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Pension reform in Ukraine. Comments on the main features of the current Draft Law

Oleksandra Betliy, Ricardo Giucci

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Institute for Economic Research and Policy Consulting
Reytarska 8/5-A,
01034 Kyiv, Ukraine
Tel: +38 044 / 278 63 42
Fax: +38 044 / 278 63 36
institute@ier.kiev.ua
http://www.ier.kiev.ua

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German Advisory Group
c/o BE Berlin Economics GmbH
Schillerstr. 59
D-10627 Berlin
Tel: +49 30 / 20 61 34 64 0
Fax: +49 30 / 20 61 34 64 9
info@beratergruppe-ukraine.de
www.beratergruppe-ukraine.de

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Executive Summary

Ukraine's pension system is in urgent need of reform. Its first pillar, a compulsory pay-as-you-go system, generates severe deficits, which have to be closed by transfers from the central Government. In 2010, the Pension Fund's deficit amounted to 2.5% of GDP. Consequently, the pension system is to a large extent responsible for the strained fiscal situation in the country. In order to reinstall fiscal stability and to stabilise state debt (in relation to GDP), a rather topical issue throughout the world, a reform of the pension system is indispensable.

Accordingly, the Government recently submitted a Draft Law on pension reform to Parliament. The main features of the Draft Law are a gradual increase in the retirement age of women from currently 55 to 60 years, a less generous approach regarding special pensions and an increase in the years of contributions for obtaining a minimum pension.

While the overall impact of the proposed measures will be rather limited in the short-term, it will eventually balance the pension's finances. As for the individual measures, our analysis shows that they are necessary.

At the same time, we do not consider the introduction of a second pillar, i.e. of the compulsory and personalised accumulative system, as a mid-term priority of the Government. In our view, the focus should remain on the financial consolidation of the first pillar.

Authors

Oleksandra Betliy	betliy@ier.keiv.ua	+38 044 278 63 42
Ricardo Giucci	giucci@berlin-economics.com	+49 30 / 20 61 34 64 0

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1. Introduction

The current pension system in Ukraine is unsustainable. The pension liabilities reached 18% of GDP, which is highest level in the region. In 2010 the deficit of the Pension Fund increased to 2.5% of GDP from 1.5% of GDP in 2009 and was financed at the expense of central fiscal transfers. Therefore, the gap in the Fund's budget is one of the major components of the fiscal deficit. If not reformed, the pension system will become even more unsustainable, putting fiscal consolidation at risk.

To put the fiscal system on a sustainable financing foundation and take into account demographic challenges, the Government submitted to the Verkhovna Rada a Draft Law on pension reform. The major steps include increase in retirement age for women, higher contribution period, and some restrictions on special pensions. The implementation of such changes is supposed to restrict the growth of pension liabilities in the future and put the Pension Fund on a stronger footing. In this paper, we analyse whether these claims are well founded.

The paper is devoted to the reform of the pay-as-you-go (PAYG) pillar of the pension system. It starts with major facts on the pension system in Ukraine. Then the major measures envisaged in the Draft Law are described and assessed. The paper ends with some conclusions.

2. Pension system in Ukraine

In 2003 Ukraine embarked on a comprehensive pension reform, which became necessary due to country's unfavourable demographic development with a fast aging and declining population. The major goal of the reforms was financial consolidation of the pension system. The existing solidarity pillar – a compulsory PAYG pension insurance – was to be reformed and complemented with compulsory individually funded second pillar and voluntary (private) third pillar of non-state pension insurance. While the third pillar went into operation in 2004 the introduction of the second pillar was postponed for several times due to deficit of the Pension Fund.

The positive feature of the reform was the introduction of formula-based calculation of pension, which depended on insurance record. However, major drawbacks and failures of the pension system remained:[1]

- ✓ Early retirement: Men retire at the age of 60 and women at 55, the lowest retirement ages in Europe. There are occupations, which allow employees to retire even earlier. The minimum contribution period remained low (20 for women and 25 for men).
- ✓ Privileged pensions: Several privileged occupational or social groups (e.g. miners, civil servants, prosecutor employees, military personnel, veterans of war etc.) receive higher payments compared to their contributions.
- ✓ Narrow and uneven contribution base: not all employed individuals contribute at a full rate. Only starting July 2010 individuals on simplified taxation were required to pay at least minimum pension insurance contribution, while lower contribution for agricultural employees phased out.
- ✓ High pension insurance contribution rate: total level of pension and social insurance contributions remain one of the highest in the region.[2] High cost of labour results in large share of wages paid in shadow, which undermines own revenues of the Pension

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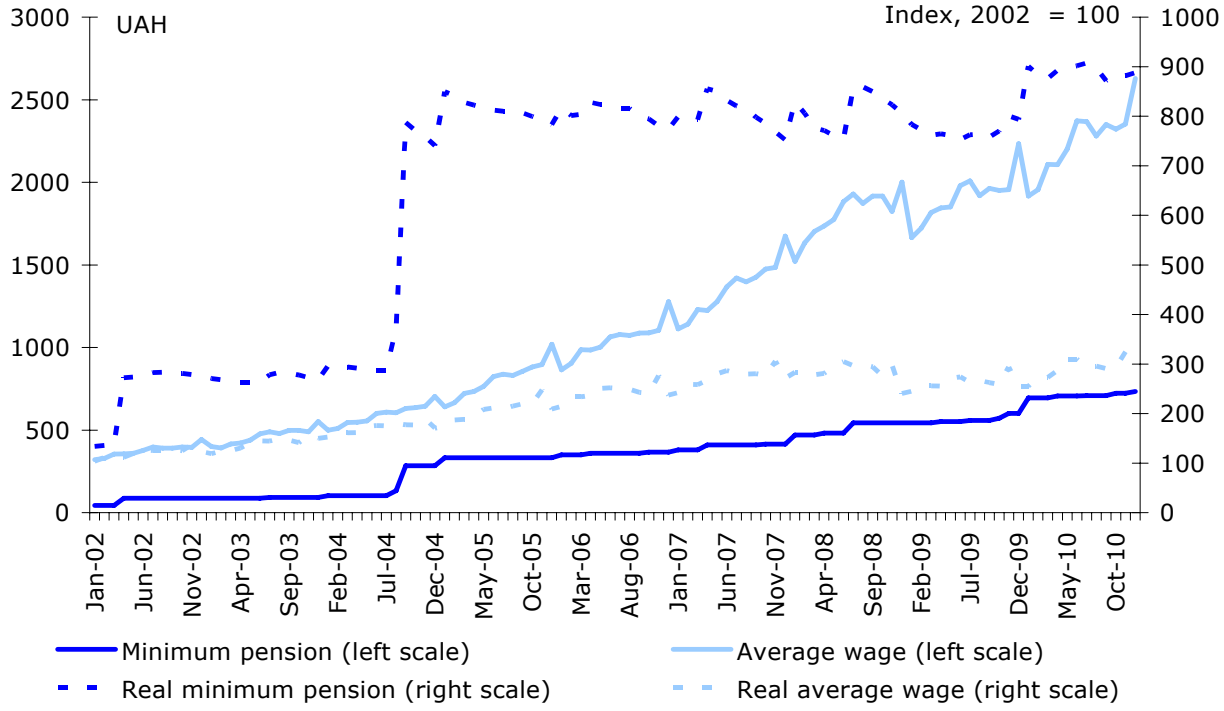
[1] See our policy paper V9, The pension system derailed: Proposals how to get back on the reform track, May 2006.

[2] In 2008 the implicit tax rate on labour (personal income tax and social security contributions) was at 36.5% for EU-27 (see for details *Taxation trends in the European Union*, European Union, 2010), which is lower than social security contribution rate in Ukraine even without personal income tax (flat at 15% in 2010). The cumulative unified social contribution, introduced in 2011, ranges from 40.36% to 53.3%.

Fund. At the same time, low pensions do not stimulate employees to require official wages, which are likely to be lower than those paid in envelopes.

These failures combined with the sharp administrative increases in minimum pensions paid through the PAYG pension system derailed Ukraine's ambitious pension reform. Pension hikes were not supported by adequate economic or revenue growth (see Figure 1). Between 2002 and 2010, minimum pensions increased by 9 times in real terms, while average wage, which is a base for pension contributions, increased by only 3.4 times in real terms. As a result, pensions of many pensioners being calculated according to the formula became lower than minimum pension. So, many pensioners receive pensions at the minimum level.

Figure 1. Minimum pensions and average wage in Ukraine



Source: State Budget Laws, Derzhkomstat, own calculations

The situation worsened in 2009, when pensions increased against the background of declined contribution base. The pension system appeared to be highly unsustainable. The Pension Fund's deficit was planned at UAH 13.8 bn, which was financed by special central fiscal transfer. Besides, there was a central fiscal transfer at UAH 34.8 bn for paying higher pensions envisaged by different pension programs, and pensions to retired judges and militaries. Overall, central fiscal transfer due to the Pension Fund reached UAH 48.5 bn or accounted for 20.0% of central fiscal expenditures. At the same time, the Pension Fund received short-term loans from the State Treasury for covering cash flow gaps, which accounted for near UAH 16 bn. Therefore, the Fund's deficit *de facto* reached UAH 31 bn in 2009.

In 2010, further rapid increases in minimum pensions did not allowed the Pension Fund to improve the financial situation. The deficit financing central fiscal transfer reached UAH 26.6 bn, while total transfer was at UAH 64.1 bn (21.1% of total central fiscal expenditures). Own Fund's revenues were under-executed, which resulted in additional accumulation of the Treasury loans. The total deficit of the Pension Fund is estimated at UAH 34.6 bn.

Table 1. The Pension Fund's budget

		2002	2003	2004	2005	2006	2007	2008	2009	2010E
The Pension Fund's (PF) expenditures	UAH bn	22.8	24.5	33.1	65.5	74.4	101.9	143.5	165.7	191.5

	% of GDP	10.1	9.1	9.6	14.8	13.7	14.1	15.1	18.1	18.2
Own PF revenues	UAH bn	19.8	22.9	31.4	42.2	54.3	76.0	102.0	103.1	119.3
	% of GDP	8.8	8.6	9.1	9.6	10.0	10.5	10.8	11.3	11.3
Total central fiscal transfer*	UAH bn	2.0	1.3	9.4	22.6**	24.6	24.9	41.4	48.5	64.1
	% of GDP	0.9	0.5	2.7	5.1	4.5	3.5	4.4	5.3	6.1
of which Transfer for financing special pensions	*% of GDP*	*0.9*	*0.5*	*1.7*	*1.4*	*3.2*	*3.5*	*4.4*	*3.8*	*3.6*
Transfer for deficit financing	*% of GDP*	*0.0*	*0.0*	*1.0*	*3.7*	*1.3*	*0.0*	*0.0*	*1.5*	*2.5*

Notes: E – estimate;

* The figures for total central fiscal transfers do not include short-term loans provided to the Fund by State Treasury;

** Starting 2005 the Pension Fund receives transfer for paying pensions to retired militaries.

Source: *Aid for Trade Needs Assessment – Ukraine: Trade and Human Development*, forthcoming UNDP report (by Burakovsky Ihor, Movchan Veronika), Pension Fund, Derzhkomstat, own calculations.

Rapid increase in pensions resulted in surge of the Pension Fund's expenditures to 18% of GDP, which is the highest in the region. Besides, the Fund became more dependent on the Government support. The continuation of such policy is not viable in the short-run and sustainable in the long run. If reforms are not conducted, the situation will worsen due to aging of population. According to the World Bank, by 2020 there will be almost one pensioner for each contributor to the system.[3] This ratio is expected to deteriorate further afterwards.

3. Main features of Draft law on pension reform

3.1 Major details of the Draft law

In December the Government submitted to the Verkhovna Rada the Draft Law on the pension reform measures (below 'the Draft Law).[4] The document envisages major steps of the pension reform, which were also defined in the Memorandum signed with the IMF in July 2010:

- increase in retirement age for women;
- increase in minimum insurance record;
- streamlining of generous special pensions.

The document also suggests imposing maximum pension size at the level of 12 sizes of subsistence minimum set for individuals that lost working ability. However, this is rather equity policy measure rather than the steps towards consolidation of pension system as not many pensioners receive such high pension.

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[3] The World Bank, *Ukraine: Country Economic Memorandum: Strategic Choices to Accelerate and Sustain Growth*, August 31, 2010, Poverty Reduction and Economic Management Unit (ECSPE), Europe and Central Asia Region.

[4] The Draft Law "On legislative measures to support pension reform", No. 7455, submitted on December 13, 2010 // Проект закону «Про заходи щодо законодавчого забезпечення реформування пенсійної системи» №7455, зареєстрований 13 грудня, 2010 року.

At the same time, the document does not contain provisions on real changes in formula for calculating pensions, which deteriorated due to sharp administrative increases in minimum pensions.

As the document closely concerns large part of Ukrainian population, it is provoked hot debate among the public. Below, we discuss major pros and cons of the suggested changes. Even thought the Draft Law also envisages changes related to the introduction of the second pillar of the pension system, we do not consider them in the paper as this is a separate topic for discussion. Besides, this measure does not seem to be coherent for Ukraine in the nearest three years.

3.2 Increase in retirement age

The Draft Law envisages the increase in retirement age for women to 60 years old from current 55 years old. It will be increased by half-a-year each year. Thus, the increase in retirement age by 5 years would require 10 years.

Besides, it is suggested to increase gradually age of women for receiving social assistance in case they do not have right for pension benefits from 58 years old to 63 years old. Such assistance is received if women do not have required minimum insurance record.

The retirement age for men civil servants is planned to be increased to 62 years old starting 2013. Such measure does not seem to be strongly justified.

According to official estimates increase in the retirement age would restrict the Pension Fund's liability by UAH 0.5 bn in the first year of implementing the pension reform. At the same time, the cumulative impact will be much higher as time goes and could reach near UAH 3.5 bn annually.

3.3 Less generous special pensions

The financing of special pensions reached near 4% of GDP in last years. The special pensions are regulated by more than 20 legislative acts. Several groups have a right for early retirement (military, policemen, miners, etc.), while others have a guaranteed pension starting from 80% of final salary (civil servants, scientists, miners).

The Draft Law suggests providing payment of special pensions to individuals that continue working only in sizes, defined by the Pension Insurance Law. Besides, special pensions to early retirees would be paid only after the persons reach statutory retirement age, if he/she continues working. Gradual increase in retirement for militaries and some other groups of individuals is foreseen.

The major restrictions of proposals is that changes would apply mostly to pensioners retiring after the Law comes into force and no existing pensions will be revised downwards. Therefore impact will be gradual.

3.4 Increase in years of contribution

The Draft Law suggests increasing the minimum insurance period. In particular, minimum insurance period, which enables individuals to receive pensions when they reach retirement age is to be increased from 5 years to 15 years.

At the same time, minimum insurance record for receiving old-age pension at least at minimum level is to be increased to 25 year for women (from current 20) and 35 year for men (from current 30).

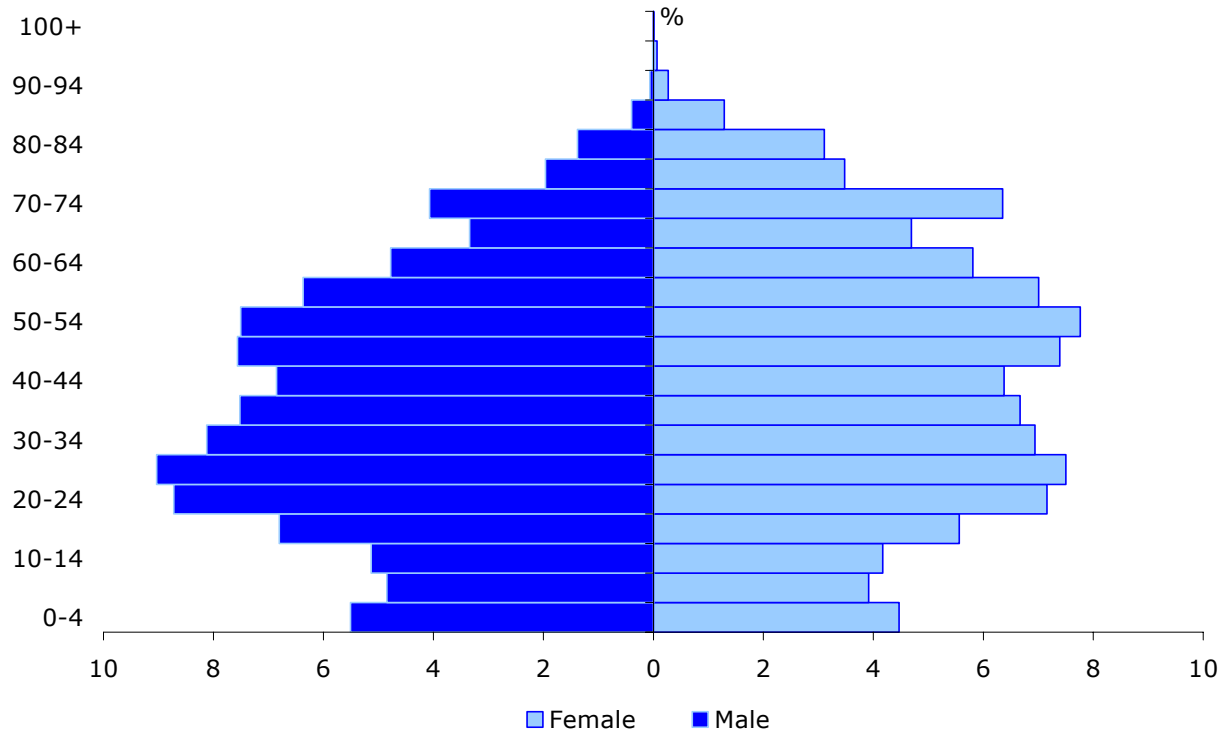
4. Assessment of reform proposals

4.1 Assessment increase in retirement age for women

Pros of the measure

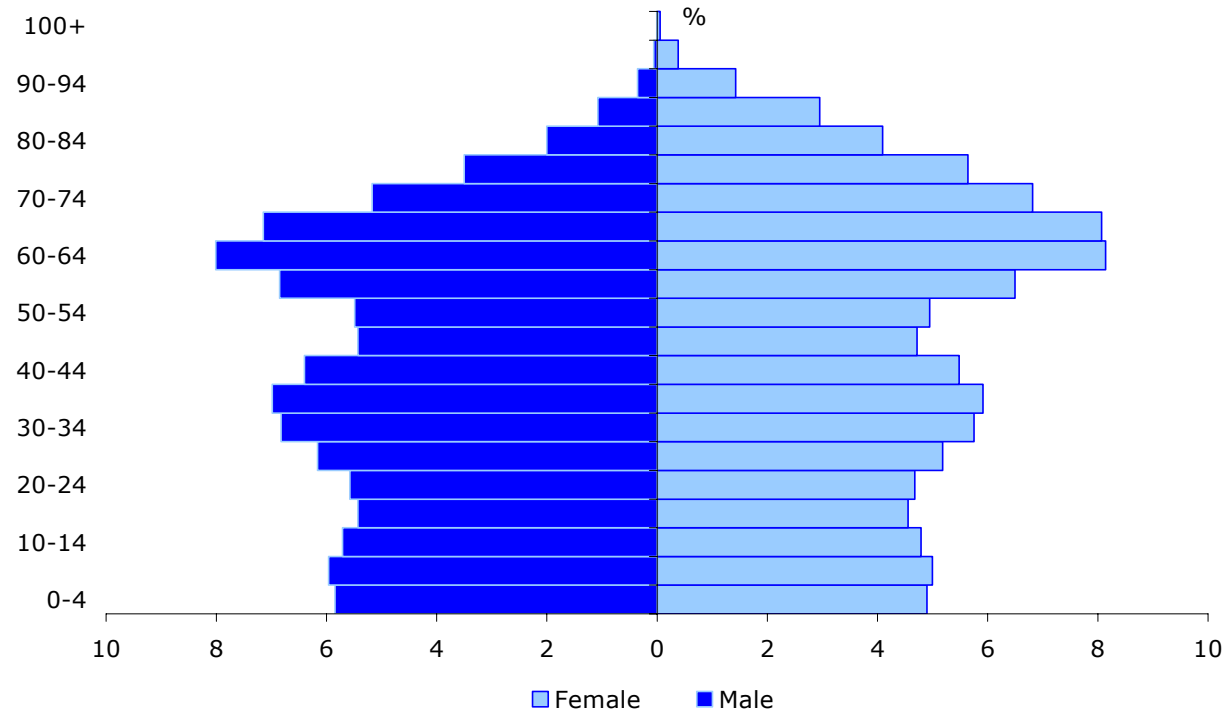
As of January 1, 2010, 64.7% of all pensioners were women. Taking into account the structure of Ukrainian population and difference in life expectancy for male and for female, the share of women-pensioners is likely to increase in the future, if no changes in the legislation are approved. Larger problems would be caused by ageing of population. According to the UN forecast, between 2010 and 2050 the share of women older than 60 years old will increase by 12.5 p.p. to 37.5%.

Figure 2: Demographic tree, 2010



Source: Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat, World Population Prospects: The 2008 Revision, http://esa.un.org/unpp, Tuesday, February 15, 2011; 5:55:30 AM.

Figure 3: Demographic tree, 2050



Source: Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat, World Population Prospects: The 2008 Revision, http://esa.un.org/unpp, Tuesday, February 15, 2011; 5:55:30 AM.

The statutory retirement age in Ukraine is one of the lowest in the region. It has not been changed since Soviet times, even though most of other countries increased retirement age. At the same time, Ukrainian women seem to live in retirement longer than in some other transitional economies.

Table 2: Statutory retirement age in selected countries

	Statutory retirement age		Life expectancy at retirement age (2008)	
	Men	**Women**	**Men**	**Women**
UKRAINE	60	55	14.3	23.7
Georgia	65	60	13.3	20.9
Estonia	63	60	12.6	21.0
	Gradual increase to 65 by 2026	Gradual increase to 65 by 2026		(17.0)
Latvia	65	65	12.9	17.4
Poland	65	60	14.7	23.0
France	60	60	22.2	27.2
	Plans to increase to 65	Plans to increase to 65	(18.4)	(22.8)
United Kingdom	65	60	17.4	24.3
	Plans to increase gradually to 68 years old by 2046	Plans to increase gradually to 65 years old by 2020 and then to 68 years old by 2046		
Germany	65	65	17.4	25.0

	To be increased to 67	To be increased to 67		
Moldova	62	57	15.0	22.1

Source: MLSP, USAID, WHO

Cons of the measure

The labour market in Ukraine remains weak. According to job agencies even before the crisis it was difficult for women to find jobs after they reach 45. The situation worsened during the crisis. Besides, women traditionally earn less than men, even while making the same jobs. Most women are employed in lower paid jobs, including care, cleaning, catering, etc.

Another weakness of the step is that expectations of women over 50 years old would be spoiled. Therefore, the state should provide good compensation mechanism for longer work of these women.

Conclusion 1: The increase of women's retirement age seems to be a proper measure, especially taking into account the demographic changes. However, it should be complemented by efficient active labour market policies.

4.2 Assessment of alignment of special pensions with general system

Financing of the special pensions creates a risk for fiscal consolidation as it is provided through the central budget. Special pensions are typically higher than general ones as they are calculated according to special rules. In particular, the pensions of civil servants are defined at 90% of their wage. The draft law suggests reducing this to 80%, which is still different than formula based pensions in the general system. The pensions to each groups is subject to some limitations. In particular, the minimum working record in particular organization is required.

Table 3: Average pension by pensioners' groups (as of Jan. 1), UAH per month

	2009	**2010**
Average pension, total	898.36	999.02
General system	874.28	967.16
Civil servants	2719.23	2958.41
Custom service	4431.78	4630.12
Judges	5636.91	5879.90
Scientists	1902.99	2379.86
NBU	4284.58	5015.86

Source: Derzhkomstat

Besides, there are jobs allowing for early retirement. These are military servants, policemen, etc. However, after retirement they continue working in other places and receiving higher than on average pensions.

Pros of the measure

The streamlining of the special pensions would restrict growth of the central fiscal transfer to the Pension Fund allocated for paying such pensions. However, the impact will be rather gradual as the Government suggests applying new norms only for new retirees.

Cons of the measure

The Government should be very careful in the steps towards restricting special pensions. Some programs are typical for many countries and are aimed at attracting more people to otherwise 'poor' jobs. In particular, these are militaries, policemen, civil servants, etc.

As in Ukraine wages in these jobs are typically lower than in private sector, people agree working there for better pension provision in the future. This includes early retirement as well as higher pensions. Therefore, if special pensions become very narrow the jobs could appear to be open.

Besides, the Government should improve situation on the labour market. Individuals still eligible for early retirement could find jobs at the market, which would provide them with fair enough salary.

The development of the third pillar of the system is needed. In particular, the provision of occupation privileged pensions is better to be shifted to the non-state pension funds. This, for instance, could relate to higher pensions to miners. Otherwise, continuation of high transfers for higher than statutory pensions to miners could be considered as indirect subsidies to mining companies, which are likely to be privatized in the nearest future.

Conclusion 2: The changes suggested in the Draft law seem to be correct ones. They will allow restricting the growth of central fiscal transfer to the Pension Fund in the middle and longer run. However, thorough analysis of all programs is needed.

4.3 Assessment of increase in contribution period

Pros of the measure

The increase in minimum contribution period should stimulate people to contribute longer to the system, which would result in inflow of additional money to the Pension Fund. However, in the longer run such people are likely to be eligible for higher pensions. Still, net impact is likely to be positive due to higher contributions paid.

Cons of the measure

Increase in minimum insurance record would automatically result in decline in number of additional years of work. As a result, it could result in lower pensions received by some groups of individuals.

Moreover, the Draft Law envisages increasing minimum insurance record for receiving at least minimum pension by 5 years. As a result, some individuals could appear in the situation of not having required insurance record by retirement age.

Conclusion 3: The increase in working record for receiving minimum pension will have net positive impact on the Fund's revenues. However, it should relate to people at least younger than 50.

5. Final remarks and outlook

The Draft Law on pension reform elaborated by the Government is a welcomed step forward. It is aimed at putting the pension system onto a sustainable path. However, its impact in the short run will be rather limited, as it would primarily concern new retirees. Still, according to the official estimates, the Pension Fund is likely to save UAH 1.7 bn in the first year of implementing the Law.

Therefore, the welcome steps are:

- Increase in contribution period;
- Gradual increase in retirement age for women;
- Certain restrictions of special pensions;
- Cap on the pensions;

- Restrictions of early-retirement schemes for certain occupations.

At the same time, the Draft Law lacks regulation on shifting the financing of 'privileged' pensions to the 3rd pillar of the pension system, which has been discussed.

The Draft Law also suggests the introduction of the second pillar of the pension system, which is not necessarily the most needed step even in the middle run. The experience of some countries during the crisis indicated that such systems are highly exposed to risks. The pension reform should start with changes in the PAYG system. Only after it becomes sustainable the Government should start thinking about introduction of the second pillar of the system. However, sustainability of the Pension Fund is difficult to reach within 5-year period. At the same time, the Government could stimulate development of the third pillar of the system.

In any case, the Government should refrain from populist policy while setting minimum pensions. The continuation of economic recovery followed by increases in average wages would provide the Pension Fund with additional revenues. At that point the Government could consider the decision to reduce contribution rate, which would stimulate wage de-shadowing. An increase in efficiency of active labour policies is also necessary.

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