Ukraine urgently needs to reform its pension system

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While economists often disagree about many things in Ukraine, they find agreement on one issue: Ukraine's pension system is inadequate and unsustainable. Report after report on the pension system in the last 10-15 years has come to the same conclusion. If nothing changes, the pension fund will become increasingly financially unsustainable and will fail to provide living pensions to Ukraine's aging population.

How did we reach this point? Ukraine is obviously not the only country that experiences the challenges related to demographics, notably a shrinking labor force and an aging population. Most European countries have experienced or are experiencing similar problems. But Ukraine is one of the last countries in Europe to face up to these challenges and reform its pension system. Notwithstanding some tinkering of the rules in recent years, the basic structure of the pension system has not changed much since soviet times.

A low statutory retirement age combined with options available to many to retire even earlier have been prominent features of this system. Ukrainians on average retire much earlier than workers in other countries in the region: the average retirement age for men is around 58½ years, and for women it is just under 56 years (compared to an EU average of 63.6 years for men and 62.6 years for women). As a result, Ukraine has over 12 million pensioners, which is close to 30 percent of the population. The statistics look even worse, when we look at how many workers are paying social contributions to support these pensioners: the ratio of contributors to retirees is almost 1 to 1, which is one of the lowest ratios in the world.

Given the many pensioners, social security contributions cover only half of the resources needed to pay pensions, even if individual pensions are low. These insufficient resources reflect also the large size of gray economy in Ukraine: for many workers, no social security contributions are paid, or contributions are paid only based on the minimum wage, even if workers are paid more. Compliance did not improve much after the sharp reduction in the social security contribution rate in 2016, and instead dramatically lowered the revenues of the pension fund. The system offers little incentives to contribute, because there is practically no link between contributions paid and the size of pensions that workers ultimately receive when they retire. Nearly two-thirds of all pensioners receive the minimum pension, which is barely above the poverty level, creating significant social problems. But the pension system can hardly afford to pay higher pensions.

In fact, paying even these low pensions would not have been possible if the budget had not come to the rescue, by transferring to the pension fund the other half of the resources needed to pay pensions. In 2016, these transfers reached a staggering UAH 143 billion (6 percent of GDP). This is the second-highest pension fund deficit in Europe, in proportion to a country's economy. But these resources do not come for free. They come from higher taxes that hurt economic growth and job creation, or come at the expense of crowding out other government spending. In fact, the annual transfers to the pension fund from the budget is almost equal to the combined spending on education and infrastructure. One can only imagine the improvement in schools and roads that would be possible if these resources were available for such spending.

What can be done? As has been done in most European countries, Ukraine needs to find a way to reduce the inflow of new retirees into the pension system and to get more revenues from contributions. There are different options to do this, ranging from further limiting the scope for early retirement, to increasing the age at which people effectively retire. An effective way to achieve this is to offer workers a richer menu of retirement ages than at present, depending on total years of service—retiring at a relatively early age would require more years of service—and providing incentives for longer employment and later retirement. In other words, higher pensions will be provided to those who contribute more and choose to work longer, and smaller pensions to those who contribute less and choose to retire earlier. By strengthening the link between paying contributions and pensions, there will be better incentives for workers to demand that contributions are paid to the level of their wages. This will be a fairer and more equitable system.

In addition to these changes, it is important to strengthen revenue administration, to reduce the number of companies that pay no, or too little, contributions for the workers they employ. Similarly, the simplified tax regime for small enterprises, which creates large loopholes for avoiding paying contributions and taxes, needs to be substantially tightened. Introducing a so-called fully-funded pension system (a second pillar) on top of the current system, as some suggest, would not make much sense if the current system is not fixed first and would be premature given the current level of development of Ukraine's financial markets and legal framework.

The debate to reform the pension system has been delayed for too long in Ukraine. It is now high time that solutions are discussed and agreed within society. There is no doubt that pension reforms are difficult and unpopular. But there should also be no doubt that only by meaningful pension reform that reduces the inflow of new pensioners and increases the number of people who contribute to the pension system, it will be possible to create room for paying better pensions that avoid old-age poverty, while keeping the whole system and the budget financially viable for future generations. As the impact of any reform measures on the pension system will only be gradual, it is critical that decisions are taken now.

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