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The political economy of pension reform in Russia: Why partial privatization?

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Abstract

We begin with a brief history of social security policy in Russia both before and after the collapse of the Soviet Union. We describe the current pension scheme and present an analysis of the strengths and weaknesses of the model, with particular attention to the way in which it may disadvantage women and low-wage and informal sector workers. The reasons why Russia is in the process of implementing a social security scheme based largely on a model proposed by the World Bank is also explored. We argue that the decision reflects the effects of both internal and external economic pressures as well as cultural diffusion via the network of neo-liberal economists and pension experts associated with international financial institutions, most notably the World Bank. We conclude with a discussion of how we would restructure the Russian scheme making greater use of the notional defined contribution (NDC) model.

Keywords: Russia; Privatization; Pension reform; Social security reform; Individual accounts

1. Introduction

Most governments around the world, rich and poor, are currently looking at projections suggesting that their social security systems will become very difficult to finance in the decades ahead. Some of these countries are already facing severe financing problems (Bongaarts, 2004; World Bank, 1994). In many places two of the most important sources of these problems are recent demographic trends (population aging) and the maturation of existing PAYG DB public pension schemes. For Russia and other former Soviet republics, there are the added fiscal burdens associated with the transition from a command to a market economy. During the years just prior to the collapse of the Soviet Union in 1991, many of these countries had generous and near universal, although ultimately unsustainable, old age pension schemes in place. One of the former republics hardest hit by this transition and these demographic changes has been Russia itself (Heleniak, 2004; Jensen & Richter, 2004; Tchernina & Tchernin, 2002).

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In this article we describe Russia's old age pension system prior to the collapse of the Soviet Union and outline the new scheme currently being implemented. We then discuss what we view as the strengths and limitations of the new scheme with particular emphasis on who is put at risk by these changes, and attempt to account for why Russia has selected a scheme that so closely follows the multi-pillar model outlined by the World Bank more than a decade ago. While it is undeniable that part of Russia's decision to adopt the World Bank model was rooted in its need for economic aid from the organization, we explore and emphasize two additional factors that strongly shaped Russia's decision. These factors are: (1) the role of social policy related cultural diffusion operating through the international networks of social security experts associated with major financial institutions such as the World Bank and the International Monetary Fund (Carruthers & Babb, 2000) and (2) the desire for international legitimacy in a world dominated by neo-liberal institutions, that is, the desire to be accepted as a legitimate actor in world society (Meyer, Boli, Thomas, & Ramirez, 1997). We believe that economic factors alone cannot explain Russia's decision to adopt the World Bank model. Rather we stress the role of cultural diffusion regarding the proper way to structure a public pension scheme in the current world economy and Russia's desire to be seen as valid player in that economy. We have some serious reservations about the viability of the scheme currently being implemented. We conclude with some comments about the need to restructure Russia's not yet fully implemented new scheme.

2. Analysis of the previous pension scheme

During Russia's communist era (1917–1991), one of the main concerns of the government was the provision of social welfare programs to both the young and old. Creating full employment and stable social security systems were at the core of the Soviet agenda (Jones, 2002). In accordance with these goals, the government devised a pension scheme to be born entirely by the state. Pensions were financed on a PAYG basis through the transfer of funds from state-owned enterprises to a social insurance component of the state budget (Fultz & Ruck, 2001). The old pension system consisted of two parts, a public component and a voluntary component, which in combination created a relatively generous social security system (Rashid, Thompson, von Gersdorff, & Zotova, 2002). The public component provided substantial pensions for all those working in the formal sector economy, while the voluntary component gave certain privileged groups a way to increase pension income. The minimum retirement age was 55 for women and 60 for men. To receive a pension, workers were required to have participated in the labor force for a minimum of 20 years.

The government established what eventually became a fairly generous and all-encompassing pension program for the nation's elderly. The first pensions were paid to Red Army veterans starting in 1924. By 1940 approximately 2 million people were receiving pensions and by 1989 the number had increased to 44 million. In the late 1980s pension coverage was nearly universal paying between 60% and 100% of the average wage (Buckley, 1997). The scheme was beneficial to women as it gave them credit for time out of the workforce due to maternity and child-care leave (Baskakova & Baskakov, 2001). This time-credit helped to equalize differences in men's and women's pensions by taking into consideration traditional gender roles. In addition to providing for women who had spent time out of the labor force fulfilling family needs, the system also created early retirement provisions for individuals with sporadic work histories due to sickness, injury, or child-care leave.

Although this system was quite generous, it had many flaws, some of which contributed to its unsustainability. First, the eligibility structure of the system led to the privileging of certain groups and to abuse of the system. As one indicator of the complexity of the system, there were over 250 categories for privileged eligibility under the pension system (Rashid et al., 2002). As a result of these privileges there were substantially higher benefits for many groups, most notably higher ranking party officials. This led to great inequality in the benefit structure. Second, the system allowed little room for individual choice. Retiring workers were placed into eligibility categories based upon past work experience and overall income level (Zelenev, 2002). Individuals were prohibited from opting out of the system or finding alternative pension financing.

One of the greatest flaws of the Soviet system was its financial instability in light of the economic transition that occurred after the fall of communism. The Soviet pension scheme was designed for a command-economy under a strong government, which could not be sustained when this economy transitioned into being market-based. For much of the time between the collapse of the Soviet Union and 1999, pension benefits were not paid on time and sometimes were in arrears for 3 to 6 months (Rashid et al., 2002). While pensions had been between 60% and 100% of the average wage during the late 1980s, during the 1990s they tended to be in the 30% to 40% range (Buckley, 1997).

In an effort to bolster the claim to being a classless society the Soviet leadership did its best to structure the social security system so as to cover the entire population. Over the long run this structuring proved to be too expensive. As the population aged and the scheme matured it became clear that it was not sustainable, a conclusion that was made painfully clear when faced with unforeseen high unemployment rates, rapid population aging, and runaway inflation during the post-Soviet 1990s.

3. The need for pension reform

Russia's need to transform its old age insurance scheme was immediately apparent after the collapse of the Soviet Union. The new Russian government faced fiscal realities making it impossible to sustain pension benefits at the level which many Russians had become accustomed to during the Soviet era. The decentralization of the government eroded many social protection programs throughout the country. For pension programs in particular, the system was pushed toward unsustainability due to population aging and the sharp drop in contributions linked to economic stagnation and unemployment (Jensen & Richter, 2004).

In a PAYG scheme, such as that in place during the Soviet era, a relatively high ratio of contributing workers to pensioners is necessary to sustain the system. When this ratio drops due to lower fertility, population aging, or high rates of unemployment, it often becomes necessary for the scheme to be subsidized by the government. The decline in the birth rate and the increase in unemployment rates during the 1990s led Russian policy makers to conclude that some sort of dramatic restructuring was needed (Tanner, 2004). Since the Russian population over age 60 has been steadily increasing in recent years (Jones, 2002), the ratio of young to old has continued to drop. This drop in turn has had an adverse effect on the sustainability of the pension system. The resulting deficits have become a major factor behind the move to radically transform the Russian pension system.

With the onset of market-capitalism, the country was unable to continue a wage structure based on wage standardization. Decreased industrial output, coupled with high inflation, produced a sharp decrease in both employment levels and real wages. With the decrease in employment and wages, poverty rates increased. This trend continued over the better part of a decade following the collapse of the Soviet Union, resulting in a situation where wages in 2000 were one-third of their 1990 levels (Zelenev, 2002).

The increased poverty and the wage crisis pushed many workers into the informal economy. Even during the later years of the Soviet era the informal economy had begun to swell as many workers chose to leave the formal economy due to excessive government regulation and the attraction of opportunities for tax evasion in the informal economy. During the Soviet era the government provided universal healthcare as well as subsidized food and housing, which had the perverse effect of giving workers less incentive to work in the formal economy (Dobronogov & Mayhew, 2000). While in the post-Soviet state most of these benefits no longer remain, in the face of rising unemployment, many workers are still turning to the informal economy which in turn further undercuts government tax revenues.

An aging population, economic instability, and a growing informal economy have thus had a serious negative impact on the Pension Fund of Russia (PFR). With fewer contributors, and among those who do contribute fewer with decent wages, the existing PAYG system proved unsustainable and the PFR had to bear the brunt of these consequences. Throughout the early nineties the government put considerable effort into trying to find new ways to "fix" the Soviet era pension system. Attempts made to keep the average level of pensions from dropping below subsistence levels by periodically raising the minimum pension, while at the same time limiting the maximum pension level, have proven ineffective (Markova, 2001).

In connection with the financial crisis of August 1998 it became obvious that these reforms were not going to solve the nation's pension crisis. The financial crisis of 1998 left Russia unable to make several debt payments which quickly led to widespread financial instability and uncertainty. Gross domestic product per capita declined by 40% and the unemployment level rose to 12%. The crisis severely lowered living standards and demonstrated the total inadequacy of the Russian social protection system within a market economy (Zelenev, 2002). With this crisis, families lost most of their savings and pensions while inflation flared. By the end of 1999 the purchasing power for the average pensioner had fallen from 120% of the subsistence minimum to between 60% and 70% of that minimum. The government had to concentrate on providing at least minimum pensions to as many people as possible (Afanasiev, 2003). If pensions were in trouble before, the financial crisis of 1998 put them over the edge.

In the midst of the financial crisis, all of the problems that the Russian system of social protection was facing finally came to a head, making the implementation of a radically new approach necessary. Pension experts in Russia were well aware of the World Bank's proposed multi-pillar model, as its success in Eastern Europe and Latin America was widely publicized by the World Bank and touted as the best way to structure national pension programs. In light of these claims, a variant of the World Bank model began to look attractive to Russia. What was needed, from their perspective, was a model that would tie benefits much more closely to contributions and sharply reduce the pension burden on the national budget.

However, Russia's decision to implement a variant of the World Bank model was neither a straightforward nor inevitable process. After the financial crisis of 1998, Russia was forced to abandon its unsustainable PAYG defined benefit system, but it was not until Vladimir Putin's presidency that the new World Bank model was considered a promising alternative. In order to address the growing pension crisis in Russia, Putin created the "National Soviet for Pension Reform," a committee charged with coming up with a solution to the nation's pension problem (Ohtsu, 2002). The committee was headed by Prime Minister Michael Kasiyanov, who staunchly advocated resolving Russia's pension issues as quickly as possible. Other political heavyweights appointed to the committee included Minister of Economy, German Gref, and Deputy Minister of Economy Michael Dmitriev, both of whom endorsed pension privatization, as well as Michael Zurabov, an affiliate of the Pension Fund of Russia, who was strongly opposed to radical privatization (Ohtsu, 2002). These government officials were also being pressured by leaders in the finance industry who argued that the introduction of a funded pillar would be one way to stimulate investment in capital markets.

It was at this time that World Bank officials became more actively involved in the pension reform process. The World Bank offered Russia an $800 million Social Protection Adjustment Loan conditional on Russia resolving its pension reform crisis (Blagov, 2004; World Bank, 1998). The World Bank did not outline the specific terms of the reform, but strongly recommended a transition from the existing defined benefit scheme to an alternative that included a notional defined contribution pillar as well as a funded pillar.

In light of the World Bank's offer and its public praise for the multi-pillar model, the National Soviet convened to decide upon a reform scheme. Both the Ministry of Economy and the Pension Fund of Russia lobbied the legislature to implement their particular reforms. After persuasive arguments from each side, the committee tentatively decided to adopt a model very much along the lines of what the World Bank had been proposing. While the World Bank itself was prohibited from taking a direct part in the negotiations (Ohtsu, 2002), its presence and influence was still apparent as we will demonstrate in the next section.

4. Why did Russia adopt the World Bank model?

By the late 1990s there was little doubt that the Russian government needed to do something to reform its pension system and it is clear that more than minor adjustments were called for. But why did Russia opt for a model so close to that being advanced by pension experts at the World Bank as opposed to other less market driven alternatives more consistent with the needs of Russian workers and the realities of the nation's economy? While we acknowledge that monetary considerations and promises of sizable loans from the World Bank did play an important part in Russia's decision to implement the World Bank model, we believe that economic factors alone cannot explain why Russia implemented the particular model that it did. To more fully understand Russia's recent pension policy reforms we must move beyond an analysis that focuses exclusively on economic considerations and toward an analysis that emphasizes external factors such as the cultural diffusion of ideas about how best to structure a public pension scheme in the context of the current world economy.

Economic sociologists point to the role of networks of policy elites, in this case international pension experts, in the transmission of institutional practices (Carruthers & Babb, 2000). The extensive contact that experts from various international financial institutions, particularly the World Bank, have had with Russian pension policy elites in recent years has made these networks increasingly relevant for Russian policy makers (Deacon, 2000a,b; Rys, 2001). Through these interactions, Russian leaders have consistently expressed a desire to be included in a world capitalist system; a system dominated by institutions such as the World Bank, which are strongly influenced by analysts who view social policy from a neo-liberal perspective (Deacon, 2000a,b). Recent pension policy reforms in Russia are in part a response to the nation's fiscal need for neo-liberal structural adjustment policies being advanced by the World Bank and in part to the desire to be respected as a player in world society.

The "world society" model was originally proposed by Meyer et al. (1997). Their model sees the nation-state not as a solitary actor, but as a culturally constructed entity embedded in a broader global society. According to this model the goals, structure, and social policy of any state are insufficiently understood if only national traditions and histories are examined. To understand why nations behave the way they do requires an understanding of how the roles, functions, and purposes of nations are determined by supranational carriers of world culture (Boli & Thomas, 1997).

There are two dominant actors in world society, the nation-states and supranational institutions. Examples of the latter include the United Nations, the World Bank, the International Monetary Fund, and the World Trade Organization. The scientific and professional authority of supranational institutions is often deferred to by national level actors. Carriers of world culture thus define what is legitimate and what has value in the world society, while nation-states are given value and legitimacy through their adherence to these assigned definitions (Meyer et al., 1997). For example, national goals of economic progress and social justice are preached by carriers of world culture and in turn are sometimes adopted by nation-states not because internal actors truly view them as viable national goals, but because adherence to such ideals give the state legitimacy in the world society.

The world culture perspective conceives of nations as rational actors. Nations then present themselves in this manner, both internally, in terms of their constitution and laws, and externally, in terms of their presentations to the United Nations and the World Bank. States portray themselves as sovereign authorities, self-determined, responsible, and committed to social justice and the protection of individual rights. Nations are quick to adopt policies geared toward such goals as national development, the institutionalization of political and legal rights, participation in supranational organizations, etc., in order to be viewed as legitimate players in the world society (Meyer et al., 1997). These policies are not autonomous decisions; rather they are enactments of institutionalized scripts. Bureaucratic authorities, central banks, educational systems, and pension programs are all required of nations that wish to participate in and be taken seriously by the major players in world society. In this way world society shapes the identities, structures, and policies of nations through this worldwide process of cultural diffusion. The result is increasing isomorphism among states in accordance with the prescriptions issued by a relatively small number of influential international organizations.

Viewed through the lens of the world society model, Russia's decision to adopt the World Bank model can be better understood. As a communist nation, Russia was denied, and willingly relinquished, access to the dominant world culture. Russia was not a member of the world society, but rather existed somewhat on the margins. It was in many ways a distinct actor structuring and formulating its policies according to the dictates of an alternative and much less widely accepted communist attempt at a world society model. After the collapse of the Soviet Union, Russia has increasingly tried to become part of the world society (Deacon, 2000a; Rys, 2001). It has sought to become an ally to other nations, a nation amenable to foreign investment, and an active participant in world trade. Russia is seeking to become a legitimate actor in world society. Yet to do so requires that the nation enacts the goals, structures, and policies prescribed by the carriers of world culture. It must be seen as supporting the goals of human rights, economic development, industrialization, and social justice. It must shape its national institutions to reflect those viewed as legitimate by the world culture and in the case of formerly communist nations this includes the privatization of state assets and a substantial decentralization of power and decision making.

In addition, it must adopt policy programs sanctioned by the world culture. As a carrier of world culture, adopting the World Bank's pension model is just one of the ways in which Russia can gain legitimacy in the international arena (Deacon, 2000a; Rys, 2001). Much attention has been given to the success of partially and fully privatized social security systems that have been introduced in a number of other countries, particularly those of Eastern Europe and Latin America. While there are many social security analysts who question the partial or full privatization of social security schemes, the majority of those affiliated with a number of very influential intergovernmental organizations (IGOs) such as the World Bank do advocate multi-pillar models. This promotion has launched a global process of imitation whereby the multi-pillar World Bank model has rapidly spread around the world and been received as a legitimate way to structure national pension programs.

By adopting the World Bank model, Russia is acting in a way that is consistent with world culture in an effort to demonstrate to the world society that the nation considers itself, and should be seen by other nations, as a legitimate actor in the world society. The reason why the World Bank proposal was selected over the Ministry of Economy or Pension Fund of Russia model was not because it is was economically superior or more financially feasible. It was, in our view, selected in large part because its adoption gives Russia legitimacy in the world society.

5. The structure of the new scheme currently being implemented

The pension reform model adopted by the Russian State is largely based upon the three-pillar World Bank model of social pension reform (World Bank, 1994). The original three-pillar World Bank model called for: (1) a first pillar that is redistributive and PAYG, has defined benefits, and is publicly supported, (2) a second pillar that is mandatory, funded, and has defined contributions, and (3) a third pillar that is voluntary, private, and funded. Reflecting the influence of the World Bank model, the new scheme in Russia is composed of three pillars: (1) the first is a government funded PAYG basic pillar; (2) the second pillar includes two components (that will be classified by some analysts as two separate pillars), both of which are mandatory, a PAYG (unfunded) defined contribution component and a funded, but largely government managed, defined contribution component; and (3) the third voluntary, defined contribution supplementary insurance pillar.

When the implementation of Russia's new social security program is complete, the first (or basic) redistributive pillar will be a defined benefit state financed pension paid for with a flat social tax and budget transfers at both the federal and regional level (Afanasiev, 2003). The flat pension will be available to all workers with five or more years in the workforce and is designed to ensure that all pensioners receive at least a subsistence income. This basic pillar will become part of the broader state pension system which also includes pensions to the military, social pensions, and now the basic (redistributive) part of retirement pensions for the general population. The central government will be responsible for the payment of these pensions.

The retirement pensions under the mandatory second pillar will be based in part on an unfunded defined contribution component and in part on a funded defined contribution component. Both components will be financed by mandatory insurance contributions with payouts depending on the amount contributed (Afanasiev, 2003). The unfunded defined contribution component is based on what is called the notional (unfunded) defined contribution (NDC) model, a model currently in place in six other nations, two of which are former Soviet republics (Williamson, 2004). An NDC scheme creates individual retirement accounts for each worker. As workers pay into this component of the pension scheme, they are credited for the amount paid in via an accounting record of the notional (or virtual) contribution (Rashid et al., 2002). While the actual contributions are real, the credit to these individual accounts is notional because the actual funds are, as with all NDC schemes, immediately used to pay pension benefits to the currently retired (Disney, 1999). The notional accumulations in these accounts will be indexed based on changes in the ratio of total wages (sometimes called the wage sum) to the total number of beneficiaries (at the time the contributions were made). As a result the rate of return will be below that based on wage indexing when (as is expected for the next several decades) the ratio of contributing workers to pension recipients declines. There is an additional provision that price indexing will be used when it would yield a higher rate of return (Rashid et al., 2002).

This second pillar also includes a component based on the worker's choice between a fully funded provident fund with the government managing the assets in the funded individual accounts associated with this pillar or the choice of private sector management of these funded individual accounts (Rashid et al., 2002). Currently most workers are choosing the government managed provident fund account option, but the number opting for private sector fund managers is likely to increase. The addition of this private sector option has transformed the Russian pension scheme into a partially privatized scheme. The capital in the funded individual accounts will accrue over the years in accordance with contributions made and investment returns on those assets. At retirement the accumulated assets will be used to purchase an annuity that will pay a monthly pension (Sylva & Zeeb, 2003). Currently, despite the existence of the private sector asset management option, for most workers the individual accounts component has the structure of a provident fund scheme, that is, the contributions from employees are matched by contributions from employers and managed by the government in separate individual accounts in the Pension Fund of Russia (PFR).

The third pillar of Russia's new pension scheme consists of private pensions financed through voluntary insurance contributions. In some cases employee contributions will be matched in some way by employer contributions, but in many cases there will be tax favored voluntary personal contributions with no matching employer contributions (Afanasiev, 2003). These pensions will be controlled completely by Non-State Pension

Funds, but they will be supervised by the Ministry of Labor. This pillar will allow workers who are both willing and able to contribute increased amounts and therefore retire with a more generous pension.

6. Potential strengths and weaknesses of the new scheme

6.1. Strengths

One obvious strength of the new model is an increase in the level of economic security due to pension income diversification. Russian workers and pensioners, knowing that they are insured on the basis of three distinct pillars, are likely to be more secure about their post-retirement futures than they were under the scheme in place during the 1990s. The basic/flat pension available to all citizens will help to guarantee that even the poorest will receive some sort of aid during retirement. The second and third pillars will provide additional economic security for the elderly. The transparency of the link between contributions made over the years and eventual pension benefits should help to make workers more confident about both the security and the adequacy of their eventual pensions.

Another potential strength is that the partial privatization implicit in the second pillar may increase savings rates which in turn may increase the level of investment and the rate of economic growth. To the extent that there is increased economic growth there is likely to be a reduction in unemployment levels and an increase in wage levels. This growth would contribute to more job security for workers and more pension security for those who are retired or near retirement (World Bank, 1994).

A third potential strength of the new Russian pension scheme is that it may ease the nation's fiscal burden, at least in the long run. The public pension funds of the Russian Federation have been in crisis since before the fall of the Soviet Union and starting in 1996 these pension funds were unable to guarantee even minimal coverage for all eligible pensioners (Markova, 2001). With the August 1998 crisis, public finances went from bad to dramatically worse and it became apparent that the existing public pension system was no longer viable. The new scheme with its fully funded component is viewed by many as part of the solution to Russia's pension crisis, at least the long-term component of that crisis.

A fourth strength of the new system is its ability to give many workers in Russia a choice in the management of their pensions. The state is now not the only pension brokerage agency. With the funded scheme, pensioners are now able to choose their own asset managers or alternatively they can remain in the PFR retaining state management of their pension fund assets.

Finally, the new pension system may have a number of social welfare benefits. In post-Soviet Russia there has been a clear deterioration in the social protection that the State has been able to offer to its citizens. Poverty has rapidly increased and there has been a growing gap between the rich and poor (Zelenev, 2002). The new pension system will help to relieve elderly poverty and eventually will help many other retired workers as well. While the structure of the new scheme is less generous than the Soviet-era scheme, it does increase the likelihood that the government will be able to make good on pension promises, representing an improvement relative to the situation in the late 1990s. The funded component of the second pillar will assure that there will be at least some funds that the government will find hard to appropriate for other purposes. Although the shift toward greater emphasis on the defined contribution model will produce a net effect that is less distributive than with the Soviet-era scheme, if it makes an unsustainable scheme sustainable, the end result will be less economic inequality. If nothing had been done and the prior scheme was allowed to default, old age income would have become largely based on family transfers and personal assets. The result would be even greater inequality than under the new partially privatized scheme.

While many analysts will no doubt take issue with of some of the purported strengths that we have listed, few will question the need that existed in Russia in the late 1990s for a major reform of the public pension system. Had Russia opted for a less radical set of reforms that did not add any defined contribution components, it would have been necessary to cut benefits or to increase payroll taxes very substantially. Even with such changes, due to the size of the informal sector and pervasive tax evasion, it is not clear that it would have been possible to salvage the old scheme without also raising the retirement age substantially, an option that would have carried a very heavy political price. Even though the new scheme has a number of potential strengths and is considered necessary, it also has a number of potential limitations.

6.2. Weaknesses

The burdens associated with major changes in social programs are rarely shared equally; typically some groups are asked to shoulder more of the burden than others. The current changes being made to the Russian social security system are not an exception to this generalization. The new scheme disproportionately disadvantages women, low-income workers, and workers in the informal sector (Popkin & Mroz, 1995; Prokofieva, 2000). Low-income and informal sector workers will be hard hit by the changes being made; but women, who were actually privileged by the former family-oriented policy, are going to take a much harder hit (Prokofieva, 2000).

The new scheme is less advantageous than the prior scheme to low-income workers and workers in the informal sector because pension benefits will be more closely tied to contributions. Low-wage workers tend to earn less and thus contribute less during their working years. As a result, under the new scheme they will end up with lower pensions than they would have received under the prior scheme had those prior benefits not been allowed to erode so drastically. Inequalities in the labor market are thus reproduced in old age at a heightened level under the new scheme relative to the previous one (Commander & Lee, 1998; Milanovic, 1998).

These very low pensions have created a new group of working pensioners who must find outside sources of income, mainly in the informal sector, in order to survive during their 'retirement' years (Tchernina & Tchernin, 2002). Those who are employed in the informal sector throughout most of their working years will be in even worse shape as pensions will now be directly tied to contributions made while working in the formal sector. Although the rapidly expanding informal sector was one of the driving forces behind the move to partially privatize pensions, the issue of how to care for these workers once the State had been freed from this burden, has not been resolved. It has been posited that tying pensions to wages will discourage people from finding employment in the informal sector; however, a shift in employment has yet to be seen. While the first pillar does offer some protection for this group, it is going to be difficult to work out how much to provide when there are no formal records of work histories (Karasyov & Lublin, 2001).

In addition to low-wage and informal sector workers, pension reform must also deal with the huge fraction of the Russian population that has been unemployed for many years prior to retirement. If benefits are tied to labor force participation, what happens to those who cannot find work? While high levels of unemployment were part of the reason for the failure of the old pension system, the new system does not have much by way of provision for such workers when they reach retirement age. While there is a first-pillar flat rate benefit under the new scheme, for many workers in the informal sector and many of the long-term unemployed it is going to be difficult to establish eligibility even for these very modest pension benefits (Karasyov & Lublin, 2001).

Women are another group disadvantaged by changes introduced in connection with the new system. During the Soviet era women who had 20 years of work experience were allowed to retire at age 55. Some 55% to 85% of their previous wages were replaced in part because credit was issued for years absent from the labor force for child-rearing purposes. Women with more than five children were allowed to retire at age 50 (Castel & Fox, 2001). While child bearing and raising is still highly valued in Russia, these ideals no longer find expression in the structure of the pension system. Women no longer receive pension benefits for time out of the labor force due to maternity leave and child-rearing.

Since pensions are directly connected to the wages under the new notional defined contribution component of the second pillar, women are disadvantaged relative to men because they generally earn less than their male counterparts. Wage levels between men and women currently differ by about 30% to 40%, which in turn translates into substantial differences in pension levels (Baskakova & Baskokov, 2001). As women make up roughly 80% of the unemployed in Russia, they are disproportionately represented among the "the new poor" (Zelenev, 2002). Unemployed women are not making pension contributions and the result is going to be meager pensions. Women are also disproportionately employed in the informal sector where few if any pension contributions are made.

There are other reasons why women will be disadvantaged relative to men under the new scheme. Not only will these new pensions replace a lower proportion of pre-retirement income for women than in the past, they will also be spending more years living on these lower pensions than will men. In Russia in 2001, the life expectancy for women was 13 years longer than for men, 72 and 59 years, respectively (World Bank, 2003). Although for women who work past the retirement age of 55, each year in the labor force will be counted as 1.5 in annuity contributions, there are still cultural expectations that women should retire early to provide care for family members, which keep many from working past the retirement age. The effect of gender differences in life expectancy is thus aggravated by the combination of provisions allowing women to retire earlier than men and these cultural views. The good news is that women will collect their pensions for many more years than men and over the long run will collect more benefits than they would have without the gap in life expectancy, but the bad news is that food, rent, and utility bills must be paid on a monthly basis. Overall women's pensions are now about 40–60% that of men's (Baskakova & Baskakov, 2001).

Differences in life expectancy between men and women also result in more women, relative to men, being widowed in their later years. At the end of the 20th century, approximately 50% of women aged 60 or older were widowed as compared to only 12.7% of men (Denissenko, 2001). Given that it is a policy of the new pension system that widows and/or widowers are ineligible to receive survivor pensions if they are collecting their own old age insurance, among retired widows who had been dependent upon their husbands' pensions to make ends meet, outliving their spouse may push them further into poverty (Baskakova & Baskakov, 2001).

Even when not taking these disadvantaged groups into consideration, there are still a variety of administrative issues that must be resolved in order for this new scheme to be effectively implemented. The success of Russia's new pension plan will depend upon the rapid development of efficient and transparent financial institutions, knowledgeable and uncorrupt asset managers, as well as an efficient tax collection and pension distribution system. Administration of the new funded component of the second pillar will increase the need for speed and accuracy in processing of information related to contributions and the level of assets held in these individual accounts (Rashid et al., 2002).

To make these reforms work, what is needed is an increase in the administrative capacity of the Russian government; but the post-Soviet state has been hampered by internal strife and diminished administrative capacity. Decentralization has weakened the efficiency of many government activities. In the case of pensions, management and information collection responsibilities are divided between the Pension Fund of Russia (PFR) and the Ministry of Taxation (Rashid et al., 2002). The Ministry of Taxation focuses on the collection of contributions, while the PFR focuses on the payment of pensions. This division makes communication between the two departments essential yet potentially problematic due to the tradition of political infighting between agencies within the Russian government.

Until recently (2004) private sector asset managers were only working with the very small third (voluntary) pillar of the Russian pension scheme. Many analysts are, with good reason, concerned about increasing the power of these Non-State Pension Funds (NPFs) since they have a history of anticompetitive monopolistic practices. The four largest funds, Surgutneftegaz, LUKoil-Grant, GAZFOND, and Elektroenergetika, currently control approximately 68% of private sector pension assets (Markova, 2001).

Yet another problem with the new Russian pension scheme is the vulnerability of pension assets to market volatility. When pensions become in large measure based on a funded defined contribution pillar, they will be subject to short-term fluctuations in the notoriously volatile Russian stock and bond markets. While the Russian government has introduced investment rules and regulations designed to reduce the level of market volatility, critics question how effective these measures are likely to be (Kosmarskaya, 2002).

7. Conclusions

Why did Russia opt for the World Bank multi-pillar pension model, a model that is not at all compatible with the nation's policy legacy? We have mentioned several important factors including economic pressure from international financial organizations and the associated need to take actions that would be looked upon favorably by the international financial community. We have also emphasized arguments linked to world society theory and cultural diffusion theory.

Many policy makers in Russia believe that there is no viable alternative for Russia that does not put a heavy emphasis on a funded individual accounts pillar. We disagree and propose an alternative that Russian policy makers are already aware of because it has been incorporated, at least in a modest way, as part of the current scheme. What we are calling for is a shift in emphasis between the two components of the second pillar of the current scheme. Currently the second tier of the new Russian scheme includes both a funded defined contribution component and an unfunded notional defined contribution (NDC) component. We believe that it would make sense, at least for the next few decades, to put the emphasis on the NDC as opposed to the funded component. There are several reasons for such a shift in emphasis.

One is the likely cost of transition from the prior scheme to the new scheme. To the extent that payroll taxes are diverted into the new funded individual accounts, they will not be available to pay pensions to the currently retired. If a substantial fraction of the payroll tax is so diverted, this is going to put a great deal of pressure on the national budget. But to the extent that the emphasis is put on the NDC component, this burden can be spread across more generations reducing the level of that burden for the current generation of Russian taxpayers.

A second reason to emphasize the NDC component is that it will be less subjected to the volatility of stock and bond markets. Such volatility is currently a problem in Russian financial markets and this may continue to be the case for many years into the future. Market volatility is a problem for any nation with a scheme that calls for investment in financial assets, and this is particularly so in nations without well developed financial markets and regulatory institutions.

A third advantage of the NDC component is that it will be less vulnerable to corruption and will make less by way of regulatory demands than the funded alternative. In a nation such as Russia, which currently has very serious problems with corruption, this is a huge advantage of the NDC alternative. There are many ways in which corruption can be a problem with funded individual accounts. Workers can be misled as to how much risk is involved and what is an appropriate risk level for their personal situation. There can be all sorts of hidden fees that end up eroding returns, particularly for accounts with relatively low asset levels as will be the case for the most economically vulnerable workers.

If the impact of corruption is to be controlled, a great deal of money must be spent administering and regulating the individual accounts. In the UK the cost of administering the funded individual accounts turned out to be much higher than originally anticipated due to unanticipated levels of corruption (Crawford, 1997). In Chile the cost of administering these funded accounts has turned out to be very high, particularly for the small accounts held by many women and low-wage workers more generally (Kay, 2000; Williamson, 2001).

If the Russian government continues to control most of the assets in the funded individual accounts as is the case today, there is another problem. Such accounts are called provident funds and the record of provident funds around the world has been rather poor (Dixon, 1989; World Bank, 1994). Many governments have not been able to resist the temptation to use this money to buy government bonds paying returns that are substantially below the rate of inflation. This has happened in many nations and it could happen in Russia as well, although the availability of private sector pension asset managers should help reduce this risk.

Our final recommendation is that Russian policy makers take a close look at how well pension schemes with substantial funded pillars are working out in other countries around the world with financial markets at a comparable level of development. Even some experts at the World Bank are now questioning how well this model is likely to work in nations with serious corruption problems and poorly developed financial institutions (Orszag & Stiglitz, 2001). The Russian government must pick a model that is going to fit Russia's current realities and is flexible enough to be modified in the decades ahead as those realities change.

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