

Expert's Opinion

Greg McTaggart: Hurry up, but... without making haste!

The last two years would be the worst for launching the Mandatory Accumulation Pension System in Ukraine; however, its implementation should not be deferred too much.

Greg McTaggart, Senior International Pension Reform Adviser with USAID Capital Markets Project is answering the questions of our correspondents.

The interview was taken by our correspondents
Yaroslav Falko and Olha Budnik

One can discuss pension issues forever. Therefore, we would like to suggest that our today's talk should be limited to one topic – the course of pension reform in Ukraine. We would like to learn what in your opinion has been achieved in the last five years and what hampers the pension reform in our country. Especially as we have more than enough reasons for this talk. Back in December 2005 the Prime-Minister Yuriy Yekhanurov signed the Pension Reform Strategy in Ukraine, however, only the private retirement provision has been implemented since that time with a small number of people participating and the MAS implementation seems to be just all talk and no action...

- Yes, and today both the Parliament members and the new ministers openly admit that in the last years very little has been done to reform the pension system of Ukraine. Well, on the one hand this may be true. On the other hand it to be objective.... May be it is good that we just talked about the reform. It may sound ironic, but just recollect the last two years. This is the time of the global financial crisis. In Ukraine the production volume declined and the social insurance funds revenues shrank... I think 2008-2009 would be the worst period to implement the Mandatory Accumulation Pension System. It just would not work and might only discredit itself. So it might be a good thing that in most cases these were just talks.

Now with regard to the non-state pension provision system, I think the problem is that our expectations of the non-state pension funds (NPFs) efficiency tuned out to be too high. That is why there is may be certain disappointment. However, let's recall that NPF system is a supplementary pension scheme. It is mostly financed by employers. We should not have expected that in the first 3-4 years NPFs would have 3-5 million participants. That is a dream! In the West even before the financial crisis the employers limited their exposure of participating in the supplementary pension provision. It means that so called private pension insurance even in the developed countries is limited by market risks. As regards the private retirement provision popularity in these countries which is reinforced by statistics, these numbers are the result of civil servants mostly participating in private pension schemes rather than in Pillar I pension insurance as it is the case in Ukraine.

However, recently we have undertaken a little research the results of which were surprising even for me. In the UK, for instance, the employers contribute into Pillar III in behalf of 2.2 million of the private sector workers. I expected this number to be higher and this is in spite of the fact that the history of private pension funds creation and operation in the UK is more than 100 years. Besides, the British system had the prerequisites which are unavailable here in Ukraine. These are strong regulators in addition to transparency and disclosure of the system for all its participants.

It is really a topical issue when to implement the Mandatory Accumulation System – Pillar II in Ukraine. However, its implementation has two aspects. In the first place, Pillar II implementation will curtail revenues of the solidarity system and this will reduce the opportunity to increase benefits for current pensioners. On the other hand too much delay with Pillar II implementation reduces the opportunities for young people to accumulate additional funds to finance their future pensions. Currently the PFU deficit is significant and the diversion of funds from Pillar I will make it even worse. Therefore, it is difficult to say what time is the most favorable for Pillar II implementation.

One of the prerequisites for adoption of the law on Pillar II implementation is at least 2% GDP growth for the two consecutive years. However, one of the most important conditions of Pillar II implementation is that the PFU budget should be balanced. It was expected that the first requirement would be met by 2011, while the issue of balancing the PFU budget is a great problem and it cannot be resolved only due to the economic growth. In my opinion, this issue could be resolved through the tax improvements, changes in the privileged retirement provision and in the amount of the minimum

pension as well as by means of increasing the retirement age. I think an integrated approach should be taken to address this issue.

The previous government thought that it would be real to start implementing Pillar II from 2014. This was specified in the Pension Reform Furtherance Concept approved by the Cabinet of Ministers of Ukraine in October 2009. May be this is a realistic term but as I said before we should not determine time "T" as the military say but rather to meet the required economic, legislative and institutional prerequisites. These changes cannot be made instantaneously. Today we have time to prepare. We should not repeat poor Polish experience when they started to introduce changes into the pension system too vigorously and it cost too much for the country and its people.

I would like to pay your attention to a number of issues that need to be addressed. Thus, the age of participation in Pillar II is still an open issue. Are these going to be only people below 40 or all who have attained 25 years old? Neither the decision was made on Pillar II contribution rate: whether it will be 7% at once or it will be phased in starting from 2% and ending with 7%? What is the limit to be invested into domestic securities and how much should be invested abroad? In addition, we should understand that the pension reform cannot be the driver of capital markets. The pension reform is the social reform in the first place. In this case the investment of pension funds is made with the only objective to ensure adequate pensions to the participants after they reach the retirement age. However, we should be confident that the capital markets will be capable to absorb Pillar II funds and will have appropriate instruments for investment of these funds.

It is important to mention the level of administrative cost. It should be more reasonable. Here is a recent example. Currently in the UK they are reforming their retirement provision and after the implementation of this reform they expect the administrative cost of pension funds to be 2% of contributions and 0.3% of the fund value. This decision has already aroused public resentment, as being too high though the British indicator is much lower than the one we have today in accumulation schemes in Ukraine.

The new Ukrainian government has already started to work for attaining the goal set. Some roundtables were held where serious discussions on the state-of-the-art and further implementation of the pension reform were in progress. The government also takes an interest in a public opinion on this matter... But I think it is required to enhance public awareness of the issues of the pension reform implementation considerably because so far informational work is being performed at the level of those people who will be almost not affected by changes in the pension system or those who are interested in its development in a particular direction. I think it is required to concentrate on informing those citizens who are at the age of 30 – 40 now as, on the one hand, the reform will effect them in the first place, and on the other hand, at this age unlike being in a younger age such information is apprehended, and, as a rule, it is apprehended in all seriousness.

However, we should not forget about the youth either. But when speaking on pension subjects with young people it is reasonable to concentrate on the issues of their financial literacy. These may be mandatory courses at higher educational establishments which, for example, will include the issues of pension provision as a separate section. These courses will relate to the ability to dispose one's own money, etc.

You said that in the West there exist strong regulators and the pension system is transparent and open. In your opinion, to what extent is the system of pension funds in our country transparent and open and to what extent are regulators strong here?

- It is required to divide this question into two. I do not want to criticize regulators. They work as much as the existing conditions allow them to do it. To my mind, in the country little attention is paid to regulation, the

background of employees of regulating bodies is insufficient, their wages are not high. Also, there are too many barriers to the regulator's effective work. It is not criticism, I only state the facts.

The second part of the question is the system's transparency. As for the existence of such a factor in the voluntary pension system in Ukraine, my answer is no. In Ukraine the funds of any market belong to its participants, no matter these are insurance companies or banks. They believe that they are entitled to take your money and to do with it all they like. Information on ultimate controllers in terms of natural persons is not disclosed. In corporate pension funds their participants are not represented in boards of these funds at all. Some information is published, but it does not explain what is going on with the participants' money. I was born in Australia. There, informing about money investment by pension funds is a mandatory condition of their existence. In Australia it is specified legislatively not only what pension funds are to inform their participants about, but the deadlines of such informing too (the information should be urgent and last minute). In my opinion, such practice in Ukraine will be impossible until fund managers have continued to believe that the contributor's money is their own money. It seems that they have not reached the level of understanding the fact that they are only trusted to manage this money, but not to dispose it at their discretion and in the way they like to. In my opinion, it is no coincidence that in Ukraine the level of confidence in financial institutions of various kinds remains very low. I think today the majority of Ukrainians will tell that they trust pension funds even less than they trust the state.

With your permission we would like to develop the subject of the lack of confidence. In the West the pension system has had a long history. For example, in Germany this history dated from the times of Bismarck. Could you give some examples of effective control over pension money in other countries? How did they manage to achieve this?

At a seminar with employees of the Federation of Trade Unions of Ukraine which was held at the end of the last month I demonstrated the findings of the research conducted and published by Mercer, a known consultancy, regarding pension systems of different countries of the world. Since the pension systems are divided into the schemes with defined contributions and the schemes with defined payments, Mercer made a separate rating for both systems. But both of them had one joint feature: the four pension systems which are the best under the both categories exercised control over the activities of pension funds jointly – it was exercised both on the part of employers and on the part of trade unions. The pension systems of Australia and Sweden were recognized the best in the system with defined contributions, and Denmark and the Netherlands headed the list of the pension systems with defined payments. As for the USA, there exists the system called 401K. The US system is managed by financial institutions and there is no requirement on equal representation of employers and employees. However, in the USA effective control over the activities of funds is being implemented.

When we took part in preparing the Law of Ukraine On Non-State Pension Provision we proposed to introduce representation of employees in an NPF board. But the proposal encountered very active opponents, namely market players for whom such representation is extremely unfavorable. In my opinion, a decisive role here should be played by the government. I am sure all fund participants should be represented in Pillar II of the pension system by all means.

To-date unlike other social insurance funds the Pension Fund of Ukraine has not built a form of management on the principles of tripartism. The 2003 Law On Mandatory State Pension Insurance envisage that the Pension Fund should be transformed into a self-governing organization five years after the introduction of this Law, i.e., it was meant that all fund participants should be represented in it. Also, this Law envisages that there should be 14 members in a board of an accumulation pension fund, including one representative from the insured persons and one – from the employers.

A pension system of any country should provide for not only some solidarity, economic efficiency, but social justice too. How is it possible to achieve this in Ukraine? Maybe, we should change the legislation, limit maximum pensions? Owing to what is justice of the pension system guaranteed, in general?

- I do not think that the pension system in Ukraine is so unjust. I prefer redistribution from the rich to the poor. But I think that in the specific Ukrainian example the state somewhat has already overdone with subsidizing poor layers of the society. Here, it is worth returning to 2003 when the law on mandatory state pension insurance was adopted. What was the situation at that time? I do not remember exact figures, but in 2003 the minimum pension was approximately UAH170 that comprised about one third of the wage. Then there were attempts to raise the minimum pension,

and a larger part of the society agreed to it. But now when the minimum pension is increased up to the minimum subsistence level we can see some "inconsistency" of the legislation. For example, the law says that if you have 20-25 years of your pensionable service you may receive a minimum pension; if it exceeds 20-25 years of your pensionable service, you will receive one percent in addition to your minimum pension (about UAH695). Now that the minimum pension has reached a higher level, it is necessary to think about changing the "soviet" pension system. At that time authorities tried to give everything and to all. In the USSR there were such schemes that were too generous. Specifically, it is related to privileged pensions, long-service pensions. The problem of privileged pensions is rather not in the fact that they existed, but in the fact that now employers have to finance these pensions by 90%. As for the Pension Fund of Ukraine it is not a big problem since the cost of these pensions is covered by employers.

I know that I shall be unpopular if I say that it is reasonable to review very seriously the amounts of the pensions that government employees receive. Thus, now government employees contribute to the Pension Fund by 3% more than all others do. But at the same time the payments they receive are much bigger and are calculated at the rate of 80-90% of their wages.

Is such a system just? I do not mind if the rich subsidize the poor. But in this case it turns out that representatives of the private sector subsidize employees of the public sector. It is unjust, but this system is in action now. And the situation will only deteriorate if the accumulation system is launched just now. If you are a doctor or a teacher, this system is not applied to you.

If a mandatory accumulation pension system is introduced, government employees as all other persons of the statutory age will have to take part in Pillar II. However, if they want to receive an additional pension, it should be solved using a separate scheme, specifically, through voluntary Pillar III – non-state pension funds.

The problem of small entrepreneurs who are single tax payers is not solved either (this is so-called simplified system of taxation). As is known these entrepreneurs don't pay contributions for their employees. The simplified system of taxation contributes to creating new jobs and hence it makes some impact in increasing contributions to social funds. But when flat-taxpayers want to know about the amount of their pensions, they will be really shocked. Injustice is in the fact that employers and small entrepreneurs who are single tax payers pay for themselves as natural persons and in addition they must pay for themselves as employers. Thus, on the one hand, the introduction of a single tax really contributes to creating new jobs, but on the other hand, it gave rise to another problem which requires its solution.

All right! In this case, please, tell us in what country would you advice us to go to receive the highest pension? Where is the most sustainable pension system in the world?

- In any country if you work as a government employee or you have managed to built a brilliant political career ... If I answer your joke seriously, it is reasonable to stay in your own country, but to work hard and effectively in order to receive high salaries and pay correspondingly sufficient contributions to pension funds.

About the Expert

Greg McTaggart has worked on pensions since 1981 and was one of the founders of the Australian mandatory accumulation system which was recently recognized by the international consulting company Mercers as being the best of its type in the world. He advised governments in the Asia/Pacific rim on the reform of their social security systems. In 1993 he started working on accumulation pension schemes in the United Kingdom and since 1996 has worked extensively on the reform of social insurance schemes in countries such as Russia, Mongolia, Vietnam, Egypt, Tadjikistan, and China. He has worked in Ukraine since 1998 advising the Ukrainian Ministry of Labour and Social Policy on pension reform issues.

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