ANALYSIS

Russia's Pension System: Back to the Future

By Peter Rutland, Middletown, CT

Abstract
Russia's 2002 pension reform is not working and the system requires ever larger bailouts from the state budget. So far attempts to fix the problem are flagging because Russia's leaders are reluctant to adopt unpopular decisions.

A Failing System
For the past several years, the Russian government has been arguing over what to do with the pension system. A major overhaul was launched in 2002. In addition to contributions for a minimum state pension (the first pillar), it introduced mandatory contributions to a private pension fund (the second pillar) and allowed for additional voluntary private contributions (the third pillar). As of 2012 the State Pension Fund levies a 22% charge on payroll, of which 16% goes to current retirees and 6% to private savings accounts.

The reform is now generally considered a failure, and the deficit in the pension fund is requiring ever-larger bailouts from the state budget.

On August 31, 2012, the Ministry of Labor and Social Protection published a new pension reform plan, the "Draft Strategy for the Development of a Pension System in Russia until 2030." The government came up with a draft "Strategy for Pension Reform," which it presented to President Vladimir Putin on October 1st. The plan marks the abandonment of key elements of the 2002 reform and, if implemented, would effectively mean a return to a state-run pay-as-you-go (PAYG) system for the majority of workers.

The plan promises that the state pension will be kept at two and a half times the subsistence minimum (approximately 20% of the average wage, depending on the region) and at a level equal to 40% of the average salary for those with a 35-year work record, commitments that are in line with International Labor Organization recommendations.

The International Origins of the 2002 Reform
In the 1990s, the World Bank and International Monetary Fund began encouraging countries to restructure their pension systems. As part of the neoliberal agenda of rolling back the state, it was considered important to have individuals save for their own retirement, with funds invested in financial markets, rather than have worker contributions cover the benefits of current pensioners (the PAYG system). This would ease the burden on state budgets—a growing problem because of the aging population in all developed countries. It would also encourage saving; provide a pool of capital for private investment; and decrease state influence over economic decision-making. Chile, which switched to a fully market-funded system in 1981, was held up as the model for a successful pension reform.

Any country shifting from PAYG to a funded system faces an actuarial challenge: existing pensioners must be paid out of current contributions and at the same time those contributions must be increased to create funds for the future. This means that the country will be paying a double pension bill for the transition period, which may stretch into decades. It is not clear that the Russian government grasped the magnitude of this challenge when it launched the reform a decade ago.

Experience in Latin America and elsewhere shows that the problems do not end there.[1] In transition economies capital markets may not be deep enough to absorb the flood of new savings and provide them with a reliable rate of return. Economic downturns can cause pension funds to lose value—as many reform countries experienced in 2008. Finally, the administrative costs of the private funds are often much higher than a single state system. These kinds of difficulties led seven of the 13 former socialist countries that had privatized their pension systems to partially or completely renationalize them by 2012.[2]

The Russian Experience
The system Russia inherited from the Soviet Union was characterized by a high level of state financing, a low level of actual pension benefits, much inequality, and a disconnect between pension and work record. The Soviet Union had a pension age of 55 for women and 60 years for men, after 20 or 25 years' service respectively. It set a replacement rate of 55% of the average wage, plus 1% for each year above 20/25. This "pension socialism" lived on after the Soviet collapse, but in the 1990s the state budget did not have the funds to maintain the real

1 Carmelo Mesa-Lago, Reassembling Social Security: A Survey of Pensions and Health Care Reforms in Latin America (New York: Oxford University Press, 2008).

2 Sarah Sokhey, "The politics of pension reform," Association for Slavic, Eurasian and East European Studies annual convention, New Orleans, 16 November 2012.

value of the pension. Part of the problem was the high level of informal employment, with many workers paid off the books in order to avoid paying taxes. By 2000 the base pension for Russia's 38 million pensioners had fallen to 33% of the average wage.[3]

The average age at which Russians become eligible for the pension is 53 for women and 56 for men—very low by international standards. Only 39% of Russian men aged 60–64 were employed in Russia in 2008, compared to 59% in the US. Despite efforts to increase the real pension, wages were rising faster in the 2000s, so the replacement rate—the pension as a proportion of the average wage—was 35.7% as of 2010, which is in line with international levels.[4]

In Russia, the IMF estimates that "the ratio of the population 65 and older to the working age population is projected to nearly double from around 18% to 36% between 2010 and 2050."[5] This would pose a massive burden on current workers, and would inevitably lead to cuts in the pension level. So the theory was that the reform should be introduced as soon as possible—before the surge in the pension-age population kicks in. Economic policy-making in the first Putin Administration was in the hands of liberals, such as Economics Minister German Gref and Finance Minister Aleksei Kudrin. Apart from the pension reform, they also introduced more market-friendly labor legislation and a 13% flat income tax.

The 2002 reform aimed to get the state out of paying pensions for the current generation of workers while guaranteeing the benefits for current pensioners. All workers born after 1967 would be subject to a 20% payroll tax (later raised to 22%), of which 14% would go to the state Pension Fund and 6% to a personal account in a private fund. However, workers distrusted the new private funds: anywhere from 70–85% took the default option and sent their contributions to the state-owned Vneshekonombank. But if all the money from private savings is being invested in government securities, then that defeats the fundamental market rationale of the reform.

Total spending on pensions jumped from 5.5% of GDP in 2008 to 8.9% in 2010—a result of a deliberate policy to shield pensioners from the effects of the economic crisis. However, this spending spike led to a deficit in the Pension Fund estimated at 1.3 trillion rubles ($40 billion), equal to 2.2% of GDP.[6] This had to be covered by subsidies from the federal budget, with pensions now accounting for 23% of federal spending. This lead to dire warnings of a budgetary crisis from Kudrin. Projecting out to 2050, pension spending could rise to 16% of GDP.

While other European countries have been raising retirement ages to 65 and above, this has remained anathema for Russian leaders. Putin specifically ruled out any increase during his presidential election campaign. Back in 2005, a move to shrink and monetize in-kind social benefits had triggered protests by pensioners in dozens of cities, something that the Kremlin is anxious to avoid.

The government presented its draft "Strategy for Pension Reform" to President Putin on October 1.[7] The document included some controversial changes in eligibility requirements in the "pension formula," such as tying the pension to the work record and lengthening the minimum work requirement for the maximum pension to 40 years. In a meeting with Deputy Prime Minister Olga Golodets, Putin advised her to cut that requirement to 35 years, but even that may be too unpopular to survive into the final draft, which should be released in December.[8] An earlier version of the draft was critically received by experts, who condemned it as a patchwork of budget-saving measures that lacked a long-term vision.[9]

What Comes Next?

The release of the Labor Ministry draft in August and the government's strategic plan in October was accompanied by an open and bitter debate amongst government officials over what parts of the 2002 reform can be salvaged, and who is to blame for the current mess.

Finance minister Anton Siluanov and Economics Development minister Andrey Belousov defend the importance of preserving the 6% private savings requirement as key to the long-run viability of the pension system; while Prime Minister Dmitrii Medvedev and Golodets favor cutting it to 2% and returning to a more PAYG system.[10] The cut from 6% to 2% would shift about 30

3 Marek Gora et al, "Pension reform options for Russia and Ukraine," CASE Center (Warsaw) Report no 91, 2010. http://econpapers.repec.org/paper/seccnrepo/0091.htm

4 Frank Eich et al, "Reforming the public pension system in the Russian Federation," IMF WP 12/201, August 2012.

5 Eich, ibid., p. 9.

6 Scott Rose, "Russia funds band together," Bloomberg, 25 October 2012.

7 "Strategiya dolgosrochnogo razvitiya pensionnoi sistemy Rossiiskoi Federatsii," 29 September 2012. http://www.rosmintrud.ru/docs/mintrud/projects/44/

8 "Rabochaya vstrecha s Zamestitelem Predsedatelya Pravitel'stva Ol'ga Golodets," 16 October 2012. http://kremlin.ru/news/16662.

9 "Strategiya zatykaniya dyr i lataniya trishkinogo kaftana," Moskovskii komsomolets, 27 October 2012. http://www.mk.ru/economics/article/2012/10/25/766204-ctrategiya-zatyikaniya-dyir-i-lataniya-trishkinogo-kaftana.html

10 Igor Naumov. "Dmitrii Medvedev zadumalsya o pensii," Nezavisimaya gazeta, 6 November 2012.

billion rubles ($10 billion) from the private funds to the state budget each year: only about a quarter of the Pension Fund deficit. On December 3rd Medvedev said a "mistake" had been made in designing the system in 2002, arguing it was unacceptable that those retiring after 2023 (that is, under the new system) will receive lower pensions than those who retire before.[11] Putin equivocated over the issue, before telling a government meeting on November 14 that the implementation of the new law, including the crucial decision about lowering the private contribution from 6% to 2%, will be postponed till January 2014.[12]

In Russia, as in many other transition countries, the logic of long-term reforms to ensure the stability of the pension system decades hence has run up against the reluctance of politicians to make unpopular short-term decisions, such as raising the pension age, increasing taxes or cutting benefits. The underlying problem is the lack of institutions of democratic accountability, which means that the decision-making process lurches forward through bureaucratic and inter-personal infighting—or sometimes stalls altogether.

About the Author

Peter Rutland is Professor of Government at Wesleyan University.

11 Kirill Sugrobov, "Oshibka Kasyanova," lenta.ru, 8 December 2012.

12 "Soveshanie po voprosam razvitiya pensionnoi sistemy," 14 November 2012. http://www.kremlin.ru/news/16823; Kirill Sugrobov, "Smelost ne khvataet," lenta.ru, 15 November 2012.

ANALYSIS

In Search for a New Social Base or Why the Russian Authorities Are Changing Their Relations with Business

By Andrei Yakovlev, Moscow[1]

Abstract

The future of Russia depends on whether the elites can agree on new rules of the game. Russia's highest officials recognize that in order to preserve the political regime, it is necessary to change the model of relations with business. However, the lack of correct stimuli for bureaucrats at the middle level continues to be a serious obstacle for development.

The State as a Group of Interests

The concept of "limited access orders" provides a useful perspective to understand what is happening in Russia today. According to this concept, developed recently by Nobel-Prize winning Economist Douglas North and his co-authors John Wallis, Steven Webb, and Barry Weingast, well-functioning markets and developed democracy represent an ideal toward which it is possible to strive, but the absolute majority of contemporary societies function within a framework of imperfect institutions.[2] The state in such societies does not have a monopoly on the legitimate use of violence in the terms of Max Weber, but rather represents a coalition of influential social groups, each of which has its own potential for violence.

According to North and his co-authors, such influential social groups have historically formed the elite of society. These groups have the ability to choose. They

1 This article is based on the results of projects carried out in the framework of the Program for Fundamental Research of the Higher School of Economics in 2011 and 2012.

2 North, Douglass, John Wallis, Steven Webb, and Barry Weingast. (2007). Limited Access Orders in the Developing World: A New Approach to the Problems of Development. Washington DC: World Bank Policy Research Working Paper No.4359, September 2007; North Douglass, John Joseph Wallis and Barry R. Weingast (2009). *Violence and Social Orders: A Conceptual Framework for Interpreting Recorded Human History*. New York: Cambridge University Press; North Douglass, John Joseph Wallis, Stephen Webb and Barry R. Weingast (eds) (2012). *In The Shadow of Violence: The Problem of Development in Limited Access Societies*. New York: Cambridge University Press.