

Will Privileged Pensions Become Part of Accumulation Pension System?

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Privileged pensions have always been part of remuneration packages for those who work under difficult or hazardous conditions. They exist in both Western and Socialist countries. The main difference between the two systems has always been how to achieve the end result.

Socialist countries have generally made privileged pensions a sub-component of the compulsory social insurance system. That made sense since it wasn't really until 1991 that alternative pension schemes – non-state pension funds – started to appear in countries like Russia. So the only option was to put them into the mandatory pension system.

The West has a much longer history of non-state pension funds so pensions for mine workers, airline pilots, teachers, firemen etc traditionally have been provided for by non-state pension funds. And in many post-socialist countries where previously there were privileged pensions as a sub-component of the mandatory pension system they have now either been abolished in entirety or have become subject to contributions by the employer and/employee to a non-state pension fund.

There are not that many people who would deny somebody who had worked in hazardous conditions the right to retire early. But what people do object to is that there is a subsidy from the general population to these privileged pensioners.

The general view is that those who work in hazardous conditions often do so because the higher wages paid to them. They know the risk they take by accepting these jobs. Generally the view is that the higher wage should be adequate compensation for them but if they want to go further and fund retirement before normal state retirement age that these pensions should be funded contributions made by either the worker him or herself or by the employer. Special pensions for these categories should not be paid at the expense of higher contributions paid by or lower benefits paid to the general population.

Western experience

To our knowledge there are no OECD countries where the compulsory state pension system allows early retirement or enhanced benefits to workers. All these arrangements are done through non-state pension funds. The most common arrangement is to allow early retirement with actuarially calculated reduction in benefits.

Typically in a defined benefit scheme people can retire 10 years before normal retirement but if they do so there is a quite considerable reduction in their benefits – basically because the fund has to pay their pension for quite some time – at 50 a fund could be paying a benefit for around 30-35 years in the West.

A typical example here is a scheme pays a benefit of 1/80 of final salary for each year of service for normal age retirement. A person with 40 years service would get a pension of 50% of their salary. But a person who retired at age 50 would get a significantly reduced benefit – 30 years service would give a pension of 37.5% and that person would be further reduced due to early retirement often by 3% for each year prior to normal retirement age. In the case above the 37.5% of final salary would be reduced by 30% giving a total pension of just over 26% of final salary.

However for those who had a privileged pension the reduction is not so severe.

For instance normal retirement for firefighters in the UK is 55. At 55 with 30 years service a person would retire with a pension on 2/3 of final salary. But a person with 25 years service can retire at 50. He or she only gets a smaller pension because they have contributed for 25 years as opposed to 30 years. They would get 50% of their salary at retirement.

One thing to notice however is that in schemes where early retirement is supported generally the employee contribution rate is higher than normal – in the firefighter's scheme above the individual firefighter pays 11% of salary as a contribution, while the typical contribution rate is 5-6%.

The schemes in the West that allow early retirement under favourable terms are generally those where there are high stress or difficult working condition occupations – firemen, air traffic controllers, coal miners, seamen. One of the arguments for allowing early retirement is that the health of these staff needs to be very high for them to do their jobs. If they

weren't allowed to retire early often they would seek retirement on the grounds of ill-health that would provide higher benefits at a greater cost to the fund.

Post-socialist countries

As stated above socialist countries acknowledged the need for certain categories of worker to be able to retire early. But up until 1991 the only real option for them to facilitate early retirement was through the compulsory pension system. In those times there were probably no real complaints from the rest of the population about this arrangement.

But the move to market economy gave rise to pension crises in many post-socialist countries with big differences in the pensions between the majority and the minority.

Many post-socialist countries simply abolished privileged pensions leaving it to employers and employees to either negotiate higher wages as compensation or agree to contribute to a non-state pension fund. Hungary and Poland are examples where this happened.

Some countries legislated to abolish privileges under the compulsory pension system and require compulsory pension contributions to an occupational scheme. Bulgaria and Slovakia are countries where this has happened.

Other countries basically did nothing – Russia is an example of this. For a long time there has been a draft law on privileged pensions that has gone nowhere within the State Duma.

Increasingly privileged pensions are becoming the focus of attention again. Two countries – Romania and Croatia – have been very prominent in debate about pension privileges recently. Both countries have been under pressure from the IMF to reform their pension systems and to reduce government expenditure.

The real debate in these countries is on how far to go in reducing privileged pensions. There is little doubt that in the near future these countries will abolish the early retirement component of privileged pensions. But the big debate will be whether all privileged pensions will be abolished. Civil servants, parliamentarians, judges etc are all in receipt of privileged pensions. We can call them "spets pensii" in Ukraine but they are in fact privileged pensions.

Ukraine is slightly different

In Ukraine there is a requirement that the employer finance an ever-increasing part of the early retirement component of privileged pensions for those in List I. For list II the employer already fully finances the early retirement component.

So the debate in Ukraine is more whether it would be better to move to a European style situation whereby the employer pays contributions each month into a npf and the person accrues the benefit at early retirement age or whether the employer pays nothing initially and then meets the full cost once the person retires.

In theory the cost to the employer should be less if the benefit is funded on contributory basis rather than meeting the benefit at retirement. Also there is less risk for the government – under the current model the employee accrues a benefit but the employer may not be in existence at the time the benefit is paid leaving the State to pick up the cost.

Generally we support removing privileged pensions from the compulsory pension system and requiring employers and/or employees to fund the cost on a contributory basis.

There is a lot of work to be done in this area – contribution rates etc – but we feel that successful operation of privileged pensions in the third pillar is the best test there can be of whether or not Ukraine can successfully operate the mandatory accumulation system.

However, this requires strengthening Pillar III regulation, ensuring its transparent and effective operation and protection of NPF participants.

* *The views and opinions of author expressed herein do not necessarily state or reflect those of the U.S. Government or the USAID*