

A strategy for reforming the Russian pension system¹

1. Introduction

It is frequently argued that in a period of economic crisis the correct course of action is to implement an “anti-cyclical” fiscal policy that entails lowering the tax burden and increasing state expenditure. In Russia, the instruments of anti-cyclical budgetary policy are progressive rates of export duty on oil indexed to world oil prices and the expenditure of resources accumulated in the RF Reserve Fund during periods of economic growth. An additional anti-cyclical measure is the tax on profit, receipts from which, however, are far more volatile than the dynamics of gross domestic product.

In late 2008 a number of additional anti-crisis measures were urgently implemented in order to reduce the tax burden on the economy. The rate of profits tax was reduced from 24% to 20%; the ‘depreciation tariff’ was increased three-fold; the procedure for advance payment of profits tax was altered; more flexibility was granted in the accounting of expenditure when estimating liability to profits tax; and a number of changes were introduced in the rules for calculating and paying VAT, including the option of quarterly payment.

Coincidentally with the implementation of the anti-crisis policy, the RF Government in October 2008 and April 2009 adopted measures proposed by the RF Ministry of Health Care and Social Development designed to ensure the sustainability of Russia’s pension system. Since these measures, when implemented, will place an increased fiscal burden on

¹ This article was first published in *Ekonomicheskaja politika [Economic Policy]* No 3, 2009.

the economy that it will be impossible or very difficult to offset by lowering other taxes without damage to budget revenues and since this will run counter to the objectives of the anti-cyclical fiscal policy, implementation should, in our opinion, be delayed until stable economic growth has returned.

The need for a pension reform that would increase the level of pension provision of Russian citizens and resolve the problems of imbalance in the pension system was realized long before Russia began to experience the impact of the global economic crisis. Our estimates suggest that in an inertia-based scenario the pension system will be in deficit by over 6 % of GDP by 2020.² A discussion of alternative models of pension reform is therefore a matter of urgency. In this article we shall assess the scale of the problems faced by the current pension system, analyze the solutions that have already been proposed and make suggestions for reforming the system in the medium-term.

2. The main problems of the existing pension system

Russia's current pension system will unavoidably, in the medium term, face two serious challenges.

Firstly, Russia – like the majority of developed countries – is being affected by population ageing. It is population ageing that creates difficulties for the future of a pension system that is based on the principle of “solidarity between generations”³. This negative demographic trend

² In this article, our forecast of the parameters of Russia's budgetary system was built on scenario-based international oil prices, an estimated GDP growth rate, the consumer price index, growth of the population's income, and some other macroeconomic parameters determined in the Concept of the Long-Term Strategy for the Socio – Economic Development of the Russian Federation to 2020: <http://www.economy.gov.ru/wps/wcm/myconnect/economylib/mert/welcome/pressservice/eventschonicle/doc1217949648141>.

It is evident that in the short term, given the ongoing economic crisis, the probability of these forecast indices actually being achieved is not high. Our long-term estimates, by contrast, will, for the most not be affected by short-term fluctuations in the economy.

³ In accordance with the inter-generational solidarity principle, payments made by the working population pay for the pensions of the older generations. The alternative is a cumulative system whereby each generation, while of

represents a strategic long-term challenge for the Russian pension system. (see *Table 1*).

As we see from Table 1, over the next decade demographic change in the Russian Federation will result in significantly increased pension expenditure owing to an increase in the number of pensioners and to a simultaneous decline in the number of employed citizens making pension contributions. By 2020, the present ratio of 340 persons of post-retirement age per thousand citizens of working age will increase to 450 persons. As the population grows older, the situation will deteriorate further.

Table 1

Ratio of working-age population to population older than working age 2007 – 2050*

Year	Population, million persons		Number of persons older than working age per 1000 of working age
	Working age	Older than working age	
2007	89.8	29.4	327
2010	87.5	30.8	352
2015	81.3	32.6	401
2020	75.3	33.9	450
2025	71.2	33.9	476
2030	67.7	33.3	492
2035	63.1	32.9	521
2040	57.1	32.9	576
2045	50.7	32.9	649
2050	45.8	31.7	692

* Table 1 presents an inertia-based demographic forecast, without any changes in the main demographic indices for birth rate and death rate.

Source: Rosstat; IET estimates.

The pre-conditions that will ensure an effective functioning of a pensions system based on the principle of inter-generational solidarity (in

working age, accumulates its own pension provision.

the absence of 'external funding') are favourable demographics (a reproduction or overall increase in the size of the population), stable growth of the level of remuneration and no significant long-term changes in the proportion of the population in employment. However, if the population is ageing and economic growth depends largely upon the external economic conjuncture, there will be a periodically occurring or steadily increasing shortfall of the financial resources required to ensure the payment of pensions to future generations (or, at least, an increase in the risk of such a development).

In Russia, an increasing proportion of pensioners in the population will confront the government with a rather difficult choice between the only two strategies that are available and both of these are fraught with political or budgetary risks:

1) maintaining the total amount of spending on pension payments as a % of GDP) at the level of 2007 will mean the replacement ratio falling from 23.4 % in 2007 to 16 % by 2020 and this will have to be accepted;⁴

2) if the replacement ratio is maintained at a socially acceptable level of about 30 %, pension expenditure will have to increase to 8.2 % of GDP in 2020, that is, by 3.5 % of GDP compared with the level of 2007.

However, abandoning the principle of inter-generational solidarity and going over to a cumulative pension system will by not solve all problems, in the short- or medium-term. Going over to a cumulative system will require substantial additional resources for funding the so-called "dual payment" of working citizens during the transition period, during which the working generation will be have to accumulate the means to fund their own pensions while at the same time paying for the pensions of the preceding

⁴ By replacement ratio we mean the ratio of the average pension to the average wage. The question whether the replacement ratio is appropriate as a benchmark for the development target of a pension system is controversial,

generation. The pension contributions paid by one generation may be insufficient to fund the pension payments of two generations. Besides, for a cumulative pension system to function adequately there have to be effective ways of investing pension funds.

Secondly, the existing mechanisms for funding the payment of pensions provide no mitigation of the financial impact of a deteriorating demographic situation, and cannot ensure stability of funding in the medium-term. What we are referring to is, above all, the absence of a system of indexation of the single social tax (SST).

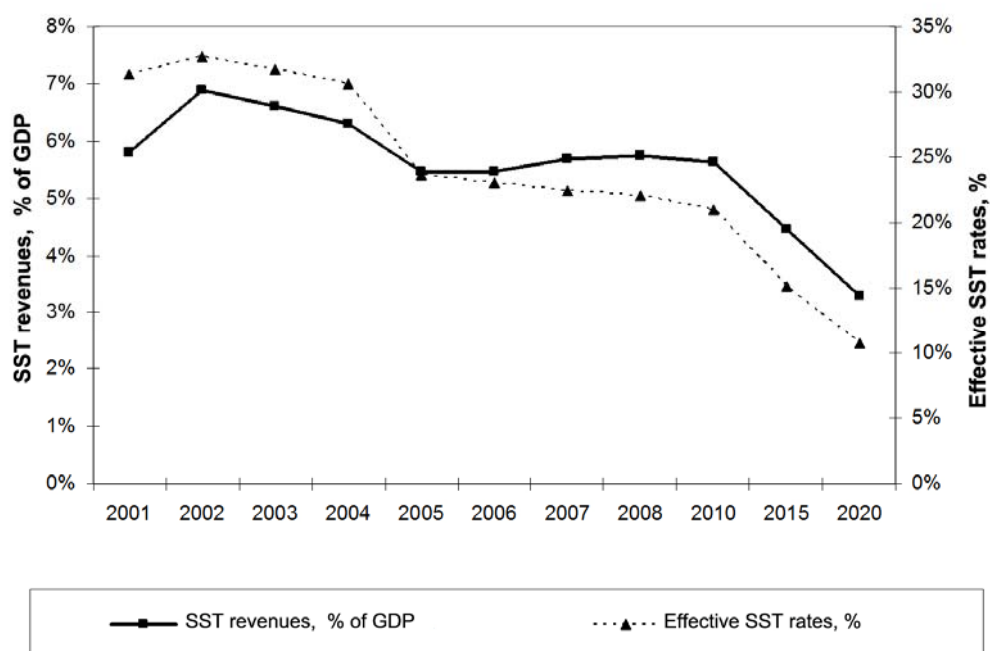
A regressive scale in the rates of the Single Social Tax (SST) in the absence of any indexation of these rates will result in a situation in which increasing nominal wages will diminish the effective rate of SST. In conditions of economic growth, when the population's incomes were increasing at an accelerated rate, the SST tax base increased more rapidly than its effective rate declined. Consequently, for a few years SST revenues actually increased as a % of GDP. However, in 2009, owing to economic instability, SST revenues will, most probably, decline, because economic difficulties impact negatively on the expansion of the tax base, whilst inflation (the growth of nominal wages) will result in a further decline in the effective rate. When economic growth returns, the high growth rates of nominal wages – assuming the existing tax system is retained – will result in a further decline in the volume of revenues as a % of GDP (See *Fig. 1*).

If we assume that expenditure on pensions will increase in order to maintain the replacement ratio at a level of approximately 30 %, then this expenditure will increase by an amount equivalent to 3.4 % of GDP in the period 2010–2020 alone. At the same time, in the absence of any indexation of the limits for applying the regressive rates of SST, the revenues of the

but we shall use it in this article as a means of comparing a number of approaches to reform of the pension system.

pension system will fall by 1.9 % of GDP by 2020 as compared with 2008⁵. As a consequence of an increase in the expenditures of the pension system and a reduction in revenues, the deficit of the pension system will increase by 2020 by up to 5.3 % of GDP.

Figure - . Dynamics of effective SST rate and revenues in 2001 – 2007 and projections to 2020



Source: Rosstat; Federal Tax Service; Ministry for Economic Development and Trade; IET estimates.

⁵ The overall decline in revenues from SST without indexation will amount to 2.5 % of GDP (5.8 % of GDP in 2008, and 3.3 % of GDP in 2020s).

Table 2

Balance of revenues and expenditures of the pension fund in 2007 and 2020 as a % of GDP

	2007	2020
Pension expenditure*	4.8	8.2**
SST revenues and mandatory pension insurance Contributions (less cumulative component)	3.9	2.0
Balance of Pension Fund	- 0.9	- 6.2

* Expenditure on the basic component of the labor pension, the insurance component of the labor pension, benefits and compensation payments and on pensions funded from the federal budget.

**In the event of the replacement ratio being maintained at 30 %.

It is therefore quite evident that in order to balance the pension system steps will have to be taken to reduce expenditures and/or increase revenues. Bearing this mind, we shall now review the proposals put forward by the RF Ministry of Health Care and Social Development and by the RF Ministry of Finance.

3. The proposals of the RF Ministry of Health Care and Social Development for eliminating the deficit in the pension system.

On 1 October 2008, the Government of the Russian Federation decided to implement a large-scale reform of the Single Social Tax in 2010. The main provisions of the pension reform and reform of SST, as proposed by RF Ministry of Health Care and Social Development, are as follows.

Increasing insurance contributions: The source of funding for the insurance component and of the basic component of the pension will become the insurance contribution (at present the deficit in payments of the basic component of the labour pension is covered out of the Federal Budget). The basic component of the retirement pension will become an integral part of the insurance pension and in future it will be subject to indexation in line with the growth of revenues of the Pension Fund of the

Russian Federation – but this indexation will not exceed the growth in average monthly wages⁶. So that the insurance contribution can indeed be used to fund the basic and insurance components of the labor pension, this contribution will be significantly increased (the current rates of the Social Tax are given in Table 3; the insurance contributions proposed by the RF Ministry of Health Care and Social Development are given in Table 4). As part of this reform, a limit to the amount of remuneration received by an employee upon which insurance contributions can be levied was fixed at 135% of the average annual wage. This limit was subsequently to be indexed annually in accordance with the growth of nominal wages. However, in April 2009 the concept of the RF Ministry of Health Care and Social Development was modified and at present it is proposed that in 2010 the limit should be fixed at 415 thousand roubles per annum, despite the fact that this sum has been estimated to be over 150 % of the average annual wage. It has also been suggested that the increase in pension contributions should be postponed until 2011.

⁶ At present, the basic pension serves as a kind of state guarantee of a minimum pension provision and does not depend on employment history or the amount of contributions actually paid (legislation requires only that a person have a minimum employment history entitling him or her to a labour pension; if this requirement is not fulfilled, then other types of pension are assigned). The basic component is established as an absolute value, and is then indexed to the rate of inflation. The insurance component of the pension depends on the amount of mandatory pension insurance contributions actually paid. Indexation of the insurance component of the pension is pegged to the rate of inflation or to the growth rate of the insurance component of SST (if the latter is higher than the rate of inflation per pensioner. The amount of the cumulative component of the pension depends not only on the amount of contributions but also on the yields generated by the pension fund to which the savings have been assigned.

Table 3

Funding the existing pension system

Tax base, thousand roubles	Contribution to insurance component of pension,%		Contribution to cumulative component of pension, %		Basic compon ent of pension, %	Transf er to pensi on fund, %	<i>For reference:</i>	
	For those born in 1966 and earlier	For those born in 1967 later	For those born in 1966 and earlier	For those born in 1967 and later			<i>Transfe rs to other off- budget funds, %</i>	<i>SST rate, %</i>
up to 280	14	8	0	6	6	20	6	26
from 280 to 600	5.5	3.1	0	2.4	2.4	7.9	2.1	10
Over 600	0	0	0	0	2	2	0	2

Table 4

Proposals of the RF Ministry of Health Care and Social Development for funding the Pension System in 2010 (%)

Tax base, thousand roubles	Insurance tariff registered for individual accounts				Solida rity tariff	Insura nce rate, <i>total</i>	<i>For reference:</i>	
	Contribution to insurance component of pension		Contribution to cumulative component of pension				<i>Transfe rs to other off- budget funds</i>	<i>Consolida ted rate of insurance contributi on</i>
	For those born in 1966 and older	For those born in 1967 and younger	For those born in 1966 and older	For those born in 1967 and younger				
up to 415	16	10	0	6	10	26	8	34
Over 415	0							

In spite of the growing tax burden, a mandatory pension insurance contribution fixed at a level of 26 % for all insured employees is insufficient to fund the basic and insurance components of the pension in the long run. The RF Ministry of Health Care and Social Development has therefore proposed that insurance contribution be increased in accordance with increases in the needs for funding. (See *Table 5*).

The tariffs proposed, according to our calculations, are extremely high. If the proposals of the RF Ministry of Health Care and Social Development are accepted, Russia will become one of the countries with the highest levels of mandatory pension contributions levied on wages (see below).

Implementation of an insurance-based pension system. The intention to move to ‘insurance-based’ principles in the pension system is central to the proposal of the RF Ministry of Health Care and Social Development. In the proposal, insurance contributions are viewed as distinct from taxation and this distinction is invoked to justify a number of provisions, in particular that which stipulates the need to administer insurance payments independently of the tax administration. However, we believe that the distinction between taxes proper and insurance contributions in the proposals is less clear and that the contributions are less “insurance-based” than is claimed.

Table 5

Insurance tariffs proposed by the RF Ministry of Health Care and Social Development (%)

Insurance tariff	2010	2015	2018	2025	2030	2039	2047
TOTAL, including:	26	27	29	30	31	33	34
– Solidarity tariff	10	11	13	14	15	17	18
– Tariff levied on individual accounts	16	16	16	16	16	16	16
<i>For reference: Integral tariff for pension, medical and social insurance*</i>	34	35	37	38	39	41	42

* The integral tariff has been estimated assuming that in 2010 – 2047 the tariffs for mandatory medical and social insurance will not be changed and that they will in total amount to 8 %.

First of all, we should note that, from the point of view of employers, there is no essential difference between the payment of employees' mandatory insurance contributions and the payment of taxes. For this reason, the size of insurance contributions needs to be taken into account when calculating the tax burden on enterprises and on the labor market.

Another important circumstance is that the different components of the insurance contribution proposed by the RF Ministry of Health Care and Social Development bear little resemblance to those of a classical insurance agreement, whereby payments linked to an insured event depend upon the size of the insurance premium and actuarial calculations. The insurance component of the pension is not fully compatible with classical insurance principles because the sum paid out (the pension received) is largely determined not by the amount of contributions that have been paid in but by the indexation mechanisms provided for by legislation, which envisage adjustments according to the rate of inflation and the growth of wages in nominal terms in preceding periods. The solidarity tariff is essentially a tax, because the amount paid in bears no relation to the size of the future pension. It should be noted that, whereas at present the 'solidarity

component' of the SST (the revenues allocated to payment of the basic component of the pension) amounts to approximately to 29 % of SST revenues to the Federal Budget and of contributions to mandatory pension insurance, after the switchover to the 'insurance principle', the share of the solidarity tariff (which is essentially a 'tax') in the overall mandatory pension insurance tariff will increase to 38.5 % in 2010 and continue increasing until it reaches 52.9 % in 2047 (see *Table 5*). This means that the proposed insurance contribution is to a greater extent a "tax" (that is, a mandatory payment, the return from which is not tailored to the individual) than the currently existing SST.

We do not criticize the overall design of the various components of the pension provision since, in our point of view, a system of state pension provision cannot be based on insurance principles alone – it should include a mandatory insurance-based cumulative component and a redistributive social security element funded by taxes. However, one should not overestimate the difference, for enterprises or employees, between the payment of taxes and the payment of mandatory insurance contributions. 'Insurance contributions' amounting to 34 % (in time – 42 %) of wages represent the same fiscal burden on the wages fund as a tax paid at that rate.

Valorisation of pensions for senior age groups. The RF Ministry of Health Care and Social Development has also proposed a valorisation of the pension entitlements of older generations. It is suggested that there should be a one-off increase in the monetary value of pension entitlements of 10% as of 1 January 2002 plus 1 % for each full year of employment prior to 1 January 1991. This re-evaluation is to be funded out of the Federal Budget (at a cost, in 2010, of 484.5 billion roubles).

This upgrading of pension entitlements will create additional spending obligations for the Federal Budget that will be subject to 'automatic' indexation according the rate of growth of the wages fund,

which indexation must not be less than the rate of inflation⁷. A slight and gradual decline in the volume of these expenditures as a percentage of GDP will take place from 2012 onwards, owing to a decline in the number of pensioners in the older age groups. Even so, the adoption of such obligations seems especially dangerous in unstable economic conditions and at a time when the government may be faced with the need to strike a difficult balance between coping with a budget deficit, providing social support to the population and controlling inflation. For these reasons, it would be preferable to have greater freedom with regard to spending obligations. Rather than make commitments dramatically to increase the government's social obligations, it would be better to rely upon indexation of the existing basic pension in line with inflation and gradually increase the basic pension at a rate that would ensure social protection of the population without adding to the risk of inflation or to the formation of a budget deficit.

The administration of contributions: One very important change introduced proposed by the RF Ministry of Health Care and Social Development is the transfer of the administration of pension contributions from the Federal Tax Service to the RF Pension Fund. This transfer was justified by the need not only to increase the collectability of payments, but also to ensure a more frequent updating of records, which currently takes place annually. However, this purely technical objective does not provide sufficient reason for increasing the burden on businesses through the creation of an additional supervisory body.

⁷ Under current legislation, indexation of the insurance component of the labor pension and of estimated pension capital are similar, namely according to the level of inflation or the growth rate of the insurance component of SST (if that rate exceeds the rate of inflation), per pensioner. If the upper limit of taxable income were to be indexed to the growth of average wages, the revenues of the Pension Fund of the Russian Federation would increase in line with the growth of the wages fund.

4. Analysis of the potential consequences of implementing the proposals of the RF Ministry of Health Care and Social Development

Imbalance of the pension system in the long term

First of all, we should note that the proposed increase in the tariff will imply, for the majority of enterprises, a greater tax deduction from their wages fund (an increase of about 1.6 % of GDP). As we have already noted, the proposed rates of insurance contribution appear to be unusually high when compared with those of the majority of OECD countries. An increase in the tax burden on labor runs counter to the current global trend of reducing the tax load on labor and capital and increasing that on consumption as a means of improving the competitive capacities of national economies.

Nor will the proposed substantially increased insurance contributions guarantee equilibrium of the pension system in the long run. To achieve this end, the proposed reform package envisages constantly increasing rates of insurance contributions. The contention that the country will acquire a deficit-free pension system if the Ministry's proposals are implemented is valid only if by the pension system one has in mind the RF Pension Fund, since substantial allocations from the Federal Budget will be needed to guarantee the funding of pension payments, irrespective of insurance contributions.

As a minimum, over the next decade the Federal Budget will have to cover the cost of the additional expenditures of the RF Pension Fund deriving from pension valorisation – to the extent of approximately 1 % of GDP. Thereafter, this additional funding will increase in order to prevent a decline in the replacement ratio. The deficit of the pension system by 2020 will exceed 4 % of GDP (*Table 6*).

Table 6

Revenues and expenditures of the pension system in 2007 and 2020 (as a % of GDP)

	2007	2020
Pension expenditure*	4.8	8.2**
SST revenues and mandatory pension insurance contributions (less cumulative component)	3.9	4.1***
Balance of the pension system	- 0.9	-4.1

* Expenditure on the basic component of the labor pension, the insurance component of the labour pension, benefits and compensation payments and also pension payments funded out of the Federal Budget.

**In the event of the replacement ratio being maintained at 30 %. In the variant suggested by the RF Ministry of Health Care and Social Development, the replacement ratio by 2020 will be maintained at 22.9 %. For this level to be achieved, 6.6 % of GDP will be required and the deficit will drop to 2 % of GDP, but it will still have to be covered out of the Federal Budget.

*** In absence of the negative effect of the rapidly increased burden on the labor market upon the level of tax evasion, the level of employment, the rate of economic growth and the dynamics of the share of the wages fund in GDP.

As a result, in 2020 – 2030, even if the rates of social contributions are extremely high, a sum of approximately 4 % of GDP will have to be paid out of the Federal budget if the replacement ratio is to be maintained at 30 %⁸.

Diminishing competitiveness of the Russian economy

An increase in insurance contributions runs counter to the current global trend of reducing the tax burden on profit and wages and increasing that on consumption.

The level of taxation levied on wages in order to fund mandatory pension provision in Russia if the proposed reform is implemented will be higher than that in France, Germany, Sweden, Austria and other developed countries (see *Table 7*).

⁸ The reason for this is the fact that, in 2020 – 2030, payments for the cumulative component will still be small, while contributions for the cumulative pension will reach their peak because a large group of workers born before 1967 will retire. As a result, the resources for the redistribution component of the pension system will be insufficient. The deficit of the redistribution component of the pension system will be further aggravated by the ageing of the population. As a consequence, during that period it will be practically impossible to maintain the replacement ratio at a level of 30 % without raising the retirement age.

Table 7

Rates of mandatory pension contributions in OECD countries

Country	Rates			Ratio of income taxation margin to average wage
	Employees	Employees	Total	
South Korea	4.50	4.50	9.00	1,627 %
Canada	4.95	4.95	9.90	104 %
USA	6.20	6.20	12.40	237 %
	1.45*	1.45*	2.90*	no threshold
Japan	7.32	7.32	14.64	148 %
France	6.65	8.30	14.95	100 %
	0.10	1.60	1.70	no threshold
Luxemburg	8.00	8.00	16.00	208 %
Sweden	7.00	10.21	17.21	110 %
Slovakia	4.00	14.00	18.00	531 % – for employees
				266 % – for employers
Germany	9.95	9.95	19.90	147 %
Turkey	9.00	11.00	20.00	270 %
Switzerland	10.05	10.05	20.10	No threshold
Austria	10.25	12.25	22.50	122 %
Russia, 2010	0.00	26.00	26.00	135 %
Hungary	8.50	21.00	29.50	316 %

* hospital insurance contribution

Source: Taxing wages 2006/2007 – OECD 2008.

A dramatic increase in the tax burden on the wages fund will make for an increase in the labour costs of enterprises (or to a reduction in wages in nominal terms if the level of labour costs for enterprises remains constant - a more probable scenario during at a time of increasing unemployment). This, according to our preliminary estimates, will reverse the downward trend displayed during the 2000s in the share of companies' expenditures going to wages, including deductions for social contribution⁹. This creates a risk that the Russian economy will become increasingly uncompetitive in international markets. We can also predict an increase in unemployment, which will occur in the most socially dangerous segment of the population – the low-paid and less-qualified strata of the labour force.

⁹ Kapeliushnikov R. I. *Proizvoditel'nost' truda, real'naia zarabotnaia plata, udel'nye izderzhki na rabochuiu silu* [Labor productivity, real wages, per unit labor costs]. // *Vestnik Levada-tsentra* [Levada Center Herald]. 2007. No. 2.

The negative effects of the reform of mandatory pension insurance contributions proposed by the RF Ministry of Health Care and Social Development will be felt most acutely by those who pay taxes under special tax régimes (simplified taxation, single tax on presumptive income and single tax on agricultural producers). In 2007 the estimated total of insurance contributions paid into mandatory pension insurance by taxpayers under special tax régimes (at a rate of 14%) was between 35 and 38 billion roubles. After adjustment for growth of wages in nominal terms of 30 % in 2008 the total volume of insurance contributions to mandatory pension insurance paid under special tax régimes in 2008 was approximately 50 billion roubles. This rate will hardly increase, least of all in conditions of economic crisis. Even so, an increase of the insurance contribution tariff from 14 % to 26 % in the conditions of 2009 will result in the tax burden on the wages of taxpayers under special tax régimes increasing by 86 % or by 42 billion roubles. If the variant that envisages an increase in the total of payments into social funds to 34 % is implemented, the tax burden on the wages fund will increase almost 2.5 times, or by 70 billion roubles.

A less progressive tax system

As we have already explained, the RF Ministry of Health Care and Social Development claims that equilibrium of the pension system can be achieved by dramatically raising the tariff for pension insurance. It is also envisaged that the currently existing regressive scale of the Single Social Tax (SST) should be replaced by an upper threshold of liability to insurance contributions of 415 thousand roubles of earnings (this limit would subsequently be indexed to the growth of the wages fund). The reasoning behind this is that, under current pension legislation, any increase in the amount of pension contributions (for example, following a substantial indexation of the SST – which will be discussed later) will result in an increase in the obligations of the pension system and of substantial obligations in relation to the well-to-do strata of the population. This is

considered to be undesirable and so a two-tier scale is proposed: on earnings up to 415 thousand roubles the tariff will be 34 %, on earnings over 415 thousand roubles it will be 0 %.

The solution offered by the RF Ministry of Health Care and Social Development will result in a loss of progression in the tax system. If, at present, part of the basic pension is funded out of taxes levied on the salaries of the higher-income strata (annual salaries in excess of 600 thousand roubles are taxed at 2%), under the new scheme, the basic pension component will be funded mainly by a tax (insurance contributions) on the wages of lower-paid workers. For example, whereas at present the contribution to the basic pension from an annual wage of 280 thousand roubles is 6% of the SST, in the event of the Ministry's proposals being implemented, 10% will be levied as the solidarity component. Thus, under the pretext of a switchover to an insurance-based system, a sharply regressive scale of tax rates will be introduced, whereby pension payments to all pensioners will be funded by out of taxes on lower-paid workers and by transfers from the Federal Budget.

Table 8 demonstrates the estimated tax burden on employees with different levels of earnings. What we find is that the tax burden of 99% of those employees who account for 94 % of the total wages fund will increase. The tax load on the lowest-paid workers with an annual wage of under 280 thousand roubles will increase by 31%. The highest increase in the tax burden - of 63 % - will be for those with an income of 415 thousand roubles per annum. For the highest-paid workers with earnings of over 2,415 thousand roubles per annum the tax load will decrease on average by 15 %.

Table 8

**Change in tax burden per employee resulting from abolition of the SST
and introduction of insurance contributions in 2010.**

Annual remuneration, thousand roubles		Share of group in total number of workers, %	Share of wages in total wage fund, %	Total tax burden per worker, thousand roubles				Change in tax burden, %	
From	To			SST		Insurance contributions proposed by RF Ministry of Health Care and Social Development		From	To
				From	To	From	To		
0	280	67	35		72.8		95.2	31	
280	415	16	19	72.8	86.3	95.2	141.1	31	63
415	600	9	16 %	86.3	104.8	141.1	141.1	63	35
600	2415	8	24 %	104.8	141.1	141.1	141.1	35	0

Source: Rosstat; Ministry of Economic Development and Trade; IET estimates

Such an uneven redistribution of the tax load is surely unjustified. As the experience of developed countries show, the better-off strata of the population usually enjoy a longer lifespan, and so in the event of the proposals of the RF Ministry of Health Care and Social Development being implemented the ratio between the contributions actually paid and pension actually received will change in favour of the rich (since better-off citizens will receive their pensions for longer than the less well-off).

The pension system will also be made more regressive by the de facto consequence of the proposals that the pension age of low-income strata of the population who have not reached pension age by 2010 will increase by 5 years from 2010. This results from the introduction of a minimum level for the labour pension. If the amount of the labour pension as calculated by the established norms turns out to be less than the minimum pension payable, then no labour pension will be paid. However, a citizen may be granted a senior citizen's pension, which at present is granted at age

65. In order to avoid an abrupt increase in the retirement age, the RF Ministry of Health Care and Social Development suggests that a transition period should be introduced during which the senior citizen's pension may be granted at an earlier age (Table 9).

Table 9

Distribution of males and females by age and date of award of the social pension

	in 2010	in 2011	in 2012	in 2013	in 2014	In 2015
Males	60 years	61 years	62 years	63 years	64 years	65 years
Females	55 years	56 years	57 years	58 years	59 years	60 years

As a result, a citizen of pre-retirement age group (for example, a man who will turn 59 in 2010) with a low level of accumulated pension entitlements (for example, owing to a long period of unemployment or undeclared employment, or a low remuneration level) will be deprived of any opportunity to receive any pension whatsoever (except a disability pension or a dependant's pension) until he reaches the age of 65.

This covert increase in the retirement age exclusively for the most deprived strata of the population, without a sufficiently long period of adjustment, is socially unacceptable. It is obvious that the retirement age should be raised more gradually. This proposal also suggests that in the calculations of the RF Ministry of Health Care and Social Development either the insurance tariff has been set too low or the subsidy that the pension system will require from the Federal Budget has been underestimated.¹⁰

Potential impact of the increased pension contribution tariff on tax evasion

It is very difficult to predict what changes there will be in the behaviour of companies and individuals as a result of a sharp increase in

¹⁰ Thus, the forecast that is given in Table 7 for the deficit of the system of pension provision, consequent upon implementation of the reform proposed by the RF Ministry of Health Care and Social Development, is somewhat underestimated.

pension contributions. However, it would be a mistake to overlook the potential impact of these measures on the level of tax revenues. Judging from the experience of the tax systems of a number of foreign countries, from our own analysis of the consequences of reform of income tax and from the introduction of the Social Tax in Russia in 2001¹¹, it seems that the risk of growing tax evasion as a consequence of this reform is very high. Preliminary calculations suggest that losses resulting from a diminution of the base for income tax and social contributions could amount to 1.5 – 2 % of GDP.

It can be predicted that the increasing burden on wages will create powerful incentives for numerous breaches of the law in relations between employers and employees, especially with regard to the lower paid. As a consequence, the incidence of liquidation of the assets through the use of “fly-by-night” companies will also increase and this will result not only in a contraction of officially paid wages but also in a reduction in revenues from profits tax and VAT.

Many enterprises may resort to the form of evasion that involves the payment of a substantial part of the wages fund to higher-salaried employees who then redistribute these sums to the rest of the personnel.

A heavier tax burden on the wages fund, accompanied by a reduction of the rate of tax on profit, will give rise to manipulations between the distribution of profits after tax (at a rate of 20% and of personal income tax on dividends at a rate of 9%) and the payment of wages (involving the payment of insurance contributions and of personal income tax at a rate of 13%) in companies where it is difficult to confine wage payments to a limited number of employees. There will be an advantage in paying workers

¹¹ Sinelnikov-Murylev S., Batkibekov S., Kadochnikov P., Nekipelov D. *Otsenka resul'tatov reformy podokhodnogo naloga v Rossiiskoi Federatsii* [An estimation the consequences of income tax reform in the Russian Federation]. M.: IET, 2003 (Research Studies, No 52 R).

out of net profit (whether in cash – for example, by distributing dividends or bonuses that are formally unrelated to specific job functions, assistance grants, etc.¹², or in kind – by granting employees special benefits.)

These kinds of contrivances could result not only in a reduction in revenues to the state budget but also in a denial of the pension rights of employees (in so far as they would be paid illegally or semi-legally and without transfer of insurance contributions).

The administration of pension contributions

In an event of the abolition of the Single Social Tax and its replacement by individual insurance contributions the administration of contributions would become an issue.

Under the present system the functions of the RF Pension Fund are as follows:

- keeping records of individual contributors and of their pension entitlements;
- administering the cumulative pension component;
- keeping records of the recipients of pensions and calculating pensions;
- organizing pension payments;
- other functions relating to social support.

Under these arrangements, the administration of the cumulative component of pensions is a specific function. The other functions performed by the Pension Fund are not affected by the source of the funds and the system would remain unchanged even if no insurance contributions at all were being paid and all funding was allocated out of general budget revenues

¹² At present, according to Item 3 of Article 236 of the RF Tax Code, ‘...payments and bonuses (irrespective of the form in which they are made) shall not be liable to taxation [in respect of the Single Social Tax] provided taxpayer-organizations do not include such payments in expenditures reducing the tax base in respect of the tax on profit of organization in the current accounting (tax) period’.

(if the principle underlying the approach to the formation of pension entitlements were to be altered – for example, if pensions were to be granted on the basis of employment history or the amount of income tax paid).

The RF Pension Fund is, therefore, at present, effectively carrying out the functions of the Federal Treasury as regards record-keeping and the organization of budget payments to physical persons, as well as the calculation of future budgetary obligations to these persons. Since the principles for calculating and forming pensions have not altered, there is no need to create a separate off-budget fund. The strategy for pension reform proposed by the RF Ministry of Health Care and Social Development appears, therefore, to be predominantly aimed at maximising the resources available to the Pension Fund and other funds and at expanding the Ministry's sphere of responsibility with regard to fiscal administration.

The reform model put forward by the RF Ministry of Health Care and Social Development envisages the transfer of administrative powers to the RF Pension Fund and to the Social Insurance Fund. This idea, however, disregards the experience of the 1990s when Russia applied a model based on independent administration of contributions by off-budget funds. Some rudimentary elements of that model have survived to this day. This model proved to be inconvenient because it imposed an excessive administrative burden upon both the state and contributors. These burdensome functions were:

- At the outset of their business activity, companies had to register and appear on the accounts of both the registration agencies and the off-budget funds. This hindered their start-up operations and was judged by entrepreneurs to be a serious 'administrative' barrier. The same requirements still exist today;
- The off-budget funds were authorized to supervise the timely and correct payment of contributions and also to enforce

payment of contributions. This made for a proliferation of audits of contributors and increased the risk of corruption. At present the off-budget funds may check that the contributions are paid in due time and in correct amounts, but cannot enforce payment of contributions;

- Taxpayers had to submit documentation at the request of each of the supervisory bodies and this considerably increased the amount of paperwork engaged in by both sides;
- Each of the off-budget funds had to maintain its own supervisory staff and fund the work of supervision and audit;
- None of the supervisory bodies had access to the totality of information concerning a taxpayer's activities since the information received by one of these bodies was not automatically transmitted to all of the others. For example, deliberate understatement of liability revealed during an audit by one of the supervisory bodies did not automatically result in the taxpayer being brought to account for all other types of contributions or for arrears and penalties in respect of contributions to other funds;

One of the most important achievements of the 2000 tax reform was the merger of administration of all social taxes (contributions to social off-budget funds) with the administration of personal income tax, as a result of which the Federal Tax Service became the only institution responsible for tax administration. It should be specifically noted that at present, in spite of a formally existing distinction between the Single Social Tax and insurance contributions to the Pension Fund, from the point of view of tax administration these payments, taken overall, can be regarded as one tax (as a single social tax).

Reverting to the system of administration that existed prior to the 2000 reform seems pointless, since in the absence of an alternative system of branch-based and/or regional off-budget funds that could compete for the taxpayers' money the administration of contributions to off-budget funds seems in no way to differ from the administration of taxes and levies as provided for by the Tax Code of the Russian Federation. A separation of functions in the sphere of tax administration will result in duplication, poor performance, and, in all probability, an increase in corruption and in a general reduction in overall tax revenues to both the Federal Budget and off-budget funds. Let us examine these problems more closely.

Duplication of functions. The base of the Single Social Tax consists of the wages or salary paid to every physical person who receives an income in accordance with an employment contract or contract under civil law. This tax base also serves as part of the base for personal income tax (after tax allowances). The creation of two separate administrative systems for the two forms of payment (insurance contributions and personal income tax) will result in the separate administration of two different taxes levied on one and the same base. The Federal Tax Service is capable of supervising payment of both of these taxes and can monitor the correctness of deductions overall, with due regard to the specificities of each tax. Budget execution could then be improved by creating a system within the Federal Tax Service for allocating the sums collected between different off-budget funds.

Not only in the sphere of tax administration will there be a duplication of functions. Enterprises and employers will have to maintain two sets of records, probably for each individual employee, and apply two different accounting and even audit procedures. The additional costs incurred by employers in their efforts to comply with tax legislation will increase both the marginal and average cost of labour. This will eventually result in a distortion of the relative prices of labour and capital, making the hiring of labour even

less profitable. This division and duplication of functions will not be conducive to either a more efficient collection of taxes or a fuller compliance with tax requirements.

Economic inefficiency: The duplication of responsibilities in tax administration will make for an inefficient expenditure of budgetary resources. All three agencies (the RF Federal Tax Service, the RF Pension Fund and the RF Social Insurance Fund) that will be engaged in levying taxes on one and the same base will have to be paid for and supervised. Employers will have to allocate extra resources to compliance with tax requirements and submit the same packet of documents for verification by at least two different organizations. A reform of this nature will reduce the economic efficiency of the tax system. Net revenues to the state budget will also be reduced since any gains that might arise from improvements in the collectability of taxes will be offset by the cost of the additional labour and capital consumed in maintaining the dual administrative apparatus. Employers will have to allocate additional resources to cover their administrative expenditure, resources that could have been used to the greater good of society.

Duplication of legislation: If the reform goes ahead, new administrative legislation will be needed, analogous to that contained in Part 1 of the RF Tax Code. However, there is actually no need for such duplicate legislation: on the contrary, if the administration of social payments is handed over to the off-budget funds, the procedures contained in Part 1 of the RF Tax Code could simply be adapted, with references to the off-budget funds being introduced in those sections of the legislation that relate to the administration of insurance contributions. Indeed, the very fact that no separate legislation is needed in itself serves as demonstration of the fact that the creation of a separate body for the administration of social payments is superfluous.

If new administrative legislation is adopted there will be a most undesirable risk of discrepancy between, on the one hand, the administrative procedures applied for supervision of the calculation of social payments and the rules for calculating these payments, and, on the other, the norms stipulated in Part 1 of the RF Tax Code and rules applicable when calculating the payment of personal income tax. Not only will taxpayers have double the work when calculating taxes that have one and the same tax base, they will, additionally, have to apply different rules in each case. This will make for a further increase in unjustified expenditure.

A lengthy period of organization: Implementation of the reform will require the formation of a new administrative apparatus, the hiring of new personnel (or transfer of competent staff from the Federal Tax Service), the development of an internal supervisory system and of other new procedures. It will take years to establish a more or less efficient administrative system – as was the case when the present Federal Tax Service was created.

Corruption: In the absence of any clear and distinct coordination and monitoring, the co-existence of two or more fiscal bodies could result in an increase in corruption. This additional ‘corruption tax’ will add to the expenditure incurred by companies in complying with the tax legislation and will tend to drive them into the “shadow economy”.

Amongst developed countries, social insurance is administered by tax agencies in Canada, Sweden, the UK and the USA, whilst in Australia, France, Germany and Japan it is administered by other agencies. However, there is a trend away from separating the collection of social insurance from that of other taxes. In two countries where the systems for collecting social insurance taxes were recently reorganized (Sweden in 1985, and the UK in 1998), collection was transferred to the tax agencies. The Russian reform of

income tax of 2000 followed that trend. To revert to the former system would be an error.

The political and economic consequences of pension reform

In current social and political conditions a rapid increase in the rates of social insurance contributions will in all probability give rise to new demands by the business community that this increase should be offset by a reduction in other tax rates. These demands will find support within certain bodies of Federal government. The measures that were recently adopted to reduce the burden of profits tax during the financial crisis and the measures that have been announced for reducing the burden on small businesses will, if tariffs for pension contributions are increased, most probably be perceived by the business community as inadequate. There is therefore a risk of increased political pressure in favour of lowering the VAT rate. In these circumstances any improvement in the equilibrium of the pension system would only be achieved at the cost of aggravating the structural deficit of the Federal Budget.

As far as the impact on the budget is concerned, offsetting a high level of social contributions by lowering other taxes is equivalent to keeping contributions at their former level while covering the deficit of the pension system out of the Federal Budget. There would be two distinct sets of consequences. Firstly, increasing social contributions while lowering other taxes (for example, VAT) produces a structural change in the tax system, shifting the greater part of the tax burden onto the labor market. Secondly, this scheme would result in substantial budget resources being pooled in the RF Pension Fund and other off-budget funds and in their being removed from the control not only of the RF Ministry of Finance and the Federal Tax Service but of the system of state authority in general. This is because the RF Pension Fund is not a body of state authority but enjoys special status as

an independent credit institution functioning in accordance with RF legislation, specifically the Federal Law of 15 December 2001, No 167-FZ.

The ongoing economic crisis has destroyed the illusions of many economists and politicians that Russia's economic development is immune to the cyclic fluctuations that affect any market economy. There will undoubtedly be periodical downturns in economic activity in the future. The proposed extremely high insurance tariff cannot, therefore, be sustained in the long run: during periods of economic decline it will have to be reduced and to a significant degree. Despite this, the RF Ministry of Health Care and Social Development, envisages the insurance tariff rising steadily and reaching 42 % by 2047.

Since Russian legislation does not envisage automatic indexation of tax parameters in response to inflation, the introduction of a threshold for levying tax on earnings above a level that exceeds that which applies under the current Single Social Tax will increase the risk of a partial loss of revenues if the indexation of that threshold is set too low. The proposed variant will not guarantee the stability of revenue flows in the event of unexpected increases in inflation (an increase in the level of nominal wages).

5. Proposals of the RF Ministry of Finance for reducing the deficit of the pension system

The core proposal of the RF Ministry of Finance for reducing the deficit of the pension system involves indexation of the SST scale in such a way that the effective tax rate will be kept at the level of 2005¹³. The tax rate and the distribution of tax revenues between off-budget funds will remain the same. This will mean that the tax burden on the labour force will

¹³ See *The Draft Budget Strategy of the Russian Federation for the Period up to 2023*, of 25 August 2008. <http://www.minfin.ru/ru/>

increase – but to a lesser extent than under the proposal of the RF Ministry of Health Care and Social Development (see *Table 10*).

The tax burden on businesses if the SST reform of the RF Ministry of Finance is implemented would also be rather high (it would increase by 1.3% of GDP). For this reason, and taking into account the crisis in the economy, we believe that a gradual indexation of the SST scale is more appropriate (see below).

As we have already noted, the implementation of the proposals of the RF Ministry of Finance for indexation of the SST scale without any change to the rules for the formation of pension capital will produce some additional obligations of the pension system in relation to the high-income strata of the population (see *Fig. 2*).

Table 10

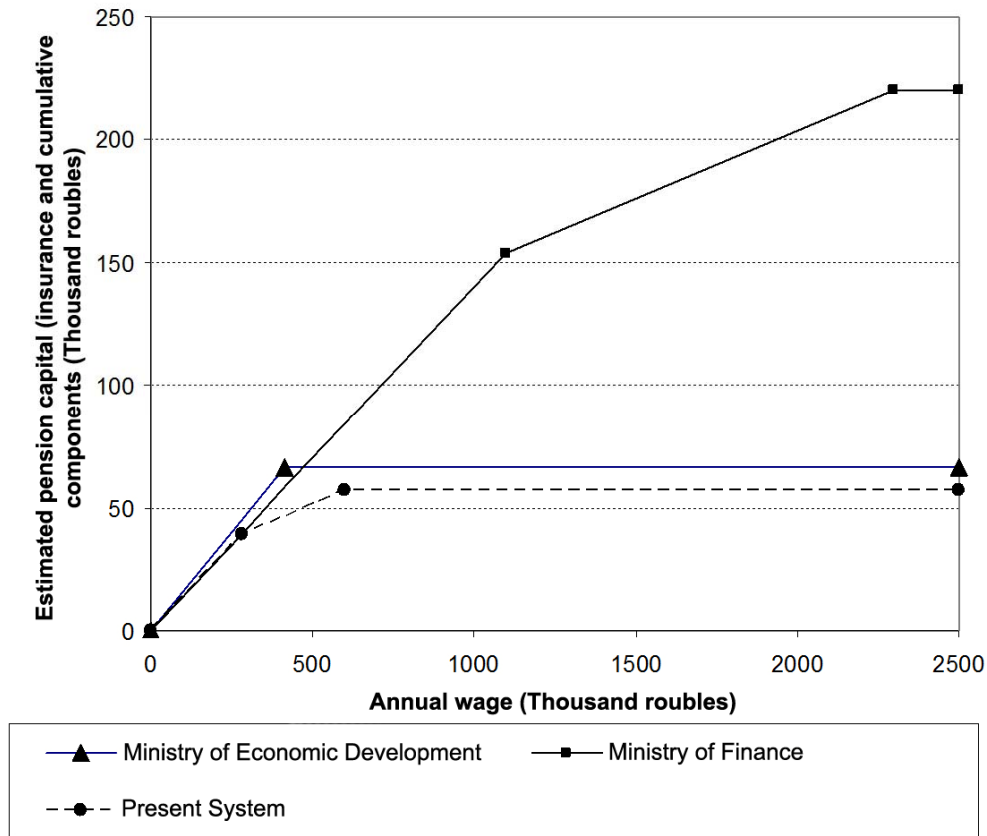
Comparative parameters of the tax burden in 2010 resulting from application of the existing SST scale and adopting the proposals of the RF Ministry of Finance Health Care and Social Development

	Brief description	Effective rate *	Revenues % of GDP*
Inertia-based scenario (existing SST scale is preserved)		18.8 – 19.1	4.3 – 4.6
RF Ministry of Finance	Indexation of existing SST schedules by rate of growth of wages in order to raise effective SST rate to 2005 level. Threshold 1: up to 1100 thousand roubles (26 %); Threshold 2: from 1,100 to 2,300 thousand roubles (10 %) Threshold 3: over 2300 thousand roubles (2 %)	24.6 – 24.7	5.6 – 5.9
RF Ministry of Health Care and Social Development	Introduction of taxable base limit: Threshold 1: up to 415 thousand roubles (34 %) Threshold 2: over 415 thousand roubles (0 %)	25.6 – 26.1	5.9 – 6.3

The effective SST rate and, consequently, the volume of revenues largely depend upon the growth of nominal wages. The values for this index in the forecasts of the RF Ministry of Economic Development and Trade differ significantly according to the scenario envisaged for Russia's economic development.

Source: Ministry of Economic Development and Trade; Ministry of Health Care and Social Development; Ministry of Finance; Rosstat; IET estimates.

Figure 2 - Pension capital, formed from payment of obligatory pension insurance contributions



Source: RF Ministry of Health Care and Social Development; RF Ministry of Finance; Federal Law № 167 of 15 December 2001 г. «On obligatory pension insurance in the RF ».

From the data presented in *Fig. 2* we can see that, if the proposals of the RF Ministry of Health Care and Social Development are implemented additional obligations of the pension system in relation to the higher-income strata will be lower than if the proposals of the RF Ministry of Finance are implemented. However, as we have already noted, this defect of the proposals of the Ministry of Finance can be removed, in the following two ways:

- firstly, by applying a more gradual and moderate indexation of the SST scale;
- secondly, by reducing the extent of dependence between contributions paid and level of pension received in the case

of highly-paid employees – that is, the replacement ratio must be reduced as the employee's income increases. Technically, this can be achieved by reducing the share of insurance contributions that influences the growth of pension entitlements in the case of highly paid workers, and by symmetrically increasing the share of insurance contributions that do not influence the increase in pension entitlements (the solidarity component of the tariff).

It will be politically difficult– especially in during the ongoing crisis – to implement the proposals of the RF Ministry of Finance for the introduction of a mandatory pension contribution of 3 % of wages for those under 40 years of age. It is proposed that this rate should be levied on annual remuneration less than 1.1 million roubles, with no contributions deducted from incomes above this level. These contributions should be transferred to individual accounts in order to create the cumulative component of the labour pension. Simultaneously, half of the contributions currently paid by employers towards the 'cumulative' accounts should go towards funding the insurance-based pensions. This proposal – even though it would increase the tax burden to a lesser degree than the proposals of the RF Ministry of Health Care and Social Development – might be perceived as an increase in personal income tax and this, of course, is always politically awkward.

As the data presented in Table 11 show, the proposals of the RF Ministry of Finance will not bring about equilibrium in the pension system; however, they have the advantage over the proposals of the RF Ministry of Health Care and Social Development, that they do not result in any deformation of the tax system, they exert less pressure on the labor market, and they create no additional incentives for tax evasion.

Table 11

Revenues and expenditures of the pension system in 2007 and 2020 (as % of GDP)

	2007	2020
Pension expenditure*	4.8	8.2**
SST revenues and mandatory pension insurance contributions (less cumulative component)	3.9	3.9
Balance of the Pension System	- 0.9	- 4.3

* Expenditure on the basic component of the labor pension, the insurance component of the labor pension and benefits and compensation payments and also on pensions funded from the Federal Budget.

**In the event of the replacement ratio being maintained at 30 %.

For the reasons given, the proposals of the RF Ministry of Finance seem to us to be superior to those of the RF Ministry of Health Care and Social Development. Even so, they cannot be implemented in the short term because Russia is currently experiencing an economic crisis; and in the medium and long-term they will not provide solutions to the growing number of problems of pension provision. Consequently, they must be supplemented by measures aimed at both increasing revenues to the pension system and reducing expenditures.

6. Pension reform – an alternative scenario

The present-day state pension system – the purpose of which is to provide insurance against loss of earnings – was introduced in developed European countries in the late 19th century in order to alleviate the condition of the older generation in industrial society. The ratio of the state pension to the average level of wages (that is, the replacement ratio) in such a system serves as a good indicator of the level of social protection provided for the older generation.

In order to provide for the elderly in industrial society (where the majority of the population no longer have a large number of children but are yet not sufficiently wealthy to have built up their own savings for later life) a replacement ratio of 40% was written into Convention No.102 “On

Minimum Standards of Social Security” of the International Labour Organization in 1952. We should note that the Convention applies the 40% replacement ratio to the case of a typical pensioner with a dependent wife. In post-industrial society where, as a rule, both spouses are employed, the opportunities for accumulating independent savings have greatly increased, there has been a significant increase in wages and some people have accumulated savings. In these conditions, if we are to measure the level of well-being of the elderly, we have to take into account some additional relationships – in particular, the ratio of the minimum and average pension to subsistence level, and the ratio of average income prior to pension age to average income after retirement age. It is the latter ratio that will more adequately describe the well-being level of the older generation, since in addition to pension they might also have other income (savings other than mandatory pension provision, income from property). In the case of the well-to-do category of the senior population ‘non-pension’ income can be substantially higher than pension income.

In contemporary Russia the replacement ratio cannot serve as an ideal benchmark of the level of well-being of the older generation. To pay a pension even at subsistence level to people on low wages would represent a high replacement ratio (at present the highest replacement ratio is to be found amongst agricultural workers and it by no means provides these workers with a high level of social protection). Also, when assessing the level of social protection of the older age groups we need to consider the current high level of non-cash benefits – free medical care, free medication, public transport subsidies, etc. Whilst the rural population might have high pensions in nominal terms, the fact that for “technical” reasons they have limited access to social certain benefits means that the level of social support they receive from the state budget is much lower than that received by urban pensioners. Conversely, in the case of high wage population

groups, even a relatively high state pension might constitute only a low replacement ratio.

This means that if the current methodology for calculating the replacement ratio is applied, a fall in the replacement ratio in the medium-term might reflect not only the ageing of the population but also an improvement in its welfare. In the short-term (2009 – 2010), if wages continue to fall and the State continues to meet its pension obligations, the replacement ratio might increase – but this will not signify an improvement in pensioners' welfare.

Let us assume that in post-industrial society the state pension will serve not so much to offset lost earnings but to prevent poverty amongst the older generations. If this assumption is correct, the differentiation of this particular benefit according to the level of remuneration received during the period of employment could either be negligible or disappear altogether. We need to consider separately the question of how widespread this type of benefit should apply to the older population. If the majority of the population have no means of existence other than the state pension, then 100 % pension provision for the population is necessary. If not, then this benefit could be paid to only the poorest strata, in order to bring their income up to the subsistence minimum or to some other guaranteed minimum.

In this long-term perspective, the main purpose of state pension provision system will probably, to an increasing degree, become the prevention of poverty amongst those of pension age. There is already a need, in the short term, to ensure that the minimum pension is set at no less than subsistence level for pensioners; and in the medium-term the pension should be set at a level that will meet a pensioner's basic needs, that is, at 2 – 2.5 times the subsistence level or at the level of the pensioner's minimum reproductive consumption budget.

The goal of enhancing the welfare of the older age groups, that is, of improving the ratio of pre-retirement to post-retirement levels of income, can be facilitated by the State (by controlling inflation, by the nature of its programme for the co-financing of pensions, by promoting the stability of the banking system, by encouraging transparency in the stock market). But in the final analysis this goal should depend upon independent initiatives taken by the citizens themselves and especially by the better off.

To sum up, the socio-political goal of increasing the replacement ratio to 40 – 50 % appears to be questionable, because it ignores not only negative trends in the economy (the ageing of the population), but also positive trends (an accelerated growth of wages). In the calculations that follow we shall consider a replacement ratio of 30 % to be socially acceptable, whilst bearing in mind that for the less well off it should be significantly higher and for better off significantly lower.

The short term

Until stable economic growth returns, no steps should be taken that will increase the tax burden on wages. In this connection, there should be only a moderate indexation of the SST scale in 2010, to bring the effective rate of SST to the level of 2008.

Since opportunities for the State adequately to finance the pension system during the next few years will be strictly limited, it will be sensible to focus pension expenditures in the most important areas of provision. In our opinion, the priority in the short term should be to eliminate poverty amongst pensioners, that is, to bring the level of the basic pension up to subsistence level for a pensioner. Attainment of this goal will require substantial financial resources (approximately 0.45 % of GDP in 2010)¹⁴. It

¹⁴ As a consequence of the accelerated indexation of the basic component of the pension from 1 December 2009, the object of which was to bring the value of the social pension up to that of subsistence level for pensioners, additional expenditures on the basic component of the pension will amount to no less than 185 billion roubles in 2010, or 0.38% of GDP and additional expenditures on financing social pensions (out of the Federal Budget) will amount to no less than 22 billion of roubles in 2010, or 0.05% of GDP.

will therefore be necessary to postpone measures for improving pension provision (in particular, valorisation of the pension entitlements of the older age groups).

The medium term

In the medium term, when the Russian economy emerges from the crisis, the rate of SST will have to be indexed, so as to bring the effective rate to the level of 2005. Thereafter, it will be necessary to index the SST on an annual basis at a rate equivalent to the nominal growth of wages, which is to say, to the rate of inflation. When indexing the rate of SST according to the anticipated rate of growth of wages, it would be prudent to devise some mechanism for subsequent adjustment whenever the actual rate of growth of wages differs from the level forecast. It should be noted that such a correction can only be made with a two-year time lag (indexing for the following year on the basis of data for the previous year).

As our calculations have shown, merely altering the SST will not balance the accounts in the pension system. Even an extremely high rate of contributions for mandatory pension insurance will not balance the accounts. This means that any reform of SST rates needs to reconcile the following objectives: maximizing overall tax revenues while at the same time minimizing the degree of distortion in the economy. Applying this logic will mean imposing strict limitations on any future increase in the rate of SST. Bearing this in mind, let us consider two variants for reforming SST rates:

1. Gradual indexation of the SST scale, so that over 5 years (by 2015) the effective rate of SST will have been increased to the level of 2005. This is a variant of the scheme initially proposed by the RF Ministry of Finance. It allows for a gradual increase in the tax burden but only to the
-

level that existed when the rate of SST was lowered in 2004. It will also make for continuity in SST legislation.

This variant can be criticized on the grounds that it will increase the value of pension payouts to the better-off strata of the population. If such an increase is considered undesirable, then within the existing SST scale, the ratio of contributions going to the fund the basic (solidarity) pension component and pensions registered on individual accounts will have to be altered. Altering these proportions would be, in our opinion, a more useful change to the pension system than a revision of SST rates.

2. Introduction a two-tier SST scale. In most developed countries a two-tier (but not three-tier) scale is used for social contributions. The scale that we consider appropriate to Russian conditions is given in *Table 12*.

Table 12

Proposal for funding the pension system in 2010 (%)

Tax base, thousand roubles	Rates of insurance tariff deducted from individual accounts				Solidarity tariff (or financing of basic pension component)	Insurance tariff, total	For reference: aggregate rate of insurance contributions (SST) %
	To financing the insured component*		To funding the cumulative component				
	Individuals born in or before 1966	Individuals born in 1967 or later	Individuals born in or before 1966	Individuals born in 1967 or later			
Up to 200 % of Russia's average wage (600 in 2010)	14	8	0	6	2	16	22
Over 600	0				5	5	5

This variant has the following advantages:

- it increases the volume of funding of the insurance and cumulative pension components (by 0.52 % of GDP in 2010 by comparison with the inertia-based scenario that envisaged no changes in SST) given that the basic pension component will be fully funded out of the Federal Budget. This makes possible a small increase in pensions for the present generation of pensioners and lays the basis for an increase in the role of the cumulative component of pension provision.
- an effective rate of SST is provided at 19 %, the tax burden does not increase (in 2010, the amount of SST revenues is not changed by comparison with the inertia-based scenario that envisages no changes in existing legislation), but annual

indexation ensures that there is no reduction in the effective rate;

- the base rate of SST is lowered – that is, less tax is deducted from the wages of the less well off. This could have a positive effect on the level of employment and the competitiveness of the Russian economy. The reduction in the SST base rate will make it possible to avoid the practice of hedging between payment of profits tax and payment of wages.
- a reduction in the basic rate of the tax, combined with a slight increase in the taxation of the highly paid could help to reduce losses caused by evasion of SST payments through the paying of wages to high-salaried employees and subsequent re-distribution “in envelopes” to the other employees;
- Fixing the threshold for deductions to the insurance and cumulative pension components at 200% of the average wage will create a territorially better balanced pension system by ensuring a socially acceptable level of pensions in those regions where the level of wages is significantly higher than the Russian average. At the same time, this variant does not incur excessive obligations on the part of the pension system vis à vis the better-off strata of the population.

The disadvantage of this variant is that it increases the deficit of the basic pension component, which would have to be funded out of the Federal Budget. If the amount of payments of basic pension component as a percentage of GDP is kept at the level of 2007, there will have to be an allocation from the Federal Budget to the basic pension component of a sum equivalent to 1.35 % of GDP (in 2007, in addition to the SST revenues, the Federal Budget allocations to this item amounted to 0.6 % of GDP).

It should also be noted that the proposed variant of the SST scale is less consistent with foreign practice that is the variant of the RF Ministry of Health Care and Social Development. In the majority of OECD countries (except USA and France) no mandatory insurance payments are charged to wages above a certain level. However, most OECD countries have progressive scales of income tax, whereas Russia applies a flat rate of personal income tax. For this reason, in the interests of a balanced taxation of the population's incomes it would be desirable to levy the 'solidarity' contribution on higher wages. This would have no affect the pension entitlements of the better-off strata¹⁵.

Bringing additional revenues into the pension system: In the medium-term, over and above mandatory pension insurance contributions and SST revenues, supplementary financial resources will have to be brought into the pension system.

In periods when global market conditions for raw materials and energy resources are favourable, the policy of paying the mineral resources rent into the Reserve Fund and National Welfare Fund should be continued. However, given the urgent need to create a balanced pension system it is arguable that the principles governing the operation of these two funds should be reviewed, so that a significant proportion of the savings accumulated can be utilized to form assets in the RF Pension Fund and to create cumulative pension saving accounts for all citizens, including citizens who have already retired.¹⁶

¹⁵ This solution is possible on the assumption that the highly paid workers have more opportunities for independently making pension savings than do lower-paid workers.

¹⁶ For further details, see *Ekonomika perekhodnogo perioda. Ocherki ekonomicheskoi politiki postkommunisticheskoi Rossii. Ekonomicheskii rost 2000 – 2007 [Economics of the transition period.. Essays on the economic policy of post-Communist Russia. Economic growth 2000 – 2007] / IET. M.: Delo, 2008. P. 1204 – 1208.*

The privatization of state property could be another source of revenues for the pension system and is an attractive alternative to increasing the tax burden. In recent years there has been a substantial growth of the state sector in the national economy and the nationalization of a number of companies that received state support during the period of crisis has contributed to this. Now there is an opportunity for large-scale privatization and this can be also be justified on other grounds: the gradual privatization and marketization of state-owned assets that are not directly involved in the execution of key state functions, in so far as it would contribute to economic efficiency, would be economically rational.

According to our estimates, the aggregate post-crisis market value of state owned shares, the property of state unitary enterprise and of land eligible for privatization is over 50 % of GDP¹⁷. Of course, privatization could not be carried out at short notice, but we have in mind that the state-owned assets themselves and not the resources generated by their privatization should be transferred to the RF Pension Fund, so that the Pension Fund (through its asset managers) could either obtain income from use of the transferred property or privatize it as its needs for funding arose.

A mass transfer of state assets to the pension system and the gradual sale of these assets as a means of funding the pension system would constitute a fundamentally new approach to the privatization of property – it would in the best interests of the vast majority of the population; it would be perceived as being just and it would potentially gain popular support. Such a policy would strengthen confidence in the institution of private property in Russia.

¹⁷ For further details, see Dmitriev M., Drobyshevsky S., Mikhailov L., Omelchuk T., Sycheva L. *Mozhno li povisit' pensii do 40% zarabotnoi platy?* [Can pensions be increased to 40% of wages?] // *Ekonomicheskaiia politika* [Economic Policy]. 2008. No 3.

Transfer of resources from the federal budget: Our calculations demonstrate that in the medium-term even gradual increases in the rate of SST, contingency transfers when prices of raw materials and energy resources are high and revenues from state property will be insufficient to guarantee equilibrium in the pension system. This means that the deficit will have to be covered out of general revenues to the state budget. If these revenues do not suffice and tax legislation remains unchanged, the tax burden might have to be increased. In these circumstances, if a choice has to be made between raising the SST, personal income tax, profits tax or VAT we believe that it would be best to increase the rate of VAT. Our reasons are as follows:

- firstly, the VAT tax base is considerably broader than that of the SST and other taxes. An increase of the VAT rate will therefore produce fewer distortions across the economy than an increase in SST. This is especially true of the labor market;
- secondly, an increase in VAT would provide a much better means of balancing the pension system in the event of a fall in energy prices than an increase in the rate of SST. The conjunctural component (dependence upon fluctuations in oil prices) is less significant in the case of VAT revenues than in the case of SST revenues;
- thirdly, an increase in VAT will have less of an impact upon the competitiveness of the Russian economy than an increase in SST. SST is a tax on wages which is in part incorporated in the prices of goods. This means that an increase in SST will impact negatively upon the competitive capacity of domestic exporters, especially in labor-intensive sectors.

VAT, by contrast, is a tax on domestic consumption: it is levied on imports but not on exported goods.

If one has to choose between increasing the rate of VAT or that of SST, the German experience points in favour of the former. Germany lowered its tax on profits and its social tax, while simultaneously increasing VAT from 16 to 19 %¹⁸. By lowering taxes on labour and capital, the German government is trying to attract investment (or at least to decrease the outflow of investment to East European countries), to increase the level of employment and to improve Germany's balance of payments. Opting to increase VAT as a means of offsetting a decline in revenues, the authorities increased a tax that is levied on imports. In this way, German exporters obtain the advantage of lower taxes on labour and capital and are less affected by the increase in VAT, in so far as VAT on exports is refunded.

It should be noted that at present Russia still has some latitude for further increasing the rate of VAT (which cannot be said of SST, its base rate being fairly high). Firstly, there is the preferential VAT rate of 10 %, which could be abolished as a means of both increasing budget revenue, and of making the tax system more neutral. Secondly, there are opportunities for eliminating both the legal avoidance of VAT (for example, by through the exploitation of special tax régimes) and illegal evasion of this tax (by the concentration of added value in “fly-by-night” companies that disappear without fulfilling their tax obligations).

The long-term

In the opinion of many experts¹⁹, a proper equilibrium of Russia's pension system cannot be achieved in the long run without raising the

¹⁸ Botman D., Danninger S. Tax Reform and Debt Sustainability in Germany: An Assessment Using the Global Fiscal Model // IMF Working Paper No WP/07/46. 2007. <http://www.imf.org/external/pubs/ft/wp/2007/wp0746.pdf>

¹⁹ Gurvich E. T. *Prioritety novogo etapa pensionnoi reformy [Priorities in the new phase of pension reform]* //8REIO. 2008. No 8; Maleva T. M., Siniavskaja O. V. *Pensionnaia reforma v Rossii: istoria, resul'taty*,

retirement age. This measure will deliver a higher replacement ratio without any excessive (and therefore unrealisable) increase in the tax burden.

In order to minimize the political costs of raising the retirement age, the measure should be introduced gradually and be applied only to relatively young people. It would be best gradually to raise the retirement age for men currently under 50 and for women currently under 45 (that is, for those categories of the population who under prevailing legislation will retire in 10 years time or later). The increase must be gradual (for example, for men by 3 months per annum, and for women by 6 months per annum).

The impact of this reform on the budget system will be felt in 10 years time (in 2020), and increasingly until 2040 when the retirement age for men and women alike will be 65. According to our forecasts, the period 2020 – 2030 will be hardest for the pension system – because the demographic situation (the ratio of recipients of pension payments to pension contributors) will be constantly deteriorating during this period²⁰, and the size of the cumulative component in pension will still be insufficient to maintain the replacement ratio at a socially acceptable level.

An additional measure would be to create incentives for voluntary later retirement – mainly for those age groups that will not be fully affected by mandatory delayed retirement. For this category of citizens, one could significantly increase the level of pensions in exchange for postponed retirement. This would have to be accompanied by job creation programmes specifically for the retirement and pre-retirement age groups. One could

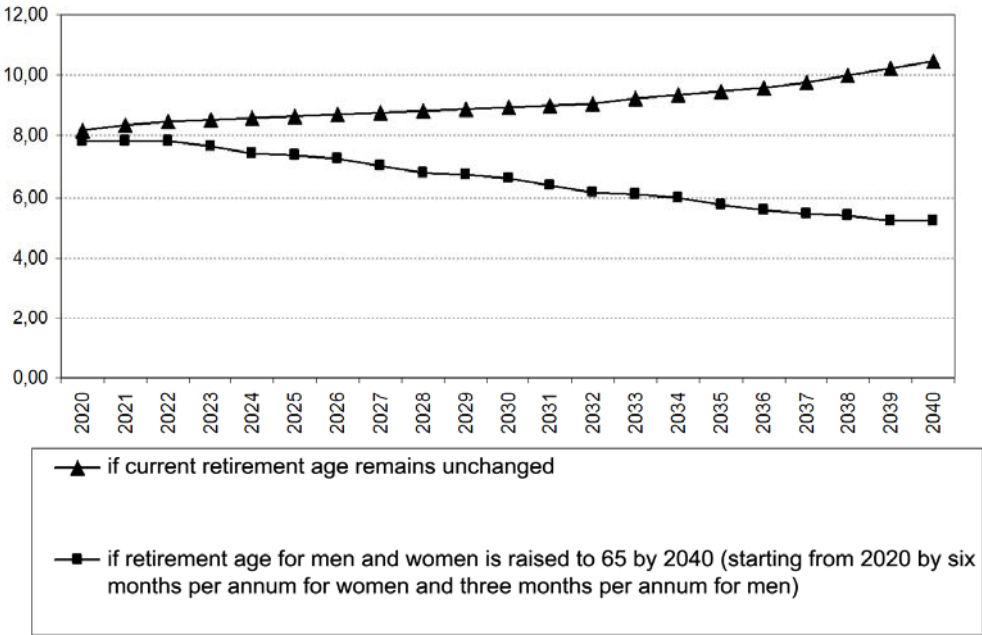
perspektivy. [Pension reform in Russia: history, results, perspectives.] An analytical report / Independent Institute for Social Policy. M.: Pomatur, 2005.

²⁰ In this connection, according to the *Concept of Long-Term Socio-Economic Development of Russia* prepared by the RF Ministry of Economic Development and Trade, life expectancy will increase from 67 at present to 72 - 75 by 2020.

consider the possibility of indexing pensions for older generations at a higher rate than the average.

Figure 3 demonstrates the expenditures needed to maintain the replacement ratio at 30% in 2020 – 2040 if the suggested change of the retirement age is implemented, by comparison with what would obtain under the existing rules.

Figure 3 - Cost of maintaining the replacement ratio at a level of 30 % in 2020 – 2040 as a % of GDP*



* The estimates shown in Figure 3 do not allow for factors that could reduce the fiscal effect of increasing the retirement age, such as an increase in invalidity or of unemployment among the older pre-retirement age groups. Factors that might increase the fiscal effect are also not taken into account. For example, this inertia-based demographic forecast disregards the possibility of declining mortality for men of working age and of considerably improved life expectancy. These factors would result in larger pensioner and pre-retirement cohorts than assumed in our estimates.

From Figure 3 it is clear that increasing the retirement age by 2040 makes it possible to reduce the cost of maintaining the replacement ratio at 30% from 10.5% to 4.4% of GDP.

Increasing the retirement age is one means of resolving the problems that will emerge in 2020 – 2030. However, the decision must be taken now, to give the population and the pension system time to adapt to the new conditions. Increasing the retirement age to 65 now for those under 30 would be relatively painless from a political point of view; but if the decision is delayed until this generation is nearly 50 there could be serious political repercussions.