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SHOULD THE PENSION REFORM PROGRAM BE CHANGED?

1. Consequences of the 1998 crisis for the pension security system

The financial condition of the pension system in the Russian Federation underwent a number of significant changes in the period following the 1998 crisis. From January through September 1999 the payment of insurance premiums into the Pension Fund declined by approximately 20 percent in real terms compared to the analogous period of the previous year. Under these conditions it was virtually impossible to prevent a drop in the purchasing power of the pensions that were awarded, especially in light of the need to make up the arrears on pensions that had accumulated over 1998. Therefore, in the post-crisis period the decline in the real value of the pensions awarded occurred at a faster rate than both personal money income and wages earned, which serves as the basis for the calculation of insurance premiums paid to the Russian Pension Fund.

The replacement rate, which is understood as the ratio of the average pension awarded and the average wages earned, fell from an average of 36 percent in 1998 to an average of 28.5 percent in 1999. Such a steep decline in the replacement rate was due in large part to the effort by the Russian government and the management of the Pension Fund to create a current surplus in the fund's budget to allow for settlement of the arrears that had accumulated by the end of 1998, when arrears totaled approximately Rub 29 billion. As a result of the consistent pursuit of this policy, the pension backlog was paid off by the end of September 1999, after which, from November 1999 through February 2000, the current surplus of the Pension Fund was used to raise the level of pensions awarded and to make lump-sum compensation payments.

In spite of the measures that were taken to increase the size of pensions, toward the end of 1999 the average size of pensions awarded remained at a level that was less than 80 percent of the minimum subsistence income for a pensioner. On average, throughout 1999 the average pension awarded as a percentage of the minimum subsistence income fell to 70.1 percent, compared to an average of 114.7 percent for 1998.[1] In the pre-crisis period (the second half of 1997 through the first half of 1998) the minimum pension level fluctuated in the range of 75–80 percent of the minimum subsistence income for a pensioner. According to Edict No. 573 of the Russian Federation President of June 14, 1997, in Russia the minimum

[1] Here and elsewhere throughout the text the size of pensions indicated is based on RSA data: *Socio-Economic Conditions in Russia: 1999*, Moscow: RSA, 2000.

pension plus compensation should not fall below 80 percent of the minimum subsistence income for a pensioner. Meanwhile, taking into account the differentiation of pensions that has actually developed, the minimum pension plus compensation fell below 50 percent of the minimum subsistence income for a pensioner and in 1999 it averaged 45.4 percent of the minimum subsistence income for a pensioner.

The steep decline in the ratio between the minimum pension and the minimum subsistence income for a pensioner made it impossible to maintain the differentiation of pensions that was in effect in the pre-crisis period. Therefore, the more rapid indexing of minimum pensions with a view to at least keeping them from falling below the dangerous mark of 50 percent of the minimum subsistence income seemed justified and unavoidable. While the ratio between the average pension awarded and the minimum pension was 1.72 from April 1998 through March 1999, by the fourth quarter of 1999 it had fallen to 1.46 as a result of the more rapid indexing of minimum pensions. In February 2000 this ratio was supposed to fall to approximately 1.37 in connection with an additional 10-percent increase in minimum pensions above and beyond the overall 20-percent raise in pensions. At the same time, thanks to the more rapid indexing, the minimum pension plus compensation, expressed as a percentage of the minimum subsistence income, grew from 37.3 percent to 53.8 percent from April through December 1999, that is, it increased by a factor of almost 1.5.

Data from the eighth round of the RMEZ (Russian Monitoring of the Economic Status and Health of the Population) point to a deterioration in the position of pensioners following the crisis. According to calculations by TACIS expert S. G. Misikhina, there was a significant rise in the proportion of pensioners among the “new poor,” that is, among the poor households from the eighth-round panel who were not poor in the previous RMEZ round. Households consisting of single pensioners accounted for 25 percent of the new poor in the eighth round, while in the seventh round they accounted for just 14.7 percent of all poor people.

At the same time, even the small pensions that the majority of pensioners received in the period following the crisis still provided for a substantial reduction in the risk of poverty among this population group. According to data from the eighth round of the RMEZ and RSA research, the proportion of pensioners among the poor continues to be lower than the proportion of pensioners among the general population. As in the pre-crisis period, the proportion of poor among households containing pensioners remains considerably lower than among the other main categories of households. According to our calculations, in the post-crisis period pensions were the only type of social payments that led to a substantial reduction (by approximately 8 percent) in the overall level of income inequality that is measured by the Gini coefficient. All other social payments either had no effect whatsoever on the level of inequality or led to an increase in the level of inequality, which was the case with benefits for children, for example.

The relatively low incidence of poverty among pensioners can be explained in part by the fact that official data on the decline in the level of accrued pensions significantly overstate the actual deterioration in pension security as a result of the crisis. As already mentioned, according to official data, the average pension accrued in the first half of 1999 fell by a factor of approximately 2 compared to the analogous period of the previous year.

Meanwhile, the payment of insurance premiums to the Pension Fund during this period fell by a significantly smaller margin—approximately by one-fourth, which meant that it was possible to provide more funding for actual pensions than one would assume from the official statistics. The collection of insurance premiums paid to the Pension Fund also fell by a smaller margin than real wages earned (it fell by 37 percent in the first half of 1999 compared to the analogous period in 1998). This is evidently tied to the fact that as a result of the widespread settlement of wage arrears that occurred in the first half of 1999, insurance premiums payable on these arrears were also made up. Thanks to this effort, Pension Fund revenues in real terms fell at a slower rate in the first half of 1999 than average wages earned, which do not include the payment of back wages from previous periods.

In order to arrive at a more precise assessment of the actual decrease in the purchasing power of pensions as a result of the crisis, one needs to bear in mind that the "accrued pension" indicator does not take into account either pension arrears or the subsequent settlement of these arrears. By making an adjustment to reflect the change in pension arrears, we discover that in the summer of 1998, that is, on the eve of the crisis, the actual level of monthly pension payments was not 130 percent of the minimum subsistence income for a pensioner, as the RSA reports, but was closer to 112 percent, that is, it was substantially lower than the level of the average accrued pension. This is tied to the fact that over the first nine months of 1998 there was a rapid buildup of arrears on pension payments. By the end of 1998 pension arrears totaled around Rub 29 billion.

On the contrary, over the first nine months of 1999 the backlog that had accumulated was almost entirely paid off. As a result, actual pension payments per pensioner exceeded by a considerable margin the average accrued pension reported by the RSA. With an adjustment to reflect the repayment of arrears, the level of monthly pension payments per pensioner in the first half of 1999 exceeded by a considerable margin the average accrued pension for this period. According to our estimate, it was just under 80 percent of the minimum subsistence income for a pensioner, and not 67–69 percent as indicated by the RSA data.

Thus, if one takes into consideration the pension backlog accumulated in 1998 and its repayment over 1999, the actual decline in the purchasing power of monthly pension payments per pensioner in the summer months of 1999 compared to the analogous period of 1998 is no more than 30 percent, and not 50 percent, as indicated by the data published by the RSA.[2]

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[2] One needs to take into account the fact that general federal statistics conceal the extremely varied nature of the dynamics of real pensions among the different regions. Indeed, the regional distribution of pension arrears in 1998–1999 was extremely uneven. Delays in the payment of pensions ranged from 0 to 4 months or more. This means that there were also wide differences in the settlement of arrears among the regions in 1999. The extremely

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On the whole, the facts presented above testify to the fact that in spite of serious difficulties that arose in the course of the financial crisis of 1998, the pension system managed to cope fairly successfully with its main task—preventing widespread poverty among elderly citizens.

2. Possible areas for improvement in the Pension Reform Program

The fact that Russia's pension system survived the "trial by crisis" fairly successfully in no way means that the need to carry out comprehensive pension reform should be taken off the agenda. In the absence of more serious reforms, compression of the pension scale and a reduction in the replacement rate in and of themselves cannot prevent a dangerous deterioration of the financial condition of the pension system over the long run, which will occur as a result of the gradual aging of Russia's population and a further worsening of the ratio between the number of pensioners and the size of the economically active population.

At the same time, serious changes in the overall economic situation and in the financial condition of the pension system itself in the post-crisis period will inevitably require an adjustment in the long-range strategy of pension reform. It seems that in light of the new situation, the most serious changes will have to be made in that section of the Pension Reform Program that is devoted to the reform of retirement pensions funded on a pay-as-you-go basis. This applies in particular to the transition to awarding new pensions on the basis of retirement savings accounts called for under the Pension Reform Program.

The concept of retirement savings accounts assumes the virtual elimination of the notion of a maximum pension. The plan is that restrictions on the maximum size of a pension will be imposed indirectly after the introduction of retirement savings accounts—as a result of a restriction on maximum wages on the basis of which pension contributions, recorded on retirement savings accounts, are calculated. A loosening of restrictions on the maximum size of a pension is one of the key conditions for the financial viability of the system of retirement savings accounts. Insurance premiums of highly-paid employees are recorded on their retirement savings accounts only under this condition. Thus, there is a direct connection between an employee's future pension and the amount of insurance premiums paid in, which creates incentives for the conscientious payment of insurance premiums.

Projections which we made based on various scenarios in the period following the crisis show, however, that under the new economic conditions a substantial increase in the differentiation of pensions funded from a pay-as-you-go system will be difficult for a long time to come, since it is capable of freezing the minimum pension at a level below 80 percent of the minimum subsistence income for a pensioner for a prolonged period, in connection

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uneven regional distribution of pension arrears further intensified interregional differences in the rate of decline in the purchasing power of pensions.

with insufficient receipts of insurance premiums paid to the Pension Fund.[3] The impossibility of a significant differentiation of pensions over the medium term is hindering the introduction of a system of retirement savings accounts: from the projections referred to above, it follows that even given relatively favorable GDP dynamics over the long term, initial introduction of retirement savings accounts will have to be postponed by 10–15 years from the time frame indicated in the Pension Reform Program.

In connection with the accelerated aging of the Russian population, however, in the coming decade the implementation of pension reform cannot be put off for such a long period of time. Consequently, an alternative reform scenario needs to be prepared. In light of the current situation, with the resumption of economic growth and an increase in real revenues going into the Russian Pension Fund, the most realistic approach would be not to increase the pension differentiation that currently exists, but to provide for an equal increase in all pensions, with the aim of bringing the minimum pension closer to 80 percent of the minimum subsistence income for a pensioner as quickly as possible.

Under this sort of reform scenario, the differentiation of pensions will have to increase in the future, although the primary factor in this increase will be not the pay-as-you-go component, but the savings component of mandatory state pension insurance. In essence, we are talking about bringing the Russian pension system closer to the pension systems that have been developed in recent years in Great Britain and the Netherlands. Both those countries have relatively small universal state pensions, which are funded on a pay-as-you-go basis. In the Netherlands the size of these pensions is the same for everyone, while in Great Britain there is a relatively small differentiation. At the same time, the majority of the able-bodied population is covered by savings-based pension insurance, which accounts for most of the differentiation in the size of pensions depending on the premiums that have been paid in.

Over the next few years the average replacement rate for state pensions funded on a pay-as-you-go basis can be maintained at a level of approximately 30–34 percent, which, judging from all evidence, will be achieved in February 2000. Actually, this assumes an indexing of state pensions based on wages during the period in question, which will make it possible to bring them up to the level of the minimum subsistence income for a pensioner.

In the more distant future (5–7 years from the point that reform is actually initiated), when significant pay-outs of state pensions begin, the emphasis should be on maintaining the overall replacement rate for state pensions funded on both a pay-as-you-go and a savings basis at approximately 33 percent. This means that the replacement rate for state pensions funded on a pay-as-you-go basis will have to fall as payments on savings-based state pensions increase.

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[3] See M. Dmitriyev. "Evolution of Russia's Pension System in the Context of the Economic Crisis." *Voprosy Ekonomiki*, No. 10, 1999.

As actuarial calculations show, in order to maintain the replacement rate at the level of 33 percent, the rate of insurance premiums earmarked for the current funding of state pensions can be maintained at the level of 27.7 percent for enterprises based on a single rate for employers, given the current base for assessment of insurance premiums.[4] This rate is in line with proposals to reduce the aggregate payroll tax burden, which call for the establishment of an overall rate of 35.4 percent for enterprises on insurance premiums paid to social extrabudgetary funds.

Another important change that will have to be made in the Pension Reform Program is modification of the mechanism for raising the standard retirement age. The Pension Reform Program calls for raising the average retirement age indirectly, without an official increase in the standard retirement age. The assumption was that later retirement would be achieved through a gradual adjustment in the actuarial factor in the formula used for retirement savings accounts. Such an adjustment was supposed to lead to a gradual reduction in the relative size of pensions paid to employees retiring at the standard retirement age, and would encourage people to retire later.

The impossibility of introducing a retirement savings account system and achieving in the foreseeable future a significant differentiation of pensions funded on a pay-as-you-go basis creates the need for a direct, gradual increase in the standard retirement age. The actuarially balanced option for pension reform, which takes into account the consequences of the 1998 crisis, called for a gradual increase in the retirement age by 5 years for men and women over a 10-year period, starting with the first year of reform. This proposal is consistent with similar decisions adopted in recent years in Georgia, Kazakhstan, and Moldova. Over the next ten years the plan is to establish the same retirement age for men and women by raising the retirement age for women to 65 over this period. One should bear in mind that for all practical purposes not a single pension reform carried out anywhere in the world over that past 15 years has managed to get by without an increase in the retirement age. An increase in the retirement age is also called for in the majority of pension reform plans that are in the development stage in various countries around the world, including transition economies.

In the process of introducing mandatory insurance savings contributions, the rate of which is supposed to rise gradually from 1 percent to 8 percent according to the Pension Reform Program, the rate of contributions to the pay-as-you-go system will fall by the amount of savings contributions. According to actuarial calculations for this particular scenario, this decline will not result in a shortage of funds for the payment of pensions funded on a pay-as-you-go basis. The continued availability of funding in this transition can be achieved by increasing the collection rate of insurance premiums through the

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[4] See *Reform of Certain Sectors of the Social Sphere in Russia*. Moscow: Institute of Economics of the Transitional Period, 1999, pp. 77–134.

personalization of their savings component, and also in connection with the initial phase in raising the retirement age and reforming the early retirement process.

In the short term, the condition of financial markets is a major obstacle to initiating the introduction of savings elements for the funding of pensions which are called for under the current Pension Reform Program. A gradual normalization of the situation in the financial markets, however, is an inevitable consequence of an overall improvement in the economic situation in the country and a resumption of economic growth. Given favorable development of the economic situation in Russia, the introduction of elements of mandatory savings-based funding of pensions may begin in 2002–2003.

In the event of the resumption of sustained growth and consistent implementation of structural reforms, the minimum economic and organizational-technical conditions required for the investment of pension reserves can be created by this time. Their initial volume may be relatively small (approximately 0.2 percent of GDP in the first year of introduction of savings elements and not more than 1 percent of GDP by the end of the third year of the transition). Such modest quantities of funds can be invested with sufficient reliability in government securities and in stocks of major Russian companies in certain proportions, and they may also be placed in time deposits with several of the most reliable and transparent banks. Furthermore, partial international diversification of the investment portfolio is also entirely acceptable. Because of their relatively small scale and prolonged nature, these operations will not put any strain on Russian financial markets.

International experience also indicates that this sort of scenario is feasible. The majority of successful pension reforms accompanied by the introduction of savings principles, which have been implemented around the world over the past 20 years, were initiated in countries that had experienced profound financial upheavals or systemic banking crises no more than 5 years prior to the initiation of pension reform. One should also bear in mind that, as international experience demonstrates, pension reforms based on savings principles in and of themselves are a powerful factor in the strengthening and stabilization of national financial markets and thereby create an environment for a gradual buildup of pension reserves over the long run.

It would also be a good idea to consider the possibility of pursuing alternative approaches to funding early retirement among the additional measures to make adjustments in the Pension Reform Program. The option of reforming pension security for early retirement that involves gradually transferring the payment of early retirement pensions to professional pension systems (PPS), which is called for under the Pension Reform Program for the Russian Federation, has a number of shortcomings, the most important of which is the unjustified increase in the burden on the wage fund of enterprises that have a significant number of jobs with early retirement rights. This does not create insurmountable obstacles to the implementation of this particular part of the reform, although it does make sense to consider alternative approaches that would be more consistent with the post-crisis situation.

One of these approaches entails the introduction of a system of insurance to cover people who have become disabled and have a minimum amount of time on the job under special working conditions, and also in regions of the Far North and areas with equivalent status. Under this system the right to receive an early retirement pension would be granted only to people who have accumulated a minimum amount of time on the job under special conditions but who have not reached the standard retirement age and have been declared disabled in connection with occupational illness or employment in regions of the Far North and areas with equivalent status, following the established procedure.

According to the available estimates, when the transition to a new system of early retirement pensions is completed in its entirety, expenditures of the Russian Pension Fund on the payment of such pensions to employees who meet the established criteria will not exceed 0.2 percent of GDP. Additional rates for payroll insurance premiums for employees covered by this type of insurance will remain at around 1 percent in the majority of cases. This is approximately 10–20 times less than the expected insurance burden under the first pension reform option, which calls for the payment of early retirement pensions to all insured persons, regardless of actual disability.

At the same time, the choice between these and other available options for reforming the conditions for early retirement must take into account both economic and political limitations. From this standpoint, flexible approaches that allow for various early retirement options for different categories of workers may offer certain advantages.