

Pension Reform in Ukraine

Remedies to Recent Fiscal and Structural Challenges

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Introduction and Summary

Decisions about pension benefits have wide-reaching social and economic impacts – pensions, workers, children and even unborn generations will be affected by those decisions, in different ways. The political implications of these decisions thus cannot be ignored, especially as an understanding of the long term social and financial impact of pension decisions is often lacking in the population, and sometimes even within the government. But the fiscal and macroeconomic impact of pension decisions are also critical, both for health of the economy and welfare of all citizens, especially the most vulnerable. This policy note analyzes the impact of recent pension decisions in the context of broader pension reform. The financial implications of system design are considered, and recommendations are provided, both for addressing the current pension imbalance, and for continuing institutional reform of the pension system.

Ukrainian policymakers, immediately after eliminating short-run fiscal problems and pension arrears in 2000, outlined a comprehensive three-pillar pension reform to modernize the existing pension system administration. The pension reform design, legislated in 2003, followed good practice standards applied in other transition economies and provided a sustainable balance in its fiscal, social and intergenerational dimensions. The sudden and large increase in minimum pension level, initiated in September 2004, and incorporated in legislation in December 2004, changed the Pay as You Go (PAYG) pension system into one with a strong fiscal and social disequilibrium. In its current design, Ukraine's pension system creates a large fiscal deficit, spends at a level (as a percent of GDP) among the highest in the world, and entails an almost-flat system of benefits, which thus provides an excessively high replacement rates for low income earners. As a result, each laborer in Ukraine is footing the bill for almost one average pensioner. This is a huge burden and is simply not sustainable. It is important to separate the pension system from the system of social protection. Poor and vulnerable sectors of the population should be protected through targeted social assistance programs, financed through the budget, not through the pension system.

Fiscally responsible management of the PAYG pension insurance system is not only a prerequisite for continuing the pension reform process in Ukraine but also for fulfilling Ukraine's economic agenda based on high growth, competitiveness, private initiative and structural renewal. The emerging pension system deficit threatens to slow down these processes, and thus prompt action is required to balance the system. Immediate reduction of the minimum pension to a more sustainable level is the fastest way to bring the system back in balance. Should the Government choose a more gradual path for reducing and/or redefining the minimum pension, it should at a minimum be combined with a set of other expenditure reducing measures, such as an increase of the retirement age, elimination of wage indexation, and tighter eligibility for early retirement and working pensioner benefits. . Institutional reform of the pension administration system, envisaged through

introduction of a single social contribution rate, unification of social contribution collection and modernization of the Pension Fund of Ukraine (PFU), is expected to result in higher compliance and collection rate among workers. On the other hand, raising PAYG revenues through a higher pension contribution rate, or financing shortfalls from the budget, should be avoided. Short run pension deficit financing should only be justified if necessary to help finance the rapid policy and institutional change necessary to bring the system back to sustainability.

The precise combination of measures to be taken will require further analysis based on data to be provided by the PFU. The Bank's pension team is ready to provide additional assistance with this analysis.

The Imbalance in the pension system has created a systemic threat to macroeconomic stability, and in particular to the fiscal framework. Our estimates show that the uncovered gap in the 2005 Pension Fund balance exceeds UAH 19 billion.¹ In case no corrective measures are taken within the Pension Fund, this gap will have to be covered by transfers from the state budget, or worse, through arrears of the Pension Fund. An additional UAH 19 billion of expenditure implies higher financing requirements for the state budget. In the extreme case of no adjustments on the revenue and non-social expenditure side, the state will have to widen the deficit and to borrow more. Simulations suggest that the deficit will increase to 6.8% GDP, borrowing needs will reach USD 6.4 billion, and inflation will exceed 25% - and this simulation assumes that the negative market reactions to these developments are mild. Unfortunately, the present parameters of the pension system - with automatic inflation indexation plus 20 percent of nominal wage growth - implies that the fiscal system will move into permanent disequilibrium once inflation exceed the five times real wage growth. But since market participants will realize that, it can actually happen very rapidly unless corrective and prudent actions are taken to bring actuarial balance to the Pension Fund.

The last time Ukraine had such a big deficit was a pre-crisis year of 1997. After that financial crisis, Ukraine followed prudent fiscal and macroeconomic policies, which have been the pillar of its subsequent economic revival. Fiscal stabilization of the PAYG system is a prerequisite for the sustainability of the pension system, for avoidance of arrears in pension payments, for taking the next steps in pension reform in Ukraine, and for macroeconomic stability of the country.

1. Main Features of the 2003 Pension Reform in Ukraine

In July 2003, the Ukrainian Parliament passed two laws which reformed the existing pension system - one applicable to the mandatory pension system, and the second establishing a voluntary supplemental pension system. The mandatory pension system changes included changes in the parameters for the publicly provided pensions (first pillar) as well as the introduction of mandatory individually funded pensions (second pillar) once fiscal and institutional conditions permit, with specific triggers defined in the law.

¹ This gap already takes into account the transfer of UAH 11.1 billion from the state budget, according to the 2005 Budget Law, that was adopted in December 2004.

The parametric changes included the following:

- An increased benefit to those who delayed retirement, beginning with a 3% increase in pension benefits for one year of delay to a total 85% increase for a 10 year delay.
- Benefits set as 1% of the pensionable wage per year of service, compared to the previous 2.2% for men and 2.75% for women for the first 25 and 20 years of service, respectively.
- Gradual widening of the calculation period from best five years prior to 2000 to full career for service accrued after 2000.
- Valorization of past earning to average wage growth.
- Indexation of pension payment specified as 100% of inflation plus at least 20% of wage growth compared to the previous ad hoc increases in pensions.
- A ceiling on income subject to contributions of 7 times average earnings.
- A ceiling on pensionable salary also equal to 7 times average earnings compared to the previous ceiling which was less than twice average earnings.
- Separation of work injury related disability from other forms of disability.
- Specification of disability benefits as a percentage of projected old age benefit rather than as percentage of salary.
- Movement of the elderly not eligible for a labor pension from the pension fund to a social assistance system funded by the state.

The reforms were oriented both toward providing fiscal relief within the pension system as well as improving its functioning. Encouraging later retirement would both potentially raise revenue and reduce pension expenditures. Lowering the accrual rate would result in lower initial benefits for those retiring and provide some incentive to work longer to achieve reasonable retirement income. This would also raise revenue. The increase in the averaging period again would lower the pensionable salary, resulting in lower benefits. The change in the indexation of pensions would provide purchasing power security but generally increase costs since the previous increases often did not cover even inflation; similarly imposing a ceiling on contributions and raising the pensionable salary would tend to reduce revenues and raise expenditures, respectively.

In terms of system design, the reforms moved toward strengthening the tie between benefits and contributions. Such a link is generally regarded as fair, since those who contribute more should receive more. It further increases individual incentives to contribute since benefits are received for each contribution, thus potentially increasing compliance. Several of the measures, such as removing the ceiling on pensions and pensionable salary reward those who contribute more. Increasing the averaging period for pensionable salary results in a better alignment of the pension paid with the average salary on which contributions were paid, instead of pensions being based on only the best salary years. Finally, removing the poverty based social pensions from the social insurance structure clarifies the role of social insurance in the Ukraine, to provide benefits to the elderly or disabled based on the contributions they have made.

2. Subsequent Developments in 2004

The reform laws were projected to bring the pension fund into surplus in 2004. However, two factors have intervened in the meantime.

Recalculation of pension benefits. The 2003 law allowed for recalculation of pension benefits for those already retired. This took place between January and August of 2004. The issue is that previously there had been a maximum pension of 3 minimum wages plus a reduction in the pensionable salary, such that almost all individuals were receiving the same flat pensions. Since the ceiling on pensionable earnings is now 7 times average wage and there is no ceiling on pensions, pensioners were asking to have their pensions recalculated under the new rules. This resulted in a rise in pension expenditures from 8.5% of GDP in 2003 to almost 10% in 2004.

Rise in minimum pension. The minimum pension which had been roughly equivalent to 43% of the minimum wage, and 18% of the average wage, was suddenly increased in September 2004 to the level of the subsistence minimum, set at 120% of minimum wage and 49% of average wage. This almost threefold increase in the level of the minimum pension increased expenditures dramatically, from almost 10% of GDP, to 11.4%. The medium term impact of this action is much greater given that this increase took place for only 4 months of the year.

Based on the pension formula, average wage earners with 40 years of work history will now qualify only for the minimum pension, resulting in 11.7 million out of the 13.3 million current pensioners in 2004 receiving the minimum pension. This undermines the contributions-benefit link just established in the 2003 law.

Further rise in subsistence minimum in 2005. The Parliament has further raised the subsistence minimum for 2005, to which the minimum pension is now automatically linked. Objective estimates suggest that pension expenditures will rise to more than 16% of GDP.

3. Possible Options

The fiscal imbalance caused by the 2004 changes needs to be addressed. Measures can be taken to either decrease expenditures or to increase revenues. Table 1 provides a summary of the available options. Detailed analysis of the financial and social impact of each of these options will require additional data from the Pension Fund. Where possible, rough approximations of the financial impact of the various measures below are provided. Within each of these broad options, there are many combinations and variants which the Government might wish to consider.

TABLE 1

Type of	Options
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Measure	
Expenditure Reducing	<ul style="list-style-type: none"> • Reducing minimum pension level or keeping minimum pension fixed at 2004 subsistence minimum until it falls to an acceptable level; subsequently indexing it only by inflation. • Revising the level of subsistence minimum. • Indexation of pensions only by inflation. • Raising the retirement age, particularly for women to 60 and gradually also for men. • Lengthening the contribution period required to become eligible for a minimum pension. • Reducing the categories of work eligible for early retirement.
Revenue Enhancing	<ul style="list-style-type: none"> • Increasing compliance by making it easier for employers through introduction of a unified social insurance contribution payable to a single agency. • Introducing regular contributions to the pension fund for agricultural workers and the self-employed.

Minimum pension. Clearly, the rise in minimum pension, applicable to both pensions in payment and future pensions, has been the major contributor to the deterioration in the fiscal position of the pension fund. Given the high contribution rates, there is no incentive for employers or employees to pay contributions for more than the minimum period of 20/25 years for men and women, nor at salaries above the minimum contribution floor. This makes the social insurance system fiscally unviable and transforms it into a social assistance scheme funded from general revenues. It is also one of the main barriers to business and employment development in Ukraine, and encourages shadowization of the economy.

Tackling this issue should be the first priority of the Government. Suggestions include reduction of minimum pension level closer to the secured level of subsistence minimum. Alternatively, the minimum pension could be fixed at its 2004 level in nominal terms until it falls to a more acceptable level in real terms, such as 75% of minimum wage (from its current level of 120% of minimum wage). Keeping the level of minimum pension at the 2004 levels would reduce the pension system deficit by almost half.

Revision of subsistence minimum. Given that the issue of subsistence minimum is likely to rise again, it would be useful for the Government to define a methodology for determining the subsistence minimum which is consistent with international practices, rather than allowing the subsistence minimum to be determined politically (in the absence of clear calculations about its impact) by an act of Parliament.

Lengthening the required contribution period for a minimum pension. Currently women and men have to contribute 20 and 25 years respectively to become eligible for a minimum pension, with upward and downward prorating of minimum pensions for longer or shorter service periods. An alternative would be to lengthen the required contribution period to 25 and 30 years or further to 30 and 35 years for women and men respectively to reduce the pension expenditures and move the minimum pension level closer to the actuarial balance with minimum wage.

Indexation of pensions in payment. The current law allows pensions in payment to grow with inflation plus at least 20% of wage growth. Almost all western European countries and non-European OECD countries legislate growth of pensions only to inflation, with the view that pensioners should be protected from a reduction in the goods basket they can afford to consume during their retirement. They are not usually given a share of real wage growth. Additional pension benefits, if desired, can be achieved by taking advantage of a voluntary pension system, such as the one already in place in Ukraine. The Government should consider moving in this direction for pensions above the minimum pension as soon as is feasible. In 2005, the suspension of adjustment of pensions for 20% of wage growth would generate a savings of more than 0.6% of GDP.

Retirement age. The retirement ages in Ukraine at 60 for men and 55 for women are low by both Western and Central European standards. Most Central European countries have increased their retirement ages to at least 62 for men and 57 for women, and most plan to raise them still further. Women in Ukraine can expect to receive pensions for almost 25 years after retirement age based on life expectancy, while the normal period for benefit receipt is about 15 years. Thus, retirement age for women should be raised as quickly as possible to parity with men. Men, with their slightly lower life expectancy and already higher retirement ages are receiving benefits for about 15-16 years on average. As life expectancy continues to rise, the retirement age for men will also need to increase.

The retirement age could increase gradually over 10 years for men from 60 to 65 and from 55 to 60 for women. Gradual increases over the next 10 years for only women is likely to result in the accumulation of savings of 1% of GDP in every year after 2010 (and growing fractions of that 1% until 2010). This measure is a powerful instrument to balance the system, but does not help the Government reduce pension deficit spending in the short run. An instantaneous increase in the retirement age would generate savings faster, but still not fast enough to offset the minimum pension increase. Indexation changes and minimum pension changes have more impact than the retirement age change in the short run because they affect all pensioners, current and future, while the retirement age only affects new pensioners.

Although the current law encourages postponing retirement by providing increases in benefits for those who delay retirement, the measure is not a substitute for increasing retirement age. Cross country empirical evidence confirms that individuals tend to value leisure and do not actively respond to such measures.

Reduction in the early retirement entitlements. The Government might want to review the categories of workers eligible for early retirement, to determine whether medical criteria truly show that certain types of work cannot be performed until the regular retirement age due to the impact of the type of work on the health of the workers or

because of the demanding physical conditions of the job in hazardous occupations. The experience of other countries shows that such a thorough screening exercise can eliminate the list of privileged professions by 30%.

Introduction of regular contributions to the Pension Fund for agricultural workers and the self-employed. The current law allows certain categories of workers, such as agricultural workers and the self-employed, to pay only a fixed amount of tax, a portion of which is remitted to the pension fund. Given the attempt to link contributions and benefits in the law, it might be worthwhile within the simplified systems, to allow these individuals to also make explicit contributions to the pension fund based on their income, or at least on an income level from which they wish their pension to be based.

Introduction of unified social contribution. Aside from the individuals who fall under the fixed tax regimes, most employers have to pay contributions to 4 different funds, each with its own registration procedures and its own method of collection. This requires a duplication of efforts on the part of the collectors, which raises administrative costs, but also imposes an undue burden on employers. Easing the administrative burden on employers by unifying social contributions could increase collection compliance 1-2 years after its implementation.

Raising the contribution rate. While raising the contribution rate could potentially raise revenue, it is not recommended. Ukraine already has one of the highest payroll taxes in the region. Raising it further would only reduce the competitiveness of Ukrainian labor. Higher contribution rates tend to increase non-compliance and have been found to actually lower revenue collection in some cases.

4. Conclusions and Recommendations

The pension system changes undertaken in 2004 have moved the pension system from a surplus in 2003 into a deficit which might be as large as 5% of GDP in 2005. Such a sizable deficit and sudden jump in its magnitude is a clear cause for alarm. The minimum pension provision, which was modified in 2004, is directly responsible for the change and needs to be addressed as soon as possible. Not only does the minimum pension affect the fiscal sustainability of the pension system, it also undoes the link between contributions and benefits established in the 2003 law, which provided individuals with incentives to contribute and be a part of the system. The minimum pension and indexation of pensions are the most effective measures in the short run as they affect both current and future pension payments, while other measures affect only future pensioners.

The World Bank has supported pension reform in over 80 countries, of which 68 countries received 204 loans, plus technical assistance worth about \$5.5 bn. The loans were in many cases to help finance pension deficits until the fiscal impact of the pension reform program started to reduce the deficits. However, most of the loans have been to finance improvements in the administration of the pension system, regulation and supervision of the voluntary pensions and funded pension schemes, improve pension policy design capacity both in the pension funds and the Government. In Ukraine a project to unify the social insurance administration and introduce a single social contribution rate has already been identified. The World Bank is ready to fully support the Government of Ukraine in its pension reform program.