

# **SOCIAL INSURANCE IN UKRAINE IN THE CONTEXT OF THE PENSION REFORM**

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The article studies the main problematic aspects in the current functioning process of the social insurance system of Ukraine. The article shows that the main problem of the proper pension reform implementation is the absence of necessary condition. Until these conditions are created, the most promising way for the pension reform is the further development of it (the introduction of professional pension schemes and corporate pension plans). Also, the social responsibility of the business structures is pointed out by authors. Special attention is paid to the problems of implementation of business entities' social responsibility and the completion of the pension reform. The article provides characteristics of the pension system state regulation, which is the most suitable for Ukraine.

*Key words:* social insurance system, social responsibility, pension system state regulation.

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## **СОЦІАЛЬНЕ СТРАХУВАННЯ В УКРАЇНІ В КОНТЕКСТІ ПЕНСІЙНОЇ РЕФОРМИ**

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Розглянуто основні проблемні моменти поточного функціонування системи соціального страхування України. Показано, що основною перешкодою для завершення пенсійної реформи є відсутність необхідних умов. Відзначено соціальну відповідальність суб'єктів підприємницької діяльності. Особливу увагу приділено аспектам реалізації соціальної відповідальності підприємств і необхідності зниження загального навантаження на бізнес у вигляді обов'язкових платежів. Акцентовано увагу на доцільності використання жорсткого режиму державного регулювання пенсійної системи для забезпечення успішної реалізації пенсійної реформи.

*Ключові слова:* система соціального страхування, соціальна відповідальність, державне регулювання пенсійної системи.

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Рассмотрены основные проблемные моменты текущего функционирования системы социального страхования Украины. Показано, что основным

препятствием для завершения пенсионной реформы является отсутствие необходимых условий. Отмечена социальная ответственность субъектов предпринимательской деятельности. Особое внимание уделено аспектам реализации социальной ответственности предприятий и необходимости снижения общей нагрузки на бизнес в виде обязательных платежей. Акцентировано внимание на целесообразности использования жесткого режима государственного регулирования пенсионной системы для обеспечения успешной реализации пенсионной реформы.

*Ключевые слова:* система социального страхования, социальная ответственность, государственное регулирование пенсионной системы.

Under the current demographic trends and the level of Ukraine's socio-economic development its system of social insurance requires special attention especially considering the fact that the influence of external and internal factors significantly complicates its functioning. In addition, the fundamental scientific, technical and socio-economic changes that are observed in the leading countries constitute challenges for the social security as a system while the increase in the efficiency of social insurance depends on the speed and the quality of responses to these challenges.

Regarding the impact of external factors on social security many publications pay special attention to the processes of the European integration [1; 2]. Most scientific papers are focused on finding ways for effective use of social partnership institutions and collective agreements despite the fact that as a result of globalization the conditions for the weakening of the social partnership are created [3; 4]. In our opinion, at the present stage of development of the social insurance in Ukraine it is expedient to analyze the consequences of the decline in the role of social partnership and the transformations in the model of labor relationships.

In preparing this article we have formulated the following objectives: 1) characterize the problematic aspects in the functioning of the system of social insurance in the post-crisis period, 2) examine the main vector of the pension reform in Ukraine, and 3) determine the nature of the pension system state regulation suitable for Ukraine's conditions.

The main objective of the state policy in the field of social insurance in the post-crisis environment is the minimization of risks involved in the functioning of the system of social insurance. It is necessary to point out that the financial and economic crisis in Ukraine has not only external but deep internal causes related to the unpreparedness of the main social institutions to exist in non-standard and complicated conditions. In the years preceding the crisis, Ukraine had experienced a relatively stable economic growth, but the possibilities of reforming the social and economic institutions were lost. In particular, a holistic concept of the social responsibility of business entities was never implemented in practice and the pension reform remained uncompleted (the second level of the pension system was not introduced). In this context, the state should give great attention to the social sphere in general and to such a considerable part of it as the area of pension provision, which, in the absence of

the necessary measures, threatens to become a source of not only socio-economic, but political risks.

The reduction of the total investments in the economy in the post-crisis period, including the reduction of investments into the social sphere, can lead to the decrease in the income of the population. In this case, the lack of sufficient income can cause significant social risks. In addition, the financing of infrastructure projects and public works by the state can also be significantly curtailed. Therefore, the social part of the state investment programs will be reduced, resulting in the economic growth without job creation. It is evident that for some time after the overcoming of the crisis employers will be severely limiting the number of people they hire, further exacerbating the problem of graduates' unemployment. The situation on the labor market in Ukraine has some specific features that were formed in the period that preceded the financial crisis. In particular, the labor market has insufficient vertical and horizontal mobility. The low vertical (social and professional) mobility is explained by income differentiation and commercialization of the health care and education. The problems of the horizontal labor mobility are associated with the imperfection of the necessary market infrastructure.

Judging from the foreign experience, social responsibility of business entities goes beyond the scope of charitable activities and becomes part of their core activities and is realized by the joint efforts of all structural units of business entities, because social investments form their reputation and reflect their stability. In a broad sense, social responsibility of business entities includes the creation of jobs with high wages and social guarantees on the part of the employer, solving the problems of the region's social infrastructure, charitable activity. The main principles of business entities' social responsibility should be: the search of new areas for social investment; the transition from charity to the creation of conditions for the economically efficient functioning of the social infrastructure, attraction of the region's population to the solving of social problems. In the world's leading countries citizens have high expectations regarding the social responsibility of business entities, which is indicative of the wide-spread practices of social responsibility. To promote such practices in Ukraine it is necessary to stimulate the social responsibility of business entities by the state.

However, the effective solution of problems in the national system of social insurance is impossible without

the consideration of the full range of factors that influence the operational parameters of the system, and without the consideration of the impact of such global trends as the growing globalization. One of the most important issues of the national social insurance in the context of the current socio-economic and demographic trends is the problem of determining the rates of social insurance contributions (Fig. 1).

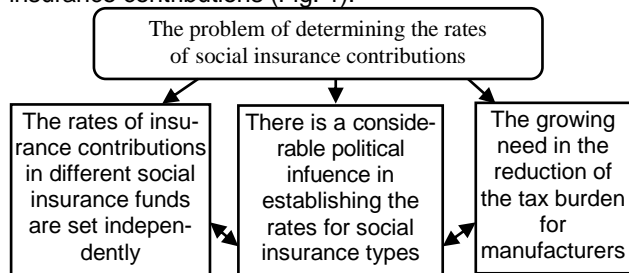


Fig. 1. Problems of determining the scientifically grounded rates of insurance contributions

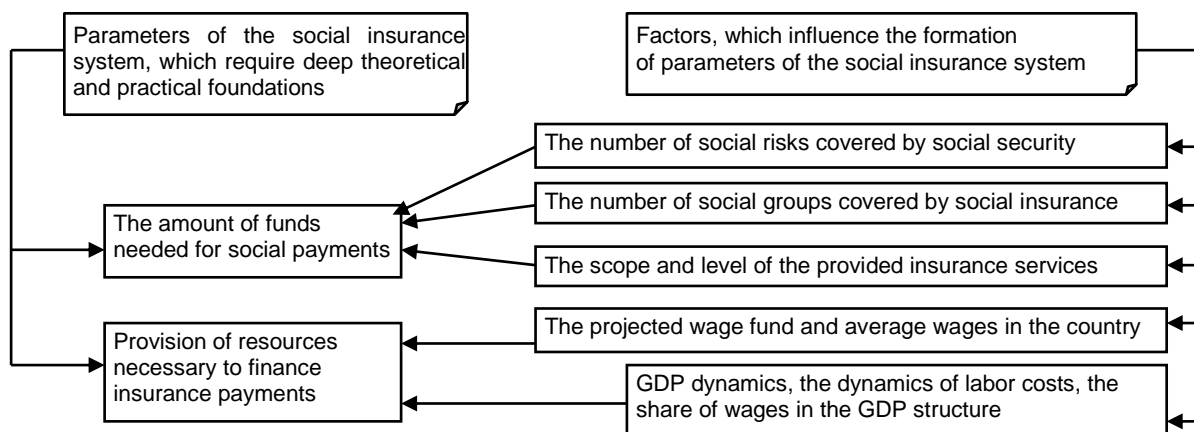


Fig. 2. Problem parameters of the social insurance system and the factors which influence their formation

#### for certain types of mandatory state social insurance

In addition, in Ukraine the share of wages in the GDP and in the production costs is still low according to the international standards due to the desire of manufacturers to win the price competition through the reduction of production costs by saving on wages (Fig. 2).

At the present stage of unstable socio-economic situation in Ukraine as a result of exogenous and endogenous factors (Table) the major financial issue in the social sphere appears to be the problem of improvement in the functioning of the pension system, which can be divided into two components: the problem of overcoming the devastating impact on the pension system of such demographic tendency as the aging population and the problem of eliminating the internal shortcoming of the pension system in its present form, which significantly reduces the efficiency of its functioning.

Table

#### Key indicators of the social and economic situation in Ukraine [5]

Indicator	2007	2008	2009	2010	2011	2012	2013
GDP in 2000 prices, bln. dollars	52,3	53,2	47,9	49,3	50,8	52,3	53,8
GDP growth/decline rate, %	7,5	1,8	-10,0	3,0	3,2	2,9	2,9
Inflation rate, %	12,8	25,2	13,0	12,4	7,8	5,9	5,3
Population figures, mln. people	46,3	46,0	45,7	45,4	45,1	44,9	44,6
Export to GDP ratio, %	44,7	56,6	50,6	47,2	48,7	51,4	54,9
Import to GDP, %	50,9	55,5	41,3	39,1	41,4	45,3	50,7
Unemployment level, %	6,7	6,4	10,0	9,8	9,5	9,2	8,9

It should be noted that further development of the accumulation component in the pension system of Ukraine would make it possible to eliminate most of the typical internal flaws and economic risks of the solidarity pension system in its present form: 1) squeezing of the labor force into the shadow

economy; 2) wage cutting; 3) early retirement; 4) inefficient use of resources of the state budget (Fig. 3).

The aggregate pension system is financed from the contributions, which increase due to the aging of the population and exercise pressure on the labor market,

reducing employment. The existing high rates of pension insurance contributions, which do not have any influence on pension sizes, push the labor into the shadow economy, where it is used less efficiently

due to the restricted access of the shadow economy businesses to capital markets and certain types of products.

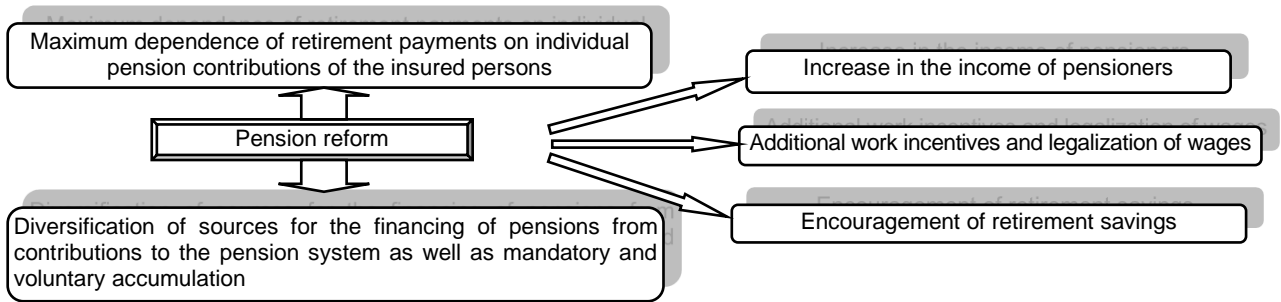


Fig. 3. The goals of reforms in the pension system of Ukraine

The legal employers are not interested in the growth of the pension contributions' absolute value and, as a result, try to restrain the growth of wage levels even when labor productivity increases. The current solidarity pension system provides for an early retirement with little or no loss in the pension size, which makes it possible to hide unemployment and provide benefits to certain layers of the population, but destroying the financial basis of the pension system and reducing the experienced workforce on the labor market. Within the system of pension insurance the expenditures of the pension system are higher than the contributions resulting in the pension fund budget deficit, which subsequently transforms itself into the public debt.

Therefore, the budget funds, which could be used to train new qualified professionals in the fields that are in demand on the labor market by investing into education, are spent on pension payments. With the current state of affairs, the aggregate system of pension insurance is not always justified, leading to the reduction of national savings, low rates of return under the state management of the pension system assets, has mostly negative impact on the labor market and the level of wages. There is also the risk of the deficit financing of pension payments, which can cause inflation. During the current pension reform there is a partial transfer of responsibility for the payment of pensions from the state to employers and citizens themselves (Fig. 4).

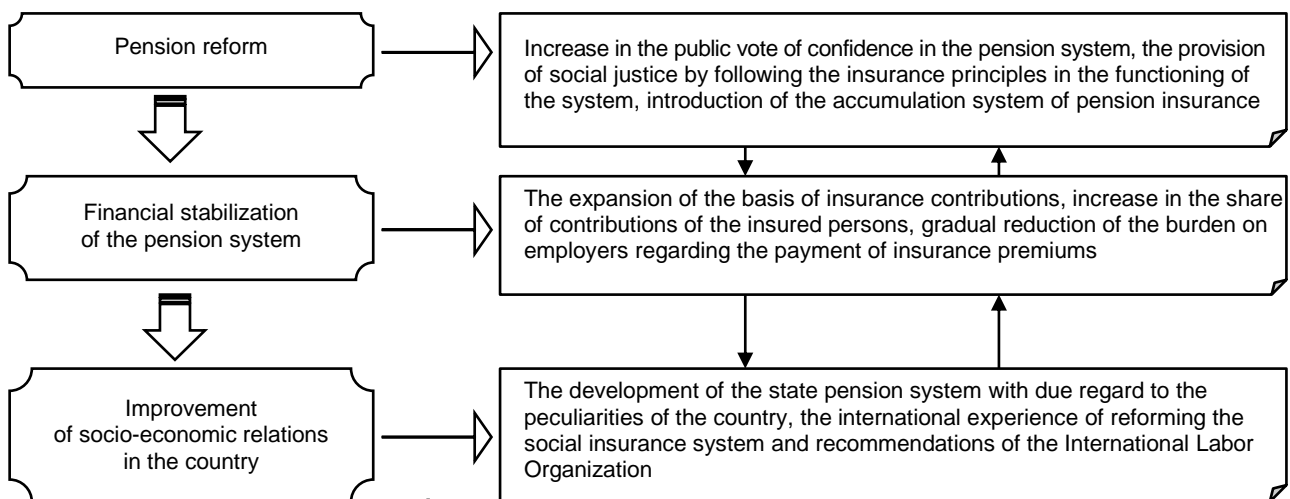


Fig. 4. Pension reform as an instrument for improving the socio-economic relations in the country

The further development of the third level of Ukraine's pension system is an important precondition for the successful implementation of the pension reform. In Ukraine, non-state pension services are provided by three types of financial institutions: non-state pension funds (NPF), insurance companies and banks. In our opinion, non-state pension funds should be given the opportunities of priority development,

because NPFs are the only non-commercial institutions among the mentioned ones. It is also expedient to increase the possibilities of participation in non-state pension provision of other financial institutions. However, the achievement of this goal is complicated by the fact that the general capacity of the market of non-state pension provision remains unsatisfactory due to the low income of the population and insufficient GDP growth

rates in the country. Practice shows that the most developed segment of the market of non-state pension provision is the NPF segment, with the banking segment being the least developed.

A promising way of improving the current pension system in Ukraine is the introduction of professional pension schemes designed to improve pension provision of citizens with working experience in difficult and hazardous conditions. The general financial, economic and social benefits from the introduction of professional pension schemes are the following: 1) employer's participation in the professional pension scheme – an important factor of his personnel policy; 2) opportunities for an employer to discontinue the transfer of obligatory pension contributions into professional pension schemes if normal (adequate) working conditions are provided at workplaces with hazardous and difficult working conditions, which must be confirmed by the results of workplaces' assessment (an incentive to improve working conditions); 3) elimination of injustices in the redistribution of financial resources in favor of the privileged categories of citizens within the pension system.

There are the following obstacles on the way to the introduction of professional pension schemes: insufficient financial resources of business entities; 2) lack of trust in financial intermediaries in general, and in the institutions that offer services of non-state pension provision in particular; 3) the probability of a temporary reduction in the competitiveness of the business entity resulting from its growing financial obligations connected to the payment of pension contributions.

In addition to the professional pension schemes an important place in the process of improving the national pension system should belong to corporate retirement programs. The economic and social benefits of corporate retirement programs provide employers with the opportunities: 1) to conduct efficient employment policy, 2) to optimize the tax burden, and 3) to attract additional investment resources.

In organizing the corporate retirement program a business entity should consider the following factors: 1) demographic indicators of the business entity (age and sex structure of the personnel, indicators of staff turnover, retirement rates, statistical data about the workers' disability and mortality rates), 2) financial indicators of the business entity's performance; 3) levels of wages and salaries in the firm.

In the current pension system of Ukraine its first (solidarity) level is the most developed, but it does not provide decent pension payments depending on the labor contribution of each working person, while the replacement ratio in all sectors of the economy remains low. Therefore, after the retirement the basic requirement of a person's economic security – keeping his and his family's comfortable living intact – is not fulfilled. However, in none of the world's countries the decent level of pensioners' living is guaranteed exclusively by the state solidarity level of the pension

system. In the implementation of the pension reform in Ukraine the replacement ratio of 60 – 75 % existing in many countries is considered. However, the revenue from all levels of the pension system (in Ukrainian conditions mainly from the first and the third levels of the pension system) should be taken into account.

The further development of the accumulating pension system in Ukraine should lead to direct positive consequences for the functioning of the national pension system as a whole. Firstly, within the accumulating pension system there is a clear dependence of the pension amounts on the contributions, which has to reduce the distortions in the labor market (pushing the labor force into the shadow economy), because employees no longer consider pension contributions as an additional burden that provides no increase in pension sizes. Secondly, the accumulated pension contributions and the corresponding investment income are transformed into retirement benefits of citizens through gradual withdrawals from accounts. This means that employees are interested in retiring as late as possible in order to receive a bigger pension. As a result, the average retirement age increases automatically without state interference. In this way, the number of experienced personnel in the labor market is kept on the same level. Thirdly, the investment of citizens' pension contributions within the accumulating system is based on economic rather than political considerations. Financial institutions, which provide accumulating pension services, try to maximize their investment profit rates by carrying out diversified investment, support the development of financial markets by creating the stable demand for new financial instruments and financial institutions leading to the creation of new jobs and increasing employment within the financial market.

Despite the partial transfer of the responsibility for pension provision from the state to employers and citizens themselves there is still the need in the preservation and improvement of state regulation of the pension system in general. There are two approaches to the pension system state regulation: soft approach and hard approach. The basic principles of the soft mode of the pension system governance are as follows: 1) mixed voluntary and obligatory participation of citizens in the pension system, 2) availability of a high degree of individual choices for citizens, 3) no need in special permits for financial institutions to carry out activities in the field of non-state pension provision; 4) opportunities for citizens to accumulate money simultaneously on several personal accounts; 5) opportunities for an employer to set up several pension funds; 6) lack of restrictions for providers of non-state pension services regarding their differentiated price policy; 7) opportunities for non-state pension providers to determine the list of services to charge fees for (in particular, fees can be charged for the admission of a person as a participant of a non-state pension scheme and for the termination of such participation; fees may or may not depend on the amounts of

accumulated pension funds of a citizen); 8) the transfer of the principle "rational behavior" into the investment activity of non-state pension providers without the detailed investment restrictions; 9) opportunities to invest the funds accumulated in the pension system into foreign corporate securities; 10) lack of requirements to the minimum profitability of invested pension funds except for guarantees against fraud. Contrary to this approach, the hard mode of the pension system governance provides for: 1) mandatory participation of all working members of society in the pension system; 2) lack of a high degree of individual choices for citizens; 3) the need in special permits for financial institutions to carry out activities in the field of non-state pension provision; 4) lack of opportunities for citizens to accumulate money simultaneously on several personal accounts; 5) lack of opportunities for an employer to found several pension funds; 6) uniform pricing in the area of pension services; 7) regulation of the types of fees, which are charged by the providers of pension services (but not their sizes); 8) detailed rules for the investment of pension funds (limiting the maximum amounts of investments into one instrument in order to avoid risk concentration); 9) prohibition or legal restriction on investment of pension funds into foreign corporate securities; 10) the necessity to follow the requirements to the minimum profitability of invested pension funds and provision of state guarantees against unforeseen reduction of investment profitability.

Countries with developed financial markets and long traditions of mostly voluntary pension systems created with active participation of economic entities may use a softer regime of state regulation. To confirm the effectiveness of the "rational behavior" principle these countries have introduced training programs on the responsibilities of managing the funds of pension system participants as well as training systems to ensure the necessary understanding and control of risks. If a state in some cases uses the restriction on investment activity and the minimum rates of investment returns on pension funds, persons who do not wish to take advantage of state guarantees may be allowed to make contributions to funds, which are less regulated by the state. In countries with underdeveloped financial markets and the lack of historical experience and practices of voluntary pension provision a hard approach to the regulation of the pension system is more acceptable. With the accumulation of experience by the providers of non-state pensions in these countries and by citizens themselves it is expedient, in the future, to use the soft mode of state regulation.

Under any circumstances a state should require that financial institutions, which are non-state pension providers, separate their assets from the assets of their founders, make minimum capital reserves, offer intensive information coverage of their activities, constantly seek to develop and improve the system of effective state supervision over the activity of non-state pension funds.

Strict state regulation of the pension system is necessary to ensure the simplicity and transparency of the pension reform, to win the public trust and to provide the necessary protection of citizens. Undergoing the process of transformation, the pension system of Ukraine should be regulated by the state on the basis of the hard approach as this would create the foundation for the further successful implementation of the pension reform and make it possible to take into account the peculiarities in the development of the national economy.

The social responsibility of business entities in Ukraine can develop only with substantial state incentives given the generally weak financial position of local business entities. Contribution rates on different types of social insurance should be coordinated among themselves considering the need to reduce the overall burden on businesses in the form of obligatory payments. One of the most important tasks is increasing the share of wages in the GDP, because the reduced wage levels lead to insufficient insurance contributions to social insurance funds. The main obstacle to the completion of the pension reform in Ukraine is the lack of conditions necessary for the introduction of the pension system's second level. Until these conditions are created, the most promising way for the pension reform is the further development of the third level of the pension system (the introduction of professional pension schemes and corporate pension plans) and finding ways to free the first level of the pension system from certain unfounded possibilities for early retirement. An effective state regulation of the pension system grows in importance during the implementation of the pension reform. In Ukraine it is expedient to use the hard regime of state regulation of the pension system to ensure the successful implementation of the pension reform.

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