

## Privileged Pensions: Privilege or Compensation?

One of the provisions of the Concept on Pension reform Furtherance is to reduce financial load on employers. This refers to financing financial retirement benefits for employees engaged in underground works, those engaged in hazardous and arduous work conditions or in positions which provide eligibility for old age pensions on privileged conditions or for the years of service. For example, metallurgists or medical employees. It is planned to develop mandatory occupational pension schemes for such employees because there are areas in which it is impossible to avoid the hazardous factors. How is this issue resolved in the West? Which way did the post-social countries follow, in particular Ukraine? Senior International Pension Reform Adviser of the USAID Capital Markets Project Greg McTaggart tells our correspondent about these issues:

- 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.

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 or 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.

**- However, somebody has to work in hazardous conditions. What stimulates people for such arduous work? Who should pay privileged pensions?**

- The general view is that those who work in hazardous conditions often do so because of 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.

To my knowledge, there are no 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.

**- “Privileged” pensioners are entitled to early retirement. In what way does it influence their pension 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 when 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 pension 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%.

**- Some countries have cancelled privileged pensions completely. Some have reduced the number of categories entitled to privileged pensions. In Ukraine some government officials have high pension benefits. From which sources should they be financed?**

- Indeed, many post-socialist countries simply abolished privileged pensions. The debate in some countries is on how far to go in reducing privileged pensions. Or 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. So the debate here 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 to pay contributions instead of the employer under the current model. Generally, I support removing privileged pensions from the compulsory pension system and requiring employers and/or employees to fund the cost of the future pension on a contributory basis. Finally, I would like to note that views expressed in this article do not necessarily reflect those of the U.S. Government and the USAID.