

# Pension Reform In Russia: From the Politics of Implementation to the Politics of Lawmaking?

## **PONARS Policy Memo No. 234**

Prepared for the PONARS Policy Conference  
Washington, DC  
January 25, 2002

*David M. Woodruff*  
*Massachusetts Institute of Technology*  
*December 2001*

Under President Boris Yeltsin, the politics of economic transformation was a politics of implementation, not of lawmaking. The decisions of bureaucrats, whether motivated by corruption or public spirit, counted for much more than the laws formally on paper. The roots of this weakness of the law were both economic and political. Economically, The prevalence of nonmonetary means of payment—goods offered in barter, or IOU's that were in effect more complex forms of barter—and the closely linked phenomenon of enterprises' chronic indebtedness to one another and to fiscal authorities marked Yeltsin's reign. The result was that both debts and the means of payment offered to cancel them were of opaque value, enmeshing bureaucrats and businesses in case-by-case decisionmaking as to which legal abstractions were substantially irrelevant. A feeble court system, continuing conflicts over control of property and excessively high formal taxes also meant that day-to-day economic activity constantly explored the far side of legality. Politically, hostile relations between the parliament and the executive branch hindered the effort to create a law-governed economy. Even bureaucrats selflessly committed to market-building regularly relied on their own discretion in the face of absent, unhelpful, irrelevant, or contradictory laws. Implementation arbitrariness especially plagued the pension system, which saw substantial delays in payouts and complex efforts to pay pensions in kind.

President Vladimir Putin's time in power, by contrast, has seen sharp changes in both economic and political conditions, changes that ought to facilitate law-based economic governance. Barter has declined markedly, easing the collection of taxes and social fees such as pension and insurance payments. More than half a decade after privatization, de facto control rights over many enterprises have been clarified, making de jure control rights feasible. Factions sympathetic to Putin and, by imperfect extension, to his liberal economic agenda now control the Duma. New forms of regularized business-government consultations have been created, and big business has shown increased interest in the legislative process. During the past two years, the Duma has passed several laws aimed at simplifying the tax system and reducing the fiscal burden, with the intent of tempting businesses out of the shadow economy. Most notably, social fees were unified and slightly reduced, and a 13 percent flat tax on income was introduced.

All of this might imply a shift from a politics of implementation to a politics of law-making, a change which could only be welcomed insofar as it strengthens the role of democratic institutions and improves the predictability of the business environment. However, the history of Russia's pension reform, key elements of which the Duma passed early in December 2001, suggests that such a conclusion would be premature. Although this reform is intended to contribute to the legalization of economic life, as explained below, it is unlikely to do so. Moreover, the political battles leading up to the reform suggest that all parties suspect the implementation of the reform will be tilted to benefit those implementing it. Probably due to such suspicions, the process failed to produce clear decisions on some critical issues—leaving ample scope for a politics of implementation to once again come to the fore.

## **Motivations for Pension Reform**

The authors of pension reform, especially Pension Fund head Mikhail Zurabov and Deputy Minister of Economy and Trade Mikhail Dmitriev, argued that both demographic difficulties and incentive problems of the old system made reform necessary. The demographic problem arose from the fact that pensions under the old pay-as-you-go system were paid out of the salaries of current workers. Its sustainability thus depended on the balance between pensioners and those in the workforce. As the postwar baby boom generation begins to retire, this balance would have been strained, especially in light of the falloff in birth rates in the 1990's.

The old pension system was also microeconomically ineffective, because it did not encourage early saving for retirement nor encourage the official reporting of salaries. Pension levels are set based on either the last two years of earnings before retirement or any five years of earnings. Lifetime earnings were thus irrelevant to pension levels. Also, only about \$120 of monthly salary was taken into account in determining pension levels, which in any event were not greatly differentiated. Thus the system created no incentive for workers to officially report income—Zurabov estimates that only about 35 percent of salaries in Russia are paid “on the books”—because underreporting wages did not affect eventual pensions.

## **The New Pension System**

Under the new pension system, pensions will eventually consist of three levels, financed by a mandatory pension fee of 28 percent of wages, paid by employers (unchanged from the present rate). Half the pension fee will go to finance the first or “base” level, a fixed pension paid to all retirees regardless of earnings. The other half of pension payments will be recorded on personalized accounts for each wage-earner. The second or “insurance” level of workers' pensions will depend on the amount paid to their account over their lifetime. Although personalized records will be kept, most of these payments will immediately be paid out to current pensioners. Thus the insurance level involves a change in the method of calculating pensions, but not a major shift in their financing.

The real novelty of the new system is in its third or “accumulative” level, which will become part of the basis for payouts starting in 2012. Beginning immediately, a portion of the personalized payments for workers who will retire after this date—one-seventh for older workers, and eventually about one-fifth for younger workers—will be invested, and pension payments will depend on the return on these investments. Initially, all the accumulative system funds will be invested in government bonds, but starting from 2004 the investments will be

diversified. Workers will also be able to choose their investment portfolio from a conservative option offered by the state pension fund or from options offered by about four private investment management firms, which remain to be selected.

### **The Political Process: Impoverished Debate Leads to a Dubious Reform**

The broad outlines of the new system—including its division into three levels and the rough distribution of pension fees between them—were worked out in the executive branch in late 2000, and saw little change in the course of parliamentary and public debate in 2001.

Nevertheless, there were some major conflicts. Among the most contentious issues was the exact proportion of pension fees that would enter the accumulative level and whether private firms could participate in their investment. The present decisions on these matters stem from a compromise, apparently imposed or brokered personally by Putin, between the positions of the state pension fund and representatives of big business (the latter demanding larger payments to the accumulative system and a greater role for private investment firms). However, details of how private firms will participate in pension investment have been deferred to a future law, and some supporters of a private role are doubtful that this law will pass.

Strikingly, the debate on the distribution of pension fees did not involve a serious analysis of transition costs, a matter quite neglected in all public discussion of the pension reform. As pension fees are channeled into investments, they become unavailable for payment of current pensions. These missing funds must be made up somehow—thus the “transition cost” of the new system. The Duma seems never to have debated the transition cost issue. Throughout 2001, government and pension fund representatives did little more than assert that enough money would be available. However, present signs are not promising. In fall 2001, the government suddenly reduced the planned “base portion” of the pension from 600 to 450 rubles (20 to 15 dollars). Because average pensions in 2001 were already around 1,100 rubles, this implies that more than half of pensions would need to be financed out of less than half of pension contributions. The accounting looks even stranger in light of planned sharp increases in pensions early in 2002. If pension fee collections fall short—a situation apparently not discussed in the legislation, although the new pension calculation procedures mean that the obligations of the pension fund do not depend on its current receipts—monies destined for investment could be at risk. Although Dmitriev asserted in the summer that the law would prohibit the use of invested funds’ to pay current pensions, the laws as passed do not seem to contain such a provision. That the reform does little to alter the demographic calculus that helped to prompt it increases the risk of future shortfalls in funds.

Another key debate—one yet to be resolved—concerns which government agency would have the authority to regulate the investment of the accumulative portion of pensions. The laws passed stipulate only that a government agency determined by a subsequent government decision will supervise investment. The failure to clarify this critical issue reflects the extent to which parties to the debate expect that implementation of the reform will be skewed according to which agency administers it. Business representatives in particular fear that, should the pension fund be given regulatory authority, it will seek to complicate life for private fund managers and keep the planned choice of investment portfolios a dead letter.

Finally, although one of the ostensible purposes of the pension reform was to encourage full declaration of wages, the reform seems unlikely to accomplish this. First, the opacity of the

transition cost issue and hard-learned distrust of government promises make it unlikely that workers will find the link between declared wages and eventual pensions credible. Second, the reform preserves the present, quite high 28 percent wage fund assessment for pensions, making on-the-books salaries quite expensive. With relatively little money being channeled into investment, investment returns are unlikely to allow a substantial reduction in this tax. Pension receipts may also fall off significantly due to tax changes beginning next year that were not considered in drafting pension plans. Although breaking the link between wage payments and pension funding seems to have been a priority of business, in practice it took a back seat to debates over who would control invested funds.

## **Conclusion**

In sum, the pension reform is unlikely to resolve the issues that prompted it. In a broader frame, the reform's unresolved issues—transition costs, dealing with potential revenue shortfalls, regulatory bodies, and forms of private-sector participation—leave ample room for arbitrariness in implementation. The reformed system will probably be no worse than the present one, and may be slightly better. However its vagueness undermines the goal of changing worker incentives, and demonstrates the limitations of the push for a law-governed economy.

© 2001