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PENSION REFORM IN RUSSIA: FIRST YEAR OF IMPLEMENTING

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[Abstract]

From January 1, 2002 Russian embarked on a pension reform to set up a three-pillar pension system and introduce funded principles of retirement pensions to be accumulated for "younger" workers. The new pension includes the flat-rate basic part which is paid to ensure a certain guaranteed minimum income, and the insured and funded parts both of which depend on amounts of insurance contributions and the resulting pension assets registered on an individual basis through the working life. The reform is aimed at improving the pension provision standards in the Russian Federation through ensuring long-term financial stability of the pension system.

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From January 1, 2002 Russia embarked on a large-scale pension reform to improve the standards of pension provision to the public and ensure the current and long-term financial stability of the pension system in the face of the upcoming serious deterioration of the demographic situation. Laws adopted back in 2001 in support of the pension reform became effective from this date.

1. Preparatory Stage to the Reform

Preparations to implement a pension reform in Russia have been going on from the mid-1990s. A number of conceptual and strategic documents to reform the pension system were adopted at the preparatory stage:

Year	**Document name**	**Document approving authority**	**Key provisions**
1995	Concepts of the Pension System Reform in the Russian Federation	Government of the Russian Federation	• setting up a three-pillar pension system • enhancing insurance principles for entitlement to retirement pensions • introducing personalized accounting • transferring early pensions related to work conditions to occupational pension systems
1998	Pension Reform Program in the Russian Federation	Government of the Russian Federation	• introducing funded mechanism to finance retirement pensions • transition to calculating the amount of retirement pensions on the basis of paid contributions and expected period of payment

Year	Document name	Document approving authority	Key provisions
2001	Pension Reform Program in the Russian Federation (revised)	National Pension Reform Council under the President of the Russian Federation	• introducing new retirement pension formula consisting of the basic, insured and funded parts • assessment and accounting for individual pension rights earned by the start of the reform • participation of private pension funds in the mandatory pension insurance system

The need to revise the Pension Reform Program in 2001 was brought about by the 1998 financial crisis which occurred three months after the Government approved the strategic document that envisaged introduction of funded principles in the pension system.

1.1. Financial Crisis and Pension Reform Decision-Making

As a result of the crisis, the purchasing power of average pensions fell from 120% of beneficiaries' subsistence minimum to 60-70% in 1999 while the Government had to concentrate on the objective of increasing pension benefits, first of all to individuals entitled to minimum pensions. Only in late-2001 did average retirement pensions reach the subsistence minimum of beneficiaries while their ratio to country-wide average wage (replacement rate) was 30-32%.

Moreover, wide-scale public discussions were held to prevent allocating part of contributions paid to the Pension Fund for payment of current pensions to accumulate funded assets, at least, unless a source to compensate for withdrawn revenues of the pension system was identified. It was also argued that the Russian financial markets did not have reliable investment instruments and that there was a risk of long-term investments losing value, should another financial crisis occur.

In the course of these discussions it was argued that in a more remote future when the number of individuals employed in the economy was equal to the number of pension beneficiaries, there would be no guaranteed solvent demand to funded assets on the part of workers.

Therefore, both assets and funded pensions financed through sale of assets could lose value relative to paid-in contributions.

Finally, costs associated with pension payment in Russia do not exceed 6% of the gross domestic product (GDP). This is twice below the level in Europe, therefore, the question is to increase rather than reduce this share so that pension benefits would ensure decent living standards rather than physiological subsistence.

The opponents argued that, to ensure the promised payment of 55-75% of earnings given the equal number of workers and pension beneficiaries, one would need to increase the contribution rate in the pay-as-you-go system to 60-65% of earnings for pension purposes alone which meant a halt to "legal" employment in Russia as such. Moreover, whatever measures were taken today with regard to the demographic policies and encouraging childbirth, 1:1 ratio between workers and beneficiaries could only be postponed from 2030 to 2035 but not avoided. Therefore, the pension system should be reformed in principle.

The National Pension Reform Council under the President of the Russian Federation was set up to achieve the nation-wide consensus on key issues of the pension reform to be implemented. The Council included people representing all factions of the State Duma, a number of the Federation Council members (governors pursuing active social policies in their respective constituent territories of the Russian Federation), government officials, representatives of trade-unions, associations of employers and pension beneficiaries.

The council discussed and approved the revised Pension Reform Program of the Russian Federation and the main pension reform draft laws which were developed by the Government and submitted by the President of the Russian Federation to the State Duma as a legislative initiative. In this way the issues of preparing and implementing the pension reform were moved from the level of executive authorities to the head of state and nation-wide levels. This ensured key decision-making within a relatively short period (within one year) and enabled to achieve certain nation-wide consensus.

1.2. Pension Reform as Part of Economic Modernization

It should be noted that the Government seriously focused on justification of proposals for the future pension system already back in 2000. In the second half of 2000 the Government generally approved the Guidelines for Development of the Russian Federation for the period until 2010 that underlined the need in higher economic growth rates for overcoming the crisis in the country's economy and defined the main areas of structural change for this purpose.

In particular, the share of wages for payment of income tax and social insurance contributions is expected to increase over ten years from 20-22% of the gross domestic product (GDP) to 35-40% GDP. This would match the proportions observed in the European economies and also in Russia before 1990. It should be noted that in the second half of 1990s, as suggested by the official statistics, cash expenditures of the public were practically twice the cash revenues from earnings and social transfers (pensions, grants and other benefits). This difference was traditionally attributed to so-called "revenues from property" which is indeed largely made up earnings from secondary (informal) employment. Therefore, we could and have to ensure "legalization" of actual earnings − the base of tax revenues and also the base of contributions to social insurance − as a strategic objective.

Once this objective is successfully achieved, the Russian pension system which relates pension increase for disabled individuals to wage increase of workers will be up to another possibility. A part of revenue increase due to higher wages from higher labor productivity could be used for inflation adjustment of current pensions. The remaining part brought by "legalization" of earnings could be used to accumulate assets for pension payment in the future as the effect of this growth factor stops.

With this in mind, in late-2000 the Government discussed the prospects of development of the pension system. Of more than fifteen options the Government selected the optimal one which provides for creating a mixed type pension system with phased introduction of funded pensions, with maximum 2-5% of payroll tax to be generally allocated for the purpose.

In 2001 Russia implemented a tax reform to reduce the tax burden on producers and increase collection amount of personal income tax. Income tax rate was established at the level of 13% while the previously applied progressive tax schedule (higher tax rate starting from established income thresholds) was abolished. Thus, individuals were discouraged to conceal or underreport their earnings. At least, this eliminated the income threshold which employers and employees could target for collusion on how much earnings to formally declare.

Insurance contributions to be paid by employers to social extrabudgetary funds were integrated into a uniform social tax (UST) with its total rate decreased 2% of workers' earnings while 1% contribution to the Pension Fund by workers from their earnings was abolished. The Government introduced the regressive UST schedule providing for a sizeable decrease of tax rate depending on the worker's earnings, especially in excess of Rb 600,000 a year (approximately USD 1,5 thousand a month). This gave an obvious advantage in relative costs of employment (in terms of labor and social insurance costs), with the competitive advantage enjoyed by those employers which hire more qualified and higher paid labor. Doubtless, this kind of labor could be afforded only by those employers that manage to organize efficient production, something that should in turn contribute to achieving the strategic objective to ensure high economic growth rates. This is necessary to increase the Russian GDP in real terms at least up to the level of 1990 over the next 10-15 years.

The pension reform in itself cannot solve the problem of higher revenues of individuals and general economic development but it should make its contribution towards this end. This was much in the focus when preparing proposals to implement the pension reform and create a new model of relations between workers and disabled individuals as regards provision of pensions.

This model assumes introduction of government-guaranteed basic income in the old age for all categories of the population, and the differentiated part of retirement pensions based on financial equivalence of benefits and contributions without any restriction on payment and redistribution of resources for the benefit of this or another group of pension beneficiaries. The new model gives up relating pensions to the previous earnings and record of employment while depending only on the amount of paid-in insurance contributions. Also, this model provides for setting up a defined contribution nation-wide pension scheme. The previous pension model of 1956 that ensured replacement of 55-75% of earnings actually ceased to work from the onset of the economic crisis in 1991-1992 and cannot be restored in any form at any time in the future.

2. Legal Framework of Pension Reform

Four federal laws from the pension reform "package" were adopted in 2001.

The focal importance lies with Federal Law No. 173-FZ "On Retirement Pensions in the Russian Federation" dated December 17, 2001 which regulates the terms and standards of entitlement to retirement pensions. As it became effective, the previous Law of the Russian Federation “On State Pensions in the Russian Federation”, No. 340-I dated November 20, 1990 became invalid.

Federal Law No. 166-FZ “On Provision of State Pensions in the Russian Federation” dated December 15, 2001 regulates terms and standards of entitlement to social pensions financed by budget transfers (to those who failed to earn the entitlement to a retirement pension), pensions to victims of nuclear and man-caused disasters, military conscripts and public servants, and also codifies pension provision standards to career military servicemen and equally treated individuals.

Yet another law − Federal Law No. 167-FZ “On Mandatory Pension Insurance in the Russian Federation” dated December 15, 2001 − defines the rights and obligations of insurants, insured individuals and insurers, procedure of contributions to mandatory pension insurance and their rates depending on the insured individual’s age and occupation.

Finally, there is Federal Law No. 198-FZ “On Amending the Tax Code of the Russian Federation and Certain Legislative Acts of the Russian Federation on Taxes and Duties” dated December 31, 2001, the last but not least in the pension reform package adopted in 2001. It establishes tax deductions from amounts of uniform social tax for the amount of insurance contributions to mandatory pension insurance.

In 2002 the Federal Law “On Investments for Financing the Funded Part of Retirement Pensions in the Russian Federation” was adopted to define the procedure and rules of pension assets investment, requirements to asset managers and specialized depositories, and a procedure for insured individuals to select an investment portfolio (asset manager).

In 2003 it is envisaged to adopt the draft law “On Mandatory Occupational Pension Systems in the Russian Federation” (approved by the State Duma in the first reading on June 26, 2002) which will regulate provision of mandatory occupational pensions related to work conditions.

In 2004 it is envisaged to codify pension provision standards in the Pension Code of the Russian Federation which is expected to define the legal framework of the new pension system to be implemented in the Russian Federation.

3. Structure of New Pension System

As a result of the reform, the pension system of the Russian Federation as a set of legal, economic and organizational institutions and standards introduced by the government with the purpose of ensuring financial security to individuals in the form of pensions, incorporates the following parts:

State pensions − a part of the pension system ensuring provision of the basic part of retirement pensions, disability pensions and pensions for loss of the breadwinner, to be financed from amounts of uniform social tax, as well as social pensions to disabled individuals and state pensions to military servicemen, public servants and other categories of individuals to be financed from federal budget transfers.

Mandatory pension insurance − a part of the pension system ensuring provision of the insured and funded parts of retirement pensions to hired and self-employed workers, as well as the insured part of pensions to disabled individuals and dependants of a deceased breadwinner, to be financed from mandatory insurance contributions.

Supplementary pension insurance and provision − a part of the pension system ensuring, in addition to state pensions and mandatory pension insurance, provision of pensions financed from accumulated voluntary contributions of employers and insured individuals.

Moreover, voluntary pension insurance and provision are regulated by the effective laws − Federal Law No. 75-FZ "On Private Pension Funds" dated May 7, 1998, Law of the Russian Federation No. 4015-I "On Organization of Insurance Business in the Russian Federation" dated November 27, 1992 (as regards individual insurance of material interests related to the insurant's pension provision) and other regulations.

Table 3. The Structure and Main Parameters of the Pension System

<table>
<tr><th rowspan="3">Pension system institutions</th><th colspan="3">State pension provision</th><th colspan="2">Mandatory pension insurance</th><th colspan="2">Supplementary pension insurance and provision</th></tr>
<tr><td rowspan="2">Pensions to military servicemen and civil servants</td><td rowspan="2">Social pensions</td><td colspan="2">Retirement pensions</td><td rowspan="2">Occupational pensions</td><td colspan="2" rowspan="2">Private pensions</td></tr>
<tr><td>Basic part</td><td>Insured and funded parts</td></tr>
<tr><td>Financing</td><td>Federal and regional budgets</td><td>Federal budget</td><td>Uniform social tax</td><td>Mandatory insurance contributions</td><td>Additional insurance contributions</td><td>Voluntary insurance contributions of employers</td><td>Voluntary personal insurance contributions</td></tr>
<tr><td>Pension amounts and procedure of calculation</td><td>Depending on years of service and cash allowance</td><td colspan="2">Fixed amount</td><td colspan="2">Depending on amount of insurance contribution</td><td>Comparable to a part of earnings</td><td>Depending on amount of insurance contributions</td></tr>
<tr><td>Governance</td><td colspan="3">Government</td><td colspan="2">Government with participation of representatives of insurants</td><td colspan="2">Private pension funds and other insurers</td></tr>
</table>

The above table shows the structure of the new pension system to be set up in the process of reform.

The position of occupational pension is shown conventionally since the final decision is yet to be made. According to the draft, occupational pension systems are mandatory for long-term provision of pensions to individuals working in hard and hazardous conditions. Meanwhile, the adopted legislation on mandatory pension insurance does not envisage this type of benefits, and there is still a controversy whether contributions to these systems should be mandatory.

The problem is that the nature of relations with regard to provision and financing of occupational pensions has not been defined. If contributions are mandatory, relations will be tax-based, with this type of mandatory payment to be included into the Tax Code of the Russian Federation. This will contradict the government tax policies to avoid an increase and seek to decrease the tax burden on producers.

If contributions are not mandatory, occupational pensions should be regarded as an additional social guarantee to workers as part of social partnership relations. In this instance it is not tax authorities but social partners that should ensure control over payment of contributions.

There are such precedents in the form of additional pension provision guarantees to airline pilots and mine workers financed from additional contributions of employers and other special deductions. However, the problem of timely and full payment of contributions by additional tariff still persists and is causing demands to the government to ensure their mandatory (tax-like) nature through legislation.

The law on mandatory occupational pension systems is expected to be adopted in the first half of 2003 so that after comprehensive discussions it could become effective from January 1, 2004 (a year later than has been previously envisaged).

4. Financing of Pensions

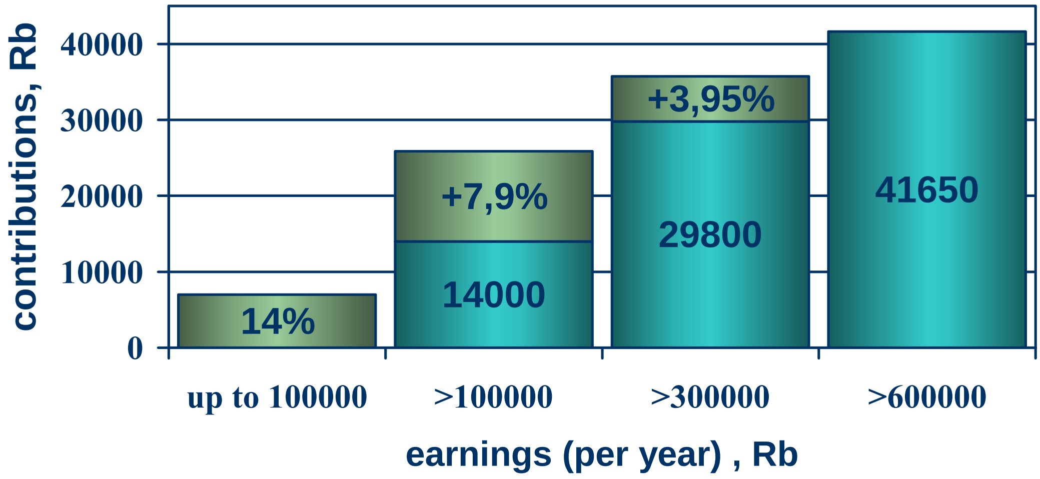
The new pension legislation maintains federal budget financing of state pensions with respect to the categories of individuals which have been previously receiving similar pensions from the same source.

These resources are credited to the Pension Fund of the Russian Federation for payment of respective pensions (except pensions to military servicemen, to be paid directly by the agencies associated with "power" ministries and departments). These payments amount to 6.3% of the total pensions.

Retirement pensions are financed from two sources − the federal budget within the amounts of uniform social tax (UST) for pension purposes and the amounts of insurance contributions for mandatory pension insurance introduced from January 1, 2002. The Russian tax legislation defines these contributions as deductions from uniform social tax. Total receipts for pension purposes amount to 28% of payroll (for the vast majority of companies), of which one half is insurance contributions and half − UST amounts minus insurance contributions.

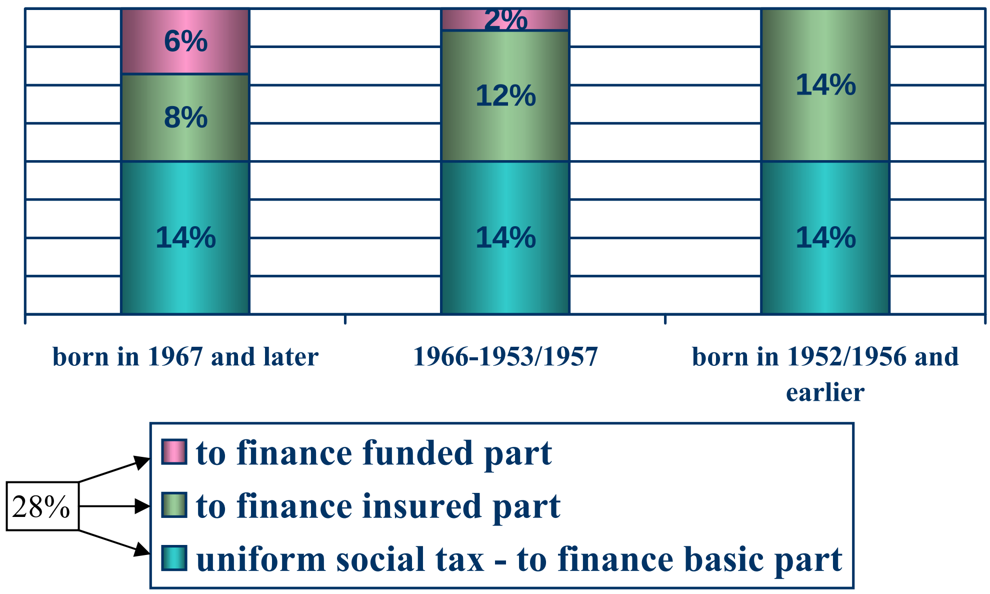
Tariffs of contributions for mandatory pension insurance are established by the Federal Law "On Mandatory Pension Insurance in the Russian Federation". Employers are required to pay 14% on the worker's annual earnings not exceeding Rb 100.000. Regression of contribution tariffs is applicable to higher amounts in the same way as to UST while, unlike UST, contributions are not paid from amounts in excess of Rb 600.000. The maximum amount of contributions does not exceed Rb 41.650 a year.

See the diagram for the regression schedule of insurance contributions.



For men born in the period of 1953-1966 and women born in the period of 1957-1966, two of 14 percentage points of the insurance contribution tariff are designed to finance the funded part of their retirement pension.

For individuals born in 1967 and later, it is envisaged to allocate 6 percentage points of the tariff for these purposes starting from 2006 (before this 3 points in 2002-2003, 4 in 2004 and 5 in 2005). See the diagram for distribution of deduction amounts to pension purposes.



For organizations acting as employers in production of agricultural goods, peasant (farming) entities, the tariff of contributions for financing the funded part of the retirement pension payable from amounts under Rb 100.000 is reduced (by 3.7 percentage points).

This privilege has been traditionally (over one decade) effective in the tax legislation and is “automatically” applied to insurance contributions. As the amount of future pension benefits directly depends on the amount of paid contributions, agricultural workers are still at a disadvantage. Meanwhile, apprehension of this situation should in the future result in revision of this and similar privileges for employers.

The same conditions of insurance contributions payable by organizations from their worker’s earnings also apply to individual entrepreneurs who use hired labor. These entrepreneurs were as many as 1.7 million at the start of the pension reform. Together with 3.2 million of organizations of various incorporation and economic orientation, they make contributions for the benefit of 49 million of hired workforce.

From January 1, 2002 new conditions for participation in the system of mandatory pension insurance we set for self-employed individuals such as individual entrepreneurs, lawyers of private practice, private detectives and others (a total of nearly 3.2 million).

They are required to make flat-rate contributions. The law established the minimum amount of this payment − Rb 150/month (approximately USD 4.8), of which Rb 100 is used to finance the insured part of retirement pensions while Rb 50 − the funded part of the same. These individuals can make flat payments in a considerably higher unlimited amount on the basis of a contract with the insurer − the Pension Fund of the Russian Federation. In this case payment for the insured and funded parts of retirement pensions are distributed in proportion of 2 : 1.

For the first time a provision was made for voluntary participation in the mandatory pension insurance system. Citizens of the Russian Federation employed elsewhere outside its territory may make payments on their behalf. Physical persons are also entitled to make payments for another physical person for whom no insurance payments are made. Payments are made in the form of flat-rate contributions under the same procedure as defined for individual entrepreneurs.

Potentially, such participants may be as many as 9 million people (out of 63 million of economically active population) who before the pension reform had no incentive to participate in the pension system since they reasonably believed that they would be anyway entitled to a pension but the amount of benefit would be small.

The law of mandatory pension insurance for the first time defined rights and obligations of participants in mandatory pension insurance − insured individuals, insurants and the insurer, the Pension Fund of the Russian Federation. Thus, the range of participants in the Russian pension system was considerably expanded since January 1, 2002. Before this date, the system involved 38.6 million of beneficiaries and the government. Employers were part of the taxation system while employees were virtually excluded from even indirect participation in the pension system.

So far a considerable part of insured individuals have failed to appreciate their rights and obligations. Meanwhile, in implementing the pension reform it was considered important to develop a formula for calculation of the retirement pension which would be absolutely understandable to insured individuals − including for assessment of the amount of future benefits depending on the amount of paid-in contributions.

5. New Retirement Pension Formula

From January 1, 2002 a new formula is introduced for calculation of the retirement pension which assumes that the pension is made of three parts:

basic part − a fixed payment established as a flat-rate amount;

insured part − a differentiated part depending on work performance of a particular individual, to be registered in his/her individual account in the form of **notional defined capital** which is understood as the amount of pension rights earned by the individual in connection with insurance payments made on his/her behalf throughout the entire working life as adjusted for inflation;

funded part − paid within the amount registered in the special part of individual nominal accounts of insured individuals.

6. Types of Retirement Pensions

It is envisaged to establish the following **types** of retirement pensions:

old-age retirement pension − payable to men reaching 60 years, women 55 years of age with minimum 5 years of insurable employment;

disability retirement pension − payable upon occurrence of disability, irrespective of the cause and on the basis of at least one day of insurable employment if the individual developed III, II or I degree of incapability of gainful employment.

Before 2004, individuals of I, II or III disability group are treated as those who developed III, II or I degree of incapability of gainful employment respectively;

Survivor pensions (for loss of breadwinner) − payable to disabled family members of a deceased breadwinner who were supported by him or her.

Record of service pension is not provided for as an insurance provision in accordance with the Federal Law "On the Basic Principles of Mandatory Social Insurance in the Russian Federation". Therefore, the retirement pension law makes no provision for this type of pensions. Moreover, it is envisaged to maintain the right to an early old-age retirement pension for those categories of insured individuals who previously earned the right to a record of service pension irrespective of their age.

In the future the government will pay a record of service pension only for military or public service under the law of state pensions, to be financed by budget transfers.

For those workers who as of January 1, 2003 have at least one half of the required special record of employment entitling to an early pension, it is envisaged to maintain this right by allowing them to earn the full required special record of employment. Individuals who have worked less than one half of the required special record of employment, and also those employed in unfavorable conditions after January 1, 2003 will have their occupational pensions established in accordance with the Federal Law "On Mandatory Occupational Pension Systems in the Russian Federation". As this law is still pending, the above date will be apparently moved to January 1, 2004.

For individuals working in the Extreme North and also "public" workers (teachers, medical doctors, theatrical workers, firemen, rescue workers, individuals working with convicts) will maintain their right to an early retirement pension irrespective of the special record of employment they have by the time of reform.

7. Retirement Pension Amount

The retirement pension amount (P) is calculated by adding the basic, insured and funded parts in accordance with the following formula:

P = BP+IP+FP where

BP − basic part of retirement pension;
IP − insured part of retirement pension;
FP − funded part of retirement pension.

7.1. Basic Part of Retirement Pension

The basic part of the retirement pension is defined as a flat-rate amount which as of January 1, 2002 was as follows:

Pension type and category of beneficiary	**Without dependents**	**With dependents**		
		one	**two**	**three and more**
Old age				
Regular	Rb 450	Rb 600	Rb 750	Rb 900
Elderly (80 years plus)	Rb 900	Rb 1050	Rb 1200	Rb 1350
Disabled I group	Rb 900	Rb 1050	Rb 1200	Rb 1350
Disability				
I group	Rb 900	Rb 1050	Rb 1200	Rb 1350
II group	Rb 450	Rb 600	Rb 750	Rb 900
III group	Rb 225	Rb 375	Rb 525	Rb 675
Survivor pensions				
Full orphans		Rb 450 each		
Other family members		Rb 225 each		

Amounts of the basic part of the retirement pension are related by simple ratios. In the major cases of entitlement (old age, disability group II, full orphans) this amount will make up Rb 450 ("basic value"). Individuals of disability group I, persons older than 80 years will be entitled to **twice** the "basic value" (Rb 900). Disability group II and family members of a deceased breadwinner will be entitled to **half** of "basic value" (Rb 225). With every dependent but no more than three, the basic part will grow by **one-third** of the "basic value" (by Rb 150).

The basic part of the retirement pension will be adjusted for inflation (price increase) within the amount earmarked for these purposes in the federal budget and that of the Pension Fund of the Russian Federation for the respective financial year. From February 1, 2002 the basic part of the retirement pension is increased by 6.5%, from August 1, 2002 by 9% and from February 1, 2003 by 6%.

The law also provides for increasing the basic part of retirement pensions over the planned increase in order to gradually make them approach the subsistence minimum of beneficiaries. So far the basic part of retirement pensions does not exceed 40% of this value on average while there is no medium-term program for achieving the above increase. It will probably be developed by 2004, the year of the State Duma election, either by the government or by deputies or candidates.

7.2. Insured Part of Retirement Pension

The insured part of retirement pensions is defined in accordance with the following formula:

IP = NDC / T, where
NDC is the amount of notional defined capital of the insured individual registered as of the date of entitlement to a retirement pension;
T is the number of months of expected payment of the old-age retirement pension as of the date of calculation.

A slightly more complicated formula is used to calculate the insured part of a **disability** retirement pension:

IP = NDC / (T x **R)**, where
R is the ratio of the disabled individual's required record of insurable employment (as of the date of entitlement to a disability pension) to 180 months.

Moreover, the disabled person's required record of insurable employment before reaching the age of 19 is 12 months, to be increased by 4 months for each full year of age starting from 19 years but by no more than 180 months.

In the denominator of the formula for calculating the insured part of the retirement pension, ratio **R** is always less than 1, something which adds to the final result.

Thus, "young" disabled individuals who failed to accumulate sufficient notional defined capital have a more privileged procedure for calculating the amount of the insured part of their retirement pensions than old-age beneficiaries. The amount of the insured part will primarily depend on the amount of earnings from which contributions were paid. If the record of insurable employment of a disabled individual is less than required for his or her age, the insured part will be slightly less than in the case when this record is equal or more than required.

The insured part of the **survivor pension** is calculated on the basis of the insured part of the disability pension as divided by the number of disabled family members supported by the deceased breadwinner (**D**) in accordance with the following formula:

IP = NDC / (T x **R) / D**.

In this case **NDC** is notional defined capital of the deceased breadwinner, **R** − ratio of the required record of insurable employment of the deceased breadwinner (to be determined depending on his/her age in a way similar to the one applied to disability pensions) to 180 months.

Thus, the insured part of survivor pensions, like disability pensions, is determined in a more privileged way than that of old-age pensions.

The insured part of retirement pensions will be **inflation adjusted** in line with price increase and growth of average monthly wage in the Russian Federation. Throughout 2002 the insured part of retirement pensions was adjusted at the same dates and by the same adjustment ratio as defined for the basic part of retirement pensions. Meanwhile, adjustment of this part of pensions is restricted by law. To warrant this, price increase should be more than 6% over a quarter, six months or one year elapsed since the latest adjustment of the insured part of retirement pensions.

From February 1, 2002 the insured part of retirement pensions increased 6.5%, from August 1, 2002 − 9%. From February 1, 2003 the insured part of retirement pensions, unlike the basic part, will not be adjusted since price increase over the last six months of 2002 was 5.55% which is less than the “threshold” value to warrant an adjustment.

At the year’s close it is envisaged to calculate per beneficiary revenue increase of the Pension Fund of the Russian Federation to be earmarked for payment of the insured part of retirement pensions, while from April 1 it is envisaged to additionally increase the insured part of retirement pensions by the difference between the growth index of the said revenues and the total ratio of adjustment performed in the previous year.

According to tentative estimates, from April 1, 2003 the insured part of pensions could be adjusted by 10-12% as the Pension Fund of Russia's revenue increase per beneficiary could be as high as 30% (supplementary adjustment ratio R = 1.3 : 1.09 : 1.065 = 1.12).

7.2.1. Expected Period of Pension Payment

The expected period of payment of old-age pensions as established in the Federal Law "On Retirement Pensions in the Russian Federation" is **19 years (228 months)**. However, this being a general rule, a lower value will be used in the transition period until 2013 for calculating the amount of the insured part of retirement pensions. This gives certain privileges in calculating pensions on the amount of notional defined capital to those who are going to retire over the next 5-10 years.

See the table below for the specific duration of the expected period of payment of old-age pensions.

Table 7.2.1. Legislatively established value of the expected period of payment of old-age pensions until 2013.

Period	T, years	T, months
from 01.01.2002	12	144
from 01.01.2003	12,5	150
from 01.01.2004	13	156
from 01.01.2005	13,5	162
from 01.01.2006	14	168
from 01.01.2007	14,5	174
from 01.01.2008	15	180
from 01.01.2009	15,5	186
from 01.01.2010	16	192
from 01.01.2011	17	204
from 01.01.2012	18	216
from 01.01.2013	19	228

The new system offers a fairly extensive range of options for entitlement to retirement pension (parts thereof) that allow to "program" an increase of the retirement pension amount. In fact, the expected period of payment of old-age pensions can be reduced if the beneficiary chooses to postpone payment for the period of one to five years.

In this case the insured part of the retirement pension is calculated by the following formula:

IP = NDC / (T − P),
where **P** is the number of years for which payment of the insured part of the retirement pension is postponed (**P ≤ 5 years**).

For individuals who earned an entitlement to an early old-age retirement pension, no special extension of the expected period of payment of old-age pensions will be provided before 2013. It is envisaged that since January 1, 2013 there will be a program of phased introduction of record keeping for early period of payment. This is the date that deputies insisted upon though the Government proposed to start from an earlier date of January 1, 2004.

In the future the insured part of early retirement pensions will be defined on the basis of the following formula:

IP = NDC / (T + E),
where **E** is the number of years that are deficient to reach the generally established pensionable age as of the start of payment of the insured part of the retirement pension.

These decisions which actually provide for a “flexible” pensionable age in a sense do something to compensate for political impossibility to adopt in Russia a program of increasing pensionable age and reaching a nation-wide consensus on this issue.

Insured individuals will themselves define at what age they will use their right to the insured part of their retirement pensions which depends on the amount of paid-in contributions and the expected period of payment. In any case, the basic part of retirement pensions will be paid to guarantee a certain minimum income. The pension beneficiary will be less dependent on his or her earnings in this period and enjoy a greater freedom of individual choice to determine the amount of his or her pension than could be afforded in the previous system.

7.2.2. Notional Defined Capital

The notional defined capital (NDC) is the basis (foundation) for defining the amount of the insured part of retirement pensions. It is composed of the following:

- total amount of insurance contributions and other receipts to finance the insured part of the retirement pension credited on behalf of the insured individual to the Pension Fund of the Russian Federation starting from January 1, 2002;
- pension rights in cash earned before January 1, 2002;

The amount of the insured individual's notional defined capital required to determine the insured part of the retirement pension is adjusted under the same procedure and at the same dates as the insured part of paid retirement pensions.

Therefore, the notional defined capital is, on the one hand, pension rights in cash earned by the insured individual in connection with payment of insurance contributions while, on the other hand, it is the equivalent cash liability of the insurer (Pension Fund of the Russian Federation) to pay insurance coverage − the insured part of the retirement pension − in the amount equal to the amount of paid contributions.

Liability deems discharged when the said part of the pension is paid and adjusted for inflation. Liability is discharged from amounts of insurance contributions to finance the insured part of retirement pensions credited to the budget of the Pension Fund of the Russian Federation over the current period.

The government assumes subsidiary responsibility on liabilities of the Pension Fund of the Russian Federation to insured individuals and covers the shortfall from the federal budget, should payable amounts exceed the received insurance contributions.

7.2.3. Conversion of Pension Rights to Notional Defined Capital

To provide equal opportunities to different age groups, it is envisaged to take into account pension rights people earned as of January 1, 2002 and guaranteed by the previously effective pension law by their **conversion** (transformation) into notional defined capital.

The "start" notional defined capital (**NDC**) is calculated by "back count" on the basis of the estimated amount of the old-age pension (**EP**), once it is notionally provided to all insured individuals on January 1, 2002 using the following formula:

NDC = (EA − BP) x **T**, where

BP is the amount of the basic part of old-age retirement pensions as of the effective date of the new pension legislation (Rb 450);
T is the expected period of payment of retirement pensions (19 years (228 months) or a lesser value established for calculation of the insured part of retirement pensions at the date of conversion, once it is performed in the period before 2013 simultaneously with entitlement to a retirement pension).
For men who earned a general record of service of at least 25 years as of January 1, 2002 and for women with at least 20 years record of service, the estimated amount of pension is determined by the following formula:

EP = SR x **AME/W** x **AMW**, where
AME is the insured individual's average monthly earnings in 2000 and 2001 (for pension beneficiaries it may also be earnings on which their pension was previously calculated) or for any five years of uninterrupted employment;
W is the country-wide average monthly wage in the same period;
AMW is the country-wide average monthly wage in the III quarter of 2001 approved by the Government of the Russian Federation to calculate and increase the state pension which amounts to Rb 1671;

SR is service ratio:

- 0.55 in case of full general record of service (men 25 years, women 20 years), to be increased by 0.01 for each full year of general record of service in excess of the required record of service but maximum by 0.2;
- 0.3 for disabled individuals with restricted employment capability of I degree (III group).

The procedure applied to determining entitlement and recalculating state retirement pensions is used to calculate and confirm the record of service in conversion.

The ratio of the insured individual's earnings to the country-wide average monthly wage (**AME/W**) is assumed to be maximum 1.2. For residents of the Extreme North or those who earned an extensive record of service in these territories, a higher ratio could be assumed − up to 1.9 depending on the regional coefficient.

In case of an incomplete general record of service as of January 1, 2002 the notional defined capital is determined on the basis of its full value (SR is assumed to be 0.55 for all insured individuals except disabled of

III group) multiplied by the ratio of the available record of service to the required one.

The “start” amount of notional defined capital thus determined is credited to the individual nominal account of the insured individual along with amounts of insurance contributions paid and credited after January 1, 2002.

Thus, the amount of notional defined capital that the Pension Fund of the Russian Federation determines to each insured individual on behalf of the government is the equivalent of insurance contributions paid in 1991-2001 before January 1, 2002, and contributions to public social insurance paid before 1991.

7.3. The Funded Part of Retirement Pensions

Entitlement to the funded part of the retirement pension is created **upon reaching the general established pensionable age**. Exception is made only for certain categories of disabled individuals.

Beneficiaries are entitled to this part on a permanent basis (for life), the amount to be defined by the following formula:

FP = PA / T, where
PA is the amount of pension assets of the insured individual registered in the special part of his/her individual nominal account as of the date when he/she is entitled to the funded part of the retirement pension.

T is the expected period of payment of the old-age retirement pension used to calculate the funded part of the retirement pension.

This period may differ from the period established for calculation of the insured part of the retirement pension.

In entitling to a retirement pension for loss of a breadwinner, no provision is made for the funded part. The amount of pension assets of the insured individual will be paid lump sum to family members supported by him or her, or, in their absence, to other relatives of the insured individuals, or, in absence of relatives, will be accounted as pension reserves (“inherited” by all other insured individuals).

The amount of the funded part of retirement pensions shall be subject to adjustment for inflation from revenues earned on invested pension assets over the year from July 1 of the following year.

Starting from January 1, 2004 the insured individual shall be entitled to give up receiving the funded part of his/her retirement pension from the Pension Fund of the Russian Federation and transfer his/her pension assets to a private pension fund.

In a summarized form, the retirement pension amount is determined as follows:

Types of retirement pensions	**Parts of retirement pensions**		
	Basic	**Insured**	**Funded**
Old-age	Rb 450-1350	NDC/T	PA/T
Disability	Rb 225-1350	NDC/(T×R)	
Survivor pensions	Rb 225-450	NDC/(T×R) /D	-

8. Funded Pillar of Pension System

In 2002 contributions to finance the funded part of the pension system as deducted from payments made by 37 million workers (men born in 1953 and later, women born in 1957 and later) were estimated in the amount of Rb 42 billion which is approximately 1.63% of the country-wide payroll or 0.4% GDP.

In 2003 receipts to finance the funded part of retirement pensions will be Rb 49.5 billion (1.66% of payroll). Adding the investment income earned over 2002, pension assets will amount to Rb 93.7 billion (0.8% GDP) by the end of 2003.

In the medium term, deductions will grow to make approximately 2.04% (2004) and 2.47% (2005) of the country-wide payroll.

Long-term forecasts suggest that the funded pillar of the pension system will reach the first stage of maturity by 2025 when reserves accumulated for individuals born in 1967 and older is expended (contributions made at the rate of 2% of earnings). By this time it is expected that pension assets accumulated largely from contributions of individuals born after 1967 (at the rate of 6% of earnings) will amount to 40-45% GDP. However, the reserves are projected to grow until 2050-2060 possibly peaking at 110-120% GDP as amounts of contributions and payments equalize (“second” stage of maturity). Further, pension accumulations will decrease as assets are sold to ensure payment of the funded part of retirement pensions.

Considerable amounts of resources to be accumulated require setting up fairly strict investment rules and providing government guarantees to ensure payment of pension benefits from these resources. These issues are regulated by the Federal Law "On Investments for Financing the Funded Part of Retirement Pensions" adopted in 2002.

8.1. Organization of Pension Asset Investment

In accordance with the law, pension assets will be passed to private asset managers which will propose a specific investment portfolio and which must comply with requirements established by the law. These companies should be duly authorized (licensed) to perform the respective operations and selected by public authorities on the basis of tenders. Tenders will be organized to identify whether the company complies with requirements but not to select the best of the available investment portfolios nor define the amount of resources to be passed for trust management.

It has been principally decided that workers will actually retain the right to choose on individual basis the asset manager (of those selected through a tender) which he or she believes to ensure the maximum performance of pension asset investment. Workers on whose behalf pension assets are to be accumulated may exercise their right starting from January 1, 2004. It was also decided that pension assets accumulated for the benefit of those who failed to make a choice will be invested into government securities managed by the government-owned asset manager set specifically for the purpose. Workers will be entitled to select another asset manager on the annual basis.

Those who have 5 years or less before entitlement to a pension will have a limited choice as they need to make up a less risky investment portfolio. It is envisaged, however, to regulate these issues in a specific federal law to be adopted no later than 2007.

The law provides for details of implementing the workers' right to select an asset manager (an investment portfolio) which largely depends on the technology of personalized records. Thus, under the current procedure employers report to the Pension Fund of the Russian Federation on how much insurance contributions they pay on behalf of each worker and how these split up into the insured and funded parts but these reports do not go with every other payment but only once a year no later than April 1 of the year following the reporting year.

On the basis of this information (reconciled against amounts of paid-in contributions and adjusted as necessary), the Pension Fund of the Russian Federation will issue an account balance statement on the annual basis to every insured individual and propose to make a choice to dispose of these resources.

Moreover, the Pension Fund of the Russian Federation will ensure transfer of pension assets to the asset manager of the insured individual's choice no later than December 31 of the year in which the worker instructed the Pension Fund to do so. The amount of pension assets to be transferred is calculated on the basis of the account balance as of January 1 of the current year plus investment return.

Since the resources credited to finance the funded part of the retirement pension cannot be identified before the employer provides personalized records, it has been decided to ensure their investment under the same procedure as established for individuals who failed to make a choice (i.e., in government securities).

Thus, minimum two-year amount of deductions for the funded part of the retirement pension (0.8−1% GDP) will be invested in government securities, at least, before transition to real-time reporting of individual data. Implementing this technology in the mandatory pension insurance system has been believed to be costly and irrelevant.

A specialized depository will exercise control of compliance by the asset manager with requirements of the law and provision of the investment memorandum.

In addition, the law provides for organization of a multi-level government and public control over pension asset investment operations performed by all participants in this process.

8.2. Investment Restrictions

The law provides for certain restrictions in terms of authorized areas of pension asset investment, prohibited instruments, limited shares of certain asset classes and restrictions of foreign investments.

Pension assets may be invested into:

- government securities of the Russian Federation;
- government securities of the constituent members of the Russian Federation;
- bonds of domestic issuers;
- shares of domestic issuers incorporated as open joint-stock companies;
- stock (shares) of index investment funds making investments into government securities of foreign countries, bonds and shares of other foreign issuers;
- mortgage securities issued in conformity with the mortgage securities law of the Russian Federation;
- ruble cash balances with credit organizations;
- ruble deposits with credit organizations;
- foreign exchange balances with credit organizations.

Pension assets may not be invested to:

- purchase securities issued by asset managers, brokers, credit and insurance organizations, the specialized depository and auditors contracted for services;
- purchase securities of issuers undergoing rehabilitation proceedings or bankruptcy proceedings (supervision, receivership, conservatorship) in conformity with the bankruptcy law of the Russian Federation or which underwent such proceedings during two preceding years.

Investments into securities of foreign issuers will be allowed starting from 2004 but these should not account for more than 20 percent of the investment portfolio. In 2004-2005 the share of foreign investments will be limited to 5%, 2006-2007 − 10%, 2008-2009 − 15% of the investment portfolio. Investments into these assets will be made by purchasing shares (stock, interest) of index investment funds.

In accordance with the law, pension assets are held by the government of the Russian Federation rather than insured individuals. Therefore, asset managers should specifically make sure there is no outstanding action at law against the Russian Federation to avoid penalizing pension assets as the property of the Russian Federation. Neither asset managers nor the Russian Federation are interested to allow this course of developments. Should a precedent occur, the Russian Federation may revise the terms and extent of foreign investment of pension assets.

8.3. Private Pension Fund Transfer Option

Starting from January 1, 2004 the insured individuals on whose behalf pension assets are accumulated, may transfer them to a private pension fund. Along with the Pension Fund of the Russian Federation, private pension funds are recognized as full insurers with respect to the funded pillar of the mandatory pension insurance system.

Workers enjoy the right to not only move to a private pension fund but move assets between funds and revert to the Pension Fund of the Russian Federation. In the late 2002 the Federal Law "On Private Pension Funds" was amended to accommodate changes required to individuals to exercise this right.

Many participants in the funded system will contribute 2 percent of their earnings. Understandably, accumulations amounting to a monthly wage will build up only in 4 years after which they will be probably interested to manage these resources. It is easy to imagine that before this date only well-paid individuals will concern themselves with selecting investment portfolio of those proposed by asset managers, and also younger workers or individuals better informed on financial markets who wish to receive a higher investment income than interest earned on government securities.

It is possible that participants in private pension funds, especially large corporate ones, will be by far more active in transferring pension assets to the private sector. To date, private pension coverage extends to more than 3.8 million people. There is a probability that it is private pension funds that will become the first large collective investors of assets accumulated under mandatory pension insurance in the early years of reform.

9. Occupational Pension Systems

Approximately 3 million individuals are employed in hard and hazardous work conditions and at excessively heavy and intensive jobs in industry, construction, communications and transport. Pension privileges in terms of early retirement have been granted to them since 1947. They could be entitled to a pension 10 years (List No. 1) or 5 years (List No. 2) before the generally established pensionable age, and also irrespective of age in case of a long record of professional employment.

Though jobs with inadequate work conditions have been decreasing over the last 10 years (together with the share of those employed in industry), the relative number of early retiring beneficiaries has been growing. In the late 1990s entitlement to every seventh pension was given earlier than the generally established pensionable age without any special reduction of its amount.

No provision was made for any additional source of financing payments in the period before reaching the regular pensionable age. The privilege was in fact financed by beneficiaries themselves by redistribution of their anyway modest income provided by the public for payment of pensions.

Only employers with inadequate work conditions obviously benefited from hiring workers to these jobs. In a market economy this situation cannot be considered fair, first of all, by employers who provide adequate work conditions (including because of costs of improving them) but at the same time bear the equal tax and insurance burden on their payroll.

Therefore, it was proposed in the course of the reform to maintain the entitlement of some workers with a long record of employment in hard and hazardous work to an early retirement pension while providing the others with entitlement to occupational pensions, an absolutely new type of provision to be financed from additional contributions by employers that use their labor in inadequate conditions.

It was proposed in the draft resolution for setting up occupational pension schemes, to be made mandatory and operating on the basis of the funded principle, to introduce insurance contributions payable either to the Pension Fund of the Russian Federation or a private pension fund.

Insurance contributions will vary depending on work conditions − 14% for those employed at underground work, hard and hazardous work, and in hot process workshops (List No. 1) and 6% for those employed at jobs with special conditions of work (List No. 2).

Moreover, it was proposed not to charge any contribution on earnings in excess of Rb 100 thousand a year. If the amount of annual earnings is less than one half of this maximum value, a fixed contribution will be paid, to be calculated on the basis of the contribution rate and specified minimum amount of earnings.

Another alternative is envisaged with respect to workers employed at jobs with inadequate work conditions who are entitled to retire 5 years earlier than the established pensionable age. Rather than making contributions to an occupational pension system, the employer will have an option to pay a compensation in the amount of these contributions to wages of workers.

Occupational pension systems may be set up on the basis of a contract between the employer and the Pension Fund of the Russian Federation or a private pension fund.

An occupational pension system set up on the basis of a contract with the Pension Fund of the Russian Federation or a private pension fund should also involve an asset manager and a specialized depository.

It is proposed to invest pension assets to be accumulated by occupational pension systems under the same procedure and rules as established for investment of pension assets in the mandatory pension insurance system.

Occupational pensions will be paid from the date of entitlement until the generally established pensionable age (normally for 5 or 10 years). The amount of pensions will be calculated by dividing the amount of assets by the payment period. If no entitlement to occupational pensions is earned while pension assets are accumulated, the worker will receive this amount until the generally established pensionable age.

Discussions of this draft law in the State Duma resulted in a fairly normal collision of contrary opinions. Trade-unions of workers argued that the amount of future payments would be too small. Employers argued that contributions were too large and cumbersome for those companies where the share of workers employed in hard and hazardous conditions could be as high as 80-90%. Nevertheless, a compromise should be sought, and it is likely that the law adopted in the first readings, possible as amended, will become such a compromise.

10. Conclusion

In preparing a pension reform in Russia, efforts were made to study the pros and cons of pension system reform in Latin American countries, looking into details of decisions implemented in Sweden, Italy, Poland, and analyzing the measures to reform pension systems of Kazakhstan, Kirgizia and Hungary.

The new Russian pension system borrowed many aspects of international pension systems both in terms of organization and principles of operation. However, specific decisions implemented as part of the pension reform were hinged on those problems which the pension system is expected to address in the public eye taking into account both the forthcoming demographic crunch and current economic challenges to its viability.

Abstruct (Russian)

В России с 1 января 2002 года началась пенсионная реформа, предусматривающая создание трехуровневой пенсионной системы и введение накопительных элементов финансирования трудовых пенсий для «молодых» работников.

Новая пенсия состоит из базовой части, выплачиваемой в твердой сумме для обеспечения определенного гарантированного дохода пенсионера независимо от его стажа и заработка, а также страховой и накопительной частей, зависящих от сумм индивидуально учитываемых в течение всей трудовой деятельности страховых взносов и сформированных накоплений.

Реформа предусматривает сохранение и фиксацию пенсионных прав, приобретенных по прежней системе, в форме расчетного пенсионного капитала. Реформа направлена на повышение уровня пенсионного обеспечения россиян на основе обеспечения долгосрочной финансовой устойчивости пенсионной системы.