In from the cold

William MacDougall examines the cautious pension reform that has been progressing slowly in Russia

While many inside and outside Russia have been understandably obsessed with the elections and the arrests of prominent businessmen, significant changes are being made to the pension system. Indeed, assuming the arrests do not signal a wholesale review of the privatisations of the 1990s, the pension reforms could turn out to be of much greater significance in the long run.

Russia has been talking of pension reform since the mid-90s, when proposals were made for a wholesale switch from an unfunded state system to a Chilean style scheme of funded provision with competing private managers. The last few months have seen repeated delays in the implementation of a much less ambitious but more complex programme.

Surprisingly, the World Bank opposed the initial proposals five years ago for a full switch to the Chilean approach. Its Finnish team leader for Russia, Hjalte Sederlof, described the radical proposals as "free market in the extreme". Some observers were shocked that the Bank should join left wing critics of reform, although one Russian Labour ministry official, Mikhail Dmitriev, said: "When the World Bank joined the chorus of criticism from the left, this was really fantastic." Still, the Bank did at least contribute an $800m loan to assist a more cautious reform package.

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before retirement. Now there will be.

But the real excitement today is over the third pillar, the "accumulative" fund. Seven per cent of contributions now, rising to 22% in 2006, will be invested in funded individual pension schemes, with private managers chosen by the individuals. Essentially it is the Chilean model for part of the pension system; it is more capitalist than America's 401k system because employers will not be limiting the choice of fund managers.

For these personal pensions, 55 firms were approved as managers in early September. The requirements were lighter than expected; a minimum of $1.3m in capital for example. Consequently, far more licences were granted than most anticipated; only three applicants were rejected. Perhaps uniquely in the world, the applicants were not even required to reveal the identity of their beneficial owners. Worse, a member of the supervisory committee that approved the firms has raised questions about their behaviour, alleging that some of the private pension funds had approached large companies offering to invest pensioners' funds in their equity in exchange for privileged

deadline meant that management would remain with Vneshekonombank, a result some think the system has been designed to achieve. Over 37 million Russians were sent notices about the new pension system. But the government's own figures suggest an error rate of 2-3%, meaning about a million notices may have gone adrift.

The deadline for replying was pushed back several times. Originally it was to be 1 July. The first couple of million notices gave 15 October as the deadline; finally workers were given until the end of 2003. Allowing three months for processing by the state-owned Pension Fund of Russia (PFR), the selected management companies will not receive funds until 31 March 2004. Various technical hitches have been blamed for the delays in printing the statements, from paper jam problems using Western printing equipment to the wrong kind of dust in the machines. Some suspect the PFR of preferring to keep its monopoly on pension money for a little bit longer - and of not being unhappy with the difficulties the delay is causing the new private managers. Indeed, the PFR was criticised by the Russian anti-monopoly minister Ilya Yuzhanov for exaggerating its

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and other dependants - a mere 1.74 - is worse than the US and most European countries. In 20 years the government predicts the rate could be as low as 1:1. While this pessimistic view may be based too much on the very difficult 1990s, the gov-

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Instead of more radical proposals, a three pillar approach was agreed three years ago and formally adopted 1 January 2002. Under the first or "basic" pillar, existing pension rights and almost half of future payments would remain in an unfunded pay-as-you-go (PAYG) state scheme. This would fund a basic pension paid to all retirees regardless of past income.

The second pillar – the "insurance" level – will also be largely unfunded. But, significantly, payments in will be recorded for each worker, and their eventual pensions will be based in part on life-time contributions. This second pillar will accumulate 40 billion roubles ($1.2bn) per year, from male workers under 50 and females under 45 years of age.

The insurance element will thus correct a major cause of the current pension deficit: employers concealing pay to reduce social charges. The old scheme was based on employers' contributions of 29% of salary; workers paid nothing. To avoid this and other overheads, most employers paying more than median wages would pay part of salaries in undeclared cash payments. Workers did not mind as they could avoid tax on the cash, and their pension would only be based on the last two years pay below $120 per month in any case. There was no benefit to declaring higher pay at the end or any pay prior to two years ers. Worse, a member of the supervisory committee that approved the firms has raised questions about their behaviour, alleging that some of the private pension funds had approached large companies offering to invest pensioners' funds in their equity in exchange for privileged access to employees. This danger will have to be watched by pensioners and regulators alike.

Workers could choose one of these private firms, or leave management to the state-owned Vneshekonombank if they make no choice or find declaring their choice too difficult. And declaring a choice was difficult: they had only two months to select a private manager, complete rather complicated forms, have their forms signed by officials, and post them back via Russia's sometimes slow postal system. Failure to make the 31 December

Reform has been slow in coming to Russia

pect the PFR of preferring to keep its monopoly on pension money for a little bit longer - and of not being unhappy with the difficulties the delay is causing the new private managers. Indeed, the PFR was criticised by the Russian anti-monopoly minister Ilya Yuzhanov for exaggerating its returns. In October he wrote to PFR chairman Mikhail Zurabov asking him to stop unfair advertising.

Aside from the main system, there is what could be called a fourth pillar of some 250 licensed pension funds, still small with only $700m under management. While some of these are open to private saving, most are corporate pension schemes.

Not encouraging was the decision at the end of August to grant a subsidiary of the state-owned Vneshtorgbank a monopoly as the depository for personal pensions. A few competing depositories would have provided much better incentives to keep costs down. Almost as strange was the choice of Vneshekonombank as the default fund manager; as this state-owned bank is the main issuer of Russian eurobonds and is the manager of Russia's foreign debt, there are potential conflicts of interest.

Russia has some 40 million pensioners, most living in abject poverty. Surprisingly for a country where for men the average age of death at 59 is below the retirement age of 60, Russia has a high dependency ratio, and it will start to worsen in a decade. Too many workers die of alcohol-related problems in their forties and fifties to support the more hardy survivors, and too few have children. The current ratio of workers to pensioners, children and other dependants - a mere 1.74 - is worse than the US and most European countries. In 20 years the government predicts the rate could be as low as 1:1. While this pessimistic view may be based too much on the very difficult 1990s, the government was right to be concerned about the sustainability of the old system.

A major issue is trust. With many having lost their savings several times in a decade to hyper-inflation, bank defaults, the MMM mutual fund default, and even straightforward theft, Russians are understandably suspicious of both private and public institutions. It will be some time before people will feel they can rely on pension savings.

The new pension system is trying to build trust through regulation and having an independent depository, but wrongly gave the latter role to a state monopoly. It rightly, if cautiously, moves away from a pure PAYG approach. It brings in competing private managers, but only for part of the pension system and even then biases choice towards a state bank. There was a massive project of distributing individual notices - with important options - to workers, which went five months behind schedule.

Perhaps the government was right to adopt a cautious approach. Perhaps it was right to have three or four pillars instead of putting all the eggs in one basket. Perhaps it was right to move slowly from a PAYG scheme to a funded system. And, however slow the start to this cautious reform, a start has now been made towards an improved approach.

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