

The price of delay: the future of Russian and Ukrainian pension systems

By Oxana Sinyavskaya

The end of “demographic dividends” as well as the beginning of the current economic and financial crisis again placed Russia and Ukraine’s pension reform problems high on the public agenda. Up until now, countries hesitated to substantially reform their pension systems due to difficulties of social and economic transition. Today they, as all other developed and transition countries, are faced with rapidly ageing populations, which makes old pension systems unsustainable in the long-run and leaves governments with no other choice but urgent reform.

What is pension reform about?

Pensions are instruments of income reallocation over people’s lifetimes for the purpose of securing their well-being in old age. In order to cope with this task a pension system should be financially stable, i.e. its liabilities should not exceed its incomes. In most countries this long-term stability is threatened by increasingly ageing populations, which dramatically change the ratio between old and young generations, i.e. pensioners and contributors, and therefore forces governments to look for new ways of pension re-balancing.

There are two basic approaches to pension reform. The first is the redecoration of existing systems by adapting its parameters (contributions, benefits or pension ages). The second is changing the system’s design, such as creating a new contract between generations. This implies transitioning to a new benefit formula, which links contributions and

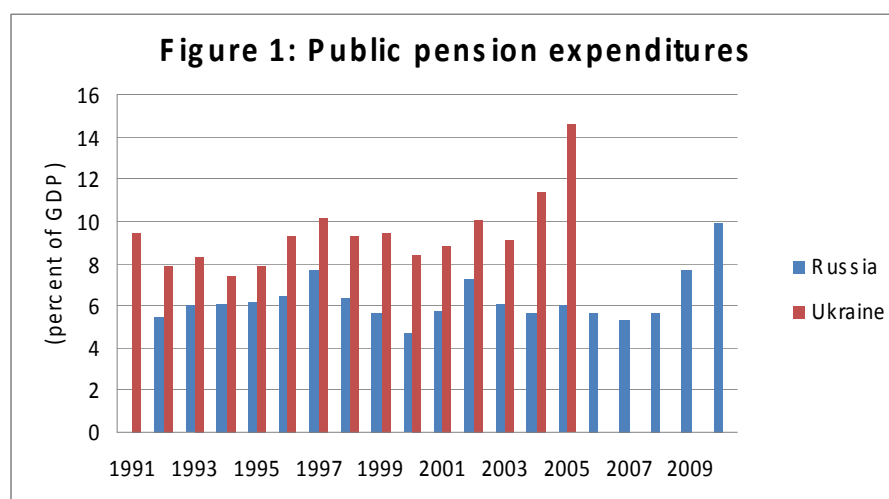
benefits, provides mechanisms of automatic adjustment of benefits and sometimes a new method of financing benefits. The choice is between three options: (1) PAYG – a social tax based defined benefit system, in which pensions of eligible pensioners are paid from contributions or payroll taxes of younger working contributors, (2) NDC – a non-financial defined contribution system, where benefits are still paid from current contributions but are automatically adjusted to demographic changes over time, and (3) FDC – a funded or financial defined contribution system, in which pensions are paid from previously accumulated savings, invested in financial markets.

Under the current ageing structure, accompanied by postindustrial development and globalization, the second option of systemic pension reform, is preferable to parametric alterations in the long-run. However, it is obviously more expensive and politically more difficult in the short-run.

Why it is so difficult to reform pensions in Russia and Ukraine?

Although early in their economic transition, both Russian and Ukrainian pension systems lost their stability and

could not provide sufficient economic security for their elderly population, there was also a lack of consensus over how to implement pension reform and even whether it was necessary. Russia started the discussion earlier than Ukraine and



Sources: Russian Statistical Agency – Rosstat: <http://www.gks.ru>; Bulletins of the Pension Fund, www.pension.kiev.ua

launched their pension reform in 2002. In Ukraine, the pension reform framework was adopted in 2004. The idea was to introduce a so called “multi-pillar” pension system, which combined traditional PAYG design (Ukraine) or minimum flat rate pensions based on social taxes (Russia) with FDC (both) and NDC (Russia) components. However, in Ukraine all of these ideas have yet to be implemented, and the system is still PAYG. In Russia, implementation of reform is not consistent (subsequent legislation adjustments cancel original ideas). Finally, Ukraine in 2004-2005 and Russia in 2009-2010 sacrificed both short- and long-term financial stability of their pension systems due to the substantial increase in current pensions, which guarantees political support of their most active constituencies.

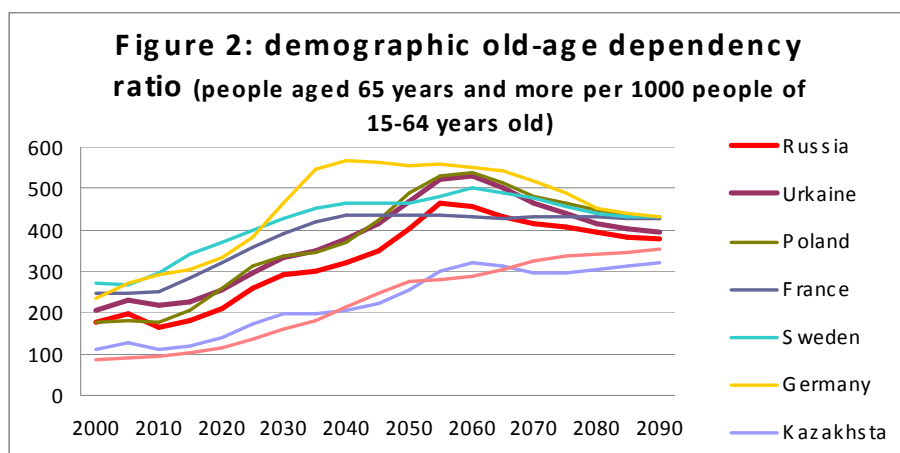
So, what are the obstacles and real constraints of pension reform in these two countries?

Reform opponents believe that most of the trouble within the pension system is related to the economic difficulties of transition. Indeed during the 1990s, Russia and Ukraine experienced substantial economic decline, periods of extremely high inflation as well as a decline of formal employment and labour productivity (which undermined pension system revenues and produced poverty among pensioners). Economic recovery in the beginning of the 2000s allowed for an increase in pensions and a balanced pension system for a while. However, improvement of pensioners’ well-being was not substantial, while stability was only temporary.

Furthermore, “economic determinists” underestimate the role of demographic factors in a pension system’s long-term instability. Meanwhile, the period of “demographic dividends” that both countries had in the beginning of the 2000s came to its end, and as in all other European countries ageing accelerated in Russia and Ukraine.

Certain features of demographic development, such as low life expectancy, especially within the male population, are an argument for why neither Russia nor Ukraine can increase its pension age. However, this is true only for men. Female life expectancy at birth is about 74, while the standard pension age is still 55. There is no reason to believe that Russia and Ukraine will never be able to improve the health of their citizens nor reduce mortality. Finally, rejecting an increase of the pension age

does not take into account ongoing changes in education and the labour market.



Source: World Bank, Health, Nutrition and Population Summary Profile, Demographic Projections <http://devdata.worldbank.org/hnpstats/dp1.asp>

Other options of well-known parametric changes are limited. In spite of the fact that pension expenditures in Russia and particularly in Ukraine are high even by most developed economies standards, average pensions in both countries are just slightly higher than the official poverty line. To the contrary, payroll taxes or contributions used to finance pension systems are comparable or even higher to many Western European economies. The reasons for low pensions and financial instability in spite of high taxes are low tax and social contribution compliance, a limited tax base and a very low actual pension age. Attempts to widen the tax base by reducing payroll tax rates failed, while compliance at least in Russia, improved only slightly. Nevertheless, the same rule does not work in the opposite direction: an increase in tax rates would most probably have negative effects on both the tax base and compliance.

At the same time, insufficient development of Russia’s and Ukraine’s financial markets became an obstacle to the introduction of the FDC funded pillar. In Russia, returns on pension investments within the mandatory system were below inflation. A potential solution would have been to use investment instruments available within financial markets abroad. However, in this case pension money did not contribute to national economic growth.

Future challenges and policy implications

During almost 20 years of transition in Russia and Ukraine, social changes were seen as a by-product of economic reforms. The pension system’s dependency on economics was overestimated, while short-term problems and solutions prevailed over long-term

decisions.

However, successful industrial restructuring requires not only flexible labour markets but also a well-designed and well-functioning social security infrastructure. If the latter does not correspond to the challenges faced by societies then it slows down rather than speeds up industrial restructuring. This suggests that social security reforms are not just on the margin of the policy agenda. They are at the centre of it.

Furthermore, even if the current threat of ageing seems insignificant in both countries due to larger economic problems, it is important to understand its crucial impact on the stability of pension systems. Unless pension systems in Russia and Ukraine are reformed soon, they face either the risk of default (on pension liabilities) or a collapse in their public finances. The combination of delayed economic transition and population ageing is very risky, and can make a country highly vulnerable to adverse economic or social shocks such as the current economic crisis.

Fortunately, both Russia and Ukraine have opportunities that rarely occur in other countries, such as obtaining significant additional income from abundant natural resources. Together with revenues from privatization and re-privatization this income can be used to finance the costs of transition to the new pension system. In addition, while their financial markets remain underdeveloped, both countries should start introducing, or returning to (in case of Russia) non-financial defined contribution systems, which are automatically adjusted to changes in population structure and life expectancy. They certainly can no longer avoid raising pension ages or reforming early retirement schemes.

All these decisions are politically sensitive and it is not clear whether Russian and Ukrainian politicians have fully realized the negative consequences of recently made decisions on their pension systems. Thus, the major challenge still lies ahead.

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