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## **STRATEGIC APPROACHES TO REFORMING PENSION SYSTEM IN UKRAINE**

*The article analyses the differences of social insurance from social welfare; it is noted that the principle of social justice should be the cornerstone of strategic reform of the pension system. In order to improve the efficiency of the pension reform some proposals are made: to offer a more complete accounting of the observed economic and demographic trends; to take into account the interests of citizens and businesses; to use a comprehensive approach to the state strategy of development of wages and pension insurance.*

**Key words:** *social insurance, social justice, pension system, pension reform, pension strategy, people, business, Ukraine.*

*В статье анализируются отличия социального страхования от социального обеспечения; отмечается, что принцип социальной справедливости должен стать краеугольным камнем стратегии реформирования пенсионной системы. С целью повышения эффективности пенсионного реформирования предлагается более полный учет наблюдаемых экономических и демографических тенденций, учет интересов граждан и бизнеса; отмечается необходимость комплексного подхода к государственной стратегии развития заработной платы и пенсионного страхования.*

*В статті аналізуються відмінності соціального страхування від соціального забезпечення; наголошується, що принцип соціальної справедливості повинен стати наріжним каменем стратегічного*

*реформування пенсійної системи. З метою підвищення ефективності пенсійного реформування пропонується більш повне врахування економічних та демографічних тенденцій, що спостерігаються, врахування інтересів громадян та бізнесу; наголошується на необхідності комплексного підходу до державної стратегії розвитку заробітної плати та пенсійного страхування.*

***Ключові слова:** соціальне страхування, соціальна справедливість, пенсійна система, пенсійна реформа, громадяни, бізнес, пенсійна стратегія, Україна.*

**Introduction.** In today's world the pension reform belongs to the priorities of social and economic policy. The variability of economic environment, demographic aging of the population, gradual increase in the duration of training and, consequently, a later age to enter the labor market make the pension reform very significant. This pension policy requires constant adjustments not only in view of the current situation, but also taking into account the long-term perspective.

The Law of Ukraine "On Compulsory State Pension Insurance" and "On Private Pension Provision" launched the pension reform which is designed to reduce the current aggravation of contradictions in this area, to ensure higher pensions to the elderly, to restore the connection between pensions and earnings and to promote the economic growth. At the same time, the economic recovery in Ukraine was accompanied by a dramatic struggle between different political groups. This led to a surge of populism in the fight for votes and braking the pension reform. Financial - economic crisis has sharply exacerbated the problem of imbalance in public finances, including pension deficits and public budgets, having lead to the need of finding the adequate ways of further reforming the pension system. In practice, however, the pension reform came down to technical and cosmetic trends improving existing systems: raising the retirement age of women,

changes in the insurance experience, some limitations of the highest pensions to future retirees and others.

The events that occurred in Ukraine in late 2013 and in 2014 led to a sharp decline in living standards of citizens, further deterioration of the economic situation of the state and pre-default public finances. This forced the state authorities to take the pension reform more seriously and, consequently, to begin the next phase of the discussion of the pension reform ways.

**Literature Review.** The problems of the pension system functioning in Ukraine, the prospects of its further development are paid much attention to. Among the leading domestic experts and scholars who are engaged in this problem, there are Demchuk L.A., Denisova O.V., Zhalilo Y.A., Smith A.P., Kostenko R., Kudin V.A., Libanova E.M., Prysiashniuk T.I., Tkachenko L.G., Kharazishvili Y.M. and others.

The analysis of recent publications indicates that experts on pension issues are virtually unanimous in the need for an immediate and radical reform of the pension system in Ukraine. For example, Smith A.P. states that the current state of the pension system is the factor that challenges not only the economic and social welfare, but also the financial sector of the state, so the need for further reform is, undoubtedly, evident [5; p.39]. One of the priorities of the pension reform is the introduction of a mandatory funded pension system (the second level). But recently, the actual need for this step as it is, has increasingly become the subject of the debate. The shift in experts' opinion from enthusiasm to skepticism about the system at the 2<sup>nd</sup> level is mainly associated with the effects of the worldwide financial crisis of 2008 on the pension systems. Nevertheless, the introduction of the 2<sup>nd</sup> level is planned for 2017. On the other hand, the introduction of the 2<sup>nd</sup> level was originally planned for 2006, then for 2009 and 2011.

Despite the considerable attention of experts and scientists to pension issues, many topical issues concerning the nature, mechanisms of action and global effects of pension reforms still remain unsolved due to its multi-faced character.

**The purpose of the article** is to clarify the strategic and methodological approaches to the pension reform, the use of which in practice will allow, in our view, to increase the efficiency of the pension system.

**The Results of the Study.** In our country, the pension insurance, since the Soviet times, has been evolving as a form of social welfare. It is gradually losing its specificity and insurance and is outgrowing into the overall social welfare. The social insurance, unlike social welfare, has several features that characterize its difference and determine the prospects for further development.

Firstly, the important feature that separates social insurance from the social welfare is a way of funding. When there is social insurance, the source of funds in the insurance fund is insurance fee and other sources provided by law. Only in some relatively rare cases, the government makes known donations. Insurance fee is always a part of the salary or income of the insured person, even in the case where an employer pays them instead of an employee. This suggests that social insurance as opposed to social welfare is not insured for free of charge and without any grounds. But in our country, the principle of equivalence of insurance pension contributions to the received pensions was not implemented.

Another important feature of social insurance, which logically follows from the previous one is a high level of welfare. If the social insurance coverage will be the same or even lower as compared to the state social welfare, the advantages of the insurance model offset, the incentives for economic activity are lost. And it should provide not only consistently high returns in the active period of life, but also worthy financial support in case of the insurance event. This is consistent with the economic insurance logic, which is also organized in order to protect the citizen from the adverse effects by maintaining his/her living standards. In the opposite case, citizens will lose the interest in active economic activities, in participation in the social insurance system and move into the category of social dependents.

Social insurance obligation is mutual. The citizen is obliged to pay insurance fees or it is done by an insurance officer. The state represented by their own

authorities may require the payment of fees to ensure the needs of the social-insurance system, i.e. pensions. When the insured event occurs, the insured person has the right to demand social and insurance coverage (material goods or services) at the expense of monetary fund which was established with his/her participation. The state is obliged to provide such support, taking into account the length of insurance service and contributions. If the state does not fulfill its duty, it violates the principle of justice.

Modern, according to the conventional approach the social justice is defined as a concept that includes equality of opportunity for individuals to participate in the labor activity, wages in accordance with its quantity and quality, meeting the immediate needs of the people through using public goods, inadmissibility of excessive polarization in the distribution of income, wealth, goods, use of the positive qualities of people. In Western countries, there is widely spread the similar opinion that justice (equity) is the condition in which "income" of each member is proportional to his/her "contribution" to the relationship. However, justice does not always mean equal "income" [6; p.376].

As the experience of the pension systems functioning in the developed countries and in some developing ones, the ideal pension systems does not exist. Even in prosperous Britain, according to Eurostat, 24% of pensioners live below the poverty line [8].

Basically, the effective functioning pension systems at the single level (only solidarity level) and multi-level, with mandatory and/or voluntary funded component, is possible under the following conditions: positive demographic dynamics, economic growth and low unemployment level. However, under modern conditions, negative demographic trend which is characteristic of the developed countries and many developing ones, including Ukraine, and the unstable political and economic components of the risks of failure pension systems are growing as well as its main function – social insurance protection for the elderly [1; article 46]. However, the *principle of social justice should be the cornerstone of pension reform.*

This principle must be borne in mind when developing all regulations for quality and successful pension reform. This reform should not be done in secret. To develop the necessary documents and their discussion there should be involved not only the specialists from the Ministry of Finance, Pension Fund, Ministry of Social Policy and other professional institutions, and independent experts, including international. Another question is that the reform should be planned for a long period of time (30-50 years), when old and new scheme for calculating pensions will operate in parallel. In particular, this reform affects those who will receive the right to retire in 25-30 years.

The analysis of the current state of the pension reform suggests that the government is trying to solve a problem, in the first turn, by reducing the deficit of the Pension Fund, which, in our view, should not be the goal of reform. If we consider the strategy for the pension reform, the following should be noted:

1. The economic and demographic conditions in which the reform should be carried out are not sufficiently taken into account. First, researching the demographics situation, it is pointed out that by 2025-2026 the number of pensioners will equal the number of employees. This really makes impossible the continued existence of the standard paying pension systems which is based on the accountability of the generations. However, the problem is not limited by these factors.

In recent years, primarily because of the development of the Internet and globalization processes there are avalanche changes in the structure of the labor market. If the former model usually foresaw the work at one employer's, and the employment prevailed at large and medium-sized enterprises, now the proportion of small businesses and self-employed is sharply increasing. Previously, the tax authorities were given the task to increase collecting insurance fees, now even theoretically, we cannot imagine the real value of wages and streams and can control them only if the market agents want to make payments themselves.

The pension system is now completely ignoring the phenomenon. The largest share of the load is in the traditional sector (standard large enterprises) and the greatest benefits belong to those who have a special pension system.

Significant demographic wave of generation oscillation in the foreseeable future fairly may be up to 30% and it was not taken into account. It is, therefore, necessary to form the provision for the period of especially unfavorable demographic failures.

2. Serious theoretical and methodological errors are made. In a difficult economic and demographic situation, the state should try to minimize their long-term social obligations and not to create new ones. It is categorically unacceptable to preserve the usual indexation mechanisms. Obviously, the simple indexation of wages, pensions, help and so on is made, majority of the money is paid to the well-to-do people and it only increases the gap between the minimum and maximum levels of pensions, it reduces social justice and does not contribute to reduction of shadow incomes. Therefore, in our opinion, it is necessary to abandon the actuarial fairness of social benefit.

3. The current system does not take into account the interests of citizens and businesses. Citizens understand that pension depends not primarily on the results of their work and certainly not on their employer's payments into the pension system, and the good will of the state. That is why, they are trying to maximize the benefits. Entrepreneurs do not receive any benefits from the increased legal wage, so they try to minimize insurance payments. Insurance payment system which is interesting to citizens and business should be developed and it should be directed to its popularization among the younger generation, especially in terms of cumulative benefits (both compulsory and voluntary). Besides, it should provide the possibility to control over their own funds, which will be stored in these systems.

4. The pension strategy is considered in isolation from the strategy of wages, with pensions being derivative of them. The state is one of the main employers in the labor market. Wages in the public sector has traditionally been low. Prior to

2014 (especially before the global financial crisis and in 2009 - 2011 to a lesser extent) serious measures of wage growth in this area were implemented. But implications of pension were not counted, and no attempt to consider this question in complex was undertaken.

5. State bureaucratic highlighting of the causes of the deficit of the pension fund is not true from an objective point of view. Indeed, the deficit of the Pension Fund in 2009 totaled 13.1 billion hrivnas; in 2010 – 26.6 bln; in 2011 – 17.8 bln; in 2012 – 15.3 bln hrivnas; in 2013 – 21.8 bln; in 2014 – 17.1 bln hrivnas and the planned deficit for 2015 is 19 bln hrivnas. In this case, the financing of pensions according to the different pension programs that are implemented by the state budget is expected to be 57.2 billion hrivnas in 2014. To 2015 it is planned to spend 61.9 billion hrivnas [ 4; c.13; 19]. On the basis of their political and economic needs, many government officials and various political groups believe that the deficit of the Pension Fund is the disadvantage and the criteria of assessing the effectiveness of the pension system, i.e. they emphasize the deficit.

If the formation of the deficit was seen in terms of practice, it could be found out that it was formed not by systemic imbalance of the pension system, but rather due to the result of populist decisions of the authorities with a view to hold on their power as long as possible. So during many years indexation of pensions was carried out to the extent that ignored the dynamics of GDP, exceeded the capacity of the economy and productivity. Naturally, such a decision should be implemented by the state budget.

The sharp decline in rates of insurance fees with simultaneous increase of pensions, even at freezing them at the current level, can be compensated only from the budget. Of course, the pension system should be outside the budget and still be completely balanced, but it is possible only when insurance rates that will be stable for a long period. Any tariff reduction should be compensated by the state budget.

6. Current retirees are the main part of our electorate, so from a political point of view, all that is required from the pension system is the regular increase of pensions. In fact, the talk of pension systems is not talking about the current

pensioners. This is the talk about those who will retire in 20-35 years; the talk about how these people have to build their savings, manage, take responsibility for their decisions. This conversation with the public must also deal with creating a model (perhaps such model or models are in the bowels of the Pension Fund, the Cabinet of Ministers, but they could not be found in free access available to the public) with the help of which calculations of long-term sustainable pension system are carried out.

7. The situation with the organizational and legal status and other organizational issues of the Pension Fund of Ukraine should be clarified from the strategic aspect. For example, under current Law of Ukraine, Art. 14 "Fundamentals of Ukraine on Compulsory Social Insurance" [2; Article 14], insurance funds are non-profit self-governing organizations. Self-management is an internal self-organization of a system aimed at the self-contained development. In this case, the number of issues is resolved without the intervention of central government.

On the other hand, the Decree of the Pension Fund of Ukraine approved by the Cabinet of Ministers of Ukraine from 07.23.2014 as well as the previous position on 6.04.2011, state that the pension fund of Ukraine is defined as the central executive authorities body (Art. 1 ) and is directed by the Cabinet of Ministers of Ukraine through the Minister of Social Policy, which implements the government policy on pensions and accounting of persons who are subjected to the compulsory state social insurance [3; Article 1]. That is, the Pension Fund of Ukraine is a part of the executive power.

Thus, there is a contradiction between the regulations, and from the practical aspects the real function of the Fund Board is becoming confusing.

The analysis of Fund Supervisory Board functions, also leads to the conclusion that the body as an instrument of control over the activities of the governing body of the fund is inefficient.

Many other issues that affect the organization of the fund structure, transparency of functioning (although in this respect over the past year there is a

positive shift), financial flows and cost effectiveness should be the subject of a separate article.

As for the implementation of the Savings Fund in 2017 (the second level of the pension system of Ukraine), the analysis of the currently existing regulations on this matter allows to make the conclusion about the desire of public authorities to further control, manage and control future costs of the Savings Fund. In this regard, it is appropriate to give an example of the efficiency of the private pension funds as compared with the state fund.

According to the minutes of the meeting of the Russian Public Council for investing pension savings from 20.04.2009, it was noted that the results of the last three years showed an increase in inflation at 37.9 % . The private pension funds increased citizens' pension savings by an average of 31.2% while the State management company increased the savings only by 3.7% [7]. Also in Russia, using the state total control over the savings fund the rules changed several times in 2003, and in 2014 and 2015 a moratorium on funded pension system was declared. As a result, the annual employer's contributions which were intended for the storage of pensions in 2014 and 2015 did not reach there. These funds were spent last year and will be spent on the current needs of the solidarity and distribution pension system as part of current payments to pensioners, that is they have been listed and transferred up to now, but there will be no benefit for future pensioners – participants of the savings funded system. In fact, one could argue that the money was stolen from the owners, though it was explained in a different way. Such freedom from the state, of course, only hurts the pension reform, the release of wages and other income from the shadow. All this creates the preconditions to the collapse of the pension reform. The stability and predictability are mandatory conditions for sustainability of the pension system.

**Conclusions.** Taking into account the aforementioned, the need to reform the current pension system is now beyond any doubt. But the cornerstone of pension reform should be the principle of social justice, which must be contained

in all the regulations that govern this issue. An average future pensioner should be the focus, which, unfortunately, has not become the case yet.

All the necessary regulations, guidelines should be prepared for the introduction of a Savings funded system and other further reforms of the pension system in Ukraine. The experience of the previous reforms suggests that they always were introduced long before all necessary documents had been prepared. This led to negative consequences.

Timely and proper resolution of other issues which were mentioned in the article, in our view, should increase the quality of pension reform and lay the foundations for its successful implementation.

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