparate articles that are neither the results of the work of an on-going research team, nor the major findings of a major conference on the transformation processes. The first two articles were originally intended for the special issue of Emergo on social insurance in Central and Eastern Europe, No. 4/2. They are broadly comparative or theoretical, rather than country-specific. For reasons of space they could not be published at that time. However, that issue did include an article by Dr. George Soros - "The Open Society Reconsidered" - which is a revised version of his well-known article from *The Atlantic Monthly, Dagens Nyheter*, etc., on capitalism with a human face. A different point of view is presented here by Professor János Kornai of the Budapest Collegium for Advanced Studies. He calls for pure-market solutions to reforms of social insurance in Central and Eastern Europe. Originally, we hoped to contribute to a mini-debate between two distinguished Hungarians, one an academician, the other a practitioner. The social price of transformation processes in Central and Eastern Europe is discussed by Dr Victor Pestoff, of the Modern Society Programme at Södertörns högskola, in his article on "Reforming Social Services in Central and Eastern Europe - Meso-Level Institutional Change after the Fall of Communism".

The other three articles included here all use Poland as a case for study. Professor Jerzy Mikułowski Pomorski, Chair of European Studies, Cracow University of Economics, and Rector of the CUE between 1990-96, presents an article on "Post-Communist Europe and the Understanding of Change: the Case of Poland". He discusses the loss of value, using D. Reisman's *The Lonely Crowd* as a starting point and presents five typologies to reflect citizen behaviour in Poland. Professor Grzegorz W. Kołodko, of the World Bank and formerly Poland's finance minister, presents an article on "From Market Reforms to Transition to a Market Economy: the Case of Poland". He compares the early starters in the reform process - Hungary, Poland and Yugoslavia - with the laggards, and explains why Poland is doing better that the rest. Dr Ngai-Ling Sum, of Manchester University in the UK, contributes an article on "Cross-Border Sub-Regionalism in East Asia: Some Implications for the German-Polish Border Regions". She discusses growth triangles and polygons in terms of their effort to reposition themselves for better geo-governance, and asks what are the implications for Poland and the Polish-German border.

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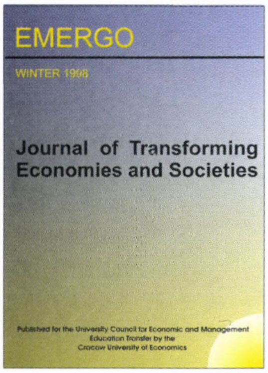

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János Kornai

The Citizen and the State: Reform of the Welfare System[1]

I would like to cover a subject that is especially relevant not only to my own country, Hungary, and other countries of the post-socialist region, but also to West European countries, including Austria. I shall leave the task of analysing the situation in Austria to my colleagues. However, the discussion of the Hungarian reform can be taken as an illustrative example to support a more general message.

I. THE VALUE ATTACHED TO SECURITY: WHAT IS EXPECTED OF THE STATE?

Let me begin with a polemic. Zsuzsa Ferge, an outstanding researcher into welfare systems who has spent decades fighting for the development of Hungary's welfare institutions, wrote an article entitled "Freedom and Security".[2] She backed up her statements with a public-opinion poll that set out to clarify how much importance the Hungarian public attaches to various social phenomena. The ultimate purpose of the questions was to reveal the value preferences shown by citizens. Hungarians, it emerged, attach almost maximum values to financial security, job security and security of health care, which score strikingly more than the various rights of freedom.

Another public-opinion survey phrased the title for the table of findings in a characteristic way: "It is the government's duty to ...", followed by the various tasks it ought to fulfil. Some 94-98% of respondents considered the govern-

1. In 1996, as in earlier years, the International Institute for Applied Systems Analysis (IIASA) in Laxenburg, Austria, held a lecture series in honour of the Nobel Prize-winning economist Tjalling C. Koopmans, one of its founders. The common subject of the series was "From Central Planning to Market Economies". The first in the 1996 lecture series was delivered by the Swedish Professor Anders Ĺlsund, research fellow of the Carnegie Institute in Washington, and the second by Leszek Balcerowicz, the Polish former finance minister who implemented his country's "shock therapy". The author delivered the third lecture, the text of which is given here.

2. See Ferge (1994). In her more recent researches, she augments her earlier statements about Hungary with some international comparisons.

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- Kornai, J. (1992) *The Socialist System. The Political Economy of Communism.* Princeton: Princeton University Press and Oxford: Oxford University Press
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ment's prime responsibility was to provide jobs and health care.[3]

Several other investigations have yielded similar results. This approach has some Hobbesian overtones. Hobbes argued that the individual's fears induce him to promote over himself a "sovereign", the state, which provides him with security. He not only accepts, but demands the Leviathan of the State, that charitable and indispensable monster.

Hobbes, though, gave a sharply delineated, narrower interpretation to security. The individual's chance of mere survival and his property must be defended from other individuals who might steal from or kill him, or plunge society into civil war.[4] This line of argument justifies the **classic** role of the state by the rational self-interest of the individual.

The interpretation of security adopted in the research mentioned earlier goes far beyond these bounds. Security has come to include protection from such uncertain factors as the financial stresses of unemployment, sickness or old age. So how does the public really envisage the state's role in this area of security?

The truth is that respondents were never asked **how much tax they would be ready to pay** if the state were to perform these security tasks. The vast majority of the public fails even to realise the connection. They feel that the **state** pays, full stop. The rest is no business of theirs. The Hungarian public shows an almost total lack of **tax awareness.** This belief by taxpayers that the tax levied on them is less than its actual extent, known in economic writing as the "fiscal illusion", has reached extreme proportions in Hungary and the whole post-socialist region.[5]

Let us make a calculation, to see the extent of the taxation, taking the case of an average Hungarian employee under the rules applying in 1995.[6] Let the starting point be the **total compensation of an employee.** This, as we shall see in a moment, includes the various taxes and social-security contributions that both the employer and the employee have to pay into the central funds. Let us deduct these one by one from a notional HFt 100 of total compensation.

First deduction. Compulsory contribution by the **employer** to the social-security scheme, and compulsory payments into the Solidarity Fund, the Wage Guarantee Fund and the Vocational Training Fund.

Remainder after the first deduction: HFt 66.70.

Second deduction. Compulsory contribution by the **employee** to the social-security scheme, and a compulsory payment into the Solidarity Fund.

Remainder after the second deduction: HFt 59.00.

Third deduction. The **employee** pays personal income tax, of which the expected average amount has been considered here.[7]

Remainder after the third deduction: HFt 44.40.

Fourth deduction. The employee saves some of his or her income and spends the rest on consumption.[8] When consumer goods are bought, the price of these includes various taxes and other tax-like levies by the state. The main item is value-added tax (VAT), in addition to which there are consumption taxes and import duties levied on certain consumer items. A deduction must be made from the total of these

3. See Róbert (1995).

4. The task of the sovereign (whether king or parliament), according to Hobbes, is to care for the Safety of the People, a phrase which Hobbes himself underlines (Hobbes, 1981 [1651], p. 376). He goes on to explain how he construes the concept of safety. It covers preservation not only of the individual's life, but of the property he has acquired by lawful industry - the objects that satisfy his wants without injury to others.

5. On the fiscal illusion, see Buchanan (1967) and Oates (1988). An excellent survey of the literature is provided in a study by Csontos (1995).

6. Piroska Horváth and Mária Kovács helped in assembling the data for the calculation.

7. The calculation rests on actual figures for the first half of 1995 and on forecasts of tax yield for the second half of the year. The ratio of personal income tax to full income from employment will have been somewhat higher in 1995 than the actual figures show for 1994. Actual sums of personal income tax paid are dispersed widely round the average, of course.

8. An average savings rate of 7.9% has been assumed.

to account for the state contributions to consumption, in the form of subsidies on pharmaceuticals, medical aids and public transport, for instance.[9] Summing up the positive and negative items, we estimated how much tax would be paid on HFt 44.40 of available income spent on consumption.

Remainder after the fourth deduction: HFt 38.50.

This, therefore, is the **net wage** remaining after the deduction of taxes directly proportionate to wages and consumption. The real "purchasing power" of HFt 100 of total compensation for employment is HFt 38.50.[10]

This proportion of tax is among the highest in the world, possibly the highest of all. It is higher than in Sweden, the epitome of a welfare state, or in any other post-socialist country.

Public spending can be divided notionally into two parts. One part covers the classic tasks of the state: public administration, the armed forces, the police, the judiciary and foreign affairs. The other concerns the "welfare" functions of the state. Interpreted in the broadest sense these include, for example, education, health care, the pension system, and all forms of benefit and subsidy awarded on various grounds, so long as these are funded by the state or the various centralised funds. Let us suppose that the utilisation of the taxes and the other sums levied like taxes is divided equally between the two kinds of task.[11]

Let us now perform a mental experiment. Let us assume that half the tax gathered is retained to finance the classic activities of the state, but the other half is restored to the employee. Instead of HFt 38.50, he immediately has a purchasing power of HFt 69.25, or HFt 70, let us say, for simplicity's sake. The employee's real earnings have been raised at a stroke by about 80%! However, he and all the other members of society have been left quite on their own. The state is not going to look after them any longer.[12] So he has to rethink matters. Who will look after him and the other citizens in times of sickness or unemployment, parenthood or old age, and so on? There is not a penny in the state coffers for such purposes. The money has all stayed in the employee's pocket.[13] Now that he has to decide where this money goes, a range of questions can be asked:[14]

1. How much of the income available to you do you want to consume, and how much do you want to set aside as savings for hard times?

2. Look at the uncertainty factors in life: sickness, unemployment, old age and so on. You have to build up a security reserve. How will you apportion this?

9. We have estimated the tax content of consumption on the basis of the 1993 Input-Output Tables drawn up by the Central Statistical Office. More recent information was not available. Again, an average value has had to be used. The actual consumption of individuals and the attendant taxation will be dispersed around the average.

10. The four deductions have not covered all the taxation. All inputs used in the production of consumer goods have a certain tax content. The maker of the consumer good is also a taxpayer (of company tax, for instance). Those familiar with Leontief's input-output analysis will easily comprehend what is meant by the **total** tax content of HFt 100 of product. It can be proved that the 61.5% tax demonstrated in the calculation is less than the total tax paid on compensation for employment.

11. Initial calculations yielded such an equal division as a rough approximation. We would like to improve the accuracy of this calculation in the future.

12. I have heightened the logic of the supposition intentionally. This redistribution, undertaken in an imaginary, hypothetical world, clearly cannot be performed in this extreme way in the real world. Apart from anything else, the state has statutory duties, which it cannot abandon instantly and unilaterally. However, a clear, thorough examination of the problem becomes easier if we start from zero, so to speak.

13. To return to the line of thinking begun in the previous footnote, I would like the subjects of the supposed experiment **not** to start from the **status quo** - not to derive their responses from the income and expenditure of the present-day pension system and health-insurance scheme, but to begin thinking about the system from the beginning. Let the subjects sense the presence in their pocket of the money that will then be taken from it to pay for pensions, hospital costs, schools, maternity benefits and other welfare spending.

14. To avoid any misunderstanding, I am not drafting here a putative public-opinion questionnaire, stating what the "technique" of questioning should be, or saying how the questions should be phrased to make the responses susceptible to interpretation and processing. I am trying to outline what are the questions on which Hungarian citizens' opinions, preferences and value choices need to be known. Let us start with ourselves, clarifying our own value choices on such questions.

• How much will you set aside yourself (in cash, bank deposits, securities or other forms of saving)?

• How much will you spend on various forms of insurance, assuming here that reliable companies exist, offering various sickness, pension and unemployment policies under legally regulated terms?[15]

• How much tax should the state gather from you for the purpose of performing certain such insurance tasks on your behalf?

3. How much do you want to give the needy? These are the options:

• You can decide for yourself whom you consider needy and whom you want to help. You pay the support yourself.

• You yourself choose the charitable institutions to which to give money, with which they can help the needy.

• The money to help the needy is gathered from you by the state as a tax, and used by the state for this purpose.

The list of questions is by no means a full one. It seems to suffice, however, to convey what a **tax-conscious** line of enquiry entails. The question each one of us has to address fully is this: Who should handle **my** money? Should I do so myself, or should the state take it out of my pocket, collect it from me by the force of state authority, and use it according to its own rules?

Not long ago, several colleagues and I organised a broad survey of public opinion. Our purpose was to discover how "tax-aware" Hungarian society is, and when it is given requisite information on the link between taxes and welfare provisions, what preferences it shows concerning reform of the welfare sector. I shall confine myself here to a single observation.[16]

Among the questions put to a sample of about a thousand Hungarian respondents were these. What burdens are placed on the average taxpayer by the provision of free higher education, by free hospital care, by the high state subsidy on medicines, and by the financing of the present pension system? Let us call it (with great latitude) a "roughly correct" response to estimate these four items within a margin of error of plus or minus 25%. It turned out, for instance, that only a fifth of the respondents gave a correct response for the tax burden associated with free hospital care. The majority did not venture a reply, or grossly underestimated the tax burden, while a sizeable minority grossly overestimated the tax burden.

Having been told the correct figures for tax costs, only a third of respondents wanted to retain the present centralised, bureaucratic system of state health care. The rest expressed preferences for various composites of a state role with market forms.

I shall make a couple more references to the survey in this lecture. It represents, of course, a modest first step towards exploring the public's tax awareness and preferences. Hungarian society's views on these matters are still not known thoroughly enough, but even this first more accurate survey shows that a considerable part of society does not want to preserve the present **status quo** in the welfare sector.

This, above all else, is why a reform of the welfare system is required.

II. THE GUIDING PRINCIPLES OF REFORM

I am an economist. My consideration of the principles of welfare reform starts out, however, not from economic principles, but from a critique of the role of the state. The benchmark here is not a desired or tolerable level of budget deficit, or even the needs of comprehensive macroeconomic stabilisation. What needs elucidating is the desirable appor-

15. The ignorance of Hungarian society is apparent from the fact that people can usually envisage only two alternative ways of financing the costs of the welfare sector. One is to pay for the services oneself, out of one's own pocket. The other is for the state to pay, so that people receive them free. This omits a third, fundamentally important option, in which an individual pays a regular, moderate sum as an insurance premium, and the insurance company sharing the risks will pay for some or all of the service.

16. The survey was conducted under the auspices of the Social Research Informatics Centre (TÁRKI). Publication of the results began in the study by Csontos, Kornai and Tóth (1996), which will be followed by further publications.

tionment of decision-making powers between the state and its citizens. For this the experiment imagined in the previous section was designed to provide inspiration. What is to be the autonomous province of the individual? At what point should this province be limited for the good of others?

Let me set forth some **guiding principles.** These are not "inferences" from observed experience, but postulates or desiderata, advanced in this context simply to reflect closely my own value judgements. For I see it as essential, when drawing up a considered plan of reform, to examine the question from a strictly normative point of view as well.

This study, however, only goes halfway even in considering the normative criteria. I do not deal with the normative demands of rational, efficient management, that is with normative analysis of the reform's economic effects. I have intentionally shifted the emphasis of this discussion towards the ethical and political philosophical side of the problem.

Even if the normative examination had been fuller, it would not have sufficed in itself. There is also a need for careful study of the programme's potential – whether it is politically and socially acceptable, and economically and organisationally feasible. This study omits such considerations altogether, which means that it cannot be seen as a proposal for reform, simply an expression of a few normative ideas on the reform.

Principle No. 1: Human Dignity. Let the decision-making province of the individual expand in the field of welfare services, and that of the state contract. Let the sovereignty and autonomy of the individual increase, but individual responsibility increase concurrently. Everyone, come what may, is responsible for his or her own life. Basically, we must all take care of ourselves.[17]

The facts mentioned in the first section of this study lead me to conclude that there should be a substantial increase in the decision-making province of the individual as compared with its present scope. The autonomy of the individual needs strengthening against the sprawling Leviathan of the state. Eventually we should reach a position where there is a concurrent fall in the state's welfare spending and in the taxes it levies. This will ensure that people do not feel the reforms **are robbing them of their rights.** They must sense the opposite: they must feel that they are regaining one of their basic human rights – the right of individual choice.[18]

Principle No. 2: Solidarity. Those who are suffering, in trouble or disadvantaged must be helped. The principle of compassionate solidarity is prompted by Judaeo-Christian religious ethics and the morality of the labour movement and left-wing political convictions. It may also derive from plain human goodness, fellow-feeling and altruism, without a specific ideological or intellectual tradition behind it.

A rider or comment can be added to the second principle: Let there be social justice in the apportionment of burdens and benefits. The criterion or an easily identifiable measure for this is a steady improvement in the situation of the groups in society that are at the greatest disadvantage.[19]

The first two criteria are meta-rational, ethical requirements.[20] There is no way of "proving" they are justified. They have come to the fore because they are fundamentally impor-

17. At this introductory, summarising level of the discussion, I leave open the question of how the individual relates to his or her nuclear family, and of how the decision-making provinces and responsibilities are shared among members of the family. Principle No. 1 might indeed be rephrased to include the word "family" in parentheses after the word individual. Similar additions might be made appropriately elsewhere in the study as well.

18. It can be seen from an economic point of view that it will become possible to make such a parallel change only when the budget deficit has been reduced to an acceptable level. Until that happens, reduction of expenditure will serve primarily to reduce the deficit.

19. This is akin to Rawls's criterion of justice (see Rawls 1971) or, more precisely, a dynamic version of this criterion. I call it dynamic because it places in the foreground the **improvement,** over time, in the situation of those worst off in society.

20. I do not imagine that these two principles, along with the three still to come, constitute a full system of ethical postulates. There can be no question of that. Yet, to my mind, the sum of these guidelines seems sufficient for an initial, outline normative consideration of how to reform the welfare system.

tant, whereas the remaining three principles offer more in the nature of practical guidance for the implementation, in the light of the first two principles.

Principle No. 3: Transparency. Designation of the state's role and responsibilities should come to the fore in political debate. Pressure must be put on politicians, parties and movements, and not least the politically active intelligentsia, to show their colours on these sensitive issues.

To my mind it is quite inadmissible for a politician to promise greater (or unchanged) social spending, coupled with lower taxation for society as a whole. It is cheap populism to do so. Let that politician declare his/her true intentions. Let him/her state that he/she wants greater social spending, and thus greater taxes imposed on society, or promise to set about reducing taxes, without concealing the fact that social spending will be cut as well.

The dilemma discussed in the first section – the citizen's choice in the extent and purpose of taxation – takes the form, under a parliamentary democracy, of a choice between parties and individual candidates. This choice, however, can only give expression to individual preferences if politicians honestly state their intentions on the question of state spending and taxation.

I would like to say a special word about the ambivalence so commonly shown by members of the intelligentsia interested or involved in politics. They watch the performances of politicians on television or radio, they follow their doings in the papers, and they repeatedly sigh about how common stupidity and dishonesty are in politics. Alternatively, they complain about bureaucracy, lack of professionalism and corruption. Yet having grumbled about these things one day, they demand state services and subsidies the next. But, to be sure, the state is run by politicians and the state apparatus! Clearly, there are present – even in important positions – in that political sphere and that state apparatus the very politicians and bureaucrats about whom they have spoken previously in such disparaging and indignant tones. I believe that such inconsistency is unworthy of the intelligentsia. I do not suppose I am alone in feeling that we have had enough empty, inconsistent rhetoric, and avoidance of the real dilemmas. Let the members of the intelligentsia have the courage and intellectual honesty to decide what sphere they wish to entrust to the state – not a notional state of exclusively expert and honest representatives and officials, but to today's real, flesh-and-blood politicians and public servants.[21]

Principle No. 4: Competition. The state's monopoly, the excessive bureaucratic centralisation and the stifling of competition in the welfare sector, must end. All the main attributes of the old system survive lustily in the welfare sector. The dominant role of state ownership has survived. So have central planning, the command method of co-ordination, and the shortage economy. The social situations and behaviour norms so typical of a socialist planned economy have likewise remained: comprehensive bureaucratic hierarchies, eternal bargaining over state allocations, and the defencelessness of the individual (as patient or customer). The absence of competition leaves too little incentive to improve the quality of services or to be economical.

Even the terminology is revealing. Economists' jargon in Hungarian reserves the term "competitive sphere" for the branches where items like bricks and braces are made and sold. Education, health care and pension schemes, on the other hand, are "saved" from the rough and tumble of competition, and still permitted to shelter behind a monopoly.

It would require a separate study to examine why the centralised, socialist planned economy has survived in the welfare sphere. Here I shall underline just one factor: the personal interests of those in **positions of power** in this sector. The ministerial, local-government and social-security bureaucracies running the welfare sector, the union leaders active in the sector, and their allies in the political sphere form together a highly influential group. Its members

21. In the public-opinion poll mentioned earlier, only 21% of respondents want to retain the present centralised, state-corporatist system of pensions unchanged. The vast majority would rather see a greater degree of decentralisation, through a "mixed" or "market" system combining state and non-state institutions, and compulsory and voluntary forms of insurance.

are tied together by many strands, and there is interaction between the functions – between ministerial, social-security, union and parliamentary posts. If decentralisation and privatisation were to speed up in this sector as well, some positions of power would disappear or weaken. Although some staff have the expertise to enable them to find good jobs elsewhere, there would certainly be a new selection process and reorganisation of positions, which many people fear.

Principle No. 4 includes the following requirements:

• Better legal and economic conditions must be offered so that non-state organisations can emerge and develop in the sector, offering welfare services alongside the state-owned organisations. There should be room for a range of ownership forms: non-profit and profit-making organisations, individual and corporate private ownership, ownership by foundations, church ownership, and so on.

• All monopolies of single organisations must be replaced by competition between parallel providers of services.

• The excessive centralisation must be reduced and give way to the fullest possible decentralisation.

This study runs a strong risk of being branded with epithets such as "Chicago", "neoliberal" and **"laissez faire",** with pejorative intent. Although it is clear from what has already been said, I would like to emphasise again that the five principles advanced here, including the fourth, do not prescribe unlimited competition. The operating conditions for organisations in most divisions of the welfare sector, above all in education, health care and insurance, need regulation and supervision by law. There should be a licence required even for the entry of a business, and subsequent supervision by a specialised state inspectorate to ensure that the law is kept. Citizens availing themselves of the service must be protected from the provider, whether it is in state or non-state ownership. Finally, the state as ultimate guarantor must settle the bill in cases where a non-state organisation goes bankrupt, and cannot meet its obligations to citizens. The legislation must clearly define the scope of the guarantees, the financial resources for which must be covered in every budget.[22] A simple list of tasks makes it plain that I do not advocate that the state withdraw, leaving the welfare sector in the lurch. All I recommend is that the role of the state be substantially reduced and, what is more important still, redefined. To regulate by law, supervise, and give an ultimate guarantee is less than, and above all different from being a ubiquitous, monopoly provider.

Principle No. 5: Adjustment time. Time must be allowed for the adaptation. Clear, transparent and explicit laws are required. These should be drafted as soon as possible. It is a great shame that so much time has already been lost. If the previous or present government had set about the task earlier, we would have advanced further by now. But however much delay there has been, there is no cause for haste in drafting the legislation. The new Acts on health, pensions, financing education and so on must be robust enough to withstand the passing of time and governments, since individuals will have to adjust their strategies in life and their individual savings and insurance decisions to the long-term commitments these Acts imply. It would be very harmful if some of the new Acts needed repeated amendments; this would undermine their authority.

The programme of reform must allow for the time it takes for new institutions and organisations to form. It is impossible to establish the non-state division of the welfare sector by state decree. Nor does it need to be planned artificially in advance. The most viable organisations and forms of ownership will emerge in time, by a process of natural evolution. Under no circumstances should a situation be created in which citizens fall between two stools. The centralised state or semi-state, corporatist organisations that operate, however well or badly, cannot wind up **before** decentralised, non-state organisations have emerged to assume their tasks, and won the confidence and voluntary consent of individuals to do so. Competition should do the main work of supplanting the old

22. Suppose that a citizen has expected a non-state insurer to pay for a costly item of medical care, but the insurer goes bankrupt. In this case the costs must be paid by a reinsurance institution, but, in the last resort, if the costs cannot be covered within the insurance industry, the state must pay the bill as ultimate guarantor.

organisations, not bureaucratic, arbitrary bans or hasty liquidations.

The new laws and the state's implementation of them must allow people enough time for adaptation, without prolonging the process further than necessary. When carrying out the reform, realistic and human account must be taken of the fact that individuals first have to become acquainted with the new conditions. Having done so, they still need time to rearrange their lives and family finances. The laws, and still more the administrative orders implementing them, must try to distinguish between the various groups in society, in terms of their capacity to adapt.[23]

III. AN EXAMPLE: REFORM OF THE PENSION SYSTEM

The general practice in Hungary is for those advancing reform proposals to come up straight away with detailed plans of action. Only from these is it possible to unravel what principles lie behind the proposal, assuming it accords with some system of values at all. I am taking the opposite course here. I have stated the principles first, and now I shall try to apply these to a specific task of reform – the transformation of the pension system. I should mention in advance that I can only draw an outline within the scope of this study.

I draw a distinction between three age groups:

The first is **the young.** Here I am thinking of those who have yet to enter paid employment, which means they have not started to pay pension contributions.

It must be made possible for these people to open **individual pension accounts,** to be held in pension funds. The pension fund will invest the regular contributions in the capital market, and add the gains from this to the account. By the time today's young people retire, several decades' contributions, yield and compound yield will have accumulated in the account. The insured person will then receive this sum as a pension.[24]

This is a "fully funded" scheme, in which the pension is met from accumulated savings, as opposed to a "pay-as-you-go" scheme, whereby the contributions levied and paid by the active population in a given year are divided among the existing pensioners. There is a difference in financing technique between the two schemes, but also a sharp economic and ethical difference. The pay-as-you-go system suggests dependence: the economically active population in a given year "keep" the economically inactive. The fully-funded individual account scheme suggests thrift: the individual enjoys the fruits of his or her own savings and investments.

Let us leave open the question of how the payment of pension contributions should be shared between employer and employee.[25] Whatever the case, the sum that has accumulated by the time of retirement is the fruit of the individual's lifetime performance. Its size will depend primarily on how much he or she has earned in a lifetime and how much of this has been saved in the form of pension insurance.[26] The formation of an individual pension-savings account perfectly fulfils the first principle. The sum built up in the account and the pension paid on that basis do not depend fundamentally on what the parliamentary majority decides for

23. Young people and old have different capacities to adapt to a new pensions Act, for instance. The same applies to the healthy and the chronically sick in relation to a new health-care Act, or, with the financing of education, to those already studying and those who have yet to apply, and so on.

24. There may be a further choice open to the insured at this point: to take a lump-sum payment, or request its conversion into an annuity.

25. So long as conditions of perfect competition prevail on the labour market, it is quite immaterial whether the employer or the employee pays the social-security and other social contributions and payroll taxes. They will reduce the employee's net wage either way. If the competition is imperfect, however, the shares paid are not wholly immaterial. Some of the actual cost (though not the whole) may reduce the entrepreneur's profits, instead of the net wage, or the entrepreneur may be able to pass some of the cost onto the consumer, in the form of higher prices (see Musgrave and Musgrave, 1980 [1973] pp. 504–10).

26. It also depends, of course, on the performance of the handling pension fund on the capital market – whether it has invested the money effectively and wisely and in general how the capital market of the country concerned, and ultimately its economy have performed during the insured's working life. To that extent he or she is "in the same boat" as other savers and investors.

momentary political reasons during the insured's retirement, say in 2040, or what indexation or other pension adjustment legislators are prepared to make.[27] The insurer and the insured conclude a private commercial contract, not a political agreement; there is a clear proportionality between the inward and outward payments.

The law will have to prescribe **compulsory** minimum pension insurance.[28] Above that, everyone will be able to decide for themselves whether to take out further, voluntary insurance policies.

If some people are unable to pay their own compulsory contribution, the state should pay it for them. This is a step that accords with the second principle, social solidarity, made by the state at the expense of the other taxpayers. It should not be taken lightly, but confined to cases where people are demonstrably unable to pay. Where that is the case, however, such a step must certainly be taken. The administration must first find out who has not paid the compulsory pension contribution. Where the reason is negligence, payment must be enforced by law. Where the reason is inability, however, for lack of information or funds, the state must step in.

While this provides a minimum pension for all, there must be no levelling of pensions above the minimum either. Everyone has the right to decide whether to live their active lives like an industrious ant or like a profligate grasshopper. Once the final stage in life has been reached, however, there should be no egalitarian adjustments between their old-age income by an omnipotent state. The ant has a right to the kind of old age she has saved for over her lifetime.

Pension insurance should not be a state monopoly. Competition in this field of insurance must be allowed, indeed encouraged, in line with the fourth principle. This will raise the choice of alternative insurance policies, reduce the management costs of insurance and, what is more important still, allow decentralised investment of accumulated pension-insurance deposits. This allows one of the most important, indeed indispensable actors of the modern capital market to develop: pension funds as institutional investors. They control a sizeable proportion of the investments in the capital markets of advanced market economies. If all the pension savings remain concentrated in the hands of the state, this gives the state too great a role in investment.

Although the state monopoly over pensions must be broken up, the state should retain some important tasks (apart from its obligations towards older generations, which will be discussed in a moment). The province, responsibilities and duties of the pension funds will have to be regulated by law. The task of providing insurance that entails running individual pension accounts will need to be subject to state licence, and certain elements of a prudent and careful investment policy for pension funds be prescribed.[29] A system of reinsurance must be built up and, as a last resort, the state must guarantee that people's pension investments are not lost even if funds are misused by the institution.

The pension savings of individuals should receive preferential treatment under tax law. There should be ways of deferring tax payments up to certain limits. The income later received as a pension, on the other hand, should not receive any concessions.

27. We cannot, of course, hope that those living and spending their income in 2040 will be entirely free of the momentary influence of parliament. The purchasing power of the money will be affected by the rate of inflation and other economic processes not immune from the influence of state factors.

28. My defence of the obligation to insure would not be on paternalistic grounds, that is, not out of a desire to further the prosperity of unwilling individuals by state compulsion. If Citizen **X**, who always had the chance to pay pension insurance throughout his active life, never did so, he might suffer serious poverty in old age, reaching the brink of starvation and homelessness. A civilised, humane society would not allow this to happen (see Principle No. 2); he would receive relief at taxpayers' expense. The interests of future taxpayers therefore require that Citizen **X** be compelled to pay a pension contribution sufficient to absolve society from relieving him in his old age. So the compulsory minimum insurance requirement is not for the sake of "forced happiness", but a preventive measure to protect other taxpayers and investors.

29. Initially, for instance, it will be compulsory to invest a high proportion of the savings in safe state securities. Only as the pension fund strengthens and builds up solid reserves can it be allowed to broaden its portfolio to cover riskier forms of investment.

The second age group is **pensioners.** We cannot refer here to the first principle. Those who are already on a pension have no way of taking an autonomous decision about their pension savings. Society, in my view, has an obligation to provide them with a decent pension.

Let us face the facts: the position of pensioners is ambivalent. They feel they have worked for a lifetime, and have paid their pension contributions. They are not being "kept" by society, since they simply must receive back their savings in the form of a pension. However, if we take a closer, individual look at the relation between lifetime earnings and contributions paid on the one hand, and the real value of the pension received since retirement on the other, the correlation turns out to be weak. A great effect on the nominal and real value of a pension has been exerted by the time the pensioner retires. Let us assume that **A** and **B** have had exactly the same flow of earnings and pension contributions, but there is a difference in time between the two. Because **A** started and finished his working life earlier than B there may be a substantial difference in their pensions. The system of calculating pensions has changed several times in the last decade, while inflation has speeded up and slowed down, and the methods of indexing pensions have varied as well. Meanwhile the pension system has been patched up and tinkered with, with strong levelling effects.

Because of all these factors, the pension received is not an annuity received under an insurance policy, and the pension contribution cannot be called an insurance premium. The transaction has nothing to do, either in an economic or legal sense, with what one might call an "insurance transaction". To call a spade a spade, the so-called pension-insurance contribution is nothing other than a **tax,** a proportionate payroll tax. Today's pensions are paid out of taxpayers' money. The ostensibly self-financing system of pension "insurance" is the largest institution with a soft budget constraint in the country: the government is legally bound to cover any deficit. As it is customary where there is a soft budget constraint, the amount of financial benefit paid is the subject of pressure-group activity, political criteria and bargaining. The actual amount of pensions at any time is decided in the political arena, in contravention of the first principle.

I wrote just now that a decent pension should be paid. Let us acknowledge that we can only resort to the second principle here. "Decency" is an ethical, not an economic category. There is no question of a private contract between the insurance institution and the insured, with benefits proportionate to premiums. The size of the pensions paid today is quite arbitrary in a commercial sense. We can only fall back upon the goodwill and decency of society and its respect and sympathy for the older generation, and of course on the fact that pensioners form a vast bloc of votes, which any political party seeking to win an election will think twice about offending.

The third age group is the **intermediate generation.** Here I am thinking of those who have been paying pension contributions, but have yet to reach retirement. The most important principle that I advocate in their case is the right of free choice. They have two main opportunities open to them.

1. To stay in the present state insurance system.
2. To transfer to the decentralised system of individual pension savings.

If they choose the latter, they must be allowed to take with them the accumulated value of the contributions they have already paid. The economic content of the transfer is plain.[30] In return for the contributions, the state undertook payment obligations that fall due on retirement. A numerical value can clearly be put on this "**pension debt**" of the state under the present laws. The state's promissory note, made out accordingly, can then be placed in the new pension fund. Special long-term state bonds could serve as such a "promissory note", and be tradable on the secondary security markets.

I cannot say what proportion of employees would remain in the old system and what proportion would choose the new. The essential

30. Here I am merely putting forward a general principle. Practical implementation of it raises many important economic, technical, financial and legal problems that I cannot cover here.

aspect is the chance to choose – the knowledge that, in line with the first principle, the individual is not confined to a single pension track laid by the state. Moreover, even if relatively few people chose to opt out, the possibility of doing so would apply competitive pressure to the hitherto monopoly state system. This accords with the requirements of the fourth principle.

Here I would like to return to the case of young people. Let us suppose a decentralised system of pension funds has already emerged. There is no reason to stop the successor to the present monopoly pension and social-insurance system carrying on as one of the competitors. Young people with more faith in a state institution than a non-state one may choose the former to manage their pension accounts.

The fifth principle also needs to be applied in developing the new pension system. The legislation must be carefully prepared, with time allowed for the system of decentralised, non-state insurers to develop, along with a reliable system of state supervision. Time must be allowed for people to grasp the new opportunities and brief themselves thoroughly before choosing the alternative that promises to be best for them.

Those familiar with pension systems abroad will know that this proposal does not match any foreign example accurately. There is a similarity with the system in the United States, but it differs from this in some essential respects. Many features have been taken from the Chilean scheme, which has pioneered a new path in the development of pension systems, while use has been made of Australian experience and New Zealand proposals, but the system suggested here is not identical with any of these.[31] Nor would it be right simply to replicate some foreign system, because close attention must be paid to Hungary's specific conditions.[32]

IV. SOME CONCLUDING REMARKS

This outline for the pension system serves simply as an example. I might have chosen another illustration – reform of the financing of higher education, for example, or reorganisation of the health service. The purpose of this article is not to popularise a specific pension reform.

The "message" of the article is connected with the third principle: that those who contribute to discussion of the welfare system, and still more those who will decide on the legislation and regulations concerning it, should declare their true colours.

The reason why I refer to one or other of the five principles repeatedly while presenting the proposal for pension reform is to demonstrate a firm link between principles and practice. There is no need to "dodge" principles to arrive at a pragmatic, practical approach, or, conversely, to become bogged down in empty rhetoric about principles without converting them into the small change of a practical proposal.

I am aware that many Hungarians do not share the system of values I adhere to and have explained briefly in this article. They espouse another one. Since the welfare system must be transformed for the good of the whole Hungarian population, and in a way that persists for a long time, the aim must be to base the reform on as broad a consensus as possible. There must inevitably be mutual concessions, away from some or other "pure" system of values or consistent body of principles. This, however, makes it all the more important to know the **basis** from which we are making the concession. To be well prepared to take part in the debate, we must clarify in our minds the system of values we espouse in relation to the welfare sector, and the practical position we adopt accordingly.

31. On the Chilean pension reform, see Camacho (1992), Corsetti and Schmidt-Hebbel (1995) and Gillion and Bonilla (1992). On New Zealand's reform proposals, see Douglas (1993). The volume compiled by the World Bank (1994) gives an excellent general view of the alternatives for pension reform and the reforms carried out in several countries (including Australia and a number of Latin American states), along with a rich body of calculations.

32. There has been little widespread public debate so far in books and periodicals on the alternatives for pension reform in Hungary. I would mention particularly the works of Augusztinovics (1992 and 1993), Augusztinovics and Martos (1995), Bod (1992) and Martos (1994), and also the World Bank study of Hungary (1995d), pp. 31-46 and 97-130. The last contains many elements of the reform outlined in this article, although my proposal takes decentralisation further.

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