

## Pension Reform: Why Cutoff Age Matters

Gary Hendricks, Senior Pension Advisor/Head of Pension Reform Department, USAID/Capital Markets Project (CMP)\*

As part of pension reform, the Verkhovna Rada has taken the first steps necessary to adopt a savings component as part of basic state pensions. Like neighboring countries, a small part of contributions to the solidarity pension would be diverted to pension accumulation accounts. Each worker would have an account that would be invested and earn interest. At retirement the account would be converted to a monthly pension benefit. The worker would still receive a solidarity pension, but it would be somewhat smaller because some contributions were diverted to the accumulation account.

Over the past decade nearly every country in Central and Eastern Europe has adopted this approach to relieve future financial pressure on solidarity pensions by financing part of worker's pensions from savings while they are working.

When the shift to accumulation accounts begins, policy makers must decide the age cutoff for participation in the new scheme. This is important because at start up the new scheme will reward younger worker more than older ones since younger workers have more years to accumulate savings and to earn interest. However, there is no standard practice and no standard cutoff age.

Experience varies from requiring everyone to join the new system to requiring only new entrants into the labor force to join. Kazakhstan and Kosovo transferred all workers to the new two-part scheme. Poland and Latvia made entry into the new scheme mandatory for workers under 30. In both countries, workers between the ages of 30 and 50 were allowed to choose whether they would like to stay in the pre-reform solidarity scheme or move to the new two part scheme with a revised solidarity (Pillar I) pension plus an accumulation account (Pillar II) pension. Croatia chose age 39 as the switching age and let workers from age 40 to 50 join the new system voluntary if they wanted. In Romania, where the reform was implemented just a year ago, the mandatory cutoff (switching) age is 35 with choice offered to those in the 36-45 age group. Hungary, Macedonia and Slovakia require all new entrants into the labor market to participate in the new scheme and give all other workers the option to choose.

Until recently countries did not allow worker who opted to participate in the new scheme reverse their decision later. However, this proved unfair to some workers. In Poland, opting back into the old system is allowed if, for instance, a long period of unemployment undermines the benefits of the funded Pillar II pension. Slovakia is also offering older workers who converted to the new scheme the option to switch back to the old system. In Slovakia many older workers who switched did not realize that

their pension would be lower under the new scheme because they had so few years to accumulate assets in their own individual account.

Although there is not clear international standard or best practice, recent experience demonstrates that the cutoff age for mandatory participation in the new two-part pension scheme and options to select participation voluntarily need to be considered carefully before the reform is enacted.

Here we have focused on the experience of the other countries in the region and the impact on older and younger workers. But, these are not the only impacts. The cutoff age also has serious ramifications for short and medium-term pension costs and for financial markets.

Solidarity pensions are financed by using current contributions to pay current pensions. Any contributions diverted to accumulation accounts will not be available to pay current pensions. Unless the solidarity scheme is collecting more contributions than needed to pay current pensions before the reform is implemented, part of current solidarity pensions will need to be paid from the state budget. This means current solidarity pensions must have adequate financing before moving to a two-tier pension and the state budget must be adequate to finance any shortfall in solidarity pension financing during initial implementation. In Ukraine this condition is not met because of the current financial crisis. Even in normal times, the condition would not be met because of political manipulation of solidarity pensions that cause costs to vary substantially from one year to the next.

Financial markets are also an important consideration. The funds in accumulation accounts need to be absorbed into capital markets and to deliver rates of return in line with average rates for private investments. If accumulation accounts are set up for the entire labor force all at once, the new funds can flood capital markets driving security prices up and interest rates down. This would not stimulate economic growth and, as interest rates and other investment returns fell, leave workers less well off than before the reform. These circumstances must be taken into account when making decision on implementation of Pillar II and the amount of pension contributions into the accumulation system.

*\*The views expressed here are those of the author and do not necessarily reflect the views of USAID or CMP*