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SOCIAL SECTOR REFORM ACTIVITY

PENSION REFORM

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PENSION REFORM IN CEE AND THE NIS

Submitted by:
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PENSION REFORM IN CEE AND THE NIS

I. Introduction

Pensions **S** benefits paid to workers following retirement**S** are a factor of public policy in a majority of countries around the world. Some 155 countries now have public pension systems (as opposed to 33 in 1940). While most of the labor force is covered by these public pensions in the industrialized world, the programs in developing countries cover far fewer workers. For example, only 20 percent of the workforce in China is covered by the public pension system, compared to 100 percent of workers in the United Kingdom.[1]

II. The Need for Reform in CEE and NIS

Pension systems have become the object of reform efforts in countries throughout CEE and the NIS. These countries typically had extensive pension systems that were mandatory, pay-as-you-go (PAYG) systems, much like the Social Security program in the United States. Under PAYG systems, current workers pay pension taxes that are used to pay the pensions of current retirees. These pensions are based on "defined benefits," that is, pensioners are promised a certain benefit regardless of how much or how little they paid in pension taxes, and current workers pay taxes to fund these benefits.

The public pension systems of Central and Eastern Europe are characterized by the following factors which make reform of these systems necessary:

! *High dependency ratios*: The ratio of current workers to pensioners is decreasing, so that there are not enough workers to support the pensions of retirees;

! *Large deficits*: National governments can no longer afford to subsidize the pension systems by making up the difference between the taxes and the amounts needed for the pensions;

! *High levels of pension expenditures*: Pensions consume a higher and higher percentage of national budgets;

! *Low pensions in absolute and relative terms*: Pensions benefits are often very small, giving pensioners little to live on;

! *Lax criteria for disability pensions*: Significant numbers of people with minor disabilities collect disability pensions; and

! *Low retirement ages:* The retirement age was low under communist systems, resulting in a large number of retirees to be funded by a smaller workforce.

[1] "Older Workers, Retirement and Pensions: A Comparative International Chartbook," Kevin Kinsella and Yvonne J. Gist, U.S. Bureau of the Census, 1995, p. 51.

Reform programs include attempts to:

- Decrease the amount of payroll taxes for current workers;
- Establish defined contribution pension plans through which each worker has an account into which he or she makes retirement contributions;
- Establish private pension funds run by private companies rather than the government; and
- Establish mandatory defined contribution accounts at the national level.

The important hallmarks of private pensions are that they should be:

- fully vested
- fully funded
- fully portable
- defined contribution plans.

Decision points include:

- Defined benefit vs. Defined contribution;
- Employer vs. Employee mandate to contribute; and
- Tax policy and government contribution.

Chile is often looked to as a model of private pension reform. In 1981, after the collapse of the public pension system, Chile established private pension funds and gave workers a choice of remaining in the government system or switching to the new private system. Ninety-two percent of the population switched to the private system. Workers are required to put ten percent of their wages into pension savings. They can chose one of 21 private pension funds to invest their savings. These funds are heavily regulated by the government to prevent fraud and high-risk investments. Workers can switch their funds to other companies at will and receive statements of their savings and the return on investment.

Countries in CEE/NIS with current pension reforms underway include: Hungary, Poland, Bulgaria, Macedonia, Romania, Kazakhstan, Ukraine, and Russia. Both the U.S. Agency for International Development and the World Bank are assisting with the reforms.

III. Pension Reform Activities in CEE and the NIS

The following summaries of pension reform activities include information about USAID activities taken from USAID Missions' Results Reviews (where applicable). Other information is taken from World Bank documents, UNDP human development reports, news reports, and other sources.

Albania

Through USAID funding in the early 1990s, USDOL assisted the Albanian Social Insurance (SII) Institute to improve staff capabilities and forecasting tools to develop realistic pension system reforms. USDOL developed a budget projection model and trained SII staff on the model. Increasing SII staff capacity with the model facilitated Albania's access to World Bank loans.

The government of Sali Berisha in 1996 declared the development of private supplementary pensions and private voluntary pensions to be part of its reform program.

Pensioners, along with the unemployed, were losers during the transition. Pensions have been kept low to keep the budget deficit under control. As a result of low pensions and rising prices, purchasing power for pensioners with agricultural pensions was only 49 percent of the purchasing power they had in 1991 (purchasing power was unchanged for pensioners receiving nonagricultural pensions). Nonagricultural pensions were worth about $38/month in 1995 while agricultural pensions were less than $10/month (compared to an average of $106/month in 1994 for all workers).

According to the UNDP, pensioners were saved by the Albanian family structure: most pensioners live with a married son and his family. Pensioners living alone usually receive help and assistance from their children. There are almost 500,000 pensioners in Albania.

Bulgaria

In 1992, the Government of Bulgaria passed the Pension Reform Act, lowering the retirement age (effectively encouraging early retirements): the retirement age for men was reduced from 64 to 60 and for women from 58 to 55. Generous provisions for early retirement led to increased pension expenditures — 9.6 percent of GDP in 1993.[2]

In 1996, the government established the National Social Security Institute (NSSI) and gave it authority over the pension system. USAID, through the Free Trade Union Institute, provides training to NSSI staff. The World Bank has a Social Insurance Administration Project to help reform Bulgaria's social insurance system. The project includes increasing NSSI institutional capacity (policy analysis, actuarial forecasting, public information and education, and personnel management improvements) and improving NSSI operational efficiency in the new market economy (reversing tax noncompliance trend and strengthening NSSI's ability to perform evaluation).

Pensioners currently comprise 25 percent of the Bulgarian population. Twenty percent of government expenditures go for pensions, but the average pension is worth only 33 percent of the average salary.

[2] Branko Milanovic, section 3, p. 5.

The public pension established prior to the transition is the primary source of income for the elderly. Five private pension funds have been established in recent years, and they operate as insurance funds. A government working group on private pension reform is drafting a law to regulate these funds. In 1998, USAID awarded a contract to the Carana Corporation to assist the Bulgarian government with reform.

The Caucasus (Armenia, Azerbaijan, and Georgia)

Many workers in the Caucasus do not have adequate pensions. Some may not have received payments for several months. In general, the pension and banking systems in the Caucasus need to be reformed to increase public confidence.

Private pensions have not yet been institutionalized in the Caucasus. Domestic savings are extremely low since per capita income is low and many people lost their savings during the transition.

In Armenia, Tacis has a project to assist with reform of the social security system and made recommendations for its simplification.

Hungary

Hungary passed legislation allowing the creation of private pension funds in 1994. By the end of 1995, there were 179 funds with 180,000 members (less than five percent of the active workforce). There are four types of funds:

- company funds (established by companies for their employees)
- trade union funds
- professional funds (for doctors, lawyers, and other professionals)
- open funds (with broader membership, often based on geographics).

Under current Hungarian law, benefits are not taxed. In addition, workers receive a 50 percent tax credit on contributions up to 200,000 forints per year. Problems with the current framework for private pension funds in Hungary include:

- Accounting rules allow fund managers to credit only income received and realized capital gains to accounts. Thus, accounts act more like savings accounts than long-term mutual funds.
- No custodians or licensed asset managers are required for funds.
- There are no guarantees for minimum benefits or returns (the law currently allows for creation of a guarantee fund, but none had been created by 1996).
- The required capital cover for external asset managers is 30 percent (but only one percent in Chile).
- Account statements are required to be sent to account holders only once per year.

The number of people receiving a disability pension increased to seven percent of the working age population over the first few years of the transition. In order to avoid increasing unemployment enrollment, the government offered generous severance packages to many employees of state owned firms, such as early retirement and retirement through disability. However, these packages have created a significant number of people dependent on government pensions.

The Budget Department needs to keep better track of Social Security Funds, so that is one of the items they will include in the Public Finance Management Network, enabling the Budget Department to track social security payments closely (World Bank, Hungary-Public Finance Reform Project, p. 3). Social security supports several of the pensions the government offers: old age pension, survivors pension, disability pension (World Bank, Hungary-Poverty and Social Transfers, p. 26). Social insurance is contribution based (both employer and employee).

By January 1996, Hungary had almost 3 million retirees (in a population of 10.3 mil). Fifty-three percent of retirees collect old age pensions, 24 percent collect disability, and 7 percent collect widower pensions (UNDP, Transition Problems, p. 7). In addition, there are agricultural annuities, orphan annuities, and accident annuities that people might collect. Pensioners in Hungary tend to be young; 34 percent of men and 39 percent of women collecting pensions were younger than 50 in 1995. Pensions represented around 10 percent of GDP in 1995, HUF 582.2 billion (similar to France, Italy, US 5%, Canada 4%).

In spite of the high costs, pensions have not kept up with inflation. In 1993, 40 percent of the population collected government pensions and was not employed at any full-time job (World Bank, Hungary-Poverty and Social Transfers, p. 25). The government plans to increase pensions by 19 percent in 1998.

The Hungarian Parliament passed a new law on the pension system in July 1997. Beginning in 1998, employees will pay 75 percent of their pension contributions to the central pension fund and 25 percent to a private fund of their choice. In addition to this, employees may elect to put additional money into a private pension account, much like an American 401K fund. There are 244 new voluntary pension insurance depository banks. These banks are helping to build Hungary's capital markets.

Through USAID funding, a U.S. Treasury resident advisor has provided assistance to the Hungary pension supervision agency since July 1997. Assistance has included: study tours for government officials, development of an information technology system for private pension funds, training for government officials and private pension fund staff, public education about the private pension system (CIPE — Center for International Private Enterprise, US Department of Commerce — is providing the pension manuals and handouts for the public education campaign), and technical assistance to strengthen pension auditing and enforcement.

Macedonia

Pensions and health insurance have not been paid for a large number of workers. The Supreme Court decided that the payment of pensions was the duty of the Pension Fund and that the central government could not be held accountable. However, the Fund is in crisis and cannot afford to pay what it owes to the pensioners. Many businesses have closed or are no longer operating legally so they are not paying into the Pension Fund. Others are simply defaulting on the contributions. The government has enforced a new regulation that requires businesses to pay contributions to the Pension Fund by the 25th of the month regardless of whether salaries have been paid (Skopje Puls, July 25, 1997, p. 5-7).

Private pensions are now mandatory in Macedonia. Originally the government thought to make private pensions voluntary, but have since changed their minds.

USAID has had a long-term resident advisor, through Carana Corporation, attached to the Social Welfare Office since 1993 who is tasked to advise Macedonia on reform of the public pension system and enhanced targeting of social assistance and delivery of social services. USAID activities include reviewing and identifying improvements in regulations and benefit payment; improving existing methods of pension payments; assisting in analyses of tax and labor market implications of pension reform; and management training (on-the-job training and workshops) for government officials. Short-term technical advisors are involved in the design and planning of "personal security accounts" to provide annuities for retirement. Private pension activities focus on planning and creating a receptive environment for reform (private reform is seen as a long-term goal).

Kazakhstan

USAID, through its contractor Development Alternatives, Incorporated, is tasked to assist in the development of a private pension system and stabilize the current public pension system. For the private pension system, tasks include developing the legal, regulatory, and policy framework; making recommendations for the best type of regulatory structure and providing staff training to the regulatory agency; providing public education; and selecting pilot entities that could function as private pension fund and increasing their capacity to operate as pension funds. To stabilize the public pension system, tasks include assessing current pension policy, improving implementation of the public system, establishing the legal framework, reducing the payroll tax, and developing actuarial-based financing accounting system.

The new private pension system took effect on January 1, 1998. It promises to provide better safeguards for worker pension contributions.

Poland

Poland's pension system presents medium-term sustainability problems for the Government. First, the system is "pay as you go," and the government's portion consumes more than 25 percent of annual government expenditures. Second, the pension payroll tax is 45 percent of wages —

encouraging companies and workers to avoid pension registration and payment. Third, the high payroll tax encourages companies to substitute capital for labor (contributing to the unemployment problem).[3]

The Parliament is considering reform legislation, and opposition parties have proposed reforms of their own. Reform proposals promulgated by the government and opposition typically include these provisions:

- raising the retirement age,
- equalizing the retirement age for men and women (women can currently retire earlier than men),
- reducing the portion of retirement pensions to be paid by the government's social security program, and
- establishing a capital-funded private pension program (pensions would be based on lifetime contributions and the investment return on the contributions).

The government's reform proposal envisions making participation in privately managed, capital-funded pension programs mandatory. These pension plans would then become major investors in Poland and provide long-term financing for infrastructure projects.[4]

USAID's efforts in Poland, undertaken by Price Waterhouse, have focused primarily on public education regarding the private pension system. Public education efforts developed under subcontract to a Polish PR firm include press kits, press conferences, and brochures. Study tours to Latin America have also been organized. In addition to public education efforts, Price Waterhouse provided written guidance to Poland on the development and adoption of private pension reform.

The next phase of USAID activity will continue the public education activities and support the development of and training for the new Office of Pension Fund Supervision. Tasks include public relations (press kits, presentations, focus groups, television, and radio) regarding private pensions; study tours for government officials and opinion leaders; technical assistance on pension fund supervision and licensing; assessment of software needs and development of software for pension fund supervision, if needed; training for pension fund supervision staff; and a regional conference and Polish public relations missions to showcase Polish reforms to CEE/NIS countries.

Ukraine

[3] "Poland: Year 2000 USAID Graduation Plan, 1996-2000," USAID/Poland, May 1996, p. 7.

[4] "Poland: Year 2000 USAID Graduation Plan, 1996-2000," USAID/Poland, May 1996, p. 7.

Pensions are a huge issue in Ukraine right now. The government fell three months in arrears and has just begun to repay those debts. The Supreme Council has proposed a pension increase in 1998, but the Ministry of Finance has rejected the idea since it would only increase budget deficits in 1998. In addition, the Ministry of Finance proposed increasing the eligibility age from 60 to 65, but the Supreme Council has rejected that measure.

Other social benefits are being paid by municipal governments, and they are raising prices and tariffs to cover these costs. Wages and pensions are still not being paid to people in most parts of the country.

USAID, through its contractor PADCO and a long-term resident advisor, has worked with Ukraine on pension reform development and improved recordkeeping and administrative practices. Tasks have included: developing individual pension reporting software, preparing a report on the state of private pension funds in Ukraine, and preparing a manual on how to regulate private pension funds. Future pension reform activities will include a full-time pension advisor who will work on introducing individual pension reporting, improving pension collections and payment systems, and providing policy advice and pension reform projections.

Uzbekistan

USAID has been working in pension reform in Uzbekistan since 1996, and has a long-term resident advisor in country. USAID's work focuses on stabilizing the public pension system and safeguarding workers' pension contributions (private pension reform is seen by Uzbekistan as a long-term goal). Stabilization tasks include: increasing solvency through policy changes, increased compliance, and development of actuarial modeling software; assisting in drafting comprehensive pension reform legislation; and establishing a pension regulatory body.

The government of Uzbekistan was not willing to undertake the major pension system revamping recommended by USAID experts.

IV. Training in Pension Reform

One of the most important pension reform activities undertaken by USAID in ENI countries has been providing training to pension reform experts and officials to build their knowledge base. Two of these experts are highlighted here. For more information on pension reform experts in ENI countries, please see USAID's Social Sector Reform Website at http://www.socialsector.net. The Directory of Experts that can be found on the website includes descriptions of experts in social sector reform, including pension reform.

Dr. Jordan Hristoskov, President, Club Economika 2000

I. USAID Training

March 1992 - Labor market training
July 1995 - Pension reform
October - November 1997 - Train the trainers program of LGI's Municipal administration project

II. Professional Experience

Presently a professor at the University for National and World Economy in Sofia, teaching Management of social security funds. Consultant of Multi-National Strategies (AID-funded project for supplementary voluntary pension funds). Former Deputy Minister of Labor and Social Policy, advisor of the President. Consultant and researcher. National co-ordinator for PHARE programme. Head of sub-committee of National Tripartite Commission.

Consultancies and Participation in Research Projects:

(1) Operational Model of the Social Infrastructure, for the Ministry of Industry and Planning, 1990. Member of the research team.
(2) Ethnic relations under the economic crisis - a regional approach to the problems, for the Administration Office of the President of the Republic of Bulgaria, 1991. Leader of the research team.
(3) Social and Labor Market Policy in Bulgaria, for the International Labor Organization (Preparation of a report "Bulgarian Challenge," 1993.
(4) Europe 2000: Bulgaria and EU. Part "Human Resources and Social Policy," for the Ministry of Foreign Affairs, 1995. Leader of the research team.
(5) Non-institutionalized Employment and Self-employment - Research study, 1996 (Team leader).

Dr. Volodymyr V. Yatsenko, USAID

I. USAID Training

US Department of Labor, Bureau of Labor Statistics, Washington, D.C. (May-June, 1995 and September-November, 1994

II. Professional Experience

USAID/Ukraine: Manager, Social Security Program, for Ukraine, Belarus, Moldova (1996-present). Kyiv National University of Economics: Associate Professor, Dept. of Human Resources Management, (1991-1996). Vice-Dean, Faculty of Marketing,(1988-1994). Assistant Professor,(1986-1990). Director of Division of Research on the Economics of Vocational Training (1984-84). Lecturer (1980-84). Chief Accountant, construction business (part-time), Kyiv (1990-93)

Consultancies:
USAID (1995-96); World Bank (1995-96); UN Office in Ukraine (1994-present); International Labour Organization (1993-96); Ministry of Labor and Social Policy of Ukraine, Member of the Governmental Task Force on Pension Reform in Ukraine (1993-present); State Committee on Statistics of Ukraine (1993-present)

Selected Publications:
1. "Pension System Affects Everyone," article in the Cabinet of Minister's of Ukraine official newspaper, Uriadovyj Kurier.
2. "The Regional Dimension of Employment Policy in Ukraine," paper presented at the ILO seminar on Regional Dimension of Employment Policy in Central and Eastern Europe, Budapest, May, 1997.
3. "Ukraine Human Development Report," 1997,1996, 1995; UNDP, Kyiv (co-author).
4. "Social Processes and Labour Market in Ukraine." Paper presented at Regional UNDP meeting on Transformation and Social Cohesion,: Bratislava, June 1996.
5. "Pension System in Ukraine." Paper presented at the national seminar on Social Protection, Employment and Pensions, organized by GOU and the Economic Development Institute of World Bank, Kyiv, April 1995.
6. "Employment Policy and Programmes in Ukraine." paper presented at the ILO conference on "Employment Policies and Programmes in Eastern and Central Europe." Budapest, June 2-3, 1996.

USAID/ENI PENSION REFORM ACTIVITIES

USAID/ENI PENSION REFORM ACTIVITIES

COUNTRY	DESCRIPTION OF USAID PENSION ACTIVITIES
Albania	Through USAID funding, USDOL assisted the Albanian Social Insurance (SII) Institute to improve staff capabilities and forecasting tools to develop realistic pension system reforms. USDOL developed a budget projection model and trained SII staff on the model. Increasing SII staff capacity with the model facilitated Albania's access to World Bank loans.
Bulgaria	USAID, through USDOL and the Free Trade Union Institute, provided training to National Social Security Institute staff. The USDOL project included increasing NSSI institutional capacity (policy analysis, actuarial forecasting, public information and education, and personnel management improvements) and improving NSSI operational efficiency in the new market economy (reversing tax noncompliance trend and strengthening NSSI's ability to perform evaluation). A USAID design team in 2/98 assessed the current status of the Bulgarian pension system, produced technical recommendations for Bulgaria on private pension reform, and planned a two year project to help Bulgaria institute private pension reform. Carana Corporation received the contract to implement the project.
Hungary	Through USAID funding, a U.S. Treasury resident advisor has provided assistance to the Hungary pension supervision agency since July 1997. Assistance has included: study tours for government officials, development of an information technology system for private pension funds, training for government officials and private pension fund staff, public education about the private pension system (CIPE — Center for International Private Enterprise, US Department of Commerce — is providing the pension manuals and handouts for the public education campaign), and technical assistance to strengthen pension auditing and enforcement.
Kazakhstan	DAI, the USAID contractor, is tasked to assist in the development of a private pension system and stabilize the current public pension system. For the private pension system, tasks include developing the legal, regulatory, and policy framework; making recommendations for the best type of regulatory structure and providing staff training to the regulatory agency; providing public education; and selecting pilot entities that could function as private pension fund and increasing their capacity to operate as pension funds. To stabilize the public pension system, tasks include assessing current pension policy, improving implementation of the public system, establishing the legal framework, reducing the payroll tax, and developing actuarial-based financing accounting system. The new private pension system took effect on January 1, 1998. It promises to provide better safeguards for worker pension contributions.
Macedonia	USAID has had a long-term resident advisor, through Carana Corporation, attached to the Social Welfare Office since 1993 who is tasked to advise Macedonia on reform of the public pension system and enhanced targeting of social assistance and delivery of social services. USAID activities include reviewing and identifying improvements in regulations and benefit payment; improving existing methods of pension payments; assisting in analyses of tax and labor market implications of pension reform; and management training (on-the-job training and workshops) for government officials. Short-term technical advisors are involved in the design and planning of "personal security accounts" to provide annuities for retirement. Private pension activities focus on planning and creating a receptive environment for reform (private reform is seen as a long-term goal).

COUNTRY	DESCRIPTION OF USAID PENSION ACTIVITIES
Poland	USAID's efforts in Poland, undertaken by Price Waterhouse, have focused primarily on public education regarding the private pension system. Public education efforts developed under subcontract to a Polish PR firm include press kits, press conferences, and brochures. Study tours to Latin America have also been organized. In addition to public education efforts, Price Waterhouse provided written guidance to Poland on the development and adoption of private pension reform. The next phase of USAID activity will continue the public education activities and support the development of and training for the new Office of Pension Fund Supervision. Tasks include public relations (press kits, presentations, focus groups, television, and radio) regarding private pensions; study tours for government officials and opinion leaders; technical assistance on pension fund supervision and licensing; assessment of software needs and development of software for pension fund supervision, if needed; training for pension fund supervision staff; and a regional conference and Polish public relations missions to showcase Polish reforms to CEE/NIS countries.
Ukraine	USAID, through its contractor PADCO and a long-term resident advisor, has worked with Ukraine on pension reform development and improved recordkeeping and administrative practices. Tasks have included: developing individual pension reporting software, preparing a report on the state of private pension funds in Ukraine, and preparing a manual on how to regulate private pension funds. Future pension reform activities will include a full-time pension advisor who will work on introducing individual pension reporting, improving pension collections and payment systems, and providing policy advice and pension reform projections.
Uzbekistan	USAID has been working in pension reform in Uzbekistan since 1996, and has a long-term resident advisor in country. USAID's work focuses on stabilizing the public pension system and safeguarding workers' pension contributions (private pension reform is seen by Uzbekistan as a long-term goal). Stabilization tasks include: increasing solvency through policy changes, increased compliance, and development of actuarial modeling software; assisting in drafting comprehensive pension reform legislation; and establishing a pension regulatory body. The government of Uzbekistan was not willing to undertake the major pension system revamping recommended by USAID experts.

Sources: USAID/ENI Project Documents and information supplied by USAID Missions.

WOMEN AND PENSION REFORM

Submitted by:
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January 1999

WOMEN AND PENSION REFORM

I. Introduction to Pension Reform

Pensions -- benefits paid to workers following retirement -- have become the object of reform efforts in countries throughout CEE and the NIS. These countries typically had extensive pension systems that were mandatory, pay-as-you-go (PAYG) systems, much like the Social Security program in the United States. Under PAYG systems, current workers pay pension taxes that are used to pay the pensions of current retirees. These pensions are based on "defined benefits" -- pensioners are promised a certain benefit regardless of how much or how little they paid in pension taxes, and current workers pay taxes to fund these benefits. See Box A for definitions of pension terms.

Box A: Pension Terms

1. **Public pension.** Public pensions are pensions provided by a government body. Individuals and/or their employers may contribute to public pensions, and governments generally cover any shortfall between contributions and benefits.
2. **Private pension fund.** Privatization of pension programs is one focus of pension reform activities. Private pension funds are private companies that take pension contributions from workers, invest the funds, and maintain individual accounts for each worker. These funds then pay workers their contributions plus earnings upon retirement, death, or disability (depending on the country's laws or regulations). Private funds are usually regulated by an agency of the central government and have to follow rules related to investing funds, reporting to account holders (workers), and paying benefits.[1] Depending on the country, tax incentives for investment in private pension funds may or may not be available.
3. **Defined benefit.** Defined benefit pensions promise pensioners a certain monthly benefit that is not based on their contributions to the pension system while they worked. The U.S. Social Security System is a defined benefit system. Defined benefit pension systems are usually also PAYG systems (defined below). Defined benefit systems are characterized by low-risk to the pensioner but also have low gains.
4. **Defined contribution.** Defined contribution pensions are based on a worker's individual contributions to a retirement account. Pensions are calculated based on the amount the worker contributed and the earnings from investments of that money. Workers, therefore, bear more of the risk, but the gains from financial investments of their retirement accounts accrue to them. In other words, these pension systems have a higher risk but also generally a higher yield.[2]
5. **PAYG.** Pay-as-you-go (PAYG) pension programs are in use throughout the world (including the United States' Social Security Program). Under the PAYG system, governments collect taxes from current

[1]Private pension funds are like the 401K and IRA programs in the United States. Workers can invest pension funds with any of a number of private companies offering such retirement programs.

[2]Workers may bear all of the risk associated with defined contribution pensions unless the government sets up guarantee provisions to reduce such risk.

workers that are used to pay the pensions of current retirees. The system is stable as long as there are enough workers to fund the pension liability with taxes that are not onerous. Under this system, there is no individual retirement account for workers or retirees; a worker's payments are not based on what he or she will receive after retirement, and a pensioner's benefits are not based on what he or she paid in. PAYG systems are defined benefit rather than defined contribution.

Among the factors making reform of these systems necessary are:

- The ratio of current workers to pensioners is decreasing, so that there are not enough workers to support the pensions of retirees.
- National governments can no longer afford to subsidize the pension systems, making up the difference between the taxes and the amounts needed for the pensions.
- Pensions consume a higher and higher percentage of national budgets.
- Pensions benefits are often very small, giving pensioners little to live on.

Reform programs include attempts to:

- Decrease the amount of payroll taxes for current workers,
- Establish defined contribution pension plans through which each worker has an account into which he or she makes retirement contributions,
- Establish private pension funds run by private companies rather than the government, and
- Establish mandatory defined contribution accounts at the national level.

II. Why is Pension Reform Important for Women?

Before the transition to market economics, women received favorable pension allowances. In most countries, women were eligible for retirement before men with fewer years of service. In addition, women often received "credit" and could retire even earlier if they had a certain number of children or cared for disabled children.

These factors influence the amount of pension benefits women may receive:

1. Women live longer than men.
2. Women generally work for fewer years than men (due to child-rearing and/or caring for elderly relatives).
3. Women earn less wages (in the U.S., for example, women earn $.76 for each $1.00 men earn).
4. Women work fewer years at particular companies and may not "vest" (i.e., be able to retain) employer contributions to private pension plans.

III. Current State of Pension Benefits in CEE/NIS

Research into current pension benefits in the region by the U.S. Social Security Administration shows that in most countries, women may still retire earlier than men and in some countries receive credit for raising children. In most countries both workers and employers contribute to the state pension system (workers contribute very little — generally about one percent of their wages) while employers pay very high payroll taxes that cover pensions, unemployment benefits, and other welfare subsidies. For example, in Bulgaria, employer payroll taxes can be as high as 57% of total payroll.

Table 1 presents an overview of pension benefits in the region.

Table 1. Pension Benefits in CEE/NIS

Country	Retirement Age for Men/Years of Contributions	Retirement Age for Women/Years of Contributions	Benefits
Albania	60/35 years	55/35 years or 50/30 years if have 6 or more children over age 8	Basic pension plus earnings-related increment at 1% for each year of coverage multiplied by average assessed wage
Armenia	60/25 years or 50/20 years for hazardous work	55/20 years or 50/20 years for hazardous work or for mothers with 5 or more children or disabled children	60% of wage base, plus 1% of wage base for each year in excess of 25 years men or 20 years women
Bulgaria	60/25 years	55/20 years	55% of average earnings during highest 3 consecutive years in last 15 years. Limited to 3 times social pension.
Czech Republic	After 1/1/07, 62/25 years (or 15 years at age 65)	After 1/1/07, 57-61 depending on number of children	Basic flat pension plus 1.5% of average indexed earnings for each year of insurance after 1985, plus 4% additional for each year of work and deferral of pension beyond normal retirement age
Georgia	60/25 years	55/20 years	55% of average earnings plus 1% of earnings for each year of work in excess of 25 (men) or 20 (women)
Hungary	60/20 years	56/20 years (age to be increased to 60 in stages through 2003)	53% of net earnings plus .5%-2% for each year in excess of 20

Country	Retirement Age for Men/Years of Contributions	Retirement Age for Women/Years of Contributions	Benefits
Kazakhstan	60.5/25 years	55.5/20 years	60% of earnings plus 1% of earnings for each year in excess of 25 (men) or 20 (women)
Poland	65/25 years	60/20 years	24% of average national salary; 1.3% earnings multiplied by number of contribution years; and .7% earnings multiplied by credit years (e.g., child raising)
Romania	60/30 years	55/25 years	54-85% of average wages during best 5 years
Russia	60/25 years	55/20 years	55% of wage base, plus 1% of wage for each year in excess of 25 (men) and 20 (women)
Ukraine	60/25 years	55/20 years	55% of wage base, plus 1% of wage for each year in excess of 25 (men) and 20 (women)
Uzbekistan	60/25 years	55/20 years	55% of average earnings

Source: Social Security Programs Throughout the World — 1997, U.S. Social Security Administration.

IV. Current Pension Reforms in CEE/NIS

Several countries are undergoing pension reform, including Bulgaria, the Czech Republic, Hungary, Kazakhstan, Macedonia, Poland, and Ukraine. Reforms generally focus on stabilizing the public pension system to insure its solvency and creating a private pension system. Private pension systems include the creation of private pension funds. Workers and their employers can contribute into the funds, and pension benefits are based on the contributions (and any investment return) rather than a guaranteed benefit from the government.

In other words, private pensions transfer responsibility for saving and investing for retirement from the government to the individual worker.

V. Effects of Reforms on Women

Moving from a defined benefit pension system to a defined contribution pension system can adversely affect women because, in general, women would contribute less to their pensions than men. In addition, women live longer than men, and their pension savings would, therefore, be stretched over more years.

These issues affect women and their pensions throughout the world; however, women in the transition economies face additional pressures. According to the World Bank, women are not participating in the work force at the same rates since the transition. Instead, many women left the work force due to declining child allowances, maternity benefits, and access to pre-school education for their children.[3] Therefore, because women are leaving the workforce, their pension benefits will be even lower under a defined contribution system.

For additional information on the effects of pension reform on women, please see “Pension Reform in Kazakstan and Ukraine: Lessons Learned,” by Mitch Wiener.

[3] Labor Markets in Transition in Central and Eastern Europe, 1989-1995, Christine Allison and Dena Ringold, World Bank Technical Paper No. 352, p. 11.

PENSION REFORM IN KAZAKSTAN AND UKRAINE: LESSONS LEARNED

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INTRODUCTION

This report describes pension reform in Kazakstan and Ukraine. The focus of the discussion is on the successes and obstacles encountered in the pension reform process. Lessons learned from the experience in these two countries are outlined, and recommendations made on how they may be used to improve USAID technical assistance programs related to pension reform.

Kazakstan implemented its pension reform on January 1, 1998. Consequently, the reform program has been implemented and there is one year of actual experience to examine. By contrast, pension reform in Ukraine is still in its early stages. No reform legislation has been passed, although draft legislation has been submitted to the Parliament. Pension reform, therefore, is still on the drawing board. In Ukraine, only the directions, options and current intentions can be discussed. In Kazakstan, actual results can be analyzed.

Kazakstan and Ukraine operate under different political systems, which have a huge impact on their respective reform processes and outcomes. Kazakstan is, essentially, a dictatorship. Although there is a Parliament, it lacks any real power under the Constitution. All power is vested in the President. Consequently, once the President has decided on a course of action, he is able to implement it quickly, with little need to build political consensus. Ukraine is closer to a democracy. The Supreme Rada, has significant power – although the Rada is deeply divided with strong factions of Communists, other leftists, and nationalist-centrist groups. These divisions complicate the pension reform debate, and slow the implementation of most types of reform.

In order to examine the impact of reform on women, other vulnerable groups, and current pensioners, this report focuses on the social impact of pension reform, meaning, primarily, benefit adequacy. However, it's impossible to discuss pension reform without also taking into account the financial impact of reform. In most cases, finances have a significant impact on the design of the final reform program.

The report discusses several key issues:

- Description of pension reform trends worldwide to place the entire pension reform discussion into context.
- Discussion of the prior and current pension system in Kazakstan, its successes, obstacles and impact on vulnerable groups.
- Discussion of the current pension system in Ukraine and the current pension reform efforts, its successes, obstacles and the impact on vulnerable groups.
- General discussion of the impact of accumulation systems on vulnerable groups.
- Lessons learned: How USAID can better support pension reform in the former Soviet Union and elsewhere in the world.

To begin, please refer to Table 1 for definitions of pension terms to be used throughout this paper.

TABLE 1: DEFINITIONS

Accumulation system	This is a defined contribution pension program. This means contributions are made to an account on behalf of each worker. These contributions are invested and earn investment income. At retirement, the pensioner's benefit is equal to the accumulated account balance.
Arrears	Pension benefits which should have been paid to retirees, but have not yet been paid. These usually occur due to lack of sufficient contributions to pay benefits when due.
Average wage	In computing pension benefits, wages are usually averaged over a specified number of years and benefits are related to this average.
Compliance	The ratio of pension contributions actually collected compared to the amount which should have been collected if everyone paid the required amount.
Enterprise	Employer
Fertility rate	The percentage of women at a given age who give birth to a child each year. This determines the number of children born each year, and also the number of a children which each woman is expected to give birth to.
Hrivnya	The Ukrainian currency. In January, 1999, the exchange rate was about 3.6 hrivnya to the dollar.
Indexed career average pay	When calculating pensions, benefits can be based on pay throughout a worker's entire career. When using this approach, it is customary to adjust or index prior years' pay for inflation.
Legal entity	Employer
Life expectancy	The number of years someone is expected to live. This is important when converting an account balance under an accumulation system into a series of monthly payments (annuities) for life.

Mandatory accumulation system	This is an accumulation system in which workers are required by law to participate.
Maximum benefit cap	Some pension plans have a maximum benefit that a pensioner can receive. First the benefit is calculated based on the plan's benefit formula. Then the formula benefit is compared to the cap, and the lesser of the two amounts is paid.
Minimum benefit guarantee	This is the opposite of a maximum benefit cap and is instead the lowest permissible pension benefit. First the benefit is calculated based on the plan's benefit formula. Then the formula benefit is compared to the minimum, and the greater of the two amounts is paid.
Minimum relative rate of return guarantee	This applies to accumulation systems only. Some accumulation systems promise a minimum rate of return. This can be an absolute amount, or it can be related to an index. A minimum relative rate of return guarantee uses an index equal to the average rate of return for all pension funds combined. If any pension fund has a rate of return more than a specified amount below the average, the pension fund is required to raise the rate of return to the minimum required level from its own resources.
MinFin	Ministry of Finance
MLSP	Ministry of Labor and Social Protection
Multi-pillar system	A pension system consisting of several different programs in combination. Typically the first pillar is a solidarity system, the second a mandatory accumulation system, and the third a voluntary accumulation system.
NBK	National Bank of Kazakstan
National Pension Agency (NPA)	In Kazakstan, the agency responsible for regulating private pension funds. It is under the MLSP.
Pension indexing	The way in which pension benefits for existing retirees is increased to reflect inflation, and sometimes increases in average real wages
Personification	The process of keeping records of contributions and wages for each worker.
Privileged pensions	Pensions paid in greater amounts and/or at earlier ages to workers in

	certain professions, in certain industries, or in certain categories (e.g. in Ukraine, victims of the Chernobyl catastrophe).
Redistribution	Providing greater benefits to lower-paid or short service workers than to the higher-paid or long service. Typically this is accomplished through the pension benefit calculation formula. Low-paid or short service employees receive greater benefits as a percentage of pay, although they make the same contributions.
Replacement ratios	The ratio of the initial pension benefit to the worker's pay just prior to retirement. This is one of the primary measures of benefit adequacy.
Service credit (years of service)	Benefits in a solidarity system are generally based on average wage and the number of years worked. Service credit is equal to the number of years the worker contributed to the system, and may also include other years in which contributions were not made. Also, in some cases, more than one year of service is granted for a single year of contributions. Some solidarity systems pay full benefits only if a minimum number of service credits have been accumulated.
Solidarity system	This is the most common type of national pension system around the world in which current workers pay taxes which are used to pay retirement benefits for current retirees.
State Accumulation Fund (SAF)	The State-sponsored accumulation fund in Kazakstan. Workers can give their mandatory contributions to the SAF or a private pension fund.
State Benefit Payment Center (SBPC)	Following pension reform, the organization in Kazakstan responsible for issuing individual identification numbers, collecting pension contributions and making benefit payments.
State Pension Fund	The organization responsible for solidarity system pension contribution collection in Ukraine. It is also responsible for maintaining personified records, and will be taking over responsibility for benefit calculations and pension payment. The State Pension Fund in Kazakstan has been abolished as part of pension reform.
Supreme Rada	The Parliament in Ukraine
Tenge	The national currency in Kazakstan. In January 1999, the exchange rate was about 84 tenge to the dollar.
Voluntary accumulation system	An accumulation system to which workers make contributions only if they choose to do so.
Workbook system	The method by which service credit is recorded in the former Soviet Union. Employers put stamps in the workbook to show the period of time for which an employee worked for them.

GLOBAL PENSION REFORM TRENDS

Pension reform has become popular throughout the world. Many nations are now struggling to redesign pension systems in response to fiscal problems, adverse demographic trends and other factors. In the former Soviet Union, nations are wrestling with some common issues that are somewhat different from those faced in other industrialized countries:

- Reform of the existing system to achieve actuarial balance and individual equity
- Improvements in administrative procedures for tax collections and benefit payments
- Whether and when to introduce a funded component to the pension system and whether this component should be mandatory
- Whether to introduce an accumulation component either into the existing pension system (through notional accounts) or as an entirely new program.

In general, the worldwide trend is toward introduction of multi-pillar pension systems. In a multi-pillar system, the first pillar is the solidarity system, the second is a mandatory accumulation system, and the third is a voluntary accumulation system. However, the relative size of the three pillars varies dramatically among countries:

- Austria, for example, has retained its solidarity system and does not intend to introduce a mandatory accumulation system.
- Sweden has kept its solidarity system as the primary system but has introduced a small funded pillar.
- Hungary and Poland provide approximately equal benefits from solidarity and accumulation systems.
- Finally, Chile and Kazakstan have moved to a funded accumulation system and are phasing out the solidarity system completely.

Introducing any type of funded pillar raises serious financial issues. Most reforms involve little change in total payroll contributions to the pension system. If part of these contributions are diverted to a mandatory accumulation system, contributions to the solidarity system are reduced. Since benefits must still be paid to existing retirees, and, in most cases, also to future retirees, the government must find a way to compensate for the reduced contributions from general revenues. As a result, pension reform has a significant impact on pension budget expenditures and overall budget deficits.

In determining the impact of pension reform on vulnerable members of the population, there are several design characteristics of primary importance. For current retirees, pension indexing and provisions to compensate for inflationary losses in purchasing power are most important. For future retirees, the key provisions differ between solidarity and accumulation systems. For solidarity systems, the key elements are:

- The formula adopted to calculate benefits (years of service, replacement rate, etc)
- Extent of redistribution toward those with short service or low pay
- Minimum benefit provisions
- Service crediting rules for periods when individuals were not employed (years in college, child rearing, etc).

For accumulation systems, key provisions include:

- Contribution formula
- Minimum rate of return guarantees
- Minimum benefit guarantees
- Contributions made by the government or employers for periods when individuals were not employed.

In general, it is more difficult to protect vulnerable people under an accumulation system than under a traditional solidarity system. Of course, such protection may be provided through other social assistance programs rather than through the pension system. But this weakens the entire concept of a pension system as an insurance system, which promises benefits in exchange for contributions made.

PENSION REFORM IN KAZAKSTAN

Kazakstan is unique because it is the only country in the former Soviet Union that has actually implemented pension reform. Consequently, the social impacts of reform can be carefully analyzed, and the successes, obstacles and challenges of introducing pension reform can be clearly identified.

PRIOR PENSION SYSTEM

The prior pension system was friendly to vulnerable portions of the populations such as the unemployed, underemployed, and women. The prior system had many features that favored those with low pay and short service. These included:

- 60 percent benefit for women with 20 years of service and for men with 25 years of service. Additional benefits for additional service are only 1 percent per year of service. This favors women and those with short service periods. Women tend to have shorter average service periods because of time spent caring for young children.
- Currently, women are permitted to retire at 56 and men at 61. Retirement ages are scheduled to be raised slowly to 58 and 63 respectively. This still favors women since they can retire five years earlier than men, and their life expectancy at retirement is about five years longer than men.
- Benefits are capped – favoring those with low pay. Maximum wages used in calculating benefits cannot exceed 15 times the calculation index. The calculation index is declared on an annual basis by the government. At one time, it was closely tied to the average wage, but this is no longer the case
- Service credit is granted for periods of military service, unemployment, university study, time spent raising children and many other reasons. This favors mothers, the underemployed, students, and those serving in the military.

The Kazak pension system suffered from many problems. The Pension Fund had significant arrears. Many enterprises either could not pay at all, wouldn't pay, or were underpaying. At the same time, the number of retirees was very high because of low retirement ages, and there were many privileged pensions. The lack of personified records weakened the relationship between contributions and benefit payments. The solidarity system could not be financially sustained because of the aging of the population caused by declining fertility rates and increasing life expectancy.

THE PENSION SYSTEM AFTER REFORM

The government of Kazakstan examined many options and chose a pension reform model closely resembling the Chilean system, although with significant differences. For example, Kazakstan will pay accrued benefits from the solidarity system as annuities rather than issuing recognition bonds as in Chile. Also, Kazakstan has established a State-run accumulation fund, which Chile did not. Kazakstan chose this approach because:

- They felt the private pension system would encourage greater contributions because this would lead to greater benefits. If a worker or enterprise failed to contribute, benefits would be reduced because there would be less money in the workers' accounts.
- The government wanted to rapidly reduce the payroll tax rate used to finance the solidarity system. They hoped this would improve compliance rates and allow businesses to operate more competitively. Although the government budget deficit was enlarged, they felt this deficit could be financed in the short run through loans and proceeds from privatization, and, in the long run, through greater economic growth and oil revenues.
- The government believed the new system would provide greater individual equity, since each person's benefits would be based on their own contributions. They also wanted to create a system that gave people control over the investment of their pension contributions.
- The government hoped the savings generated by the private pension system would generate greater economic growth by increasing the domestic savings rates and providing capital for development and expansion of Kazak businesses.

Participation in the accumulation system is mandatory for all workers in all industries. Employers are required to contribute 10 percent of each worker's pay either to a private pension fund or to a State-run pension fund. The pension fund law states these contributions are to be deducted from workers' pay, but in reality, the employer is making the contribution on the worker's behalf in addition to pay. This may change in 1999.

Employees are permitted to choose among any properly licensed pension fund. Each employee may contribute to only one fund. If no choice is made, the employee will be automatically enrolled in the State Accumulation Fund. At any time, the employee may transfer accumulated contributions from one pension fund to another. However, past and future contributions must reside in the same fund. Employers or employees may make additional contributions voluntarily. Mandatory contributions are taxed only after the participant retires and begins receiving benefits. Voluntary contributions, within limits, are also taxed only when distributed.

Contributions to funds are invested, and earn a rate of return. Accounts must be maintained for each employee, and the pension fund is required to allocate total investment income to each participant's account on a monthly basis. Employees must receive a statement of their account balances at least once per year and can receive information more frequently on request. The mandatory accumulation system includes a guaranteed minimum rate of return relative to the average of all funds. However, this does not guarantee that participants will not suffer negative rates of return in some years (as, in fact, has happened during 1998 in Chile and Russia). At retirement, the employee receives a distribution of the funds accumulated in his personal account. Retirement age under the mandatory system is generally the same as the retirement age under the solidarity system.

Until December 31, 2000, benefits from the private pension system will be paid in lump-sums, since account balances in the beginning will be quite small. Thereafter, benefits must be distributed as monthly or quarterly payments. The mechanism for converting the account balance into periodic payments has not yet been worked out. It is hoped that, by then, there will be a functional life insurance industry, and workers will be required to buy an annuity from the insurance company of their choosing. This means the pension fund will give the worker's accumulated contributions to an insurance company, and the insurance company will then promise to make periodic payments to the retiree for as long as he or she may live.

There is also a minimum pension guarantee provision in the new law. Anyone who participates in the new system for at least 75 percent of the time between January 1, 1998 and pension age will be entitled to receive this minimum. Basically the government promises that the sum of the benefits from the solidarity system and the accumulation system will not be less than an established poverty level. Currently, the minimum monthly pension is 3,000 tenge or about $36 USD.

This new system is far less friendly to vulnerable members of the population.

- Contributions (which determine future benefits) are only paid when someone is actually working. Consequently, while someone is unemployed, in college or school, raising children, or ill, no contributions are made or benefits are earned.
- Women retire earlier and live longer than men. Consequently, they will have smaller accumulated account balances (because they contribute for five years less), and, when the account balance is converted into an annuity, the benefit will be much lower (because women's life expectancy is greater).
- Although there is a minimum benefit guarantee, many unemployed people and those suffering injury or sickness may not meet the 75 percent service requirement.
- Investment risk is transferred completely to individuals. If investment earnings are too low relative to wage increases, then benefits may be insufficient to meet minimum "replacement rate" expectations. (This issue is further discussed in the section on "Benefits from Accumulation Systems.")

SUCCESSES

The USAID pension reform team was heavily involved in Kazakstan's pension reform. The biggest success was that pension reform legislation was passed quickly and reform was actually implemented. The biggest failure was that the legislation, the regulatory system, and administrative systems were designed and implemented too quickly, and as a result, embodied serious errors including:

- *Laws passed*: Pension reform legislation was passed by the Parliament and signed by the President in June, 1997. The law radically changed the pension system from a solidarity system to a funded accumulation system. Unfortunately, the law provided inadequate protection of participant assets. However, many changes requested by the USAID project team were incorporated into the final law, or in follow-on regulations, by-laws, pension rules, and contracts. However, further amendments are needed to create a truly effective and complete system.

- *New organizations created*: The law created two new organizations: the National Pension Agency (NPA), and the State Benefit Payment Center (SBPC). The NPA is part of the MLSP, and is responsible for regulating pension funds. While it is currently fulfilling its licensing functions, it is not yet fulfilling all its regulatory functions. Two critical aspects of the pension law are currently being violated – both with potentially serious consequences. Employers are selecting pension funds and making transfers on behalf of all their employees. This is clearly illegal under the pension legislation and creates conflict of interest. Custodians are not independent of asset management companies and pension funds as they are supposed to be. This increases the possibility that money will be stolen. The State Benefit Payment Center was created to centralize the collection of contributions and distribution of benefits for both the solidarity and accumulation systems. But the SBPC did not even own computers on January 1, 1998, and did not properly allocate contributions between the two systems, and failed to maintain properly personified accounts for the accumulation systems in the first half of 1998. The situation improved during the second half of 1998. Nonetheless, it is not clear that the SBPC is needed. Many of its functions could be handled more efficiently by other existing entities.
- *Creation of national retiree database:* The process of centralizing contribution collection and benefit payments will eventually result in the creation of a centralized retiree database. For the first time, the government will have accurate information about retirees in a readily accessible format. Management information will be readily available by querying the database, and reliable statistics will be available to the Ministries responsible for managing the pension program
- *Creation of a private pension system*: Pension reform has resulted in the creation of private pension funds and asset management companies. Unfortunately, the pension reform law also created a State Accumulation Fund, which controls more than 80 percent of total accumulation system assets. This stifles the development of private companies because there aren't sufficient contributions for the private funds to survive. There is also the risk that contributions to private pension funds will be misused or stolen because regulatory safeguards are inadequate and provisions of the pension law are being violated.

Although radical reform has been implemented, the foundations of the system are unstable, and the risk of failure in some parts of the system are high. The design creates a riskier system than is necessary. The primary source of system risks is the haste with which reform was implemented. Analysis of the social impacts and fiscal costs of reform were inadequate. USAID should consider establishing prerequisites for any future pension reform program in other countries (see “Lessons Learned” below).

OBSTACLES

The design and implementation of pension reform encountered several obstacles including:

- *Inexperience*: Members of the former Soviet Union have no experience with private financial institutions. Government officials are familiar with solidarity systems, and many understand how they work, what their problems are, and how to fix them. However, this is not true of accumulation systems. Few government officials understand how private pension funds function and what is required to properly manage them. Rather than owning and managing companies, as under the Soviet System, the government's role now is to create a favorable environment for private companies to flourish. This involves regulation and enforcement rather than ownership.

- *International donors*: During design and implementation, international donors recognized serious flaws. Their concerns were brought to the attention of the Kazak government. USAID voiced concerns through the embassy, while the World Bank and Asian Development Bank voiced concerns through Aide-Memoirs and conditionalities attached to the initial loan approval or to the release of future loan tranches. But the speed of the reforms and the number of different concerns raised meant the government failed to respond fully to all issues. It would have been better if the international donor community had coordinated their activities more carefully and prioritized its concerns. Focusing on a few essential features in the reform package, may have produced better overall results.

- *Corruption*: Corruption is a significant impediment to reform in all parts of the former Soviet Union. It is endemic within government and the business community. Some key decision makers oppose properly written laws and regulations because it would hinder criminal activities. Private pension systems will create a large pool of money that can be misappropriated and misused in various ways -- banks can hold contributions for several days to earn float, improper expenses can be charged against plan assets, a portion of investment returns may be skimmed, or pension fund assets can be transferred abroad..

- *Power of Kazak financial institutions*: Pension reform in Kazakstan was dominated by the financial community – the National Bank, Ministry of Finance, and the National Securities Commission. Ostensibly, the MLSP was the leader of the pension reform effort, but in practice, it was weak. Consequently, financial issues were the primary focus, and benefit adequacy was given only secondary consideration. Because pension reform was a capital markets project within USAID, the focus on financial issues was further intensified. This made it difficult for the USAID mission and the project team to analyze social issues. USAID may need to consider a more coordinated approach involving both the capital markets and social reform and democracy teams in future pension reform projects.

- *Politics – cancellation of blue-chip privatization*: Rapid turnover among government officials and in the direction of reform make it difficult to build the necessary skills among counterparts. Kazak pension reform was based on a relationship between pension reform, capital markets development, and privatization. One of the key goals of pension reform was to allow private pension funds to invest in the emerging Kazak equity market. The equity market was to be rapidly developed by privatizing up to 30 large Kazak corporations through the stock market. In November, 1997, after the pension law had been passed, the Kazak government abruptly scaled back the blue-chip privatization program. This weakened the design of the pension reform because private pension funds no longer had any advantage over the State Accumulation Fund. The pension reform legislation allowed private pension funds to invest in Kazak equities, while the State Accumulation Fund was prohibited from making such investments. It was anticipated that over time the private pension funds would earn higher yields than the State Fund, and participants would select private funds. In fact, private funds are now at a very significant disadvantage. Both State and private funds have the same available investments. However, the State fund is the default fund. As a result, it has about 80% of plan assets, and can achieve economies of scale not available to the private funds. There is also less risk of losing money due to corruption or theft in the State fund than in private funds. Consequently, there is little reason for workers to select private funds. The cancellation of the blue chip privatization program also reduced the range of available investments, and reduced fund managers' ability to diversify investments and reduce risk.

- *Violation of laws – elections of funds and anti-affiliation*: Passing a law, unfortunately, does guarantee compliance. Only vigorous and impartial enforcement accompanied by significant penalties for violators can assure compliance. Building an effective regulatory organization is a long process. This is especially true for private pension funds, because countries in the former Soviet Union have no history of private financial institutions, and have few people who truly understand how such institutions work.

PENSION REFORM IN UKRAINE

Although Ukraine has not yet implemented comprehensive pension reform, it has started building foundations for future pension reform, and the Cabinet of Ministers has submitted two draft pension bills to the Parliament. The first would reform the existing solidarity system and create a mandatory State-run accumulation system. The second would establish the legal foundation for a private, voluntary, pension system.

CURRENT PENSION SYSTEM

The current pension system is similar to the pension system in Kazakstan prior to reform. It favors those with low pay and short service at the expense of high wage earners. These include:

- A benefit equal to 55 percent of average wage for women with 20 years of service and men with 25 years of service. Benefits are increased by 1% for each additional year of service. This favors women and those with short service periods.
- Women are permitted to receive pensions beginning at age 55 and men at 60. This favors women since they can retire five years earlier than men, and receive benefits for five years longer.
- Benefits are based on average wages during the 3-years preceding pension age.
- Service credit is given for periods of military service, unemployment, university study, time spent raising children and many other reasons. This favors mothers, the underemployed, students, and those serving in the military.
- Maximum benefit of 59.86 hrivnya (about $17 USD in December 1998) and minimum benefit of 37 hrivnya (about $10 USD) for most retirees. This favors people with low wages and short service, since they receive the minimum benefit. This provision also penalizes those with high pay and long service, since their benefits are hardly based on wages and employment period at all.

The current system suffers from many of the same problems that plagued the prior Kazak system. The State Pension Fund had significant arrears, contributions and benefit payments are often paid in-kind, many enterprises either can't pay, won't pay, or purposely underpay. At the same time, the number of pensioners is high because of low retirement ages, and the large number of privileged pensions. The ratio of retirees to contributors in Ukraine is even higher than in Kazakstan. The government is aware that its solidarity system faces increasing financial problems due to declining fertility rates and longer life expectancy.

CURRENT REFORM PROPOSALS

Pension reform in Ukraine is complicated by a difficult political environment. The Parliament is split among Communists, other leftists, nationalists and centrist reformers. It lacks strong leadership and the factions are poorly organized. A new Parliament was elected in March, 1998. Presidential elections in October 1999 further complicate present reform efforts. Nonetheless, it has been possible to reach agreement on certain issues, some of which can be implemented without Parliamentary approval:[1]

- Personification of the solidarity system, including a pilot project in L'viv oblast to test procedures – scheduled to be "rolled out" nationwide during 1999 and 2000.
- Transfer of responsibility for benefit calculations and payments from the MLSP to the State Pension Fund. This transfer is also part of the L'viv oblast pilot program.
- Establishment and budget funding for an Office of the Actuary within the State Pension Fund. This will provide the government with critically needed financial analysis of the current and proposed pension systems.
- Two draft pension laws. The first modifies the existing solidarity system and creates a State-run mandatory accumulation system. The second establishes a legal framework for a voluntary private pension system.

The draft law on mandatory pension insurance proposed several significant changes to the solidarity system to improve its overall actuarial balance:

- Benefits under the solidarity system would be based on assigning equal credit for each year of service (1 percent of average wage for each year of service). The current formula gives more credit for the first 20 years (for women) or 25 years (for men) than for later years.
- On a prospective basis, service credit would be primarily given for years in which contributions are made. Credit for certain periods of unemployment, child care, etc. are retained.
- Benefits would be based on indexed career average pay, encouraging greater compliance in paying contributions in all years.
- The years of service required for full old-age retirement would be increased to more realistic levels and are made equal (at 35 years) for men and women.
- Incentives for voluntary delayed retirement would be introduced.
- The solidarity and accumulation systems would be personified. This would encourage contributions, reduce non-compliance, and assure accurate benefit calculations. Ultimately, the workbook system could be completely eliminated.
- The maximum benefit cap would be removed, allowing benefits to truly reflect differences in past wages and years of service. (Note: This provision is very expensive – beyond the present fiscal capacity of the Government.)

[1] Under the Ukrainian Constitution both the President and the cabinet of Ministers may issue decrees on topics that are not directly covered by current law. This provision is interpreted with some flexibility.

- Benefits for all pensioners would be indexed to the increase in average wages and benefits for existing pensioners would be recalculated once or twice per year depending on the level of inflation. (Note: This also may not be affordable.)
- The system would be amended to provide benefits from a mix of a solidarity and an accumulation system. This would alleviate the demographic pressures created by an aging population, and reduce the risk that the government will not have the financial resources to meet pension payments when due.

If these changes were implemented, the new system would be either neutral or even favorable for vulnerable groups. After 30 years, the solidarity system would continue to provide about half of total pension benefits. Minimum pension benefits are retained. Voluntary incentives to make contributions are included in the reform. This should reduce arrears (especially acute among the rural poor). The mandatory accumulation portion, of course, will be unfavorable for vulnerable groups, as explained in "Benefits from Accumulation Systems."

SUCCESSES

Although pension reform has not yet been completed, there are already several successes. These successes reflect the different approach adopted by the Ukraine USAID mission and in the composition of the project team. Ukraine placed pension reform in its social sector reform program, leading to a more balanced focus than in Kazakstan, where the project was isolated in the capital markets reform program. Key successes to date include:

- *Personification*: This is the foundation for improving the solidarity system's finances. Personification is needed to assure accurate and abuse-free benefit calculations, and to give employers incentives to contribute. Combining personification with indexed career average pay provides employers with a powerful incentive to contribute in every year. Personification is necessary regardless of the ultimate type of pension reform adopted
- *Office of the Actuary*: The government must develop the capacity to perform accurate financial analyses of the solidarity system. It must be able to provide decision makers with long-term and short-term projections of contributions and benefit payments, calculations of the implicit liabilities for the system, and evaluations of proposed changes. The government's commitment to fund the Office of the Actuary at a time of severe government financial stress indicates a significant commitment to sound pension reform
- *Restructuring responsibility for benefit calculation and payment functions*: Currently the administration of the pension system is divided between the Pension Fund and the MLSP. Whoever has financial responsibility for the pension system should also have administrative control of the system. Consolidating these functions within the Pension Fund is an important political step forward.
- *Development of draft laws:* By drafting legislation, the government has indicated its commitment to reform and established the desired reform structure. But, as in Kazakstan, the draft laws are seriously flawed and the implementation schedule for the mandatory accumulation system is

far too ambitious. Consequently, the USAID pension reform team has opposed adoption of these laws in their current form

- *Implementation focus:* In the former Soviet Union, preparing option papers about what must be done is not enough. The government needs detailed hands-on assistance to implement reforms. The USAID team is providing this assistance -- developing much of the software needed for personification, and directly assisting with the hiring and training of Office of the Actuary personnel
- *Use of locals and small number of resident expatriate advisors:* The USAID project team and the local Mission believe it is important to use and train a large number of Ukrainians as an integral part of the pension reform project. To the extent possible, local project staff is used to work directly with government counterparts. The project team and the Mission also believe that long-term expatriate advisors are much more effective than short-term advisors, because they are able to build trust and confidence among their counterparts. They are also able to learn the details of the operations of the pension systems.

OBSTACLES

- *Democracy*: , Ukraine is more democratic than Kazakstan, and power is more evenly distributed among the branches of government. This makes the reform process more complex. A handful of government officials and the President cannot make and enforce decisions. The Parliament will pass the reform legislation only after vigorous debate. This means that public opinion is much more important in shaping pension reform in Ukraine.
- *Politics*: Economic reform in the Soviet Union has largely resulted in declining GDP, increasing unemployment, high inflation, and an increase in the number of poor people. The poor, including many retirees, tend to support the Communist party, and about one-third of Parliament deputies are Communists, socialists or members of other left-oriented factions. To implement radical reform, it's necessary to address the concerns of leftist deputies, many of whom favor stronger social protection programs to ease the plight of the poor. In Kazakstan, this dynamic was much less important, since the Parliament has no real power.
- *Corruption*: As in Kazakstan, corruption is an impediment to reform.
- *Lack of knowledge about non-state financial organizations*: As in Kazakstan, few people understand how private financial institutions work.
- *Constantly changing governments*: Recent elections in the Rada, the upcoming Presidential elections, and constant changes in Cabinet of Ministers weaken the pension reform momentum.
- *Short-term outlook*: Government officials and business leaders rarely think more than a few months ahead. The recent financial crisis and general economic turmoil cause many to focus on quick, short-term gains rather than long-term planning.

THE PAYMENT OF BENEFITS UNDER AN ACCUMULATION SYSTEM

Benefits paid under solidarity systems are calculated from formulas that include past wages and years of service. Often, service credit includes non-working periods. By contrast, benefits paid under an accumulation system are based on contributions, investment income, and life expectancies at retirement. Workers take the risk that investment income will not provide adequate benefits, or that account balances will not purchase adequate benefits due to increases in life expectancy. Unemployment and other absences from the work force reduces benefits. Five years out of the workforce during a working lifetime may reduce benefits by up to 20 percent.

The charts below show the replacement ratios (pension benefits as a percent of wages in the last year prior to retirement) under various benefit calculation formulas. In these examples, men are assumed to receive pensions at age 60 with 35 years of service, and women are assumed to receive pensions at age 55 with 30 years of service. The mortality table used to convert account balances into annuities is based on actual Kazak and Ukrainian mortality in 1994 and 1995.

DIFFERENT INTEREST AND WAGE INCREASE ASSUMPTIONS

This section shows how differences in real wages and interest rates affect replacement ratios. The greater the percentage by which real interest earnings on accounts exceeds the annual rate of increases in real wages, the greater the replacement ratio at retirement. In these examples, real wage increases are assumed to be 4.5 percent. Real interest rates are assumed to equal 4.5 percent plus the “spread”. If the spread is 0.5 percent, then real interest rates earned on investments of account balances are 5 percent. The impact of the spread on men and women is shown in the charts below.

Men – Assuming 35 years service and receipt of pensions beginning at age 60

Spread	*Replacement Ratio*
0.5%	45.91%
1.0%	51.87%
1.5%	58.67%
2.0%	66.42%

Women – Assuming 30 years of service and receipt of pensions beginning at age 55

Spread	*Replacement Ratio*
0.5%	28.49%
1.0%	32.12%
1.5%	36.21%
2.0%	40.81%

For any assumed spread, replacement ratios for women are much lower than replacement ratios for men. This is because women are assumed to make contributions for five years less than men, they begin receiving pension benefits five years earlier than men, and on average, live five years longer than men after they begin receiving pensions. Assuming investment earnings exceed wage growth by 1 percent, women receive a benefit of about 32 percent of pay compared with a benefit of 52 percent of pay for men. This is a significant problem for women under accumulation systems. The magnitude of the problem can be significantly reduced if retirement ages for men and women are equalized. But even then, replacement ratios for women would only increase to about 43%percent.
43 percent. Note that this problem is even more serious if the size of the pension is analyzed, rather than just the replacement ratio. Women generally receive significantly lower wages than men in the countries of the former Soviet Union, and this is likely to continue for many years to come. Consequently, women will receive a smaller percentage of a significantly lower wage.

IMPACT OF NO CONTRIBUTIONS FOR SEVERAL YEARS

For this analysis, we assume real interest rates exceed real wage increases by 1 percent. We then look at the impact of not making contributions for a period of five years. This simulates the impact of unemployment, or leaving the workforce for a period of years, perhaps to raise children. For men, we still assume retirement at age 60 with 35 years service, and for women, retirement at 55 with 30 years of service.

Men – Assuming 35 years service and receipt of pensions beginning at age 60

No contributions period:	*Replacement Ratio*
None	51.87%
25 – 30	42.03%
30 - 35	44.01%
35 – 40	44.38%
40 – 45	44.72%
45 – 50	45.06%
50 – 55	45.37%
55 - 60	45.68%

Women – Assuming 30 years of service and receipt of pensions beginning at age 55

No contributions period:	*Replacement Ratio*
None	32.12%
25 – 30	25.19%
30 - 35	26.59%
35 – 40	26.84%
40 – 45	27.09%
45 – 50	27.32%

50 – 55	27.55%

These charts show that even five years of absence from the workforce can significantly reduce benefits – by between 15 percent and 25 percent. This is especially true if the five years is early in a career, because these contributions earn interest for the greatest period of time. One of the highest periods of unemployment is for those just graduating from university. In addition, women often leave the workforce to raise children early in their careers. Consequently, accumulation systems are generally not favorable to women or the underemployed. They work best for high paid, professional males.

LESSONS LEARNED

What lessons can USAID learn from the experiences with pension reform in Kazakstan and Ukraine? What can be done to improve USAID technical assistance programs in other republics in the former Soviet Union and elsewhere around the world? Six lessons could be applied to the design and execution of USAID-sponsored pension reform programs in the future:

LESSON 1: USAID MUST PROVIDE OBJECTIVE ADVICE, NOT SELL PRODUCTS

Today, pension reform is a hot political topic. Many people and organizations are trying to sell pension "products" as the correct solutions for everyone. A good consultant does not tell their client what to do. Rather, the consultant provides their client with education and analysis which is sufficient to allow them to make their own decisions. There are many different views regarding pension reform, and there is no one correct answer. However, there are certain types of reform which are clearly incorrect and should be avoided. Within the range of reasonable options, we do not believe USAID should insist on one particular approach. Rather, USAID project teams should provide the government with detailed financial analysis, and analysis of pension benefits among different categories and different generations of retirees for a range of reasonable options. The project team should also clearly show the government the implications of each particular strategy for the government, the private sector, workers and retirees. Project teams and USAID must also clearly outline the steps required to implement each particular approach, and assist with actual implementation. Once USAID starts insisting on a particular approach to pension reform, the project team loses all credibility, because they are no longer perceived as objective. In order to have a significant role in the pension reform debate, the USAID project team must be seen by all parties – the government, Parliament and the local business community as providers of objective advice and unbiased analysis.

LESSON 2: DEFINE OUTCOME MEASURES THAT ARE UNAMBIGUOUS

USAID must carefully consider what constitutes success – and success must include qualitative as well as quantitative performance indicators for pension reform programs. Passing laws is not enough. USAID must establish minimum acceptable standards for these reforms based on the prevailing economic circumstances at the time the reform is implemented. And finally USAID should clearly identify those features of pension reforms which are not acceptable – specified increases in budget deficits or in the inequality of benefit distribution among pensioners, for example. This means USAID should clearly articulate the "size of the sandbox" within which pension reform can be conducted. Any reform falling within the sandbox should be supported, and those falling outside would not be supported, or even, in consultation with other involved donors, opposed. Many reasonable options in the United States, for example, could not be implemented in Ukraine or Kazakstan because of the current state of their financial institutions, laws, regulatory organizations, capital markets, etc. What is unacceptable today may become the preferred option in ten or twenty years. But the focus must be on what can be implemented today.

LESSON 3: FOCUS ON THE PRIMARY OBJECTIVE

The primary purpose of a pension system is to provide adequate retirement income to workers. However, pension system costs must be reasonable in relation to total budget expenditures, as a percentage of GDP, and in relation to the benefits provided. If this primary goal is ignored, it is likely the new system will fail.

In Kazakstan, for example, the need for funding for the capital markets drove the design of the pension system, rather than the other way around. This was a direct consequence of including the pension project in the Office of Market Transition (OMT) and treating it as a capital markets project.

The primary purpose of the pension system must be to provide adequate pension income. If it can also assist with other economic objectives, that is a beneficial collateral outcome. But basic priorities must be clearly kept in mind. No effective pension reform is possible unless benefits are adequate to allow older workers to retire, and unless reasonable contributions are available to fund the promised benefits.

LESSON 4: BALANCE SOCIAL AND FINANCIAL ASPECTS OF PENSIONS

One of the challenges for any pension reform project is how to meet both the financial and social objectives of reform. The primary purpose of pension programs is social -- to allow older workers to voluntarily leave the work force and live at an acceptable standard. However, benefits must be fiscally sustainable. Promising benefits which are beyond the system's fiscal capacity leads to large pension arrears, frustrating pensioners and reinforcing political opposition to further reform. Pension reform includes both social and financial elements.

Unfortunately, in the USAID scheme, each project receives a code which defines what the purpose of the project is. In Kazakstan, the pension project was a financial project and was located within the Office of Market Transition. Consequently, the focus of the project was on the financing of the pension system, and little attention or focus was spent on the social aspects of the pension reform – assuring adequate retirement benefits for different groups of citizens. In Ukraine, the pension project was part of the overall social sector reform project. In this instance, social analysis was paramount, but at least in Ukraine, significant attention has been focused on financial aspects of reform.

Consequently, a different internal management structure may be needed to assure both aspects receive equal attention in USAID-funded pension reform efforts. And the USAID management structure must recognize the essential connection between social sector support programs and political and economic reform efforts.

LESSON 5: THINK ABOUT THE VULNERABLE AND DISADVANTAGED

Countries have political – and usually constitutional – obligations to provide protection for their less fortunate members. The turmoil due to currency conversions and inflation following independence cast many citizens in the former Soviet Union into poverty by destroying the value of their savings and pensions. Accumulation plans tend to favor professional males with no periods of interrupted service, while punishing the more vulnerable members of society. Women are especially hard-hit because of earlier retirement ages, longer life expectancy, and time out of the work force to care for children. When designing the pension reform, the low-paid, women, underemployed, disabled and other vulnerable groups must be carefully analyzed to assure benefit adequacy. It's possible to do this through a combination of social programs, including pensions, welfare, targeted assistance programs and guaranteed minimum income programs. Consequently, it is critical to think about how to integrate all the country's social protection programs when designing the pension reform.

LESSON 6: PRIVATE PENSION SYSTEM IMPLEMENTATION REQUIRES A SYSTEMATIC APPROACH

There are many arguments for implementing private pension systems in the former Soviet Union. The primary reasons are to establish a strong link between contributions and benefits, reduce the role of government entitlement programs, and generate long-term domestic savings to finance economic growth. These arguments are compelling. However, at least in the former Soviet Union at this time, there are equally compelling reasons to delay private pension system implementation. Many good ideas will fail if they are implemented before their time. Reform must take place in a systematic way; each step must be completed before moving to the next step. Some reasons to delay implementation of private pension systems in the former Soviet Union include:

- *Problem of corruption and theft*. In the former Soviet Union, corruption and theft are rampant. Private pension systems create a huge cash reserve, which is supposed to be invested for the exclusive benefit of workers. However, extensive experience in the former Soviet Union indicates that there are many opportunities for criminals to make huge profits from the accumulation system. This is especially true if administrative systems are weak, regulatory oversight is insufficient, or if there are conflicts of interest.
- *Problem of high wage increases relative to real returns:* Replacement ratios from accumulation systems depend on the difference between real rates of return and real wage increases. High returns alone are not sufficient to assure adequate benefits. The returns must exceed real wage growth, as demonstrated in the section on "Benefit from Accumulation Systems". In the former Soviet Union, wages were only about 25 percent of GDP, because such a large portion of compensation was provided by entitlement programs. In Western countries, wages are a much higher percent of GDP – about 60 to 65 percent. Consequently, as Ukraine and Kazakstan make the transition from planned to market economies, wages will grow rapidly due to reductions in entitlement programs, improvements in productivity and a transition to a Western-style tax system. This will make it even more difficult for accumulation systems to produce adequate replacement ratios
- *Problems with increased budget deficits:* Introduction of a private pension system inevitably increases pension budget expenses and therefore State budget deficits. In the former Soviet Union, pension systems are already unable to meet benefit obligations from payroll contributions. Consequently, either transfers from the State budget are required, benefits are paid in-kind, or pensions are not paid on time. In most countries in the former Soviet Union, budget deficits are already high as a percent of GDP. Typically pension reform adds another 1 percent to 1.5 percent of GDP to the budget deficit. Due to the Asian and Russian financial crises, the cost of bor-

rowing for governments in the former Soviet Union has skyrocketed. Consequently, it is difficult to finance these increased budget deficits. When the mandatory accumulation system is introduced in this environment, governments inevitably force the contributions to be invested in government debt, often at below-market interest rates, to finance the increased budget deficit. Consequently, the private pension system becomes nothing more than just another government pension program. It provides no capital to finance the growth of the economy at all.

- *Problems with unstable local capital markets:* In general, local capital markets have far from adequate safeguards in the former Soviet Union. Most trading actually takes place in private deals, and not through the exchanges. The volume of trading activity is extremely low, especially since the Asian and Russian financial crises. Kazakstan has made more progress than Ukraine in requiring compliance with international accounting standards, amending its Civil Code, developing a proper joint stock companies law and introducing proper recordkeeping and clearing procedures for trades. Nonetheless, the local capital markets are extremely thin, the volume of information and disclosure available to investors is limited, and the reliability of administrative procedures is still questionable.

- *Problems with lack of diversification:* In Kazakstan, all contributions must be invested only in local capital markets. No contributions are permitted to be invested overseas. Consequently, the entire pension system depends on the financial health of a single country which is in the midst of a serious economic crisis. In Ukraine, the currency has devalued by almost 60 percent since mid-August of last year. Devaluation has been less in Kazakstan to date, but is widely expected to accelerate in the new year. In addition, Ukraine has already announced it will begin printing money to meet its financial obligations, and has revised its inflation targets for 1999 upward. It is likely Kazakstan will follow a similar path in 1999. In the United States, a money manager who invested 100 percent of assets in Kazak government bonds, or only in one country's securities would be arrested. When all contributions must be invested in a single unstable country, there is a large risk of serious investment losses. Why should the mandatory accumulation system be forced to buy securities which no one else in the world wants?

After considering all the risks associated with private accumulation systems in the former Soviet Union, USAID should seriously consider whether it makes sense to actively support the introduction of private pension systems <u>at this time.</u> We believe that ultimately it makes a great deal of sense to have a private pension system. However, it may be that such systems should not be introduced for another five to ten years. Private pension systems will tend to work only when the following conditions have been met:

- The economy is growing
- Capital markets are developed
- There is a stable banking system
- Budget deficits are under control
- The existing solidarity pension system is in actuarial balance

- The entire legal, regulatory, and administrative structure for the mandatory accumulation system has been developed and thoroughly tested
- Extensive training of regulators has taken place
- An effective investment management profession exists

Introduction of private accumulation systems in the former Soviet Union at this time could create far more problems than it solves.