

The Burden on the Employer Is to Be Decreased

Greg McTaggart, Senior International Pension Reform Adviser of the USAID Capital Markets Project, believes that Ukraine's economy is going to be non-competitive if the system of social contributions remains unchanged.

The Business Fact File on Mr. McTaggart

Born: 12/1/1952 in Melbourne, Australia

Education: 1971-1973 – Bachelor of Sociology, Monash University (Melbourne, Australia);

1979-1983 – MBA, Monash University (Melbourne, Australia).

Employment:

1974-1984 – public employee responsible for the pension reform, State of Victoria, budget and administrative department;

1984-1995 – Jacques Martine Pty Ltd, deputy general manager (running private pension funds, advising countries of the Asia/Pacific rim on social insurance matters, participating in the development of the Australian pension reform, and consulting the U.K. Labor Party); 1996-1997 – technical advisor in Russia (participating in the creation of the NPF system in Russia);

1997-2000 – developing a new social insurance system in Mongolia;

1998-2000 – analyzing the social insurance system in Ukraine;

2001-2004 – USAID Pension Reform Implementation Project, advising Ukraine Labor and Social Policy Ministry on social insurance system reform;

2004-2006 – developing a draft law on the pension reform in Russia;

2004-2006 – advising the Ministry for Labor, Invalids and Social Issues in Vietnam;

2006-2007 – teaching the social insurance staff in the regions in Ukraine;

2006-2008 – the lead advisor in Egypt (analyzing the country's pension system);

2008-2009 – consultant on matters of social insurance in Tajikistan (advising the Labor and Social Policy Ministry and State Directorate for Social Insurance and Pensions);

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Marital status: Married, with two sons.

Hobbies: traveling, cooking foreign dishes

In what countries did you consult governments on pension reform issues and what were your recommendations?

I started this career in mid 1980s in Australia. At that time, trade union leaders had been seeking to improve the work environment and raise pension benefits, so ultimately, a compromise had been reached: the trade unions dropped the demand for higher wages, so that the additional funds from the employees' payroll could be remitted as contribution to their individual accumulation accounts. To that effect, relevant agreements had been signed in various sectors of the country's economy. This was a win-win situation, and, eventually, the government of the country made the accumulation pension system mandatory. The employers' contributions have gradually been increased from 3% to 9% of their payroll.

This scheme had proved its worth, so we started getting invitations for advising the governments of the Pacific Rim countries.

Tell us more on Australia. As far as I know, their pension system is funded from the federal budget?

It is partially funded. We have in place a system of targeted benefits, which is indeed fully funded by the government, although eligible to claim it are only those belonging to the poorest category of the population. The more property you own and the higher your income is, the smaller portion of your pension will the government-funded pension constitute. Those persons with income exceeding a certain level will not be entitled to the State pension at all. Presently, about 50% of the Australian citizens do not draw State pensions. From the very beginning, our reform was to make sure the Government share in funding pensions is decreased.

However, there is no way this system can be compared to Ukraine: pensions in Australia are paid from the money collected as tax, there is no such thing as social insurance in Australia, which means people do not pay insurance contributions.

And who funds the “non-government portion” of the pension?

The employer. As I said, during the reform, people were seeking have their salaries raised. Instead, they received higher pensions, also at the employers' expense. The currently debated point is that 9% of the payroll is insufficient as pension contributions. On the eve of impending elections, the current government promises to increase this level by 6%, to 15%. Of this increase, 3% will be contributed by the employee, who has not contributed anything to date. The other additional 3% will be contributed by the employer, getting a tax benefit by the same amount. In other words, the actual contribution of the employer will constitute 9%.

But the solidarity system will also continue, will it not?

Yes, it will, but its share will gradually go down, and the share of the accumulation pension will go up until complete transfer to the accumulation system.

Do you think it may serve as a benchmark for Ukraine?

I think you are to introduce the accumulation pension system, too. Because the population of Ukraine, as that of other countries, is aging. And not only in relative sense, as the percentage of pensioners in the county, although this is also the case. Pensioners now live longer than before, despite statements to the contrary. And with a further development of the health protection industry, they will live even longer. But the financial capabilities of the government are limited. This is why the only way out is to transfer the pension provision burden on citizens.

One of the biggest problems at the moment is lack of stimuli for an individual, with so many people drawing the minimal pension. Do not get me wrong, I do not object to them continuing to do so, it being a mere UAH 750 per month; but this amount is being drawn by 2/3 of the retired citizens. For them, the amount of their pension does not depend on how long they had contributed to the Pension fund while they were employed. Salaries in Ukraine are very low: to have a big pension, one is to earn at least UAH 12,000 today. Had somebody foreseen this situation, the pension system could have gone a different way.

For instance, in such countries as Australia, Great Britain, Denmark, and Netherlands, the amount of the solidarity pension depends on the period of paying contributions, rather than on how much the contributions had been, i.e. it depends on how long one had lived in the country and how long one had paid pension contributions. In this case, most of the population draws a certain “solidarity” basic pension, with the well-to-do people subsidizing the poorer citizens. The differentiation of pensions occurs at Pillar II, the accumulation level of the pension system, where pension payouts depend on the amount of accumulate contributions. There the amount of pension depends on the amount of salary.

There is a valid argument against the introduction of the accumulation system: with the economy expanding, there will be funds for pensions both with the pay-as-you go and the accumulation system, whereas at the time of economic recession, vulnerable to crisis will be both the solidarity system (due to the unemployment) and the accumulation system (because of failed investments). So what is the point then?

To a certain extent, you are right. But the matter is not only in the economy; let us not forget the demography. With the solidarity system, if the demographic situation goes out of control, even the best of economies will find it problematic to fund the pension system.

Let us be frank: currently, employers in Ukraine are shouldering the enormous burden of social payments. An average employer pays into

social insurance funds, such as disability, unemployment, industrial accidents and pension funds, about 40% of the total payroll. In some industries this ratio is a lot higher, since they pay significant amounts as insurance for industrial accidents. But even the 40% makes Ukrainian employers non-competitive. Anyone contemplating whether or not to launch an enterprise will pass Ukraine for this reason. So this load on the employer should be trimmed, if the Government wants the employer to create more jobs or pay higher wages. As for protecting the accumulation system from financial crises, there exist various mechanisms to this end. Needless to say, a significant portion of pension contributions is to be invested domestically, - so that more jobs are protected, more individuals start paying contributions, and the burden on the payroll gets less weighty. And so that this money earns profit. But a major portion of contributions should be protected against the economic shocks that may occur in Ukraine. A certain portion of pension assets are to be invested abroad for the purpose of pension assets diversification.

But we have all witnessed what had happened in 2007-2009 with the European pension funds investing in “reliable” financial instruments in the U.S....

Personally, I know more about these risks, because I am closer to pension than you are. But for such young people as you, the planning horizon is not limited by five years. You should plan 30-40 years ahead. And in this prospect, one can say: yes, there will happen bad years during the next 30-40 years, but typically for each bad year there will be 20 good ones. There have been 2-4 economic meltdowns in the previous 30 years. But over the remaining 26 years, markets were growing. Even now, despite the events in the previous two years, the returns on 30 or 40-year pension investments are quite normal. Surely one cannot expect 15-20% returns every year. As you correctly said, there would be bad periods. But in case a person's contributions over the entire period, when he worked and paid contributions, he gets a 3-4% return above inflation, he will be quite well off in old age.

Advocates of investing abroad claim the stock market in Ukraine is under-developed, so there is “nowhere to invest money”.

However, we all know how many areas are in our country with chronic under funding. What is it that stands in the way of investing resources where they are needed?

Nobody says they should not be allocated there. In a majority of countries, where the accumulation system is already in place, no less than half the accumulated moneys is invested domestically. For instance, a British pension fund will invest 60% of capital in the British assets and treasury obligations, this is true. But currently, Ukraine indeed lacks developed capital markets. So where does one invest the money? To keep it in Ukraine so that the money does not leave the country? Or maybe to invest the money abroad, so as to ensure sufficient returns for future pensioners?

Correct me if I am wrong, but, as I understand, you do not believe the accumulation system will be implemented short term? In your opinion, is it necessary to increase the retirement age, that is, do we need to make adjustments within the solidarity pension system?

It is a separate issue. The matter of the retirement age is totally dependent on the financial situation of the State. The PFU budget deficit has already reached about UAH 30 billion. At the request of our Project, GfK Ukraine polling company performed a public survey and found that a majority of people are not aware of the details of the pension reform and of the challenges that the GOU faces. They do not mind if the deficit keeps growing and the government does not offset it. But for the money to be assigned anywhere, it needs to be taken from somewhere. The GOU funds the education system, social construction projects, and many other areas, - so if all the revenues go to cover the pension system deficit, where does it get funds for the other needs?

There are many things in life nobody loves doing, like work more. Or pay more taxes. One needs to choose one thing, but Ukrainians want both to retire early and contribute little into the Pension Fund of Ukraine (PFU). But these are mutually exclusive options. (Quote highlighted by Business)

But an increase of the retirement age cannot resolve in principle a single problem, this measure will simply delay the problems by 15-20 years in the future (see The Business, issue #30 of July 27, 2010, pages 15-18).

In addition to a financial aspect, the pension reform also has a human aspect. If I were asked if I would like to work until I am 68, as the U.K. government wants me to do, - I do not think there is any doubt that I do not feel like it in the least. It is not worth asking the question whether or not to increase the retirement age. The problem is only how fast to do it: for men and women simultaneously, starting as early as 1 January 2011, or to raise it first for women, and then, when their retirement age is the same as that of men, to increase it further for both men and women, as envisioned by the Cabinet of Ministers' Economic Reform Program for 2010-2014. Personally, I support the latter alternative.

But you say this will not alter the demographic trends, what then is the benefit of increasing the retirement age?

That is correct, the problem will not disappear overnight. For example, under the Economic Reform Program, it is expected that the retirement age will be increased by six months each year. This measure will apply to about 300,000 citizens in the first year of the reform (about 600,000 people retire annually in Ukraine, so one can estimate that half of the retirees were born in January - June). But this will not save you billions of hryvnias. The process will bring some benefits with time.

Well, this effort will bring some results, but after some period of time, the problem will return, since demographic trend will persist.

But the proposals are not limited to raising the retirement age only. In addition, the period of contributing required to claim the minimal pension is proposed to be increased. I do not know whether this change will be introduced immediately or gradually, but this measure, along with raising the retirement age, will help cut the budget deficit substantially.

These proposals are highly unpopular. We have seen how ignominious was the failure of the “benefits monetization” in Russia, where the stance of the government was a lot stronger than that of the Ukrainian government now ...

I do not think that if Russia has not succeeded in doing something, Ukraine should not even try to do it. In the other post-Soviet countries such as Moldova, Uzbekistan, Tajikistan etc., reforms have been completed, and the retirement age increased.

There is a lot more popular proposal: to cut all kinds of “special pensions”, increase the retirement age of those who retire at the age of 40-45, and cancel the privileges. Why not start with this?

Prior to 1991, you had no accumulation system, as it was not needed: the State was the only employer. But today, as before, one and the same system takes care of the social provision for the entire population and for public servants (military personnel, judges, government employees). These categories are not equal: one hryvnia contributed to PFU by an ordinary citizen and by a Rada deputy, results in him receiving a higher pension than an ordinary citizen. So I understand those who say: let us make the system of social insurance a straightforward social insurance system. Privileges should be taken out of the framework of the general pension insurance system, within which all pensions should be equal.

So how much can we save if preferential and special pensions are cancelled?

Just like with the retirement age increase, this initiative will not help save a lot of funds the very next year. But in 20-30 years' time, this will come to significant additions to the budget. In 2003-2004, estimates had been performed of the money needed to fund early pensions for employees working in harmful environment. The conclusion from the estimates was that the general load on the payroll in those sectors where employees are eligible to have early retirement pensions, should be raised by 15%-20%.