Pension Reform and the Development of Pension Systems: An Evaluation of World Bank Assistance

Background Paper
Russia Country Study

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Abbreviations

ESSP	Employment Services and Social Protection Loan
GDP	Gross domestic product
IEG	Independent Evaluation Group (formerly OED)
IMF	International Monetary Fund
NDC	Notional Defined Contribution
NPC	National Pension Council
NPF	National Pension Fund
OED	Operations Evaluation Department (changed its name to IEG in December 2005)
SPAL	Social Protection Adjustment Loan

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Preface

This paper belongs to series of 19 country and regional case studies commissioned as background research for the World Bank's Independent Evaluation Group (IEG) report "Pension Reform and the Development of Pension Systems." The findings are based on consultant missions to the country or region, interviews with government, Bank, donor, and private sector representatives involved in the pension reform, and analysis of relevant Bank and external documents.

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1. Evaluation Objectives and Methodology

1.1 The goal of this report is to provide an external, independent evaluation of the role of the World Bank in promoting and supporting the pension reform process in the Russian Federation.

1.2 To perform our task, we based our analysis on a factual and qualitative assessment. For the first, we considered

- The overall design of the pension system before reform;
- The degree of necessity of the reform, and its priority with respect to other reforms; and
- The efforts made by the Bank to adapt the general formula (as described in the Bank volume *"Averting Old Age Crisis")* to the specific characteristics and circumstances of Russia.

1.3 For the qualitative assessment, we considered

- The degree of transparency of the reform process;
- The degree of "ownership" of the reform by Russian political institutions; and
- The support from the Bank to develop all of the direct and indirect means to sustain the reform and evaluate its performance (the development of an administrative and information system, the organization of the various institutions involved in the process, etc.).

1.4 The main sources we used were

- Selected documents provided by the Bank;
- Interviews with representatives of various relevant institutions and organizations; and
- Selected journal articles and papers.

2. Background

RUSSIAN FEDERATION: MACROECONOMIC DATA

2.1 As a general rule, proper appraisal of a pension system cannot be done without considering the specific characteristics of its social and economic environment. In the case of Russia, this rule seems most appropriate. The difficulty in grasping the essential traits of the Russian economy and society—especially in its painfully long transition toward a market economy—are extreme. The sheer dimension of the problems that arose in the past 10 years, in such a complex and vast country, is daunting. The following pages are only an introduction to pension reform in Russia and the role played by the World Bank. Consequently, although many topics are indeed highly relevant to the pension issues, it is outside our scope to thoroughly describe the social and economic aspects of the transition.

2.2 Table 2.1 is a first look at the magnitude of the numbers involved (more extensive data are shown in appendix B).

Table 2.1: Size of the Russian Federation

Geographical area	17,075,200 square km
Population	
Central Intelligence Agency estimate, July 2003	144,526,278
US Bureau of the Census, 2002	144,979,000
Population projections for 2020	
US Bureau of the Census	135,952,000
World Bank, World Development Indicators	130,595,000

Economic Review

2.3 The present-day Russian Federation was the very heart of the old Soviet economic system, which collapsed in December 1991. The resulting shock to the Russian economy and social fabric was understandably greater than what was experienced by most of its trading partners, especially in Central Europe.

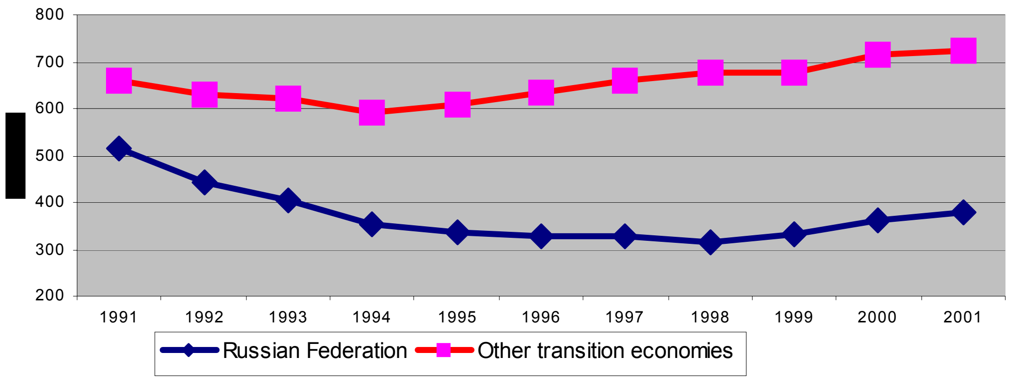
2.4 Russia's gross domestic product (GDP), measured in 1995 US dollars, shrank for seven consecutive years—by 1998 it was barely 60 percent of its 1991 value. The subsequent rebound has been promising but by 2001, the country's GDP had recouped only about one-third of its total decline. By contrast, all of the other transition economies had collectively recouped their 1991 GDP by 1997, and in 2001 their joint production was roughly 10 percent higher than in 1991 (see figure 2.1).

2.5 Russia's ruinous economic fall may have been somewhat cushioned by the spread of the second or informal economy. According to one estimate (Ovcharova 1996),[1]

[1] According to official estimates (Kolosnitsyna and Topinska 2002), the Gini coefficient doubled in the 1990s, from 0.2 to 0.4. As for poverty, one-third of the population had incomes below the poverty line in

in the beginning of the 1990s, 20 percent of the working population was occupied in this sector, and 15–20 percent of incomes were not reported. The view that the informal economy may have experienced vigorous growth is supported by the fact that Russian electricity power consumption fell by only 20 percent during this period, in line with the rest of the transition economies.[2] Not all electricity is put to productive use, however, and some waste of resources must be allowed for in the calculations.

Figure 2.1: Russia Federation and other Transition Economies GDP – Constant 1995 US$



2.6 Conversely, it has also been argued by Gaddy and Ikes (1998) that the Russian economy may be smaller and possibly may have contracted by more than what is shown in the statistics. This view is connected with a large portion of the transactions having been conducted as barter, at least up until 1997–98. According to Gaddy and Ikes, in 1997 the share of barter in payments was more than 50 percent.[3] In 1997, Russia's Karpov Commission reported that the country's largest companies conducted 73 percent of their business in barter and other non-monetary means, and paid only eight percent of their tax payments to the federal government in cash.

2.7 Regardless of the debate about the informal economy's role, production contractions of this length and magnitude are usually observed only after defeat in a major war. In Russia's case, they occurred without any war having been waged. High inflation, which continued until 1995, certainly added to the depression in economic activity: rapid and widespread consumer price increases followed the 1992 market liberalization and had adverse effects both in generally accentuating the depth and the duration of the crisis, and specifically among the social groups whose wages and transfers were lagging behind.[4]

1992; the percentage declined to one-fourth in 1994–96, but increased again to more than one-third in 1999 as a consequence of the 1998 crisis (see Ovcharova 1996).

[2] See World Bank 2003a.

[3] Gaddy and Ikes 1998.

[4] Klugman and Braithwaithe 1998.

2.8 Gross capital formation understandably bore the brunt of the reduction, shrinking nine years in a row, from 36.3 percent of GDP in 1991 to 14.7 percent in 1999, dropping by nearly two-thirds. In the core manufacturing sector of metalworking and engineering products, spending on plant and equipment in 1997 was no more than 5.3 percent of what it was only seven years earlier.[5] Over 70 percent of industrial plants are thought to be beyond their normal productive cycle. By contrast, final consumption (both private and government) reduced by a "mere" 17 percent during the same period. This was partly achieved through the piling up of foreign debt (doubling between 1991 and 1999). "Modern goods" consumption, however, experienced vigorous growth (there were over 500 television sets per 1000 people in 2001, as compared with fewer than 370 in 1991; the number of telephone mainlines and cars per 1000 inhabitants also increased sharply). This suggests that inequality and poverty must have increased and, although statistical evidence is scanty, anecdotal evidence abounds.

2.9 It is understandable that production would have changed shape profoundly. While most resources were tied up in the obsolete manufacturing system at the end of the Soviet era, aging and giant uncompetitive industrial complexes were increasingly scrapped in the new market-oriented scenario. Entering the arena of world competition, Russia specialized in the areas where it had a competitive advantage, that is, largely in raw materials and, particularly, oil. Furthermore, exports were largely redirected from the traditional markets of the Commonwealth of Independent States to the world market, at large. Oil and natural gas exports rapidly became the single largest export item and the surge in oil prices provided a very welcome boost to the Russian economy overall, and specifically to state finances. This was an important factor in Russia's ability to resume normal government financial activity, pay arrears, and set development goals. However, high reliance on natural resources has somewhat restricted the scope for diversifying the economy, which implies a high vulnerability to any sudden collapse in the price of oil.

2.10 In 2002, more than half of the country's oil production was exported, and in the first nine months of 2003 the share of oil exports rose even further. The petrochemical industry now accounts for roughly one-fifth of total industrial output, slightly more than the traditional engineering sector. A whole array of new industries has been sprouting up, from pharmaceuticals to food, to building materials. While investment has been brisk in the service sector, particularly in communications, transportation remains one of the most important Russian problems. The country relies on an obsolete railway system, and investment in the road network ought to receive high priority.

2.11 The upturn in Russia's economic prospects in the late 1990s was, therefore, largely due to external factors, such as the increase in oil prices. Also crucial was the role played by the economic reforms introduced under President Vladimir Putin. Achievements in 2001 included far-reaching tax and legal reforms, the replacement of Soviet-era labor and land codes, a deregulation package, and a new pension system. In his annual address to Parliament on April 19, 2002, the President focused on economic

[5] Gaddy and Ikes 1998.

development and a more aggressive assessment of Russia's possibilities; his emphasis was on administrative reforms and the reduction of inefficiencies.

2.12 While the adoption of economic reforms since mid-2000 has been impressive, implementation and enforcement of legislation remain a key issue. Perhaps the most lasting damages of the troubled transition are to be found in the country's demography. The birth rate collapsed from 14.6 per thousand in 1989 to 8.3 per thousand in 1999, with the biggest drop occurring in the troubled 1992–95 period. The rate then stabilized, and in 2001 it stood at 9.1, a hopeful sign but not enough to reverse the overall negative outlook. Of all the transition countries, only Moldova and Latvia have experienced a bigger fall. The death rate, conversely, soared from 10.7 per thousand to 15.6 per thousand, an increase of 46 percent, definitely greater than in all other transition countries. Average life expectancy at birth decreased from 68.9 years in 1990 to 65.6 years in 2001. Russians younger than 15 years of age numbered 34 million in 1990 and only 26.4 million in 2001, a reduction of one-quarter. A cursory examination of death rates suggests that they have been high in all age brackets, supporting anecdotal evidence of the heavy human toll taken by the environment of hardship.

Table 2.2: Russian Federation Population Projections, 2000–20 (in thousands)

Age	*2000*	*2005*	*2010*	*2015*	*2020*	*percent variation 2000–20*
0–14	26,403	21,546	20,876	20,387	19,643	–25.6
15–64	101,359	101,023	101,082	96,813	91,659	–9.6
65+	17,793	19,752	16,614	17,324	19,293	8.4
Total	145,555	142,321	138,572	134,524	130,595	–10.3

Source: World Development Indicators, World Bank 2003a.

2.13 Russia's working-age population will decrease abruptly in the second decade of the 21st century. The country will have to build an expanding economy upon a shrinking population base and an even greater shrinking reservoir of the youngest members. The problem is somewhat tempered by the trend in the elderly population: after peaking around 2005 the number (reflecting past, officially encouraged, baby booms) will shrink considerably in the following 10 years.

PENSION SYSTEM IN THE EARLY 1990S

2.14 Like many of the other transition economies, Russia inherited the old Soviet pension system. Unlike the other countries, however, Russia attempted to maintain its pension system even in the face of almost prohibitive resource constraints and a negative demographic outlook, with a growing dependency ratio. Four major points may explain the seemingly peculiar Russian behavior:

- The system was not an "externally imposed" social-protection scheme, but rather a fundamental national institution, a pillar of the social compact, whose performance people did not perceive as a clear failure, or even particularly in need of drastic change.

- There was widespread sentiment that not everything the old regime had done should be scrapped and this was enhanced by the severe worsening of life conditions, in general, and of the elderly, in particular.
- Policy makers did not have a clear framework with which to interpret the interrelationships of the pension system with the general performance of a market economy, and it was not exactly clear which "efficiency paradigm" should be used in the new post-Soviet society.
- Finally, the main motivation for urgent reform in other Eastern European countries, that is, the aspiration to maintain and reinforce their newly acquired independence, was probably much less effective in Russia, where the change of regime could hardly be described as the winning of independence.

2.15 These aspects should be kept in mind when evaluating the difficult path of pension reform in Russia; they constitute a response against the all-too-easy (ex-post) assertion that problems should have been handled differently, and much more radically (see, for example, Kotlikoff 2000).

2.16 The starting point of any investigation of the Soviet-type social-protection system must be acknowledgement that, despite its many deficiencies, it had actually "worked" in the planned economy. Although this may well be because people's expectations were so low, and the majority of the population knew that "a poor working life would be followed by a poorer retirement."[6]

2.17 Pensions, and indeed the whole social protection system, were then seen as just a "compensatory mechanism" for those in need and only later, in the second half of the decade, was the reform possibly conceived (and not without hesitation) as an independent goal, instrumental to economic growth (Thompson 2002, p.33). The pension system's inability to cope with the enormous problems arising from the transition was thus not immediately perceived; most of the difficulties were pervasive, and even those which were specific to it (delays in payments, poor indexation, a decreasing level of tax compliance) could be attributed more to the problems generated by transition than to the system itself.

2.18 The Soviet type of social protection generally consisted of a "visible" and an "invisible" component (Gillion and others, 2000, p. 544). The former provided pensions, short-term cash benefits, and health care. The latter, natural in the planned economy, "added security through specific socialist income-redistribution mechanisms, such as guaranteed employment, the provision of low-cost housing and heavily subsidized basic goods and services (food and services for large families, education, cultural services, and so on)" (Gillion and others 2000, p. 555).

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[6] Walter Connor, as quoted in Kapstein and Milanovic 1999, p.10.

2.19 As for the pension system,[7] it was a badly designed PAYG scheme providing: old-age and early-retirement provisions for retirees, survivors' benefits, disability pensions, and social benefits for the elderly who did not qualify for a pension of any kind.[8] In broad terms, the system was highly redistributive and conceptually seen as an integrated part of the workings of the planned economy, with state enterprises actively engaged in social protection programs. But it was also poorly administered, monitored and supervised for its efficacy and efficiency, and fragmented into various schemes,[9] each with rules differentiated by gender. In short, it had many of the deficiencies—certainly not unknown in Western Europe—characteristic of highly manipulated systems that are meant to serve too many inconsistent goals and that hid various privileges.

2.20 Eligibility conditions for old-age pensions were set up during the early 1920s, when the system was established to provide pensions for Red Army veterans and a few other categories of public workers[10] and were kept practically unchanged thereafter (Buckley 1998). Women could attain the pension benefit at the age of 55, with a minimum seniority of 20 years; men were required to be at least 60 years old and to have worked for at least 25 years. Some exceptions were, of course, introduced on considerations of equity, for example, in favor of workers employed in dangerous or/and physically demanding jobs. On this basis, women were allowed to retire at age 50 after 15 years of service, and men at age 55 after 20 years of work. Exceptions were also made for pragmatic reasons, such as for workers on collective farms, who—perhaps because of their weaker bargaining position but also because of the higher likelihood of their working a little even at older ages—were offered less favorable conditions. For them the required conditions were 60 years of age for women and 65 for men, with a minimum of 25 years of service for both.

2.21 In terms of composition, in 1990, around 72 percent of pension benefits were for old age; most of the remaining 28 percent were granted under early retirement provisions.

2.22 Benefits reflected the prevailing wage and price structure, particularly the heavily subsidized prices for essential goods and the non-wage forms of compensation. The pension level was determined according to an earnings-based formula. Replacement ratios were set between 50–75 percent of the recipient's best five years of wages (or of the last two, depending on the worker's choice). The average replacement ratios (average pension with respect to average wage) were, however, much lower. For 1989–95, Gillion and others (2000, p. 560) report the following annual figures: 35.5, 33.7, 33.8, 25.8, 33.6, and 35, with respect to net wages. A minimum pension benefit was set at a level not

[7] The highly fragmented nature of the system can be appraised by considering that the legal base was made up of about 50 different laws and legal acts.

[8] Social pensions were paid to people with less than five years of employment at age 65.

[9] An important scheme, administratively separate from the rest of social security, was one for farm workers, which was highly subsidized by collective farms.

[10] The enlargement of pension coverage to new categories occurred through a trade union agreement. A comprehensive pension system was created only in 1956; collective farm workers, however, were still excluded, although it was considered a responsibility of the collective farms to provide resources to their elderly workers. Only in 1964 was pension coverage expanded to include collective farmers and their families, though in a separate scheme (Buckley, 1998).

below 80 percent of *the minimum elderly subsistence income.*[11] The ceiling level amounted to 3 times the floor level (3.5 times for some categories), but some pensioners received considerably more (5 times the minimum benefit).

2.23 Benefits were set in nominal terms and, given that inflation was conceptually inconsistent with the planned economy, automatic adjustments were practically unknown. Pension levels were thus kept constant in money terms for years, if not decades, which was not so much of a problem until the inflation rate “exploded” in the early years after the collapse of the regime.[12] After the institutional break, the first government’s reform in early 1991 introduced an indexation mechanism: given the high price instability, benefits were indexed quarterly, but legislation did not specify any indexation mechanism, so it was up to the government to make a decision each quarter.

2.24 Up until 1993, pensions were, in fact, adequately protected against inflation. Since then, however, they have not kept pace with inflation and their purchasing power has been greatly eroded (see box 2.1). Some difficulty in grasping all the different aspects of the issues connected with price inflation, especially with respect to the interactions between indexation and real growth, was manifest in some of our interviews. It is certainly true that any measure of inflation is arbitrary to some degree. The importance of setting a precise rule, however, by which to index the benefits to a commonly agreed measure, was somewhat underrated. As a consequence, indexation was perceived as a sequence of discretionary adjustments, dependent not only on budget capability to accommodate compensation, but also on changing priorities in the political arena. The mechanism was thus negatively affected in its ability to maintain value and reduce uncertainty.

2.25 As for financing, the system could rely on a payroll tax rate of 29 percent (nominally divided between a 28 percent employer contribution and a 1 percent employee contribution) and on integration provided by transfers from the federal budget to cover the specific pension responsibilities of the government. Collected funds were (and are) administered by the pension fund, which was established in 1991 as an independent authority (but then immediately placed under the Supreme Soviet).[13] With the collapse of the Soviet regime, however, tax collection became ever more difficult, given that the obsolete administrative method was incapable of monitoring the new situation as well as the complex transfer structure between the pension fund, its regional offices, and the regional agencies in charge of benefit payments.[14] At the beginning of the new regime, a huge office computerization had been started, with the aid of the World Bank (see Kolosnitsyna and Topinska 2002). The introduction of computers and computerized

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[11] During most of the 1990s, the average pension fluctuated just above the level of the minimum elderly subsistence income, but fell to 70 percent of that level in 1998 as a consequence of the financial crisis. Regarding the minimum, it varied substantially in the period, with a declining trend relative to both the minimum elderly subsistence income and to the average, reaching 50 percent of the minimum elderly subsistence income in 1995 and even less in 1998.

[12] See the statistical table in appendix B.

[13] From the very outset of the transition, the Pension Fund became an item of political contest between the president and the Supreme Soviet. It was only after the defeat of the latter in 1993 that President Boris Yeltsin placed the Pension Fund under the government’s strict control (Cashu, 2001).

[14] In 2001, the collection of contributions was transferred to the Central Tax Authority.

networks improved the administrative process by reducing the incidence of errors and by cutting red tape. However, the change could only prevent further worsening and did not really improve the overall performance of the system. Russia's economic crisis, in fact, added to the difficulties of collecting taxes and contributions. The rapidly decreasing earnings and income base made the actual payment of pensions particularly difficult and started recourse to the use of delays as a policy instrument.

2.26 In macroeconomic terms, pensions were the largest item of social protection expenditure: the ratio of it to GDP increased from 5.9 percent in 1989 to 6.0 percent, 6.6 percent, and 7.3 percent in the subsequent three years, contracting again to 6.4 percent and 5.9 percent in 1993 and 1994.[15]

2.27 Russian demographics have greatly deteriorated since the start of the new regime, with a marked decline in the population (by about three million people in the 1990s), despite a net immigration. This is the result of a continuing reduction in the fertility rate and a sharp increase in adult mortality, in particular, among middle-aged males (within 10 years, the life expectancy of Russian men fell from 64 to 58.4 years, while that of women fell from 74 to 72). As a net result of these different and partially conflicting tendencies, the ratio of pensioners to the working-age population had been rising for several years: from 28 percent in 1980 to 34 percent in 1994; when early retirees were included, it reached nearly 50 percent.

2.28 In parallel, the ratio of contributors to retirees, or the "coverage ratio," declined from 3.08 in 1989 (with many variations between urban and rural areas, at 3.42 and 2.34, respectively) to 1.80 in 1994 (see statistical table, appendix B), with a further decline in subsequent years to 1.74 in 2002, mostly because the collapse of production caused the loss of many jobs.[16]

REFORM ATTEMPTS DURING THE 1990S AND EARLY 2000S

2.29 Despite the initially broad effectiveness of the pension system, it was soon clear that the system Russia inherited from the Soviet era was ill-equipped to face the severe economic downturn, the declining contributory base, and the rapidly worsening dependency ratio, which impeded the transition. The high degree of disparity of treatment within the system, as a consequence of its fragmentation, with marked differences between farm and industrial workers, military personnel and public employees, became more evident and, therefore, less socially acceptable in the new market environment, which was creating disparities of its own. Moreover, the delays in pension payments, which represented a kind of "response"[17] to the financial difficulties of the system, angered people because the large majority of the elderly relied specifically on these payments to live. Moreover, the situation was made worse by the new restrictions imposed on work after retirement age, which were officially motivated by the goal of

[15] United Nations Children's Fund data, as quoted in Gillion and others 2000, p. 561.
[16] In addition, see World Bank 1995a, p. 37; World Bank 1995b, pp. 67, 68, 70; World Bank 1996b, pp. xviii, xix, 66, 68, 69; World Bank 1997a, pp. 5, 6; and Kolosnitsyna and Topinska 2002, pp. 3–6.
[17] Although the delay was certainly accounted for by the administrative weakness of the system, it was also an instrument by which to keep some control on outlays.

fighting unemployment (a not uncommon failure in understanding how a market economy works). The evidence was undeniable that if pensioners had been ill treated under Communism, they fared even worse in the new system.

2.30 Probably because of the macroeconomic and financial problems of Russia, this was not, however, the main worry prodding the government toward reform (although it was a main concern for the Bank). Instead, controlling expenditure and improving tax and contributions collection, while maintaining the basic structure and coverage of the Soviet system, were the main motivations behind the first reform attempts.

2.31 The earliest government interventions date back to 1991, much later than the economic reforms of the *perestroika* period. In order to reduce administrative overlap and costs, the separate structure in charge of pensions for collective farm workers was abolished in favor of a unified system of pension provision, and the pension fund, an independent state authority, was established. However, the regional decentralization of political and administrative power created new problems for pension payments and tax collection.[18]

2.32 However, the method for calculating pension benefits was not modified, so inequality persisted and farm workers' pensions, in particular, continued to be much lower than the average, leading to swelling poverty in rural areas.

2.33 In order to address the poverty issue, and under pressure from the Bank, the government established a minimum pension and an indexation mechanism to protect benefits from inflation. Both measures, however, were more like discretionary policy interventions to limit public complaints, rather than effective targeted pieces of reform.

2.34 The indexation procedure, in particular, was quite complicated. The minimum pension benefit was aligned with the minimum wage and indexed to price inflation. Because all of the other pension benefits were linked to the minimum pension, a whole indexation structure was shaped. Officially, this should have restored the purchasing power of pensions, which had been eroded by high price increases. In practice, because adjustments were decided through presidential decrees, the mechanism served mainly to put pension expenditures under the government's control. Moreover, differential indexing according to pension level reduced the difference between the floor and the ceiling, and increased the number of pensions at the minimum level.

2.35 The weakness of the Russian banking system further complicated the problem, greatly adding to the delays in payments, which in various parts of Russia were measured in term of months, not days[19]—a difference that is quite significant, given the high monthly inflation rate.

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[18] Responsibility for the pension system's design and operation is allocated among different ministries: the Ministry of Labor and Social Development devises strategies and plans, the Ministry of Economic Development and Trade is responsible for economic forecasts and investment issues, and the Ministry of Taxation collects contributions within the unified social tax.

[19] An average delay of three months was estimated.

2.36 The government and political structures of Russia were additional barriers to reform. Political struggle and instability characterized the decade. The end of the Soviet Union in 1991 and the birth of Russia as an independent state came after a two-year power struggle. In 1993, another struggle involving the President and the Supreme Soviet, led to the adoption of a new constitution and a general election to appoint a new Duma. Another election took place in 1995, resulting in a parliamentary composition that was relatively hostile to the president's reform proposals, an antagonism that continued until President Boris Yeltsin resigned in 1999. In the meantime, while several ministers, in different cabinets, were responsible for parts of the program, frequent changes in the government also created obstacles. For example, at the Ministry of Social Protection, seven ministers held the top office between 1994 and 2000, each trying to "modernize" the ministry, thus changing or freezing previous reform attempts.

2.37 Irrespective of these difficulties, if the initial reluctance to completely reform the inherited Soviet pension system had some justification, its persistence in subsequent years—after all the deficiencies and the suffering imposed on the elderly population became more and more evident and could no longer be attributed to the hardship of the early transition—is much less defendable.[20] In fact, rather than redesigning the system, or even proceeding with the more traditional parametric reforms—such as increasing the retirement age—the "Russian way" mainly consisted of cutting the real value of pensions and delaying benefits payments.[21] Although probably not easy, a sterner attitude against this practice by the Bank and other international donors and lending institutions would have helped. This criticism, however, was left to outside critics to make, by individuals like Willem Buiter and Joseph Stiglitz. Buiter claimed the IMF should take responsibility for its somewhat relaxed attitude toward "sequestration" (a large recourse to arrears). Stiglitz asserted that: "Reneging on social payments was not only tantamount to breaking an implicit social contract, it destroyed social capital that is vital for economic development, especially if at the same time the government is transferring vast amounts of wealth to a few individuals" (as quoted in Kapstein and Milanovic 1999, p. 17).

2.38 Therefore, until 1995, the reform of the social protection programs, and of the pension system, in particular, did not receive the attention it deserved, for two reasons: (i) the priority agenda was dictated by ever-new emergencies; and (ii) probably the belief that promoting growth was the most effective way to fight poverty, not only in the long run, but also to shelter the poor in the short run (an attitude that is responsible for the neglect toward the worsening income distribution.

2.39 In 1995, under pressure for a loan from the IMF, aimed at covering the pension arrears, the government started a discussion on the three-tiered pension structure, along the lines advocated by the Bank, that is, inclusive of a basic social pension, a mandatory labor pension (financed though payroll tax rates), and a supplementary private pension

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[20] Political disagreement on the issue was not absent, as exemplified by the resignation in 1994 of the Minister of Social Protection, Ms. Ella Pamfilova.

[21] According to Cashu (2001), pension arrears were already a distinct retrenchment practice in the Soviet Union, which Russia simply maintained and expanded. The pension arrears crisis engulfed Russia in mid-1995 and became a hot political issue, with attempts by the government to solve it in close to elections. Only in 1999, partly as a consequence of the high oil price, were the arrears redeemed.

(funded through individual savings). The 1995 crisis, however, created new problems for the administration, which reacted by setting aside the proposed reform.

2.40 A new burst of political activity in the pension field enlivened the year 1997. In June, the government reaffirmed its commitments to preparing the multi-pillar system. Specifically, the three planned tiers were: one financed by the public budget to provide minimum income security and protection against poverty in old age; a second tier with one (or more) mandatory earnings-related programs, to be fully or partially capitalized in the medium term; and a third tier, with one or more voluntary earning-related pension schemes, to be fully capitalized in the long run.

2.41 Meanwhile, further efforts were deemed necessary in order to: strengthen the revenue base of the pension fund, to improve the procedures of contributions collection, and to adjust the minimum pension payments for socially vulnerable pensioners. It was decided, in particular, that the minimum payments should be adjusted at least once a year, but not more often than quarterly. It must be stressed that such a provision generates modifications in all the benefits, as the minimum payment works as a benchmark for all the others.

2.42 As for steps toward a less unbalanced budget for the pension fund, measures to enforce tax payment compliance by large companies as well as annual audits for the pension fund[22] were introduced. Moreover, the government transmitted to the Duma draft legislation on non-state voluntary pensions. Concurrently, the government expressed the intention to submit to the Duma a bill introducing a systemic pension reform (to be prepared before the end of 1997). This commitment is strictly linked to the emergence of a change in attitude with respect to the pension system, which started to be considered much more as an insurance mechanism, rather than as an assistance device. The need for greater ownership of acquired pension rights by the workers, and of a greater connection between pension rights and paid contributions, began to change the perspectives of policy makers. The emergence of this "insurance principle" was frequently referred to in our interviews as one of the most important achievements of the period.[23]

2.43 The government also prepared draft legislation to further reduce the benefits of working pensioners and to shift financial obligations for early retirement to companies and sector-funded schemes. In 2000, the responsibility for collecting pension contributions was passed on to the Ministry of Taxation. This required a good relationship between the ministry and the pension fund, which was responsible for data collection about workers' earnings profile and for the payment of benefits. It was envisioned, moreover, that the planned pension reform would include a public information campaign and an educational program.

[22] However, according to Kolosnitsyna and Topinska (2002), these measures were introduced with considerable and unnecessary delay.
[23] Indeed, the link at the individual level between paid contributions and pension calculation was reinforced through the Federal Law No. 113-FZ, July 21, 1997, "On the Procedure for Calculating and Raising State Pensions."

2.44 All of these good intentions, however, suffered a setback as a consequence of the new, deep crisis of 1997–98, itself largely a result of poor policy measures. In 2001, 10 years after the collapse of the Soviet regime, an internal Bank document could thus still state that no systemic reform had yet taken place in Russia.[24]

2.45 President Vladimir Putin's first years of rule impressed a more vigorous pace on the reform process, not only in terms of macroeconomic stabilization and growth policies, but also in terms of the pension systems. In 2001, precisely to give new stimulus to the reform, President Putin established the National Pension Council (NPC), with the aim of bringing major political and social forces on board and favoring the formation of a consensus on the direction and design of the reform. It included representatives from the Duma, political parties, government ministries, trade unions, employers' association, and civil society organizations. According to Cashu (2001), however, the body was mainly "a lobbying mechanism under the veil of inclusiveness, rather than a mechanism that permitted effective compromise." The government was the main actor, resorting to "a whole range of Machiavellian tactics to manipulate the outcomes" (see box 2.2).

2002 REFORM

2.46 Despite the political limits of the decision process, the 2002 reform effectively introduced a multi-pillar system, with an important change with respect to the system designed in 1997–98, that is, the adoption of a notional defined contribution formula (NDC) within the PAYG component, signaling perhaps new awareness of the need to set the pension system "straight" in economic terms.

2.47 In the new steady state, the system would have universal coverage (embracing the employed, self-employed, and independent farmers), and would be made up of:

- A basic (flat-rate) benefit, covering the redistributive purpose of the public component;
- A notional defined contribution public scheme; and
- A mandatory ,funded pillar.

2.48 Despite the objective of establishing uniform rules, special provisions for civil servants, military personnel, war veterans, and other groups are maintained. The financial means were to come from payroll taxes paid by employers; the previous rate of 28 percent is maintained but split into two halves: 14 percent contribute, as part of the overall Single Social Tax, to finance the basic flat-rate pension (which is very low and fixed in absolute terms, although with variations between categories), and other social insurance items, such as illness and medical care indemnities, and maternity benefits. The remaining 14 percent, targeted for the pension fund, is meant to be split further (see box 2.1) in order to finance the contributory (eight percent) and funded (six percent)

[24] The improvements realized by the Pension Fund in eliminating the arrears accumulated during the crisis, however, have to be reckoned. Also, the Pension Fund established some pilot programs to start individual accounts.

components.[25] Workers may choose whether to leave the contributions targeted for the funded component, to be administered directly by the pension fund (the default option), or to hand them over to a private asset manager.

2.49 The main features of the new reform can be summarized as follows:

- **Financial equilibrium:** From unofficial simulations (by Pomazkin and Martineau, as reported in Thompson 2002),[26] it can be judged satisfactory in the most optimistic scenario, acceptable in the basic scenario, and problematic in the pessimistic scenario. Doubts can be raised, however, about both the solidity and the consistency of the underlying assumptions in all scenarios. On the one hand, in all scenarios both growth rates and financial returns seem quite optimistic. On the other hand, even in the basic scenario, the assumed inflation rate (a long-run rate of seven percent) hardly seems consistent with a stable macro-economy and with Russia's prospective participation in trade agreements (such as the World Trade Organization), and even less with its aspiration to join the European Union (possibly through the intermediate step of a Common European Economic Space.
- **Replacement rate (the ratio between average pension and average earnings):** Taking into consideration the three pillars, this value is expected to decrease from 36 percent in 2002 to 19 percent in 2050 (Thompson 2002, p. 9). This trend affects both the basic component and the NDC component (Thompson 2002, pp. 17, 21). The prospective reduction in the replacement ratio casts doubts on the capacity of the new system to satisfy standard "adequacy" criteria and thus on the political sustainability of the system. Moreover, the very low replacement rates, in principle, should be reflected in a surplus of the PAYG component. However, we have not seen specific projections of such a surplus and it is doubtful, anyway, that it will be sufficient to cope with the adverse demographic conditions during the transitional period. References to this surplus were often made in our interviews, with statements about the possibility of using it to keep pension benefits at an acceptable level. Even assuming that, despite the above-

[25] This description refers to the "regime" situation after 2006; the current (as of 2004) split is four percent to the funded component and 10 percent to the NDC. According to the present law, the elderly members are excluded from the funded component, and thus pay the entire 14 percent to the NDC system. The exclusion of middle-aged and elderly members, however, has caused objections and kept discussion open about this provision, as well as about transitional matters.

[26] We are not aware that any official projections for the new system have been produced or released. The section is thus based on the World Bank report, *Pension Reform in Russia* (Rashid and others 2002) and, in particular, on the projections referred to in the text. From our interviews, however, the importance of basing policy evaluations on good projections of likely scenarios was clearly acknowledged. Specifically, although there is no formal commitment to publish regular long-run pension projections, pension policy does make common use of such projections. The adopted pension-projection model is by Pomazkin and Martineau and has been developed in cooperation with the World Bank. In this model, all of the macroeconomic projections are exogenous and are produced by a different (general equilibrium) model, and is operated by a unit at the Ministry of Finance; the unit includes staff from the Ministry of Economic Development and Trade.

mentioned demographic reasons, that this surplus will actually be created, this hardly rigorous approach is an example of how, in Russian policy, the statement of a principle may overshadow its practical application (a point we will discuss in the conclusion).

- **Incentives:** The basic benefit, which alone absorbs half of the payroll tax rate (14 percent out of a total of 28 percent), is computed on a flat-rate basis. This means that the contributions to this pillar have no marginal effect on benefits. Neither is the NDC component fully correlated with contributions (a variable part ranging between eight and 12 percentage points of the remaining 14 percent). This is because of several reasons: (i) a component (the difference between 660 and 450 *rubles*) is, in practice, still independent from the contribution; (ii) in the transition to the new system, all workers were given recognition at a quite high seniority level;[27] (iii) the conversion rate of the pension amount into an annuity is independent of the age of the worker at retirement; and (iv) the rate of return on contributions (that is, the capitalization rate) depends on a complex mechanism, thus appearing closer to an inflation rate than to a rate of wage variation. For all these reasons, the nature of this contribution is rather similar to a tax, with incentives for evasion, while its lack of correlation with the retirement age provides a disincentive for employees to work until retirement.

2.50 A point which deserves to be mentioned, and which is very relevant to pension policy in general, is the inadequate recognition of pension contributions as workers' own savings for retirement. Therefore, even in the new system based on an "insurance principle," pensions are seen as a benefit paid by the state or by the firm, but hardly as a regulated instrument for the reallocation of the individuals' income in their life cycle. In particular, according to our interviews, the concept of a "wage package," of which payroll taxes and employers' pension contributions are important components, does not appear to be a principle clearly recognized by most Russian officials, and even less so by the public. Contributions to the public pillar are mostly seen as affecting the firm's profitability rather than as a structural element of wages, and, along the same lines, employer contributions to private funds are perceived as a "gracious" gift, being paid on condition of favorable liquidity situations rather than as a clear obligation.

2.51 Distortions of the labor supply and lack of employee awareness of the future consequences of unpaid contributions are, therefore, likely to emerge.[28] Moreover, this gives rise to a somewhat relaxed attitude by policy makers and regulators concerning the solidity of company-based funds. These consist mainly of partially funded defined-benefit schemes, with a weak regulatory framework and characterized by rather "intermittent" company compliance. The uncertainty that these circumstances cast on the future performance of the funds appears to be underestimated.

[27] Moreover, the initial capital for the NDC component appears to have been calculated giving more weight to "acquired rights" than to contributions actually paid under the old system.

[28] A statement of the pension position is planned to be sent periodically to each insured person, in the hopes of increasing the "ownership" of contributions consistently with the already mentioned "insurance principle." However, this very important feature has not yet been implemented.

2.52 A further point worth noticing concerns the relationship—which seems to be contradictory—between the funded component of the public pension system, both publicly or privately managed, and the private pension funds. On the one hand, stricter constraints are imposed on the management of the funded component.[29] On the other hand, the regulation of financial markets is slightly more developed than the "embryonic" stage, thus adding to the risks stemming from the much more liberal investment policy allowed to the private pension funds. All of this makes the state-funded component of the pension system a very peculiar product, possibly closer to the risks and performance of the NDC component, rather than to the risk-return mix offered by the private schemes.[30]

2.53 On the whole, the scenario expected of the new reform is not very encouraging. The stability of the system is uncertain, the coverage level is progressively decreasing, confidence in the funded component has far to go, and the incentives to work until retirement are weak, while the regular retirement ages have not been raised.[31]

2.54 The reform can be described as a step toward an efficient pension system. However, one cannot but describe it as a late, partial, and somewhat inconsistent step. *Late* because it took as much as 10 years to introduce and during this time, slow and expediency-led tinkering with the old system caused much unnecessary hardship and the spread of poverty among the elderly. *Partial* because (a) it does not fully embrace the main underlying principle of a good pension reform, that is, the separation between its insurance and assistance/redistribution goals; (b) irrespective of the effort to build a unified pension scheme, it allows for too much differentiation, thus leaving more room for politicians' manipulations; and (c) it lacks a properly designed insurance component (based, for example, on the actuarial principle), and rather relies on fixed parameters, instead of indexing them according to the economic and demographic variables governing the system. *Inconsistent* because it delivers conflicting signals and, above all, it does not clearly deal with adequacy and sustainability, so that what is adequate may not be sustainable and what is sustainable may not be adequate.

2.55 A final weak feature to be stressed is that, during the whole decade, pension reform in Russia seems to have received very little support from the population. Whether this is because of the inability of the government to produce credible policies, and to

[29] The state Pension Fund can only invest in bank deposits and government bonds, while private companies involved in the management of the public-funded pillar appear to have a higher degree of freedom, although they are severely limited in their investment in foreign assets, which cannot exceed five percent of the portfolio (this limit is planned to be raised to 20 percent in 2010).

[30] Recent (as of 2004) discussions have focused on the possibility of reducing the pension payroll tax from the 28 percent level, transforming part of it into a voluntary contribution to the funded part of the public pension (according to an opting-out clause). This provision would come on top of the already established—but not yet implemented—provision that will allow workers to transfer the funded part of their public pension to private pension funds, and not just hand over its management to a private asset manager.

[31] The increase in the retirement age is certainly a very difficult (almost unacceptable) political option in a country that is experiencing a decreasing life expectancy, irrespective of the fact that, at the standard retirement age, life expectancy in Russia is not significantly lower than in other Eastern European countries. This very important issue should be confronted on it own, mainly by improving health services and life conditions, and not by "accommodating" policies such as allowing for a relatively low retirement age.

convince the population that the reform was indeed necessary to promote growth, or because of the oscillating and controversial advice given by experts and supporters (including the Bank), remains an issue.

2.56 Why was the Bank so "accommodating" with respect to the Russian government? Why did it not insist more in terms of setting priorities, good reform benchmarks, sound administration, proper training, capacity building, public campaigns, and so on? Or why did it not even insist on more "conventional wisdom," parametric remedies, such as an increase in the retirement age; a strengthening of the link between contributions and benefits; measures to reduce tax evasion and increase fiscal revenue (a difficult objective, in any case, if a large part of the payroll tax is perceived as a pure tax)? The next sections try to answer these questions.[32]

[32] In addition, see World Bank 1995a, pp. ii, iii, v, 21, 22; World Bank 1995b, pp. 69, 71; World Bank 1996b pp. 67, 69, 70; and World Bank 1997a, pp. 8–11, 33, 34, 43–46.

Box 2.1: Summary of Recent Pension Reforms in Russia

The first stage of the pension reform process in Russia began with the passage of legislation, *On State Pensions in the Russian Federation*, on November 20, 1990. In this context, the Pension Fund was created, a state agency acting as an independent extra-budget financial intermediary, based on contributions from all employees and all employers. The law (i) established a unified pension system for all workers, covering the whole population; (ii) abolished the most-privileged benefits (merit pensions) and incorporated the least-privileged scheme (collective farmers' pensions) into the unified system; (iii) established that the amount of the minimum pension cannot be below the minimum living standard; (iv) provided a protective mechanism against inflation; and (v) connected the pension amount with workers' previous wages and seniority.

1. Regulation of the Pension Fund and the timing of contribution payments were ratified in 1991.
2. A new law, *On Increasing State Pensions in the Russian Federation*, was adopted in autumn 1992 as a measure against a very strong increase in the inflation rate.
3. Beginning in September 1993, it was established that the Pension Fund would be run by the government and no longer be an independent entity.
4. On January 11, 1993, the indexation of pensions was stopped and it was substituted by a discretionary provision of pensions, depending on a decision by the government, as a form of "compensation" (without enactment of any law to abolish the previous rules).
5. This "compensation," which replaced the indexation mechanism, was implemented by the President of the Russian Federation with a decree on October 27, 1993. In practice, this decree cancelled the link between the pension amount and the cost of living, which threw the majority of pensioners into poverty.
6. Beginning in May 1994, indexation alternated with compensation.
7. A new law, *On the Procedure of Calculating and of Increasing State Pensions*, on January 2, 1998, established that pensions should be indexed every quarter.

The 1997–98 reform proposal

The pension reform program in 1997–98 suggested structuring the pension system as follows:

1. Provision of pensions by the state for individuals who are not eligible for State Retirement Insurance.
2. State Retirement Insurance was to be the main component of the system. The amount of the pension would depend on seniority and contributions, and financed by (i) the current payments in the Pension Fund; (ii) a funded part (the percentage of payroll tax targeted for financing this component in 2001:1 percent; 2003: 3 percent, 2006: 5 percent, 2009: 7 percent); and (iii) supplemental pension insurance and provision. This scheme was supposed to be in force starting on January 1, 1999, but its application was postponed as a result of the recession in August 1998.

The 2002 reform

The pension reform of 2002 introduced a multi-pillar pension system and shifted the pension provision mechanism from a defined benefit to a defined contribution. The defined contribution system is composed of:

1. A notional defined contribution, pay-as-you-go pension scheme;
2. A second, mandatory funded pillar; and
3. A basic benefit.

After the 2002 reform, the pension system was to be financed with a total payroll tax rate equal to 28 percent of wages, but in reality 14 percent goes to finance the basic component of the scheme, which is the same for all pensioners and very modest. On the one hand, this helps to prevent poverty among today's elderly; on the other hand, this will not allow current young generations to achieve adequate pension benefits.

Table 2.3: Social Security Contributions

<table>
<tr><td colspan="4">Before 2001 – 28 percent of wages was paid by the employer and 1 percent of net wages was paid by the employee.
Beginning in 2001 – 28 percent of wages was paid by the employer.</td></tr>
<tr><td colspan="4">After the 2002 reform – 28 percent of wages was paid by the employer.
Half of the pension contributions was to go to finance the first or “base” level, a fixed pension paid to all retirees regardless of past earnings. The other half of payroll taxes was recorded in a personalized account for each wage-earner. Starting in 2006, for individuals born in 1967 and later, the plan was to allocate 6 percentage points of the contributions to this account (the 2006 percentage is the result of a gradual increase, from 3 points in 2002–03, to 4 points in 2004, then to 5 points in 2005).</td></tr>
<tr><td>Contributions</td><td>Individuals born in 1967 and after</td><td>Individuals born in 1966–63/57</td><td>Individuals born in 1952/56 and earlier</td></tr>
<tr><td>To finance the funded part</td><td>6 percent</td><td>2 percent</td><td></td></tr>
<tr><td>To finance the NDC part</td><td>8 percent (4.3 percent for farmers)</td><td>12 percent (8.3 percent for farmers)</td><td>14 percent (10.3 percent for farmers)</td></tr>
<tr><td>Uniform social tax – to finance the basic part</td><td>14 percent</td><td>14 percent</td><td>14 percent</td></tr>
<tr><td>Total</td><td>28 percent</td><td>28 percent</td><td>28 percent</td></tr>
</table>

Box 2.2: Russian Politics on Reforms: Retrenchment or Redesign?

The role played by political institutions in shaping social reforms (in particular, the unpopular ones that try to cut deficits) has been the subject of lengthy theoretical analysis. Hypotheses have been advanced that the success of such reforms may depend on the government's ability to overcome the opposition, whose power, in turn, depends on the structure of political institutions.

In many other transition countries, the generally high acceptance of painful reforms, motivated by credible future improvements in life conditions made possible through independence, made cuts in social spending much more easily acceptable than in Russia, the heart of the former empire.

Political and institutional factors played a key role in affecting the government's pension retrenchment strategy in Russia. As the largest social expenditure program, pensions were an obvious target for retrenchment. In order not to lose the voters' support, Russian politicians tended to promise pension increases during electoral periods, and introduced cuts at the beginning of the new legislature. Retrenchment in Russia was enacted mainly by restricting benefit eligibility criteria or by one-time benefit cuts. As the less "visible" component of pension schemes, indexation was the most affected mechanism.

In the case of the pension reform, the country was characterized by a political disagreement between the government and the Duma, whose veto power was able to block the government's proposals for spending cuts. Indeed, the Russian government had to devise "manipulation strategies" to control the outcome of the reforms. In October 1993, President Boris Yeltsin placed the pension fund under the government's control. He also decided that the timing and the rate of compensation mechanisms (introduced in parallel to indexation) would be decided through presidential decrees, thus removing the veto power of the Duma. A further measure that strengthened the government's control was a law passed on February 1, 1998, shifting pensions from price to wage indexation, with the government having the right to determine the quarterly average wage. Despite wide public indignation and opposition by the Duma, in 1998 the government presented a lower estimate than the Statistical Committee's of the quarterly average wage, thus justifying a corresponding cut in pension spending. Another retrenchment measure was the structural delay in benefit payments, which reduced the amount of the accrued rights through inflation.

The government's most effective strategy to secure consensus on unpopular social reforms was the creation of an inclusive political structure, the National Pension Council (NPC) established by President Vladimir Putin in February 2001. NPC included representatives from the different social groups, and was chaired by the prime minister. Although it had been presented as way to negotiate policy solutions, the establishment of the council was basically a channel for overcoming veto power against the government, settling from the inside any disagreement with the unions and Duma members. The rules of the NPC were set by the government, which devised the institution so as to be able to control it and to reject suggestions that were not in line with the reform project they had conceived. No independent evaluators were admitted, and there was no dispute of the actuarial calculations supplied by the pension fund with other studies. In practice, the council was dominated by the head of the pension fund, with other members lacking the expertise or the political strength to oppose his authority (those who were thought to be "uncomfortable" with the government's views were excluded from the start). Even when they would obtain some concessions, these were disregarded by the government in the end, as was the case with the basic pension, which was established under pressure from trade unions and international organizations, but with an amount set by the government and discretionally indexed to price. Also, the short period of consultation on pension reform did not allow the members of NPC to provide a thorough evaluation, and discussions were organized so as not to leave any room for disagreement. It seems then that the NPC was more of a lobbying tool, rather than an opportunity to foster discussions about social reforms.

Source: This box draws heavily from Cashu 2002.

3. Evolution of Bank Assistance

GENESIS OF BANK INVOLVEMENT

3.1 The reform of social insurance systems—along the lines expressed in the 1994 "manifesto," *Averting the Old Age Crisis*—has always received high priority in the Bank's strategy for transition economies. Both social and economic reasons account for this. On social grounds, the Bank was well aware of the immediate necessity to protect the weakest segments of the population from the consequences of the collapse of the previous economic and social structures and, in the longer run, of the relevance—of a well-functioning social security system. From an economic point of view, there was a clear need to control, in an environment of scarce resources and weak institutions, the already generally large share that welfare expenditures made up of the overall state budget and GDP. There was also a clear view that various distortions—characteristic of the previous programs—would impose burdens on the prospects for economic development.

3.2 This general philosophy obviously represents the central reason for the Bank's involvement in the case of the Russian transition. Its outcome, however, has turned out to be much less linear than in other transition economies, marked by the restructuring of loans, reallocation of funds, postponements, delays, and even cancellations of previously decided interventions. The obvious consequence of these actions was lower efficacy.

3.3 At the beginning of the 1990s, the Bank's involvement in social protection lending and assistance agenda was thus essentially motivated by concern about how the breakdown of the Communist regime and structures would affect poverty. Even with very little statistical support, it was evident that living conditions in Russia were rapidly deteriorating for a large majority of households and that the rapid rise in poverty could not be quickly stopped because of the country's poor economic performance, rising unemployment, and the inability of the social protection system in place to cope with the new social demands.

3.4 Support for building an effective social protection system—and of its largest component, the pension system—was thus considered a crucial element, if not the most relevant one, of the Bank's assistance strategy, whose ultimate goal was the construction of a democratic society and a market economy. Recommendations then focused on better targeting of social programs, enhancement of institutional capacity, redesign of the social security system, and modernization of the labor code.

3.5 In the implementation of this strategy, however, at least in the first years of the Bank's assistance, concern about the short-run effectiveness—even if at very low levels—of already existing programs seems to have been largely about the efficiency of the overall program design, as implied by its incentive structure and its long-run sustainability.[33]

3.6 It is difficult to tell whether this outcome was mainly because of a "more timid" Bank attitude—as compared with other Eastern European countries, where the Bank was much more "authoritative" and where its argument more or less "commanded" the reform—or because of the specific Russian characteristics mentioned earlier. These characteristics include its recent history as a great power and the more uncertain nature of changes in its political situation, which could hardly be thought of as hard-won independence worthy of great sacrifices as was the case in other transition countries. The answer probably is that both kinds of factors were at work, a combination that certainly reduced, from an ex-post perspective, the overall effectiveness of the Bank's interventions.

3.7 In any case, it seems true that in the early years of the transition the Bank did not really confront the reluctance of the Russian government to radically change its pension system, but rather strived to raise its standards to an acceptable minimum. Even in the second half of the 1990s, when the government's commitment to reform was even less straightforward than before, the Bank did not firmly stand up to the government's priorities.[34]

3.8 It was perhaps inevitable that to keep the system "working"—that is, to realize improvements in the functioning of institutions and local offices responsible for benefits payment, to eliminate arrears, to achieve a better targeting of the beneficiaries—would seem more urgent and more important than to convince policy makers that the building and implementation of a new system was a necessary and critical step in the strategy to sustain economic growth. Pointing out these general difficulties does not, of course, mean that the Bank ought to be absolved of specific mistakes that it made. The Bank could claim, afterward, that the mistakes were inevitable, given the sheer complexity of the post-Soviet economic, political and social environment.[35]

3.9 According to the documentation we reviewed (see references), Bank assistance seems to have been both supply and demand driven. In any case, the Bank's influence appears to have been strong in the initial years of the transition, especially in drawing up

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[33] With the exception of the new scheme for unemployed people, this was the main objective of the Employment Service and Social Protection Loan.

[34] For example, the Bank accepted incomplete compliance with the pension-reform requirements of the Social Protection Adjustment Loan in order to pay out the second tranche of the loan. Technically, the SPAL only required that the government agree to a reform plan and submit draft legislation to the Duma, a condition with which the government complied but it was not able to develop a reform proposal that was politically and fiscally sustainable (Thompson 2002, p. 16). This brought about the criticism that "disbursement should have rewarded action, not promises."

[35] In his external review of the 2002 Russian Federation Country Assistance Evaluation, Ofer writes: "*The most important oversight of the Bank was that it failed to appreciate the specially difficult and complex situation. . . . presented by Russia, including the deep sense of humiliation for the collapse of the empire, in contrast with the feeling of liberation in Eastern Europe. The Bank therefore failed to tailor a specific assistance paradigm that will take Russian complexities and sensitivities into account*" (World Bank 2002b, p. 67).

the agenda and the roadmap. In contrast, the relationship between the Bank and the Russian government certainly worsened during the second half of the 1990s. The failure to make progress with a systemic pension reform in those years can also be attributed to this rather negative evolution, which contrasts with the "good climate" that Bank staff had been able to create in other transition countries.

3.10 Subsequent events show that an irregular path was taken, in a kind of "stop-and-go" process, with intermittent reform proposals, neither wholly consistent nor politically sustainable. The Bank itself highlighted in a 1995 document that the Russian government had expressed an interest in accelerating reform of the social sector. In fact, although the government had asked the Bank to expand the lending specifically for this end, it turned out that pension reform continued not to be among the government's priorities.

3.11 Within the government, the debate about the reform was quite lively in 1995 (see World Bank 1995b, pp. 70, 71), and the government issued a conceptual framework for reform, inspired by the three-tier system. However, it did not include a funded component. Rather than radical change involving true diversification of financial sources and risk, the three tiers were more the result of variations in the existing pension provision and underlying formulas. Inevitably, then, the Bank suggested amendments and expressed disappointment about the reform's timetable.

3.12 Disappointment was not confined to the general question of pension design, but extended to more specific topics, like the poor results in terms of capacity building, financial and actuarial education, and public information campaigns, so that, even after many years of work on these issues, both the required professional skills among the policy makers and bureaucrats, and popular support showed shortcomings.

Description of Bank Assistance

3.13 Bank assistance since the fall of the Communist regime has included, as is normally the case, lending and non-lending support. Loans were issued both for social security reforms and for more general purposes (see appendix A; also World Bank 2002b, which describes the various stages of Bank assistance). Non-lending instruments consisted of both technical and analytical assistance. Surveys, analyses, and research were conducted, directed at increasing knowledge about various aspects of the Russian economy, in particular, those that had been disregarded for ideological reasons in the Communist era, like unemployment and poverty. They were also directed at raising policy makers' consciousness of the need to intervene in this area, as an important condition for good functioning of the new market economy. Bank staff participated in the major study of the Soviet economy, released in 1991 in cooperation with the IMF and the European Bank for Reconstruction and Development. The Bank co-sponsored household surveys to develop reliable estimates of the distribution of income, and a more knowledge-based assessment of the social protection programs. Workshops and seminars were also organized as part of an information campaign.

3.14 The Bank's analytical work was particularly effective in documenting the need for better targeting of social protection programs, a goal made unavoidable by the wide gap between a very tight resource constraint and the increasing demand for assistance (the high inflation and the generally unstable macroeconomic environment of this period are, to a large extent, the result of the government's attempt at ignoring the constraint by printing more money). The publication in 1995 of the first poverty assessment study, aimed at supporting the Russian government with the necessary knowledge base to deal with the poverty problem, is a relevant case in point.

3.15 All of the documents expressed concern not only for the design but also for the implementation of changes and reform measures. They also stressed the political difficulties of getting the reforms approved and actually carried out at the various administrative levels. This concern did not, however, translate into effective pressures to overcome the various obstacles, so that, from an ex-post perspective, some of the objectives—including pension reform—of these documents proved to be quite unrealistic.

3.16 Because the administrative weaknesses of Russia's system was deep and required urgent interventions, the importance of strengthening bureaucratic capability was also a major worry for the Bank. For example, in the 1992 loan (see below), one of the main objectives was precisely to provide equipment and technical assistance to the Federal Employment Service.[36] The Bank also supported the computerization of administrative processes and prepared plans to improve tax collection, delivery of social services, and payment of benefits. Moreover, a mid-1990s country assistance strategy although not specifically directed at pension reform, included a plan for the realization of regional pilot projects. The plan aimed to improve the delivery of social services through computer systems for processing pensions and the management of the fiscal budget, in general.

3.17 Considerations of budget constraints were, of course, very important in the plans for increasing efficiency. The Bank stressed the importance of financing the inevitable expansion of benefits through a reduction in other budget items—such as subsidies to inefficient state enterprises and to high-income households—and, in the pension area, through limiting benefits indexation to minimum pensions only.

3.18 Lending instruments generally bring together adjustment, implementation, and investment loans. In the Russian case, in 1993–2001, the Bank's overall lending commitment to Russia averaged slightly more than one billion dollars per year. These loans were for many different purposes, from investments in software and hardware to the improvement of pension management and training programs for local officers. The strategy was based on setting up pilot projects in some regions to verify the efficacy of the proposed changes and to introduce public employees to the new technologies.

[36] According to Thompson (2002, p.12), however, the Bank staff had problems in smoothly processing the large procurement of personal computers, so that by the time the loan became effective, the Federal Employment Service had used its own and other donors' resources to proceed with the computerization plan. Moreover, an additional loan specifically aimed at improving the administrative performance of the Pension Fund was prepared but was never approved.

3.19 In the field of social security and social protection, two main projects were carried out in the early stage of the transition: the Employment Service and Social Protection Loan (ESSP) for US$ 70 million, effective in 1994, and the Social Protection Adjustment Loan (SPAL) for US$ 800 million, effective in 1998. To these programs, more targeted but very important assistance program have been added: two directed at coal workers, Coal Sector Adjustment Loans I and II, for US$ 500 million and US$ 800 million, respectively, and the Social Protection Implementation Loan for US$ 28.6 million, effective in 1998.

3.20 The ESSP's main objective was to improve the ability of the Federal Employment Service to cope with the effects on (un)employment of enterprise restructuring, and to develop active labor market policies. Considering the scarce familiarity of the Russian policy makers with this kind of operations, and the anticipation of a large increase in the number of unemployed people, these objectives appear to have been consistent with Russian needs. The project subsequently became mostly a vehicle "for upgrading the information processing capacity of the pension payment function within local social protection offices" (Thompson, 2002). In the end, 90 percent of the budget went to the employment service component, although not without a restructuring imposed by delays and procurement difficulties in the office computerization process.

3.21 The SPAL objectives were to mitigate the effects of the transition on the poor and to start building an effective and efficient income-support system, as an essential component of a market economy, and more specifically, to construct a three-tier pension system and means-tested child allowances. Its vision of a systemic pension reform differed somewhat from earlier Bank recommendations, which were more centered on parametric changes to the existing system, such as an increase in the retirement age, and also marked a departure from the "budget neutrality" of previous recommendations. In fact, the new proposals implied an increase in pension expenditures, which was very problematic from the point of view of the required fiscal stabilization.

3.22 The SPAL documentation also noted how the pension reform could have negative impacts on women, as a consequence of their greater difficulty in funding their own pensions, both in the reformed PAYG component, characterized by a stronger correlation, at the individual level, between benefits and contributions, and in the funded component, due to their poorer working careers and lower average wages. Although implementation of the SPAL project was seriously affected by the financial crisis, it seems that the project contained shortcomings in itself, particularly in the definition of its strategic objectives (insufficiently analyzed) and in adaptation of the chosen strategy to the complex regional structure of Russia.

3.23 While the SPAL's targets (despite the "deficiencies" mentioned earlier) can, on the whole, be considered consistent with the transition toward a sustainable scheme, actual results of this operation have been very scarce because in the planned period very few changes occurred. The criticism implied in the Bank's evaluation should be further mitigated by the consideration that those were highly abnormal times. During the second half of 1997 and in 1998 Russia experienced perhaps its deepest crisis and, not surprisingly, the government's priorities shifted toward other areas.

3.24 Within this complex situation, there was a “silver lining.” Significant achievements included the solution of organizational and technical problems, in particular, improvement in the delivery of benefits has been critical, as shown by the halving of the number of mistakes (–55 percent) and of pensioners’ complaints (–48 percent). Also, the waiting time to get information has been cut considerably.

3.25 In the reform process, the Bank had many counterparts: the Federal Employment Service, Ministry of Social Protection, Ministry of Labor and Social Development (formerly the Ministries of Labor and of Social Protection), Ministry of Finance, local administrations (pilot social assistance) of Belgorod, Kaluga, Moscow, Novgorod Volgograd and Voronezh, Komi, and Udmurtia Republics. Although the level of sophistication of these institutions was not part of the appraisal in Bank documents, in general, the personnel involved appeared to be quite skilled.[37]

[37] In addition, see World Bank 1995b, pp. 70, 71; World Bank 1997a, pp. 9, 11, 14–17; World Bank 1997c, pp. 4–6, 11; World Bank 1998, pp. 3–6, 14–7, 21, 25–27, 29–33, 41–44, 47, 48, 51, 53, 54, 129–131, 133; and World Bank 2002b, pp. 12, 20.

4. Assessment of Development Impact

OUTCOMES

4.1 The following assessments are made after having considered both the relevance and the efficacy of the Bank's assistance to the Russian pension reform. Relevance indicates the extent to which the objectives of the overall assistance and of individual projects were consistent with the country's initial conditions, needs, and development priorities. Efficacy indicates the extent to which the objectives were achieved.

Relevance

4.2 The core point in assessing relevance is whether the pension reform was really a priority in the context of the difficult Russian transition toward a market economy. If it was, because it was not introduced in the first 10 years after the institutional break in 1991, one should ask what have been the costs of the delay. It turns out that asking the typical questions that substantiate relevance—is the reform supportive of economic development? Does it provide an effective system of income support for the elderly? Does it aim at reducing the distributional disparities, between households, genders, and regions? Does it strike a good balance between efficiency and redistribution, between financial equilibrium and equity?—appears rhetorical in the Russian context because a comprehensive reform was introduced only in 2002. And, as already stated, this is still very problematic.

4.3 Indeed, the main conundrum of the Russian pension reform appears to involve the connection between short-run emergency measures and long-run design. This is a typical problem in transition economies; in the Russian case, however, it appears to have been left unsolved insofar as measures that looked adequate in the short run came at the price of a substantial delay in the redesign of the system's structure. Moreover, when the reform was at last introduced, it represented only a weak compromise between adequacy and sustainability. Within this context an evaluation of pension reform can only be done by constantly being mindful of this missing junction between the short run and the long run.

4.4 As for the possible linkage between economic development and pension reform, it seems to have been neglected. Modifications to the Russian pension system in the 1990s were introduced mainly as a measure to alleviate poverty and were nevertheless limited by budget considerations. The former was the real priority, the latter the real constraint, on a year-to-year and sometime even month-by-month basis. Short-run considerations consequently commanded more attention than the less urgent question of good design. With this short-run horizon, amending the immediate shortcomings, as well as building a new unemployment insurance scheme, seemed to be the true priorities. The inefficiencies within the pension system (the contracting payroll tax base, the difficulties in tax collection, the endemic arrears, and the poor indexation mechanism) were acknowledged, but mainly for their immediate consequences on the resources of the poor. This may have been reasonable under the country's circumstances, but it makes it difficult to evaluate the relevance of pension reform in and of itself. Moreover, the tradeoff between efficiency and distribution, which constitutes the foundation of the efforts to effectively separate social insurance from social assistance and to strike a good balance between the two, was insufficiently acknowledged. As is normally the case, the less transparent systems are, the more privileges they hide. But if privileges are a bad thing in a rich economy, they are unacceptable where resources are badly needed for poverty relief.[38]

4.5 What probably was missing in the Russian case was the ability of the Bank and other donors to construct a strong enough case to convince policy makers and executives in government that a good social security and social assistance system is an essential instrument of a well-functioning market economy and of a sound democracy. A case for a conceptual framework, where the social insurance and social protection systems are crucial factors in determining the overall economic performance—for their effects on savings and work choices as well as on the functioning of capital and labor markets, and ultimately as a precondition for social peace—was not really made (irrespective of the frequently renewed intentions to prepare a master plan for a systemic reform that was sustainable in the long run). In this perspective, the Russian reforms paid less attention to concepts like risk diversification, the intertemporal budget constraint of the system, microeconomic distortions, and the negative impact of bad design on households' labor and savings choices. Again, while this is understandable in an emergency situation, it is difficult to accept that Russia has been in a state of permanent emergency for 10 years. Moreover, the failure to convey the message may have given Russian policy makers the idea that sheltering the poor was an important goal, but for reasons outside the economic domain.

4.6 The end result was more of an antipoverty program than a pension reform. This is why the Bank's strategy concentrated on the better targeting of minimum pensions, on raising their level (which was periodically lowered in real terms by inflation), and on helping the pension fund clear arrears.

4.7 To be effective, moreover, the strategy of sheltering the poor required the reduction of the bureaucratic "distance" between agencies delivering services or providing cash transfers and the poor themselves. This implied both a fundamental change of approach in the administration and an effort to reduce geographical disparities, that is, the regionalization of assistance on efficient terms. This last aspect motivated the pilot projects to computerize and improve the efficiency of local administration.

4.8 In summary, the development of an effective system of income support and of poverty relief received the high priority that the Bank attributed to it. The other two factors of a good pension reform: consistency with economic development objectives and the balance between efficiency and redistribution, although they were indeed highly relevant, seemed to have gotten much less attention than they deserved, thus reflecting

[38] Indeed, only in the late 1990s did the Russian government establish a commission to phase out the complex system of privileges that was a feature of the previous scheme. We do not know if there was resulting legislation.

the missing link between short-run emergencies and long-run design. Table 4.1 summarizes the evaluation of relevance.

Table 4.1: Evaluation of Relevance

Features	***Relevance***
Supporting economic development	Substantial
Sheltering the poor and reducing distributive gaps	High
Striking a good balance between efficiency and redistribution	Substantial
Overall evaluation of relevance	Substantial

Efficacy

4.9 As a general premise for the evaluation of efficacy, it should be stressed that the pension reform process proceeded along a very discontinuous path, characterized by a certain degree of rethinking, intermittent stop-and-go, and some cutback in the earliest objectives. The question of how much these shortcomings can be accounted for by "external" factors (like the poor fiscal condition of the budget, the unstable macroeconomic environment, the 1998 financial crisis), and to what extent they can be attributed to "internal" factors (inadequacy of the assistance programs). Although it is impossible, of course, to give a precise answer to this question, the importance of the internal factors—especially the failure to establish a *consensus view* of the objectives that were strongly shared between the government and the Bank, as well as roadmap for the pension reform—cannot be denied.

4.10 In particular, under the ESSP, probably both the government and the Bank failed to grasp the fact that a good mix of parametric and structural reforms of the pension system would have achieved better protection of vulnerable groups than a program too focused on interventions for the unemployed. Although some significant results were achieved in terms of pension calculation and payment (with a reduction in both the number of mistakes and amount of time to process new pensions) as well as in terms of the workings of the benefits-level adjustments, a wider vision of pension and social assistance programs could possibly have helped in avoiding "unnecessary" poverty. In addition, it would have helped to set the country on the path toward improving social protection so as to be more consistent with steady economic development.

4.11 Probably, as a reaction to unsatisfactory aspects of the ESSP project, the SPAL was not only more focused on pension reform, but also tried from the start to strike a better balance between short-run interventions and long-run achievements. In practice, however, the former prevailed and, though the project was successful in improving the legal basis for voluntary pensions and in eliminating pension arrears, a major disappointment was the failure of implementing a systemic pension reform. According to earlier evaluations (Thompson 2002), the Bank missed the opportunity to link the disbursements to effective results, and accepted a generic reform proposal which proved to be politically unacceptable to the Duma.

4.12 In short, the efficacy of the pension reform was profoundly hindered by the inability to strictly link short-run needs and long-run objectives. This is perhaps the main reason for the government's limited commitment—throughout the decade—to a systemic reform. While it is somewhat understandable that the government would mainly see the negative impact of such interventions, it is perhaps less obvious why the political shock could not act as an engine for reform as it did in other countries.

4.13 Some important positive achievements have to be acknowledged. The 2002 reform, irrespective of its many shortcomings, can be seen as a relevant turning point. However, it can also be interpreted as a sort of late result of the joint commitment and effort of the Bank and the government, and confirmation that the earlier work, even amid misunderstanding and controversies, had not been wasted. From this perspective, one can surmise that the Bank's initial objectives were too ambitious rather than faulty; the specific Russian social and economic conditions required more time to absorb these entirely new concepts and frameworks, that is, to recognize them as "their own" and not just as the products of a "patronizing" donor.

4.14 The slow understanding of the importance of an efficient and adequate welfare system in a modern market economy, and of the pension system as a means to foster economic development, strongly limited the government's willingness to face the challenge. This, of course, cannot be attributed to any specific fault by the Bank. The Bank did fail, however, to orient its interventions toward promoting a cooperative environment, which in other countries had helped to create a consensus view on comprehensive reform. Table 4.2 summarizes the evaluation of efficacy.

Table 4.2: Evaluation of Efficacy

Features	*Efficacy*
Support to economic development	Modest
Sheltering of the poor and reducing distributive gaps	Modest
Striking a good balance between efficiency and redistribution	Modest
Overall evaluation of efficacy	Modest

Overall Outcome Evaluation

4.15 The overall evaluation takes into account both relevance and efficacy, and can be seen as the extent to which the major relevant objectives of the project were achieved or are expected to be achieved.

Table 4.3: Overall Evaluation of Outcome

Item	*Rating*
Relevance	Substantial
Efficacy	Modest
Overall outcome evaluation	Moderately unsatisfactory

INSTITUTIONAL DEVELOPMENT IMPACT

4.16 The institutional development impact is assessment in this section is based on its relevance and efficacy, while the requirements that will make the reform sustainable in the long run independent of international help, will be discussed later.

4.17 Regarding relevance, the need for widespread capacity-building interventions, both at the central and local level, was expressly recognized by the Bank and was included among the priorities of pension reform. Institutional development, however, is composed of two dimensions. First, capacity building and technical assistance efforts are determined through improving the efficiency of the administration on an operational basis, especially on pension payments and contributions collection. Second, a more far-reaching view is needed, and resources must be devoted to building policy-making capacity according to a broad and shared understanding of the workings of a modern market economy. From an ex-post perspective, this second aspect of the institutional development process appears to have been insufficiently stressed and (again, in accordance with previous evaluations) has represented a major obstacle to the political feasibility of implementing a systemic pension reform.

4.18 Efficacy is very much conditioned by the disconnect between short-run and long-run objectives. The ESSP contributed significantly—through office computerization and better organization—to improving the management of the pension system in Russia. There were improvements in accounting, benefits provision, monitoring, and providing information to the public, important achievements in and of themselves. Training courses were offered to Russian executives, thus increasing their familiarity with the new system, and the results obtained in the regional pilot projects show that the local institutions are indeed ready for "modernization."

4.19 At the highest level, our interviews confirmed a clear understanding of the problems involved in the pension area. They also confirmed a more than adequate analytical capacity, especially within the Ministry of Economic Development and Trade, and the Ministry of Finance, which showed both determination and readiness to adopt an innovative approach.

4.20 These good results, however, are somewhat offset by the fact that the "culture" surrounding a good pension architecture seems to have failed to spread to the lower levels or to reach all sectors of the administration. Again, this drawback can be attributed to aspects of the Russian Federation, including its sheer size. It is illusory to believe that the prevailing government philosophy could be changed simply by convincing a small circle of people of the benefits of the “new view.” Certainly, philosophical (or ideological) differences existed even within the donor community, for example, about the role of the funded component in the proposed pension design.

4.21 It is not surprising then that, according to our documents, even the economic and sector work, which is the basis for a tailored approach, practically neglected to include pension reform issues (see Kolosnitsyna and Topinska 2002). The result was that the anticipated policy-making capacity in the field failed to materialize at various levels, ranging from the actuarial capability within the government, to the broader issue of building a public consensus on the need for pension reform. Table 4.4 summarizes the evaluation of institutional development impact.

Table 4.4: Overall Evaluation of Institutional Development Impact

Item	***Rating***
Relevance	Substantial
Efficacy	Modest
Overall institutional development impact evaluation	Modest

SUSTAINABILITY

4.22 Sustainability can be defined as the capability of the system to deliver adequate pensions, while substantially maintaining a financial equilibrium (at least in the long run), within reasonable scenarios. “Adequate” pensions can be achieved through a sufficiently high contribution rate, “good” composition of the pension wealth, and relatively high returns to contributions (or at least uncorrelated returns that could partially compensate for a shock in one of the portfolio components, whether funded or PAYG). Such a system is, in our view, sustainable both economically and politically. Economic sustainability is thus to be considered in terms of both the reform’s internal consistency and its ability to withstand negative demographic and macroeconomic changes. Political sustainability requires the government’s willingness to proceed with the reform, continued capacity building, and popular support.

4.23 How does the Russian pension system fare in this respect? On economic sustainability, we cannot avoid warning that the demographic perspectives for Russia are likely to impose a difficult challenge to the pension system, as it is currently designed. As for the economy, growth has to be quite strong in order to sustain the system. On the whole, while the gains in terms of operative efficiency are (with some caveats) likely to be sustainable,[39] the long-run design that emerges from the 2002 reform is less likely to be so.

4.24 As already stated, the new reform does not fully embrace the principle of a clear separation between insurance and assistance. The "insurance" component is still only partly based on the principle of "actuarial equivalence," and the link between contributions and benefits is still weak, owing to inappropriate parameterization of the NDC component. Moreover, the actuarial capacity within the pension fund appears to be still very weak. This hinders its ability to monitor and forecast the evolution of pension expenditures, which is necessary to help the government in adopting appropriate adjustments, given that these are not automatically built into the system. As for the funded component, financial markets still represent an uncertainty as to their support toward the sector's future development. The regulatory framework does not seem sufficiently robust to grant an adequate level of security to the accumulated reserves, particularly to the fast-growing private pensions. Also, the professional skills, which could guarantee good management of assets, largely still have to be built.

4.25 In short, the stability of the system is very much uncertain, the incentive structure is weak, and its long-run adequacy is in doubt because the coverage level is expected to decrease in the future. Moreover, the system seems too vulnerable to political interference, which could easily take over through short-run "necessities." Recognition of these problems is, however, present at the highest level of the administration, which is ready to concede that the 2002 reform is just the starting point of an ongoing process that will affect both the sustainability and the adequacy of the system (for example, through an increase in the normal retirement age).

4.26 As for political sustainability, the 2002 reform was somewhat the result of a compromise. Moreover, public understanding of the reform appears to be at a low level, while support is possibly even lower. This essentially means that the sustainability of the reform is conditional upon the overall political stability of Russia, a topic that is beyond the scope of this evaluation. Table 4.5 summarizes the evaluation of sustainability.[40]

Table 4.5: Evaluation of Sustainability

Item	*Sustainability*
Economic sustainability	Modest
Political sustainability	Modest
Overall evaluation of sustainability	Unlikely

[39] Doubts have been raised about the sustainability of the computerization process, given that a plan for financing the replacement of equipment as it ages is still missing (Thompson 2002).
[40] In addition, see World Bank 1993, p. 2; World Bank 1995a, pp. vi, 4, 34, 59; World Bank 1995b, pp. xv, 76, 77; World Bank 1996a, p. 51; World Bank 1997a, pp. 3, 17–19; World Bank 1998, pp. 21, 25; World Bank 2001, pp. 8, 9, 11, 12; World Bank 2002b, pp. 9–13, 23, 29, 35, 36; and World Bank 2002c, pp. 5, 7–10, 14, 16–18.

5. Results

5.1 In order to evaluate the Bank's and the borrower's performance in the specific field of pension reforms, a more focused approach is needed toward the evaluation of the overall social protection scenario. According to our documentation, interviews, and previously detailed evaluation of various aspects of the Bank's involvement, it seems fair to start by recognizing that the emergency interventions in the first half of the decade were quite effective. To this we can espouse a positive appraisal of the non-lending support to technical advancement, assessment, and analysis of problems in the social protection field.

5.2 In the second half of the 1990s, however, the loosening commitment in pursuing consistent systemic reforms in the pension area was observed, both on the part of the Bank and the borrower. In particular, the failure to produce an adequate pension reform under the SPAL was a major shortcoming that prevented us from rating the Bank's performance in the specific pension area as satisfactory.

5.3 We have no evidence for disagreeing with the weaknesses highlighted in previous evaluations, which illustrated shortcomings in the relatively poor design of the SPAL, overly ambitious objectives within a short time frame, and weak supervision instruments—in particular, with regard to the release of the second tranche of the loan, which was conditional upon "nominal" compliance by the government with the pension reform (Thompson, 2002).

5.4 It is difficult, however, to establish whether this was because of weakness in the preparation phase of the loan or in the supervision of the government's compliance with its requirements, given that the formal conditions for the tranche release were, in fact, met. Again, this might reveal an excess of confidence on the Bank's part regarding the government's commitment.

5.5 It may well also be the case that the unsatisfactory performance was, to some extent, unavoidable, given the very difficult environment and the lack of political consensus on the need for a comprehensive pension reform, and on a roadmap. And it is very likely that the counterfactual—e.g. had the Bank not been there—would have resulted in a much worse situation for the poorest segments of the population, which suffered from the transition.

Table 5.1: Evaluation of Bank Performance

Item	*Performance*
Quality-at-entry	Unsatisfactory
Quality-at-supervision	Unsatisfactory
Overall Bank evaluation	Unsatisfactory

5.6 An important question thus remains unanswered: Why was the Bank unable to catalyze such a consensus through an extensive and farsighted capacity building approach? The responsibility cannot be blamed only on the Bank's operations, but also on (at least) two other relevant factors: (i) the peculiar situation of Russia, with respect to other transitional economies, and (ii) the relationships within the wide donor community involved in Russian reforms.

5.7 Regarding the first factor, we have already stressed the widespread sentiment that Russia was the heart of the Soviet system, and that not everything from the old regime had to be reshaped. The nation-building aspiration, which was so important in other transition countries, instead acted as a deterrent to reform in the Russian case.

5.8 As for the second aspect, a large donor community contributed to the Russian reforms. For example, in the pension area, the ESSP benefited from the participation of eight other bilateral donors (see Thompson, 2002), and the SPAL agenda was developed while the Bank was working with the IMF to devise conditions associated with an Extended Finance Facility. Moreover, a European Union program financed technical assistance to the Ministry of Labor in the field of pension reform. In this composite environment, the Bank might have been influenced by an overly optimistic vision of the macroeconomic perspectives put forth by the IMF. More relevant, though, are the different ideas on pension reform maintained by European experts, which possibly gave the government the impression that the issue was indeed a controversial one, thus weakening the argument for a major systemic intervention.

5.9 The performance of the borrower presents the same drawbacks that are observed on the Bank's side. By focusing on the pension issues, major improvements have been reached in the quality of services delivered by local pension offices. Once the long-run design is considered, however, the performance cannot but be rated *unsatisfactory*; and the government's scarce commitment was a key factor to the pension-reform failures during the second half of the 1990s.

5.10 According to Thompson (2002), the government "was not able to develop an acceptable financial management system to allow a pension reform implementation loan under preparation to go forward." It also failed, under the SPAL, to decide on a policy-making process that could produce an acceptable and politically sustainable pension reform plan. Our interviews confirmed a mixed picture of highly competent "islands" (at both the political and administrative levels) and of a less-prepared bureaucracy, showing only nominal compliance with the new concept and frameworks.

5.11 Moreover, although the 1998 financial crisis that profoundly hindered the reform processes was partially because of external factors (such as the low prices of Russian exports, especially oil, and the Asian financial crisis), poor government policy choices cannot be ruled out. Accordingly, we propose the following ratings of the borrower's performance.

Table 5.2: Evaluation of Borrower Performance

Item	*Performance*
Preparation	Unsatisfactory
Implementation	Unsatisfactory
Compliance	Unsatisfactory
Overall borrower evaluation	Unsatisfactory

5.12 Finally, in a "what-if-not" scenario, the Bank was undoubtedly an important player in the Russian transformation, in general, and of the social protection reforms, in particular. The scale of the problems faced by Russia, however, and the very intricate political situation—characterized, in the 1990s by a certain degree of rivalry between the Duma and the government—do not allow the singling out of the Bank as holding crucial responsibility either for the successes or for the failures of the reform process.

5.13 Certainly, had the Bank not been present, important support—of both a financial and technical nature—for the poorest segments of the population would have been missing. Given the general worsening of the economic situation and of the income distribution, this could have possibly resulted in a dreadful outcome for these people. The program for alleviating difficulties in communities affected by the coal mines closures has been highly effective. However, evaluating the costs of: the delays in the pension reform; the stop-and-go process; and the modest impact in establishing, from the beginning, a firm foundation for the reform is certainly more difficult and more speculative.

5.14 In this respect, given the political situation and the large donor community involved in capacity building activities, the possibility of the Bank effectively promoting a much needed comprehensive vision of pension reforms is not optimistic.

6. Lessons Learned and an Agenda for Future Action

6.1 It is difficult to derive lessons from the Bank's experience in Russia, mainly because of the *unique* characteristics and circumstances of the country in the 1990s. Even though many of the transition economies in Central and Eastern Europe confronted similar problems, Russia stood alone both before the collapse of the Soviet system (due to its then-dominant role) and after the collapse (due to the severity of its problems and the absence of clear goals), which could have allow the country to choose a well-specified reform path. As just one example in the pension area, the prospect of raising the retirement age, which in other systems would have been an obvious response, was politically unfeasible in Russia because of the sharp decrease in life expectancy.

6.2 From an-ex post perspective, then, it should not be too surprising to observe that many things have gone wrong, or that it took too long, with much unnecessary suffering and poverty, for the country to get on the right track.

6.3 *The first lesson is that there is no ready-made formula that can easily and instantly be applied to any country. The special nature of Russia's problems should have been recognized from the start, including the size of the country (which poses problems in and of itself). Although there is some recognition of this in Bank documents, the Bank should learn to have more respect for national characteristics and be prepared to adapt.*

6.4 Part of the explanation is that some mistakes were probably unavoidable, but it is difficult to establish exactly which they were. First, Russian leaders lacked a clear understanding of the importance of setting reforms (possibly because of the country's role in the previous regime) from the outset, on consistent principles and frameworks, in legal as well as in economic terms. This means a less linear progression toward both democracy and a market economy. In the specific area of social protection and pensions, too much of the inherited system was simply amended, instead of completely changing the system, which was necessary because the foundations of the new system were different.

6.5 The prevailing attitude, which can be summarized as "We have problems, just like any other country," accounts for the persistence of old concepts and habits, even within the new frameworks. A common attitude was for the government and the political elites to be content with having introduced the "right" principles, while leaving their actual implementation to the political process. Examples of these attitudes are not difficult to find: indexation is an important case in point.

6.6 The indexation of pensions (and of wages) was introduced in the Russian system, but the idea that compensation for the loss in purchasing power of nominal incomes should be based as much as possible on "objective" measures of the inflation rate was somehow considered "optional." A variation of the same theme is the persistent difficulty of reasoning in terms of real—instead of nominal—interest rates (so that high nominal rates *as such* were, and, unfortunately, are still often considered to provide good returns on savings). Another example, more in line with the pension reform, is the introduction of the "insurance principle" within the pension system. Many Russian officials whom we talked to during our visit took pride, and rightly so, in the endorsement of this principle in "as early as 1997." However, the fact that even after the 2002 reform the insurance principle has been only partly introduced (and not without inconsistencies) is considered of minor significance.

6.7 *The second lesson lies, therefore, in the old adage, "the devil is in the details." Even correct principles cannot do much good if they are loosely applied. The degree of awareness of this was initially low in Russia, and the Bank has not been able to substantially increase it.*

6.8 The lack of a clear set of final goals prevented full awareness that radical change, but also consistent change, was needed and therefore had to be, more or less, unconditionally adopted. This approximate methodology to identify goals and instruments can account for the lack of a shared view—at least across the political spectrum, if not in the civil service and in the population, at large—of a unified reform path. In our view, the inability to convey a clear message about the logical consistency of various steps in the reform path is perhaps the main area where more determined action by the Bank could have made the difference. The goals were not always clearly set, and possibly adjusted from time to time, which strengthened the opinion among Russian politicians and officials that consistency and continuity in the reform process were not absolutely necessary.

6.9 *The third lesson then is that the strong connection between instruments and results is often non-negotiable and not an object of excessive political bargaining.*

6.10 An important element of an effective reform process is awareness by the civil service of the need for deep, qualitative change in the administrative system, in terms of both personnel and procedures. Bureaucracies have a natural tendency to resist change; in Russia they were not even given a good incentive to accommodate reforms. In a weak legal framework, it was difficult, on the one hand, to develop a "client-oriented" attitude in the bureaucracy; on the other hand, it was also difficult to establish monitoring, control, and evaluation mechanisms as well as simulation techniques, so as to project long-term consequences of demographic changes and policy measures.

6.11 The result of these deficiencies was the development of a difficult and diffident relationship between Bank and Russian officials, at least in the first few years of the transition. The Bank was criticized by the Russian government for "wasting money" on initiatives that were not yielding expected results (for example, conducting seminars to promote the right "economic culture," which Russian officials did not think they needed). The Bank was not able to claim credit for providing a "tutorial" role, which it had successfully implemented in other countries.

6.12 *The fourth lesson is that the bureaucracy's acceptance of change is a variable that should be taken into account in defining Bank strategy in any country; civil service sensitivity to problems can be enhanced, at least in the upper echelons, by ad hoc Bank programs, which work well when neither inferiority nor superiority complexes develop in recipient countries.*

6.13 A final point is the recognition of a particularly difficult trade-off between short-run and long-run objectives. Reform of the pension system affects all present and future generations. A much broader consensus is needed than what short-lived governments and parliamentary majorities can provide. In Russia, the effort to build this social consensus, perhaps not a priority in itself, was somewhat spoiled by the fact that the country's transition during the 1990s was dominated by short-run emergencies, with no clear perception of wider horizons and of important goals achievable in the long run. The balance of these two, often conflicting perspectives, may come naturally in long-established market economies. This is certainly not the case when democracy and a market system are being introduced under an emergency situation, as the Bank certainly knows all too well.

Appendix A: Bank Assistance Instruments for Russian Pension Reform

LENDING INSTRUMENTS			NONLENDING INSTRUMENTS	
Instrument	**Aim**	**IEG Evaluation**	**Instrument**	**Aim**
Country assistance strategy prior to mid-1990s				
Rehabilitation Loan (US$ 600 million) **(P-5834-RU)** Approved 1992, Effective 1992	1. To start enterprise reform. 2. To conceive and implement pro-competition and anti monopoly policies. 3. To establish a social safety net.	**Outcome**: Satisfactory **Sustainability**: Likely **Institutional Development Impact**: Substantial **Bank Performance**: Satisfactory		
Employment Services and Social Protection Project (US$ 70 million[a]) **(as from IBRD No. 24013)** Approved 1992, Effective 1993	1. To develop the Federal Employment Office capacity. 2. To improve pension administration. 3. To reform the pension system. 4. To start designing a modern pension system.	**Outcome**: Satisfactory **Sustainability**: Likely **Institutional Development Impact**: Substantial **Bank Performance**: Satisfactory **Borrower Performance**: Satisfactory		
Country assistance strategy after mid-1990s				
Second Rehabilitation Loan (US$ 600 million) (prepared in 1993 and programmed to be activated during the 1994 CAS) **(RU-PA-8838)** Approved 1995, Effective 1995	1. To develop the private sector. 2. To implement pro-competition and antimonopoly policies. 3. To reform the financial sector. 4. To reform the social protection system.	Not available.	**Poverty Assessment Report** ***Poverty in Russia: an Assessment*** Issued in 1995	1. To understand the main poverty determinants and the individual parts of the population most affected by poverty.
			Economic Report ***Russian Federation Towards Medium-Term Viability*** Issued in 1995	1. To focus on the economic situation of Russia and the possibilities for the future. 2. To aid the conception and implementation of policies and reforms toward a sustainable economy.

Continued…

Instrument	Aim	IEG Evaluation	Instrument	Aim
			Economic Report ***Fiscal Management in the Russian Federation*** Issued in 1995 and 1996	1. To highlight the links between fiscal management and macroeconomic stability. 2. To provide suggestions for policies and reforms to be undertaken.
Country assistance strategy for 1998–99				
Social Protection Adjustment Loan (US$ 800 million) **(RU-PA-38573)** Approved 1997, Effective 1997	1. To mitigate the adverse effects of transition on poor and vulnerable people. 2. To reform the social insurance net (including pensions, unemployment assistance, and social assistance).	**Outcome**: Moderately unsatisfactory **Sustainability**: Likely **Institutional Development Impact**: Modest **Bank Performance**: Unsatisfactory **Borrower Performance**: Unsatisfactory		
Social Protection Implementation Loan (US$ 28.6 million) **(RU-PE-46496)** Approved 1997, Effective 1997	1. To create an efficient pension system. 2. To reallocate public financial resources efficiently. 3. To delineate responsibility for social issues at decentralized levels.	Not available		
Third Structural Adjustment Loan (US$ 1.5 billion) **(ID: P055137)** Approved 1998, Effective 1998	1. To support the reform of infrastructure monopolies. 2. To aid private sector development. 3. To improve fiscal management. 4. To aid financial sector restructuring.	Not available		

Continued…

Instrument	Aim	Instrument	Aim
Country assistance strategy for 2000-01			
	1. To support systemic reforms for economic recovery and private sector development. 2. To improve the protection of socially vulnerable households. 3. To ensure universal access and acceptable quality of basic social benefits.		
CAS 2002–05			
	1. To reduce poverty. 2. To achieve economic modernization. 3. To create an environmental framework favorable to investments in the real sector. 4. To improve fiscal efficiency. 5. To reduce local differences in social and economic development.		

a. The loan was revised and lowered to US$ 60 million.

Appendix B: Russian Federation: Statistical Summary

	1990	1991	1992	1993	1994	1995	1996	1997	1998	
Macroeconomic data										
GDP current prices (LCU)	644,213,000	1,398,520,000	19,006,000,000	171,510,000,000	610,745,000,000	1,540,493,000,000	2,145,656,000,000	2,478,594,000,000	2,741,051,000,000	4,766,83
GDP current prices (US$)	579,067,900,000	542,104,100,000	442,000,000,000	393,450,100,000	325,917,500,000	337,708,700,000	418,617,100,000	428,464,200,000	282,434,600,000	193,61
GDP real rate of growth	-3.00	-5.00	-15.00	-9.00	-13.00	-4.00	-3.00	1.00	-5.00	
GDP per capita (constant 1995 US$)	3,666	3,473	2,967	2,713	2,375	2,280	2,208	2,235	2,131	
Nominal Monthly Wage (current LCU)	297	552	6,014	59,577	216,224	484,325	805,367	965	1,108	
Nominal Monthly Wage (current US$)	177	316	32	66	98	106	157	167	112	
Rate of inflation (GDP deflator)	16	129	1,490	888	307	163	44	14	16	
Demographic statistics										
Total population	148,292,000.00	148,624,000.00	148,689,000.00	148,520,000.00	148,336,000.00	148,141,000.00	147,739,000.00	147,304,000.00	146,899,000.00	146,3
Population 0 - 14	34,048,480.00	33,510,050.00	32,980,140.00	32,458,630.00	31,945,370.00	31,440,250.00	30,361,440.00	29,319,660.00	28,313,640.00	27,3
Population 15 - 64	99,366,280.00	99,284,380.00	99,202,620.00	99,120,980.00	99,039,470.00	98,958,100.00	99,433,130.00	99,910,620.00	100,390,600.00	100,8
Population 65 and above	14,877,230.00	15,403,080.00	15,951,370.00	16,523,260.00	17,119,930.00	17,742,650.00	17,751,270.00	17,760,610.00	17,770,680.00	17,7
Life expectancy at birth M	74	74	74	72	71	72	73	73	73	
Life expectancy at birth F	64	64	62	59	57	58	60	61	61	
Life expectancy at birth	69	69	68	65	64	65	66	67	67	
Fertility rate	1.89	1.73	1.55	1.39	1.40	1.34	1.28	1.23	1.24	
Pension statistics										
Old - age pensioners (thousands)								28,993	29,023	
Disability pensioners (thousands)								4,813	4,816	
Seniority pensioners (thousands)								577	631	
Social pensioners (thousands)								1,269	1,339	
Total numeber of pensioners								38,184	38,410	
Old age average benefit (current LCU)								385.1	430.7	
Old age average benefit (current US$)								66.5	43.4	
Disability average benefit (current LCU)								333.7	352.3	
Disability average benefit (current US$)								57.6	35.5	
Survivor's average benefit (current LCU)								256.5	257.1	
Survivor's average benefit (current US$)								44.3	25.9	
Seniority average pension benefit (LCU)								388.0	390.4	
Seniority average pension benefit (US$)								67.0	39.3	
Average nominal pension (LCU) *	92	184	1,754	13,232	81,217	188,000	302,000	366.4	402.9	
Average pension (US$)	54.7	105.4	9.4	14.7	36.9			63.2	40.6	
Coverage ratio			2.08			1.80	1.78	1.70	1.66	
Replacement rate	33.7	33.8	25.8	33.6	35.0	39.8	38.0	39.5	36.4	

Source: World Bank, Goskomstat, various documents, IMF estimates in"Pension Reform in the Baltics" and Ufficio Italiano Cambi

1 Rubles per month. For 1991 average of two quaterly figures; for 1992 and 1993 average on four monthly figures; for 1994 average of six monthly figures

2 The used exchange rate is the UIC's one, but it appears wrong clearly; a better hypothesis suggests a value of 15,5US$ instead of 8.2US$

3 The used exchange rate is the UIC's one. The IMF show a US$ amount of 11.3, instead of 1.5.

* Since 1997 new rubles (1 new ruble = 1,000 old rubles)

Appendix C: Interviews

Sergei Afanasiev	Deputy Head of the Pension Department, Ministry of Health and Social Development
Dmitry Alexeev	Social Insurance Institute
Viacheslav Bataev	National Pension Fund (NPF) Inspection
Mikhail Dmitriev	First Deputy Minister, Ministry of Economic Development and Trade
Sergei Kalashnikov	Head of the Department of Social Development and Environmental Protection
Dmitry Konshin	Social Insurance Institute
Alexander Kurtin	First Deputy Chairman of the Pension Fund
Vladimir Mudrakov	Director of Development Department Gazfond NPF
Dmitriy Pomazkin	Pension Modelling Expert
Igor Shanin	Secretary, Federation of Independent Trade Unions
Andrei Slepnev	Deputy Director General, Council of Employers' Trade Unions of Russia

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