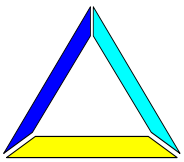
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S3

The Analysis Of A Draft On Pension Reform

Conclusions and policy recommendations

Ukraine's current Pay-As-You-Go (PAYG) pension system suffers from the problems that are common among other European transition countries:

- Falling birthrates combined with low retirement age will contribute to deteriorating dependency ratio.[1]
- Lack of direct connection between the amount of benefits and the amount of contributions creates incentives for evasion.
- The system is extremely complicated. A great number of privileged pension schemes make it non-transparent and difficult to administer.

Simulations of the effects of a draft of the law "On mandatory state pension insurance" showed that

- The draft currently discussed in the parliament is more detrimental to the dependency ratio because it preserves current retirement age.
- The draft preserves privileged pensions that undermine efficiency of the pension system.
- Funded pillar is too small to alleviate the pressure of demographic changes on the PAYG pillar.
- The proposed pension system turns out to be fiscally unsustainable. In the long run it would lead to large deficits.

We propose the following recommendations:

- Review the pension privileges. If additional benefits are desirable, they should be funded from separate budget items, not from the pension fund.
- Design an optimal transition to a higher retirement age consistent with international standards.
- Introduce a funded pillar that significantly complements the PAYG pillar, with the perspective of investing in foreign financial markets.

[1] Dependency ratio indicates economic responsibility of the economically active for those who are not. It is calculated as a ratio of children and retired persons to the working age population.

1. Present situation and international experience

The current pension system in Ukraine is a Pay-As-You-Go (PAYG) pension system, in which the payroll contributions of the current working generation are used to finance the retirement generation. Since Ukrainian society is affected by the same demographic trend towards falling birthrates as other transition and industrialized countries, financing of the existing pension system will be placing an increasing strain on the economy.

The most important source of financing the Pension Fund is a 33% payroll contribution, out of which 32% is paid by the employer[2]. At present, approximately 15 million persons in Ukraine receive pension benefits. However, the heavy burden of contributions combined with small benefits lead to tax evasion. Out of 24 million employees, only 16 million regularly contribute to the Pension Fund.

The severe problem of pension arrears was solved in September 2000, when the government managed to pay them out. Since then, the minimum amount of a pension was gradually increased from UAH 55 to UAH 87, while the average pension increased from UAH 66 to UAH 128.

Current retirement age in Ukraine is 55 for women and 60 for men, which is comparable to other East-European countries, but is lower than in the EU countries. International experience showed that low retirement age is a poor and inefficient employment policy tool, which inevitably drains the pension system. That is why all East-European countries are currently designing their pension reforms, where one of the proposed changes is the gradual increase of the retirement age.

The common feature of pension reforms in European countries is their multi-pillar structure. The traditional PAYG pillar is gradually limited to provide a certain minimum level of benefits that all employees, regardless of their income, can rely on. The increasing importance is given to the funded pillar, in which mandatory contributions accumulate over time to provide employees with a source of retirement income that directly reflects the amount of their contribution. Some countries also add the third pillar, in which voluntary contributions by employees and/or their employers further supplement the pension benefits.

The most common misunderstanding about pension reform is the notion that the introduction of the funded pillar is equivalent to the "privatization" of the pension system. That is not true. In most countries, both pillars are administered and regulated by governments. The difference between them is the method of financing. While the PAYG is a pure government redistribution scheme that separates benefits from contributions, the funded pillar is a savings-investment system managed by the government, in which own contributions become a source of future benefits. It gives the employees more control over their finances, it makes planning for the retirement easier, and last but not least it makes the pension system more transparent. Some

[2] Other sources are excise tax revenues from sale of cars and jewelry, foreign currency and real estate transactions, and mobile communication services.

countries add the third, purely privately managed pillar to provide employees with even more control over the investment decisions.

2. Results of simulations of two drafts of the law "On mandatory state pension insurance"

The parliament considered two drafts of the law "On mandatory state pension insurance". The first one, № 1128 from 01.09.2000, was rejected by the Parliament in 2000. It was replaced by the second draft from 27.09.2001, which has passed the first reading. Both drafts propose the following changes:

- Pensions are indexed in accordance with the law "On indexation of personal monetary incomes". The payouts are indexed at the pace of inflation plus 20% of the last year's real growth rate of the average wage in Ukraine;
- Benefit is determined by the average wage during the working period;
- Benefit is increased if a pensioner voluntarily delays his/her retirement;
- The parliament determines the pension contribution rate into the mandatory state funded system for each year. In the 2001 Draft, the maximum contribution rate could not exceed 7% of wage;
- In case of a Pension Fund deficit, the government provides pension payments through the PAYG system from the state budget;
- The benefit in the PAYG system is not limited;
- Both drafts retain privileged pensions.

The Parliament rejected the first version of the law, because it preserved the existing system of privileged pensions. That would place an additional burden on the budget of UAH 2 bn a year. The law would have introduced a pillar of voluntary funded personal accounts, but did not guarantee savings on these accounts. Parliament also opposed the increase of the retirement age, believing that this could harm employees who would retire in years immediately following ratification of the law. In contrast, the second draft only creates incentives for late retirement through higher pension payments, but it keeps privileged pensions.

We used the HIID accounting pension model[3] to project the effects of both drafts on financial sustainability of the Pension Fund over the period of 2001 through 2035. Simulations assume that the current system will be replaced by the new system with a smaller PAYG pillar supplemented by a funded pillar in which each employee has own individual account.

Simulation 1 is based on the earlier version of the Draft (01/09/00), which proposes to increase the mandatory retirement age from the current age of 55 for women and 60 for men to 60 for women and to 65 for men by 3 months every half a year. It also proposes to raise pension benefits by 8% for every year of working after the official retirement age. However the total increase cannot exceed 75%.

Simulation 2 is based on the last draft of the law that passed the first parliament reading on 15/11/01. This draft does not require increasing the

[3] Harvard Institute for International Development

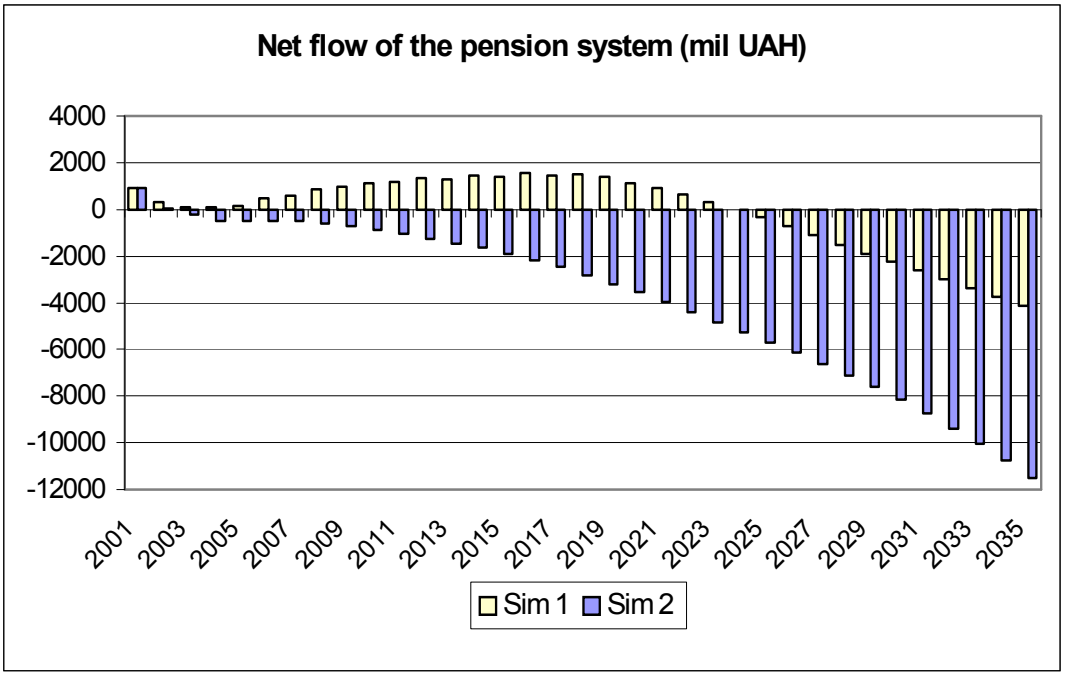
retirement age, but provides incentives for delayed retirement by higher pension payment: starting from a 3% increase for 1 year of post-retirement age work and up to 85.32% for 10 years.

In both simulations we assume a PAYG pension system, under which the payroll contribution rate is reduced in stages from 33% to 26% of wages by the time a fully-funded layer is introduced (as proposed in the both drafts). The individual employee's total contribution rate increases from 4% to 7%. As a result, the total contribution rate stays at 33%.

The net flow of the pension system[4] is shown in Figure 1. In both drafts, the pension system turns out to be fiscally unsustainable. We obtained this result despite the optimistic assumptions about the economic growth and budget revenue. In the long run both laws lead to large deficits that grow with time.

As Figure 1 demonstrates, the changes to the pension system proposed by the drafts law would not guarantee the solvency of the pension system. Namely, the increase of the retirement age proposed in the rejected draft (Sim 1) does not itself make the system financially sustainable in the long run, and neither does the small fully funded pillar that gradually increases from 3% up to 7%, as it is proposed in the second draft.

Figure 1 Source: own estimates.



To reduce the deficit of the Pension Fund the pay roll contributions could be increased. That would, however, negatively impact cost of labor and increase unemployment.

[4] Net flow of the pension system is defined as revenue (payroll contributions) minus expenditures (total state pension payouts and administrative cost) of the Pension Fund.

We therefore propose the gradual introduction of a complementary funded pension system combined with an increase of the retirement age. However, stability and credibility of the new system will require that the revenues be invested in foreign financial markets, safe from short-term domestic political and economic changes. We suggest that contributions to PAYG and fully funded pillars should be roughly equal to 15%.

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