

4. GETTING PENSION REFORM BACK ON TRACK

A. INTRODUCTION

4.1 The Pay-As-You-Go (PAYG) pension system in Ukraine encompasses a variety of problems that threaten its fiscal sustainability. These problems range from poorly designed features on both the revenue and expenditure sides of the system, to such threats as an aging population (by 2055 there will be 1 worker in Ukraine for every 1.42 pensioners). In 2003 the government enacted legislation with the objective of reforming the system by adding to it a second fully funded mandatory pillar, and a third, voluntary, and private fully funded pillar. While the core legislation was approved, the envisioned full reform was not implemented owing to the fact that its institutional and administrative underpinnings were not ready for implementation. Moreover, increasing expenditures and record deficits in the system in 2004 and 2005 put the implementation of the multi-pillar system on hold. In the last two years there has also been considerable activity in terms of adjustments of certain features of the system. Some of these adjustments have been driven by electoral promises such as the September 2004 measure to increase the minimum pension, which was one of the main factors responsible for the growing deficit. Yet, as a result of recent increases, the PAYG system represents one of the highest transfer levels in the world as a share of GDP (see Table 4.1). After the presidential election, the government started to face this tension, and in March 2005 certain measures were implemented to control pension payments. These efforts were positive for the system's balance (i.e., reduced expenditures from an expected 17 percent of GDP to 15.3 of GDP in 2005) but they did not avoid the overall hike in pension payments and the deficit that year. Nevertheless, their positive effect on the pension system will continue in the following years.

Table 4.1: Overall Pension Expenditures as Percent of GDP: An International Comparison

Country	As percent of GDP	Country	As percent of GDP
Cyprus	8	Austria	14.5
Czech Republic	7.8	Belgium	10
Estonia	6.9	Denmark	10.5
Hungary	6	Finland	11.3
Latvia	9.8	France	12.1
Lithuania	5.3	Germany	11.8
Malta	5.4	Greece	12.6
Poland	10.8	Ireland	4.6
Slovak R.	7.9	Italy	13.8
Slovenia	13.2	Netherlands	7.9
Bulgaria	9.1	Portugal	9.8
Romania	6.4	Spain	9.4
EU new and accession	8	EU pre-2004	10.4
Ukraine 2003	9.2		
Ukraine 2004	11.4		
Ukraine 2005	15.3		

Note: Ukraine figures include pension payments for government employees

Sources: EU and OECD.

4.2 At the beginning of 2006 additional measures were approved to control pension expenditures. These measures are likely to succeed in reducing the ratio of pension expenditures to GDP, at least during 2006.¹⁰⁸ Almost in tandem, the Government of Ukraine launched its Strategy for Pension System

¹⁰⁸ For example, instead of an increase up front in the minimum pension benefits at the beginning of the year, the minimum pensions would gradually reach the minimum subsistence level by December 2006. This chapter provides an analysis of these measures in section D.

Development. The general precepts of this strategy are commendable as they are geared to control expenditures and increase collection efficiency in payroll taxes in order to implement the long-awaited reform. The analysis and fiscal impact estimation of the expenditure-reducing measures introduced recently and the measures envisaged by the government's Strategy show that they have a positive impact on the system's balance.

4.3 However, the fiscal impact estimation of the government's strategy also shows that the measures planned, while positive, are *not sufficient* to bring sufficient savings to the system to allow a fiscally smooth introduction of the second pillar (in 2008 or 2009) and to allow a rate reduction in the high marginal rates of the payroll taxes (social insurance contributions).¹⁰⁹ In order to move the system onto a long-term path of fiscal sustainability while reducing the high marginal burden of the contributions, as originally envisaged, additional savings measures are recommended, including the following:

- Increase the retirement age for women from 55 to 60 years, with an increase of 6 months per year (completed by 2017) starting in 2007. This measure would save an average of 0.32 percent of GDP annually, starting from 0.1 percent in 2007 and increasing to 0.7 percent by 2015. As life expectancy continues to grow, the retirement age for men and women would need to be further increased.
- Lengthen the required contribution period for eligibility for a full minimum pension to 30 and 35 years for women and men, respectively.¹¹⁰ This measure would save an average of 0.17 percent of GDP annually, starting from 0.1 percent in 2008 and increasing to 0.2 percent by 2015.
- Suspend the increase in pension benefits up to the subsistence minimum if the pensioner continues to work.¹¹¹ This measure would save an average of 0.54 percent of GDP annually, starting from 0.5 percent in 2007 and decreasing to 0.4 percent by 2015.
- Replace the minimum pension with means tested benefits for any pensioner whose family's per capita income falls below the minimum subsistence level.¹¹² Only low income pensioners whose household income is below the notional amount of the "subsistence minimum" should receive the automatic increase. This measure would save an average of 0.33 percent of GDP annually, starting from 0.5 percent in 2007 and decreasing to 0.4 percent by 2015.
- Introduce a regular contribution rate for those taxed under the simplified tax system (STS). This measure would save 0.1 percent of GDP annually from 2007 to 2015.

4.4 This chapter analyzes the recent developments in the Ukrainian pension system, and the current PAYG system parameters. It provides estimates of the fiscal impact of the newly announced government strategy for pension reform. It suggests concrete additional reform options to enhance the medium-term and long-term sustainability of Ukraine's pension system, and provides a detailed estimation of the fiscal savings that could be achieved. The analysis in this chapter is based on simulations generated by the Ukrainian Pension Simulation Model developed in collaboration by the Government of Ukraine, the

¹⁰⁹ Currently, the employer's contribution alone is around 37.5 percent of the wage. Together with the employee's contribution this rate reaches around 40 percent (although there is a rate variation depending on the employee's type of work—see Chapter 2).

¹¹⁰ Currently, the required minimum service period for a full minimum pension is 20 and 25 years for women and men, respectively. The minimum pension for shorter service periods is prorated. For every additional year of service the minimum pension is increased by 1 percent of the pension calculated by the formula, which also raises the equity issue. Extending the minimum service period for the full minimum pension to 30 and 35 years and prorating it for shorter service periods would be more equitable and cost effective.

¹¹¹ Working pensioners are currently entitled to the minimum pension regardless of the labor income they earn. This measure would entitle them only to the regular pension calculated with the pension formula as long as they continue to earn labor income.

¹¹² The increase in the minimum pension currently occurs automatically up to the level of the "subsistence minimum." The subsistence minimum is a notional amount set by the government each year in the annual budget. This amount is well above the minimum wage in Ukraine.

National Academy of Sciences of Ukraine, and the World Bank (see Annex 4.1 for a brief description of the model).

B. THE UKRAINIAN PENSION SYSTEM: EVOLUTION, CURRENT ISSUES AND PLANNED REFORMS

4.5 Like many other countries in the region, Ukraine has a PAYG pension system with several problematic features. The Ukrainian system features a conventional defined benefit formula with generous replacement rates, low retirement ages (60 for men and 55 for women), the full old-age pension entitlement based on 20 years of service for women and 25 for men, and numerous special early retirement provisions.¹¹³ These characteristics have been particularly problematic considering the country's demographic trends (for example, the shrinking contribution base and the growing beneficiary population). In addition, the system's sustainability faces compliance difficulties on the revenue side, owing to the high contribution rates, perverse incentives in the tax system (for example, the option for individuals to be taxed under the STS with a considerably lower burden), and weak revenue administration.¹¹⁴ Box 4.1 provides a chronology of the pension system in Ukraine.

Box 4.1: Chronology of Events and Milestones in the Ukrainian Pension System

- *1991*: First Pension Law enacted-- base of the Ukrainian system (among other features, aimed at providing generous replacement rates).
- *1991-2005*: Constant ad hoc adjustments of pension benefits made to cope with growing dependency ratio.
- *2003*: New pension legislation enacted, setting the stage for a comprehensive reform based on a multi-pillar system. It also introduces changes in the current system (i.e., first pillar).
- *2003-2004*: Several parametric changes to the first pillar implemented.
- *2004 (September)*: An increase in the minimum pension introduced prior to the 2004 presidential elections (this action would drive deficits up in 2004 and 2005).
- *2004-2005*: Pension payments hiked from 9.2 percent of GDP in 2003 to 11.4 percent of GDP in 2004. The year 2005 is a record high in pension expenditures (15.3 percent of GDP). As a consequence, deficits increased from 1 percent of GDP in 2004 to 3 percent in 2005.
- *2005 (March)*: Amendments to the pension legislation introduced to control the negative fiscal outcomes.
- *2005-2006*: Additional measures introduced to control the deficits (changes to indexation rules for pension benefits in 2005 and in 2006, instead of an up-front increase in the minimum pension benefits at the beginning of the year, the minimum pensions should gradually reach the minimum subsistence level by December 2006).
- *2005 (December)*: The government's Strategy for Pension System Development is announced. Among other things, the Strategy envisages the elimination of the pension deficit by 2008 and the launching of the second fully funded pension pillar in 2009 or earlier if fiscal conditions allow. Moreover, it envisions the unification of several functions of the four insurance funds, and a single contribution.

¹¹³ A defined benefit scheme is a guarantee that the pension agency will pay a benefit based on a prescribed formula. The replacement rate is the value of a pension as a proportion of a worker's wage during a base period before retirement or the entire lifetime average wage.

¹¹⁴ The issues and recommendations regarding social insurance contributions (payroll taxes) are discussed in detail in Chapter 2. This chapter links its discussion to issues and recommendations in that chapter and re-states some of key arguments.

4.6 **Replacement rates were for many years lower than mandated before 2004.** This took place over the years in order to adjust the system to the rapidly growing dependency ratio.¹¹⁵ The adjustment took place through the imposition of a maximum cap on pension benefits, which in turn eroded the value of pensions. In addition, ad hoc benefits adjustments for inflation, and other factors, were put in place. As a result, the system has paid low and almost flat benefits.

4.7 **During 2003-04, legislation was enacted to reform the current system with a multi-pillar pension system.** The rationale behind this pension reform was to replace an ill-performing system with one that would: (i) provide adequate pensions, including a minimum benefit; (ii) ensure a transparent and direct link between lifetime contributions and benefits; and (iii) diversify the sources of pension income between current social security contributions and accumulated savings. The new legislation called for the establishment of three pillars: the first and second pillars as mandatory, and the third pillar to be voluntary. The first pillar is financed on PAYG principles; the second and third pillars would be fully funded. Box 4.2 briefly describes the second pillar.

Box 4.2: The Second Pillar of the Pension System, as Envisaged by the Approved Legislation

The second pillar is envisaged as a fully funded component of the system. Ukraine chose to link the PAYG benefits to contributions through the German point system, as in Hungary, the Slovak Republic, Slovenia and Croatia. That is, the current total pension contribution rate (i.e., payroll tax rate) would be divided in two between the mandatory pillars: the upper 7 percentage points of the contribution would go to fund the second pillar, and the remaining 26.8 percentage points (approximate, as rates vary by type of work and industry-see Chapter 2) would continue to fund the current PAYG first pillar. The second pillar would include people below the cut-off ages of 45 for women and 50 for men. People aged 40-35 and younger, as well as new labor force entrants, would have to join the new multi-pillar system. Workers between the ages of 40-35 and 50-45 would be given the choice of remaining in the first pillar only or of enrolling in the multi-pillar system, like younger workers. This decision should be made within one year following the year of the introduction of the second pillar. If the current proposal remains unchanged, Ukraine would have one of the largest second pillars in the region. The new legislation conditions the introduction of the second pillar on macro-fiscal and institutional reform triggers, including the following: (i) balancing out the pension system deficit, (ii) recording real GDP growth above two percent for 2 consecutive years prior to its introduction, (iii) establishing institutions for supervising the funded system, (iv) creating a voluntary pension funds market in the country, and (v) requiring that the minimum pension should not be lower than the minimum subsistence level.

4.8 **While the second pillar is yet to be introduced, some parametric changes to the first pillar established in the 2003 Law were implemented in 2004.** These changes include the following:

- (a) An increased benefit to those who delayed retirement, beginning with a 3 percent increase in pension benefits for one year of delay, to a total 85 percent increase for a 10-year delay.
- (b) Benefits are set as 1 percent of the wage (subject to pension) per each year of service (before this, the figure was 2.2 percent for men and 2.75 percent for women).
- (c) Indexation of the pension payment for inflation¹¹⁶ plus at least 20 percent of wage growth (previous indexations were made on an ad hoc basis).
- (d) A ceiling on the taxable wage (contribution) equal to seven times the average earnings, the previous ceiling was less than twice the average wage in the country.
- (e) Separation of work injury-related disability from other forms of disability.

¹¹⁵ The dependency ratio is the number persons receiving pension benefits (from a certain pension scheme) divided by the number of workers contributing to the same scheme at a certain point in time.

¹¹⁶ The part of the income below the subsistence minimum is subject to indexation for inflation, while the part of the income above the subsistence minimum is not compensated at all.

- (f) Specification of disability benefits as a percentage of the projected old age benefit rather than as a percentage of salary.
- (g) Movement of the elderly not eligible for a labor pension from the PF to a social assistance system funded by the state.
- (h) An optional recalculation of pension benefits for those already retired in accordance with the new pension formula that has no maximum cap on the pension payment (benefits paid) (the previous law had a maximum pension payment ceiling of three minimum wages).

4.9 **Some of these measures increased pension payments.** As stated above, the new law allowed those already retired to have a recalculation with the new pension formula, which does not have a maximum cap on pension benefits (see [h] above).¹¹⁷ Owing to this recalculation, total pension expenditures in the first three quarters of 2004 jumped by around 20 percent.

4.10 **Just two months preceding the presidential elections a significant increase in the minimum pension took place.** All pension benefits that were lower than a notional amount established by law called “the subsistence minimum” were raised up to this threshold (which is above the minimum salary), which resulted in a hike in pension payments during the last quarter of 2004 and throughout 2005.¹¹⁸ More than 12 million Ukrainian pensioners started to receive benefits equal to this “subsistence minimum” amount.¹¹⁹ Prior to this change the ratio of minimum pension to average wage was 18 percent. The resulting minimum pension level after this change (49 percent) is high and is well above most observed levels in other countries (see Table 4.2).

Table 4.2: Minimum Pension Levels in Comparison with Average Net Wage, in %

Country	Percent	Country	Percent
Belgium	30	Canada	14
Czech Republic	12	Ireland	30
France	29	Japan	19
Hungary	21	Korea	30
Luxembourg	42	Netherlands	34
Spain	33	New Zealand	38
Switzerland	19	Norway	18
UK	15	US	19
Bulgaria	16	Latvia	33
Ukraine	49	Poland	25

Note: Most recent years.

Source: World Bank.

4.11 **As a consequence of these changes, pension expenditures in 2004 and 2005 increased drastically along with Pension Fund deficits.** Pension payments increased from 9 percent of GDP in 2003 to 11.4 percent in 2004. This trend continued, reaching a record level of 15.3 percent of GDP in 2005. This high ratio, even by European standards, unavoidably led to increasing deficits that reached 3.3 in 2005 (see Table 4.3). This fiscal gap was ultimately covered by transfers from the state budget to the Pension Fund.

4.12 **The negative fiscal outcomes of the minimum pension increase were partially addressed in March 2005 through amendments to the Law.** These amendments included: (i) the partial abolishment

¹¹⁷ The previous law had a maximum pension ceiling of three minimum wages.

¹¹⁸ The concept of “subsistence minimum” is discussed in detail in Annex 4.2. The resolution adopted in September 2004 is CMU Resolution # 1215.

¹¹⁹ For most low income earners (the bulk of the contributors) this represented up to 200 percent of the replacement ratio.

of the wage component in the minimum pension indexation¹²⁰; (ii) the abolishment of the rule that allowed 1 percent of the minimum pension increment for each additional year of service above 20-25 years for women and men, respectively; and (iii) the abolishment of the rule that allowed increases in supplementary payments to special categories of pensioners based on the increase in the minimum pension. It is estimated that this measures created expenditure savings close to 1.5 percent of GDP.

Table 4.3: Pension System Budget Outline, UAH billion, 2003-05

Year	2003	2004	2005	2006/1
Payroll tax revenues (including government employees)	22.8	31.4	42.8	49.4
Transfers to PFU from different sources,	2.1	6.2	22.9	
<i>Of which:</i>				
State Budget,	1.9	6	22.6	18.5
<i>Of which:</i>				
regular transfer (1)	1.9	2.2	6.7	8
deficit coverage	0	3.8	15.9	10.5
Unemployment Fund	0.1	0.1	0.1	
Work injury and occupational decease fund	0.1	0.1	0.1	
Total PFU revenues	26.7	39.8	66.3	
Total PFU expenditures	24.5	39.2	64.1	68.3
Deficit/Surplus,	0	3.2	13.7	8.3
Including				
carry-over for next fiscal year	2.2	0.6	2.2	2.1
Total PFU expenditures, % of GDP,	9.2	11.4	15.3	14.2
Deficit % of GDP	0	0.9	3.3	1.7

Note: In 2004 the state budget assumed full responsibility for financing special pension programs (e.g., special pensions for civil servants, social pensions for people who never worked, supplements to war and labor veterans, blood-donors, victims of political repression, inhabitants of mountainous areas, scientists, recipients of merit pensions, Chernobyl victims, servicemen and other allowances).

1/ This estimation is based on the macro projections discussed in Chapter 6 (under the conservative scenario).

Sources: Ministry of Labor; Ministry of Finance.

4.13 The measures to create expenditure savings that were implemented in 2004 and 2005 (March) missed some critical issues. For example, these measures did not address the issue of the mandatory retirement age, which currently remains at 55 for women and 60 for men. These retirement ages are considerably lower than in EU and other OECD countries. Other issues that were left out include the following: (i) the lengthening of the minimum contribution period, which is currently very short in Ukraine;¹²¹ (ii) the inclusion in the regular system of the individual in the FAT and the STS; (iii) the treatment of working retirees; and (iv) several revenue related measures, as discussed in Chapter 2.

4.14 The government's strategy to move the pension reform forward will have a positive impact on the system's balance. With the objective of making the long envisaged (and approved) pension reform possible, in December 2005 the government adopted a policy plan called the "Strategy for Pension System Development for the period 2006-2016." This Strategy envisages the elimination of the pension deficits by 2008 and the launching of the second fully funded pension pillar in 2009, or earlier, if the

¹²⁰ The original pension reform law envisaged the price adjustment of pensions and, in addition, increases in all benefits in payments by 20 percent of nominal wage growth recorded in the year preceding the adjustment (so-called wage adjustment coefficient). The partial wage adjustment introduced in 2005 means that (i) pensions are increased by the difference between inflation and wage adjustment coefficients, and (ii) pensions are subject to wage growth adjustment only when the inflation adjustment coefficient is lower than the above-mentioned wage adjustment coefficient.

¹²¹ The minimum contribution period for becoming eligible for disability, survivors or reduced minimum pension is 5 years.

policy measures yield a stronger fiscal impact.¹²² In parallel, the President and the government expressed their vision of reducing payroll tax rates by about 20 percent over the medium term. Box 4.3 briefly describes the Strategy.

Box 4.3: Main Features of the Government Strategy for Pension System Development

The adoption of the Government Strategy is an important step towards reforming the pension system along the lines of the multi-pillar design. However, it contains general policy provisions only and does not specify changes to some pension system parameters. Key policy measures listed in the Strategy include the following: (i) the introduction of a single social insurance contribution payment; (ii) the strengthening of the link between pension level, length of service and contributions paid; (iii) the streamlining of the payment of pensions to working pensioners in relation to their labor incomes; (iv) the revision of the list of occupations eligible for early retirement; (v) the introduction of general pension system principles for the military and other professions for which the legislation does not stipulate the mandatory payment of contributions; (vi) the streamlining of the procedure for the indexation of pensions and their raising in accordance with average wage growth; (vii) the creation of an administrative system for the second pillar; (viii) the introduction of the second pension pillar; (ix) the stimulation of the payment of wages and pensions through banking institutions; (x) the introduction of norms to collective bargains and sector agreements on minimum contribution bases and the establishment of responsibility for noncompliance; (xi) the creation of a system for electronic reporting by employers on the insurance contributions payments; (xii) the revision of the retirement age in accordance with the increase in life expectancy after 2010; and (xiii) the transfer of early and privileged pensions from pay-as-you-go to a funded system. However, several specific details about the implementation of these policy measures have not been clearly stated in the Strategy. Moreover, the changes in some of the areas above, particularly in those related to the expenditure side, are very marginal and consequently would have a limited impact.

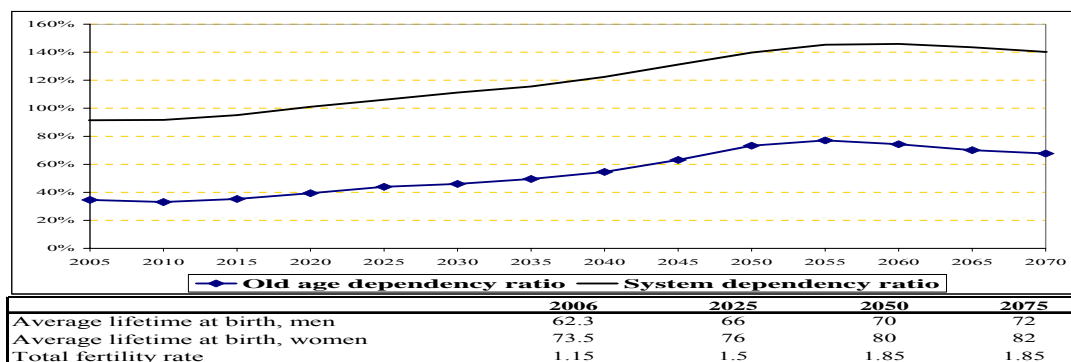
4.15 The majority of the suggested policy measures in the Strategy focus more on increasing pension revenues than on curbing the high pension expenditures.¹²³ Most of the measures for improving revenue collection stated in that Strategy are geared in the right direction (see Chapter 2). However, only a few measures to reduce pension expenditures are articulated in that document. The most relevant reforms of that Strategy are analyzed and measured in terms of their fiscal impact in this chapter.

4.16 The aging population, coupled with early retirement, would continue to pose a risk to the fiscal sustainability of the system. It is essential for policymakers not only to take measures to reduce the short-term PAYG deficit, but also to enact comprehensive measures to prepare the pension system for unfavorable long-term demographic changes. Ukraine has a population that is already old and that is shrinking. Life expectancy is increasing and fertility rates are low. Along with the rest of Europe, Ukraine will experience a rapid aging of its population. The most evident effect on the pension system is the rise of the system's dependency ratio (already the highest among transition countries). The system dependency ratio in Ukraine is projected to increase further from 92 percent in 2005 to as high as 140 percent in 2050; this increase would also be fueled by the current generous early retirement provisions and by a significant drop in the number of active contributors (see Figure 4.1).

Figure 4.1: Old Age and System Dependency Ratios in the Absence of Reforms, 2005-75

¹²² Recently the government has been discussing the introduction of the second pillar in 2008, and it was agreed with the government that 2008 would be used for the pension system modeling in this report.

¹²³ However, none of the suggested revenue improving measures challenges the simplified tax regime, which allows small businesses and individuals to pay significantly lower contributions than in the regular system (see Chapter 2).



C. ARTICULATING REFORM OPTIONS

4.17 **With the introduction of the second pillar, contributions to the first pillar (PAYG) will be reduced, and thus further policy changes to this latter pillar are necessary to control expenditures.** In Ukraine, a further reduction of pension expenditures is necessary to obtain a balanced PAYG and to offset the transition costs of the second pillar. There are a variety of measures that can achieve this reduction in the short, medium, and long terms; the most feasible of these are listed in Box 4.4. This section focuses on explaining what these policy changes are, what they imply, how the current features of Ukraine’s pension system rank internationally, and why they are important for the system’s sustainability. Then, the next section of this chapter (Section D) provides an estimation of the fiscal impact of key measures according to changes planned under the government’s Strategy, and according to the recommendations of this report. While some of the reform options in Box 4.4 are depicted in the government’s Strategy, the fiscal impact, as discussed and estimated in the next section, depends on the specifics of the measures (that is, when implementation starts, and how marginal or bold are the changes to the parameters that they address)

Box 4.4: Outline of Selected Reform Options (parametric changes to save resources for the system)

- Increasing the retirement age.
- Lengthening the contribution period required to become eligible for a full minimum pension.
- Suspending the increase of pension benefits to the subsistence minimum for working pensioners.
- Tightening generous minimum pension eligibility criteria through better targeting (means testing of the minimum pension).
- Eliminating or at least reducing early retirement entitlements and special pension privileges for certain occupational categories.
- Requiring individuals currently under the STS to contribute at regular rates.
- Indexing pension payments at the inflation rate.
- Differentiating minimum pensions through increasing the benefits for years of contribution above 30 and 35 years for women and men, respectively.

Increasing the Retirement Age

4.18 **The pension system’s retirement age is one of the most critical variables in determining system costs.** It directly affects the number of years during which benefit payments are made and also the number of years during which workers make contributions. A higher retirement age also reduces the number of new pensioners and increases the labor force. The retirement ages in Ukraine are low by Western European, Central European and OECD standards.

4.19 Moreover, most of the Central European countries have increased their retirement ages to at least 62 for men and 57 for women as they have moved into the EU. In some cases they plan to increase their retirement ages further in order to ensure fiscal sustainability of their systems (see Table 4.4). In Ukraine, women can expect to receive pensions for almost 25 years after retirement (that is, based on life expectancy after retirement), while the normal period for benefits elsewhere is about 15 years. Thus, one of the least burdensome ways to bring the pension system to long-term balance is to raise the retirement age for women. Men, with their lower life expectancy and their already higher retirement ages, receive benefits for about 15-16 years on average. As life expectancy continues to rise, the retirement age for men should also increase.

Table 4.4: Mandatory Retirement Age in Selected EU, CEE, OECD, and CIS Countries

Country	Male	Female	Country	Male	Female
Albania	65	60	Austria	65	60
Croatia	65	60	Denmark	67	67
Republic of Cyprus	65	65	Finland	65	65
Estonia	63	63	France	60	60
Hungary	62	62	Germany	65	65
Lithuania	62.5	60	Greece	65	60
Macedonia	64	62	Ireland	65	65
Poland	65	60	Italy	65	60
Romania	65	60	Japan	65	65
Slovak R.	65	60	Norway	67	67
Slovenia	63	61	Portugal	65	65
Russia	60	55	Spain	65	65
Turkey	60	58	Sweden	65	65
Kazakhstan	63	58	Great Britain	65	60
Ukraine	60	55	USA	65	65

Source: World Bank.

Lengthening the Contribution Period Required to Become Eligible for a Full Minimum Pension

4.20 The current required contribution period in Ukraine is short. The system requires a contribution period of 20 years for women and 25 years for men for eligibility for the full minimum pension benefit. The minimum pension for the longer service periods is increased by 1 percent of the pension as calculated by the formula, while those with shorter service periods are entitled to a prorated minimum pension benefit, which raises both cost and equity issues. This feature, although it is a candidate for reform, was not harming the system's finances significantly in the past when the guaranteed minimum pension benefit was set at low levels (for example, at 20 percent of the average wage). However, the increase in the minimum pension to the subsistence minimum level, which implied a rise in the minimum pension to 49 percent of the average wage in 2005 (or 120 percent of the minimum wage), made the short contribution period an important threat to pension system sustainability. The recommended policy at such high minimum pension replacement rates is to award them to those with the longest service periods (i.e., 30 and 35 years for women and men, respectively) and prorate them for those with shorter service periods.

Suspending the Pension Benefits Increase if the Pensioner Continues to Work

4.21 Many countries suspend PAYG pension benefits for those who continue working. This policy is not in place in Ukraine. As much as 20 percent of pensioners report that they continue to work while receiving a pension, and the actual figures is likely to be even higher. Furthermore, Ukrainian working pensioners are qualified, like working contributors, to the increase of pensions to the minimum pension level. In the short and medium terms, the government should consider suspending this top-up increase to the subsistence minimum for working pensioners. Working pensioners' total income is almost always higher than the subsistence minimum. Moreover, the bulk of these pensioners are not in the lowest income and poverty brackets. Those that are, would be eligible for poverty targeted social assistance. In

fact, the use of the subsistence minimum as a basis for pension calculations affecting all pensioners mixes a social insurance issue with a social assistance issue. Poor pensioners should be targeted with social assistance programs, not through a wasteful and unfair increase in the overall pension system minimum.

Targeting the Increase of Pension Benefits Up to the Subsistence Minimum

4.22 **The large increase in the minimum pension has essentially eliminated the link between pension benefits and contributions.** Owing to the increase in the minimum pension, the current system pays almost flat benefits (at the level of the subsistence minimum) for more than 95 percent of pensioners. The poverty reduction argument of this policy loses strength because of the complete lack of targeting. Moreover, it should be borne in mind that pensioners are not among the poorest in Ukraine according to Ukraine's Household Budget Survey. Through targeting (for example, means-testing), critical savings in the system could be achieved without curtailing the benefits of poorer recipients (see Box 4.5).

Box 4.5: A Simple and Cost Effective Strategy to Target Pension Increase to Poor Pensioners

The most efficient and cost-effective way to eliminate poverty within the pension system is to use means testing in order to target poor pensioners. Targeting could be introduced in the following manner. The recipients could be divided into four different groups. The first and largest group (one-fifth of pensioners), consists of pensioners living alone. For them a pension is most likely to be the primary source of income. The second group, comprising one-sixth of pensioners, are couples living together—a married couple normally receives two pension payments in its own right. The third group comprises multi-generational households with pensioners, in which no other member is a wage-earner (these households usually consist of pensioners, children and the disabled)—this is a very small group (around 1 percent). And the last group, representing almost 40 percent of Ukrainian households with pensioners, consists of multi-generational households in which at least one member of the household is a wage-earner. In this last group, it is important to note that the significance of a pension for household income depends upon the number of employed persons in the household, since household members usually pool resources. In light of these group compositions, the targeting would consist of automatically allowing the level of the minimum pension (at the subsistence level) to the first three groups. Only the last group should be means tested—which would save resources in carrying out means testing for the whole population of pensioners.

^{1/} This targeted approach to the minimum pension increase would ensure compliance with Article 46 of the Constitution of Ukraine for all Ukrainian pensioners.

Introducing Regular Contributions for Individuals under the STS

4.23 **The STS is an obstacle to the expansion of the base of payroll taxes (pension contributions).** The current law allows certain categories of workers, such as individuals taxed under the STS (and agricultural workers taxed under the FAT), to pay only a fixed amount of tax, a portion of which is remitted to the Pension Fund. But this fixed amount is several times smaller than the corresponding contribution under the regular tax system (see Chapter 2). To compensate the Pension Fund for this revenue loss, the budget makes a special transfer to the Pension Fund to cover the payments of individuals under these special tax regimes. In practice this is a subsidy, one that introduces inefficiencies and inequities into the tax system. While a step-wise phase-out of this scheme has been approved for agricultural workers under the FAT by 2010, contributions from individuals under the STS remain an issue.¹²⁴ Curtailing this subsidy for individuals under both special tax regimes would increase the system participation rate significantly (by around 7 percent in the next 10 years).¹²⁵

¹²⁴ The gradual introduction of regular contributions for agricultural businesses paying a fixed tax was initiated in 2005.

¹²⁵ The system participation rate is defined here as a share of contributors in active employment and gives combined information about coverage and compliance.

D. FISCAL IMPACT OF RECENTLY IMPLEMENTED, PLANNED, AND
ADDITIONAL RECOMMENDED REFORM OPTIONS

Measures Introduced During the Period of 2005- 06

4.24 **During 2005-06 several fiscal savings measures were introduced, and they are expected to have a strong impact on reducing pension deficits.** The key factor influencing a favorable pattern is a tight indexation rule introduced by the 2005 Budget Law. In addition, in 2006 instead of an increase up front in the minimum pension benefits at the beginning of the year, the minimum pensions would gradually reach the minimum subsistence level by December 2006. The law introduces a quarterly indexation of the minimum pension starting from UAH 350 to be applied in the first quarter of 2006, rising to UAH 359 during the second and third quarters, and to UAH 366 in the last quarter. Effectively, the minimum pension would be raised by 8 percent in 2006, some 10 percentage points below the expected nominal wage bill growth and 6 percentage points below the expected nominal GDP growth.

4.25 **As a result, in 2006 pension expenditures are expected to drop further to around 14 percent of GDP.** Table 4.5 shows a simulation of the potential impact of the measures introduced. These projections assume that no further changes in the current legislation would take place; it also assumes a constant system participation rate.¹²⁶ As shown in Table 4.5, pension expenditures fall significantly through the projection period. Again, the key factor influencing a favorable pattern is the very tight indexation rule. However, this would take place only in the absence of policies geared to increase pensions. It also implies that the same indexation rule is applied each year. Due to the model specifications these estimates are quite sensible to the real wage growth dynamics.¹²⁷

Table 4.5: Simulation of Pension Expenditures without Further Parametric Reforms, 2007-15 ^{1/}

	2007	2008	2009	2010	2011	2012	2013	2014	2015
Conservative Scenario									
Expenditures, as percent of GDP	13.5	13.0	12.6	12.2	12.0	11.7	11.5	11.3	11.0
Replacement rate, %	40	38	37	35	34	33	32	31	29
Base Case Scenario									
Expenditures, as percent of GDP	13.5	12.7	12.1	11.6	11.2	10.8	10.5	10.2	9.9
Replacement rate, %	38	36	34	32	30	28	27	26	24

^{1/}Includes the impact of introducing regular contributions from payers of a fixed agricultural tax. During 2005-06 payers of a fixed agricultural tax were to pay 20 percent of the pension insurance contribution rate. Starting from 2007 this share will grow by 20 percent per year to reach 100 percent in 2010. The state budget took full responsibility for covering the difference and transfers the money to the PF through the Ministry of Agricultural Policy.

4.26 **But without any further pension policy changes, the introduction of a second pillar in 2008 would keep the system in deficit until 2015.** With the introduction of the second pillar, the annual revenue forgone to that funded scheme is around 1.3 percent of GDP in the first year. From there it grows steadily up to 2 percent of GDP by 2015. Pension savings generated by the current pension indexation policy will partially help offset the initial pension deficits caused by the loss of contribution revenues diverted to the second pillar. However, during the period 2007-15, a significant part of the financing gap would still have to be covered by the government by the cutting of public spending elsewhere, through public debt issuance, and/or through increasing the burden of taxpayers.

¹²⁶ Under a status quo scenario, system participation rate remains around the current level of 73 percent.

¹²⁷ See a description of the model in Annex 4.1. See a detailed discussion of the macro-scenarios' assumptions used for this report in Chapter 6.

Fiscal Impact of Planned Measures of the Government's Strategy

4.27 **This section evaluates the fiscal impact of the three savings measures of the government's Strategy.**¹²⁸

- (a) The increase in the retirement age for women to 60 at the rate of 6 months per year, starting in 2010.
- (b) The introduction of the indexation of all pension benefits in payment status by 20 percent of the nominal wage growth.
- (c) The suspension of the increase in pension benefits up to the subsistence minimum for working pensioners (starting in 2007), and the payment of only the formula part of the benefit.

4.28 **The expected fiscal impact of these three policy measures envisaged under the government's Strategy is the creation of savings that are, on average, 0.42 percent of GDP annually for the period 2007-15.** The cumulative savings for that period are close to 3.8 percent of GDP (under the conservative macro scenario). The savings start at 0.2 percent of GDP in 2007 and increase up to 0.6 percent of GDP in 2015. These savings vary slightly between the two sets of macro scenarios (see Table 4.6).

Table 4.6: Fiscal Savings Under the Government's Strategy, 2007-15

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2007-2015 (cumulative)
Conservative Scenario										
Savings, as % of GDP	0.2	0.3	0.3	0.4	0.4	0.5	0.5	0.6	0.6	3.8
Base Case Scenario										
Savings, as % of GDP	0.2	0.2	0.3	0.4	0.4	0.5	0.5	0.7	0.8	3.9

4.29 **The savings generated by policy changes under the government's Strategy are not sufficient to offset the pension system deficits in the long run and to allow a rate reduction in payroll taxes.** The government Strategy addresses the weaknesses of the current system only partially. The savings generated by the expenditure side elements of this strategy are necessary and positive but are not sufficient to bring long-run sustainability to the pension system. For example, these measures would not be sufficient to serve as a counterweight to the decline in the replacement rate in the long run. Moreover, they would not provide enough fiscal space to allow a payroll tax reduction as planned by the government's administration.

Fiscal Impact of Recommended Reform Options (measures to create fiscal savings)

4.30 **Additional measures/reforms are necessary to bring the needed savings to the pension system.** The government should consider the following concrete parametric reforms to the PAYG system (first pillar):

- (a) Gradually raising the retirement age for women from 55 to 60 by 2017, with an increase of 6 months per year beginning in 2007. The government's Strategy also plans a reform on this front (i.e., increasing the retirement age for women to 60 only from 2010 at the rate of 6 months per year) but it is more marginal than the plan recommended here.

¹²⁸ The introduction of the second pillar with a 7 percent contribution rate in 2008 is assumed. These estimations also assume a cut-off age for second pillar participants of 50 for men and 45 for women.

- (b) Extending the contribution period required to become eligible for a full minimum pension from the current 20-25 years to 30-35 years of service for women and men, respectively.
- (c) Suspending the automatic increase in pension benefits (up to the subsistence minimum) if the pensioner continues to work (this measure is also considered in the government's strategy).
- (d) Replacing the minimum pension with means tested benefits for any pensioner whose family's per capita income falls below the minimum subsistence level
- (e) Introducing regular contributions for all employees in the STS.

4.31 **The measures suggested here generate more than three times the savings of the measures envisaged under the government's Strategy.** The expected savings for the system of these recommended (additional) measures are, on average, 1.51 percent of GDP annually from 2007 to 2015. The cumulative savings for this period are close to 12.3 percent of GDP. The total savings start at 1.1 percent of GDP in 2007 and increase up to 1.7 percent of GDP in 2015 (see Table 4.7).

Table 4.7: The Fiscal Impact (savings) of the Recommended Measures, 2007-15 ^{1/}

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2007-2015
Savings generated by retirement age increase from 55 to 60 years by 2017, with an increase of 6 months per year beginning in 2007.	0.10	0.10	0.20	0.20	0.30	0.40	0.50	0.60	0.70	2.90
Savings generated by lengthening the required contribution period from the current 20/25 years to 30/35 years for women and men respectively.	0.00	0.10	0.10	0.10	0.20	0.20	0.20	0.20	0.20	1.40
Savings generated by suspension of increase of pension benefits up to subsistence minimum if pensioner continues to work.	0.50	0.50	0.50	0.50	0.50	0.50	0.40	0.40	0.40	4.40
Savings through replacing minimum pension with means tested benefits to any pensioner whose family's per capita income falls below the minimum subsistence level.	0.40	0.40	0.40	0.30	0.30	0.30	0.30	0.30	0.30	3.00
Savings generated by introduction of minimum pension contributions for employees under simplified tax regimes.	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.60
Total savings	1.10	1.20	1.30	1.20	1.40	1.50	1.50	1.60	1.70	12.30

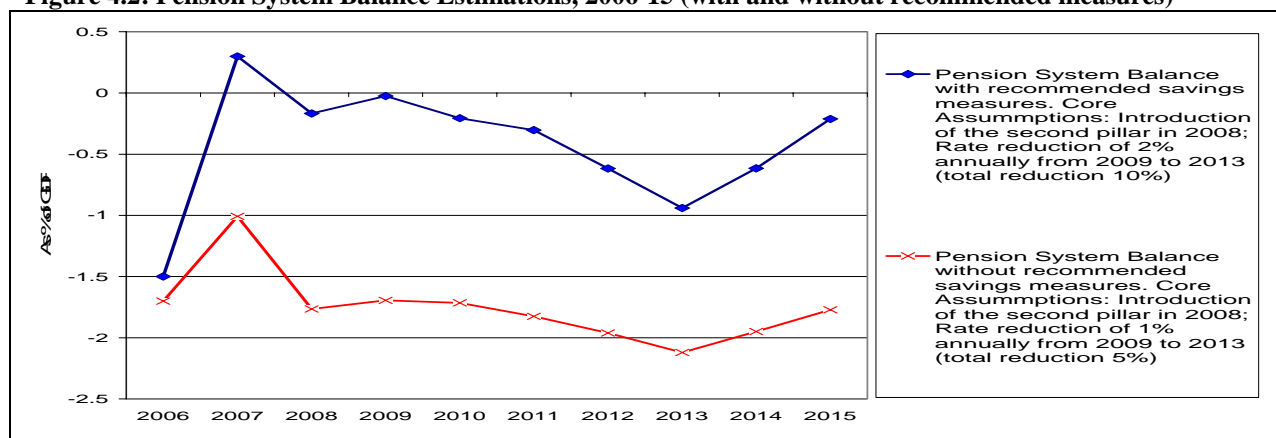
^{1/} Estimations using the "base case" macro scenario (see Chapter 6 for detailed assumptions of this macro scenario).

4.32 **A rate reduction in contributions (payroll tax) would create large deficits if it is not coupled with the recommended savings measures in the system and parallel key reforms.** As stated in Chapter 2, the rate reduction should be accompanied by several reforms geared to broadening the revenue base and improving compliance in order to avoid severe revenue losses, including the unification of function of the insurance funds under the PF (moving towards a single rate in the medium term), the reform in the simplified tax system, and an overall enhancement in coordination between the insurance funds and the STA. In addition, the government should consider a rate reduction after (or in parallel to) the introduction of the second pillar of the pension system (that is, when a stronger link between contributions and benefits is present). Figure 4.2 shows projections of the pension system balance under two different scenarios. In one scenario, the recommended measures are not implemented and a 5 percent rate reduction is applied spread out over 5 years (1 percent each year from 2009 to 2013).¹²⁹ This

¹²⁹ In addition to these assumptions, the assumptions of the "conservative" macroeconomic scenario are embedded in these projections. See Chapter 6 for the full set of assumptions and discussion of the scenarios depicted in this report.

projection shows the larger deficits in the figure below. In the second scenario, the recommended measures are implemented and even a larger rate reduction (10 percent) is applied, also spread out over 5 years (2 percent each year from 2009 to 2013).¹³⁰ In longer-term projections, this scenario shows surpluses in the system after 2015 even with that significant cut in the contribution rate. While these are two scenarios of many possible ones, they highlight the sensitivity of the pension balance to both the savings measures recommended and the rate reduction.

Figure 4.2: Pension System Balance Estimations, 2006-15 (with and without recommended measures)



Source: Based on a projection of the Ukrainian Pension Model- developed in collaboration by the Government of Ukraine, the National Academy of Sciences of Ukraine, and the World Bank.

E. CONCLUSION

4.33 **While the government’s Strategy measures are positive for the system’s balance, they are not sufficient to introduce the second pillar and reduce contribution rates, and to bring long-run fiscal sustainability to the system. Consequently, additional savings, as recommended in this report, are urgently needed.** The savings achieved through the recommended measures outgrow revenues passed on the funded second pillar, which allows a fiscally smoother transition. The savings also allow more fiscal space for a rate reduction in payroll taxes, which is a critical policy reform for Ukraine. Moreover, while the projections show that the system would be back in balance after 2015 (or as early as 2011 without rate reductions) policymakers need to think about the longer run (i.e. beyond 2015). The rising dependency ratio— product of an aging population, low retirement age and numerous early retirement provisions— poses a serious risk to the long-term sustainability of the system. The measures recommended here are geared to mitigate those risks.

4.34 **Finally, the recommended reforms are geared to protect the poorer pensioners and are in line with international practices.** Because targeting is involved in the measures suggested, the changes will protect poorer pensioners. The reforms presented are critical to a viable system for present and future retirees. Moreover, they follow the same path of reform implemented by countries with the same types of problems that have moved into EU (e.g., EU-8 countries), and other EU and OECD countries.

¹³⁰ In addition to these assumptions, the assumptions of the “base case” macroeconomic scenario are embedded in these projections. See Chapter 6 for the full set of assumptions and discussion of the scenarios depicted in this report.