

## To the Problem on the Methodology of Pension System Institutionalization in Russia

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### Abstract

*The need to form the methodology of institutionalization of the pension system in Russia is reasoned by a number of factors related to the defects of the distribution model's Institute, the most important of which are unacceptably low level of pension amounts, high insurance rates, independence of the accrued pension's sizes from the level of wages, the economically active population's reducing, and a growing number of pension recipients among immigrants from the former Soviet republics. Moreover, the payment of current pension expenses was carried out from current receipts, which testified the financial collapse of the system. As a result, the distributional model of the national pension system is almost discredited both financial and socio-political points of view. The article analyzes different points of view of domestic researchers on the reforming problems of domestic institutions in the pension system, substantiates the benefits of cumulative distribution system's Institute in comparison with the distributional system and describes trends and controversies. From a critical position the implications of legislative acts' implementation in the sphere of pension provision are analyzed. All this has led to several important conclusions, including the problems' identification of insurance model implementation, the pension system's specific benefits' revealing, which are manifested in certain negative social and economic consequences that results to the formation of a methodological platform of institutionalization of the pension system and allow to provide real evolutionary rather than fragmentary and situational nature of its institutional model's reforming. This article is intended for researchers, teachers and students studying the problems of formation and development of the domestic pension system, its research methods within the discipline "Economics of public sector (government) services", "Pension and social security" and for specialists of regional authorities, dealing with the problems of development of the pension system, social protection and social security of the population.*

**Keywords:** *methodology of institutionalization, evolution, pension system, social insurance, the accumulation model, distribution tools, government guarantees, investment risks.*

## 1. Introduction

### 1.1 Relevance of the problem

The most important area of socio-economic transformation in this country is pension reform, designed to make economic basis for the formation and development of the cumulative model of the domestic pension system, as well as to encourage the development of pension insurance (Agapov & Degtyarev, 2007). However, until now in most regions there is a shortage of funds for payment of the insurance part of labor pension which is covered by transfers from the Federal budget (Soloviev, 2007), indicating on a low level of financial stability of the national pension system as a whole (Roik, 2008). Wherein the average size of pensions are increased significantly slower than the growth of the average monthly wage in the country, which significantly affects the financial situation of pensioners (Courtin, 2009). The national pension provision institutional system's evolution taking place in the country is carried out fragmentarily and unsystematically, has occasional and situational character, which significantly reduces the effectiveness of these reforms and increases the risk of violating the financial sustainability of the pension system as a whole. It is quite natural thing that organizational, economic and legislative background of the evolutionary development of the domestic pension system should be considered from the standpoint of the factors reasoned the beginning of a whole set of reforms in this area (Agapova, 2007). The reforms of the domestic institutions of the pension system is not provided with the methodology of the process of institutionalization, which significantly hinders its development, does not allow to use completely all the advantages of the evolutionary nature of its development allowing systematically and comprehensively take into account historical experience of pension provision of the population.

## **2. Methodological Framework**

### *2.1 Research objectives*

Objectives of the study are: systematization of the causes and pre-existing defects in the existing distributional models of domestic pension system, the reasoning of the institutional structure of the modern pension system in Russia, comparison and evaluation of advantages and disadvantages of funded pension model, the reasoning of the necessity for temporarily storing the mixed pension provision system and, as a result, justification of the need to develop methodologies for the institutionalization of pension provision system in Russia.

### *2.2 Theoretical and methodological base*

Theoretical and methodological basis of the study are the fundamental study of the theory of institutional Economics, theory of services, methods of system, economic, structural, dynamic, and statistical analysis, methods of economic-mathematical modeling, sociological surveys and expert assessments, as well as scientific and practical publications of foreign and domestic scientists, revealing the content of social policy and mechanisms of its implementation in relation to the pension field, justifying the development and formation of the institutional approach to the justification of the pension system.

## **3. Results**

### *3.1 Systematic causes and pre-existing defects in distribution models of domestic pension system.*

Pre-reform distributional model of the national pension system is characterized by a number of systemic deficiencies, most important among which are:

- unacceptably low level of absolute and relative sizes of the pension which do not allow to provide the subsistence level;
- relatively high rates of insurance contributions paid to the pension Fund;
- the independence of the accrued pension's size from the level of wages;
- the reduction of the number of economically active population;
- the presence of unnecessarily extensive system of social benefits, excluding the recovery of pension contributions from them;
- a growing number of pension recipients among immigrants from the former Soviet republics of the USSR;
- payment of current pension expenditures was carried out from current receipts, testified to the financial collapse of the system.

There is no doubt that there were objective for all countries causes that weakened the financial capacities of national pension systems, to which should be attributed primarily global trends of populations aging and increased life expectancy. As a result, the distribution model of the national pension system is almost discredited both from financial and socio-political points of view. In other words, there is a narrowing of pensions' funding base, due to the decreasing in employees' number from the salaries of whom the insurance premiums are collected.

However, even it seems to be obvious that the former pension provision system is characterized by financial insolvency and there is a need to reform it on the principles of cumulative models, not all economists are unanimous in this idea. So, for example, some researchers (Bochkarev, 2002) during the discussion of these issues in the early 2000-ies, argued that the demographic situation in Russia, although it was impaired, but not so dramatically that we had to make a decision on transition to a funded pension system. In their opinion, the share of the working-age population in the total population varied slightly and stabilized at 59-60%. Indeed, according to statistics, in 2013 the share of the economically active population accounted for 68.5 %. Therefore, according to the authors, the demographic factor, rather, was the excuse, not the reason for the implementation of funded pension model.

However, objective data indicate that the ratio of employed in the economy number of people and the number of pensioners is not in favor of pension distributional provision system's expectations. Thus, if in 1995, one pensioner corresponded to 1,80 employed in the economy, whereas in 2000 this ratio had fallen to 1.75, and in 2013 to 1.66 (Regions of Russia, 2013).

Equally important impetus to reform the old system of pension provision was made by legal factors such as extensive practice of the legislative establishment of preferential and early retirement, the number of occupations with

such benefits reached 1.5 thousand names, and the total expenditures reached one-third of all pension payments upon retirement. In addition to this group of causes can be attributed the fact of the link's loss between pensions and wages. On the basis of legislation existed in those years, the ratios of the maximum and minimum amount of the pension size was limited to three times, and for people working in adverse conditions – no more than three and a half times (Shafigullin, Grunichev & Mishina, 2004).

To the group of social causes proving the need to reform the national pension model should be included such as the overall growth of unemployment and the declining trend in the number of payers of pension contributions, structural shifts in employment. The decline in the number of economically active population at the time of the reform's implementation reached its peak value. So, if the number of economically active population in 1991 was 75.8 million people, in 2001 it fell to 71.5 million people. It should be noted that this indicator even in 2009, had not yet reached the level of 1991 and was only 75.6 million people (the Regions of Russia, 2010).

The most important economic reasons for the need to reform the national pension model are the overall decline in production and in gross domestic product, paralysis of the circulation, the sharp rise of barter and promissory note schemes of mutual settlements between economic entities, the growth of a company's debt on a salary, the use of special loan accounts, the growth of government borrowing from the Pension Fund, the liberation of a number of enterprises from pension payments paying due to their crisis state and a number of other objective reasons. According to experts, the active using of barter and informal forms of payments led to the fact that by 1996, the real rate of contribution to the Pension Fund decreased to 16.7 % instead of the accounted value of the wage Fund which was normative to 28 % (Regions of Russia, 2010).

### 3.2 The institutional structure of the current pension system in Russia is justified

We do not aim to explain in details the entire process of legal and organizational-economic transformation of the domestic pension system from a historical point of view, since we are interested in the economic prerequisites and mechanisms of this transformation. In Fig.1 a modern mixed model of the domestic pension system is presented.

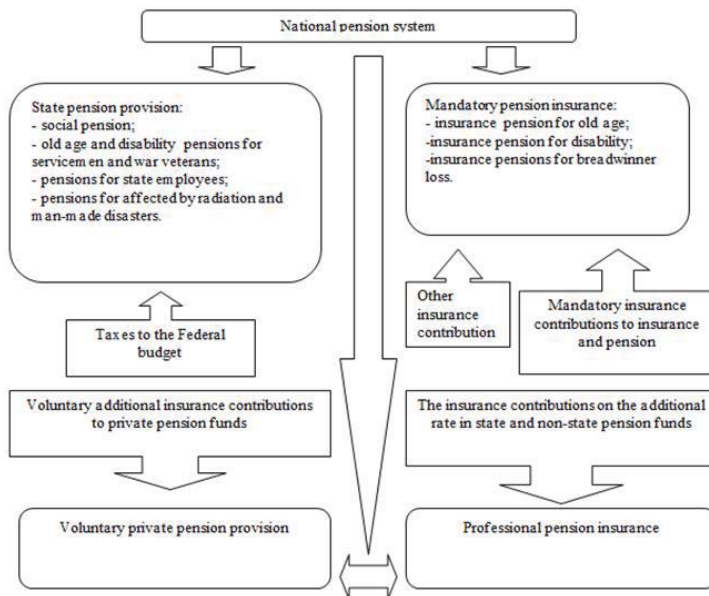


Figure 1. Institutional structure of the current pension system in Russia

Economic scientific idea of this period on the problems of reforming the Russian pension system can be divided into three independent flows. Representatives of the "antireformist" currents of economic thoughts of the period on this issue (Bochkarev, 2002; Wolfe, 2002) insisted on the capacity of the distributional system of pension provision, which,

allegedly, is experiencing temporary surface difficulties, which are not of a systemic nature, common to many developed countries, where the demographic situation is basically similar with the Russian trends. Supporters of "radical reformist" current (Soloviev, 2002; Agaptzov & Degtyarev, 2007), by contrast, justified the radical reform of the pension model and the model of accumulated pension provision. So, in their view, the distributional model of the pension accruals is not able to ensure the future financial stability and balance of pension provision system if indexed pensions to wage growth and inflation. Delaying of the reform of the distributional system exacerbates the insecurity of social debt, increases costs pension and passes them on to future generations. In addition, the transition to the funded pension system model will not only minimize the consequences of the demographic crisis, but will reduce the tax burden on the manufacturing sector and improve the investment climate in the domestic economy. Supporters of "liberal reformist" current of economic ideas of that period (Roik, 2008; Baboshkin, 2006; Courtin, 2009; Kiselev, Sabitov, 2004) who are the absolute majority, justify the necessity to implement a mixed model of pension provision, which forms the basis of the reforms of domestic pension provision. In their view, contemporary patterns of social and political Russian mentality form all the necessary prerequisites to reform the pension system on the basis of existing in developed countries, a mixed model based on the state socially guaranteed minimum, and the use of tools of pension funds' accumulation in the period of employment of a citizen.

Mixed model of the pension system, which began to be implemented since 2002, carried out the reform of as organizational-economic so institutional characteristics of the new system (see figure 1). These characteristics were based on the principle of separation of basic, savings and insurance parts of pension provision, each of which had a deep institutional and economic burden, as expressed in legislation norms of organization of social provision, insurance and investments. So, the basic part of labor pension, first, is guaranteed by the state, and secondly, is financed from the Federal budget, and thirdly, is established in a fixed amount based on the value of the minimum wage in the country. It is also provided the indexation of the basic pension depending on the growth of prices and wages. Therefore, the main social burden of the Institute of basic pensions is to combat poverty by means of the unified social tax which accumulated in the Federal budget.

In contrast, the Institute of insurance and investment simultaneously perform the functions of the individual and collective economic interests' meeting on individual additional income generating with the purposes of its provision for old age. If the insurance part of labor pension is determined depending on the amount of insurance contributions paid by employers and posted to an individual account of an employee throughout his employment, the accumulative part of labor pension is formed by a particular part of insurance premiums, which is accounted for in the special part of individual personal accounts of an employee in a particular age group and investment income received from placing of pension accumulation's fund. It should be noted that in the vast majority of developed countries, the insurance and investment institutions pension systems play a decisive role in pension provision of the population.

### *3.3 Advantages and disadvantages of funded pension model in Russia are disclosed*

Institutional analysis of the structure of the modern pension system in Russia shows that the storage system has certain advantages over a distributional system, which are following:

- not just differentiation of pensions, but the direct dependence of a pension of a particular employee on the size of the savings generated in the course of employment, including income from the effective investment of accumulated funds;
- the provision of the insured's with choice of services provided by various insurers and other participants in the funded component, the development of competition between them in order to do the most effective investment of accumulated pension funds;
- the investment factor's forming of macroeconomic mechanism for socio-economic growth.

However, in the reform process the main trends and contradictions of its implementation were highlighted. If the basic part of the pension system is relatively clear, in respect of the insurance and, especially, its cumulative components much still remains controversial. As it is known, the Institute of funded pensions based on long-term investment, brings more and more significant contribution to total pension income of citizens, which, according to experts (Roik, 2008), account for over one third of the financial resources of the system. Most debates revolve mainly around issues related to the purpose of the funded component of the national Institute of investing in the interests of the individual or the national economy as a whole. However, as it is seen, this problem does not have a valid base for discussion, as the richer the citizens of a country, the richer is the country itself. The main problem here is different – the formation of the state guarantee mechanism for minimizing of investment risks and ensuring of profitability at the level of average inflation. Currently, the law provides for the guaranteed compensation of the accumulated funds placed only in the state managed

companies, which invest only in government securities whose yield is strictly limited.

The international experience offers a whole system of diversification of the state's portfolio of investment programs, including:

- diversification of assets and optimization of the management companies' investment portfolio structure;
- compulsory insurance of professional liability of participants in the investment process;
- establishing a legal framework for the activities of management companies and specialized Depository;
- transparency providing of the investment process at all levels by regularly informing the insured throughout the period of investment of pension accumulation funds.

However, the determining factors in the development of cumulative elements of the pension system were and are subjective factors in the assessment of the huge size of these funds and their significance for economic development, which is the dominant factor of the active promotion of the benefits of funded institutions, even if they have purely declarative nature.

The only issue, but not a problem, here is the question of the ability of the domestic stock market to "digest" these huge amounts of money and not "choke", in other words, the problem is in Russian stock market's ability to take the retirement savings as an investment resource and avoid the negative consequences. However, according to the Ministry of economic development of Russia, the volume of pension funds as investment resources amounted in 2013 to 3.8 trillion rubles, and the capacity of the domestic stock market, represented only by the market of government securities exceeded 1.5 trillion rubles, and the total stock market capitalization amounted to 0.77 trillion US dollars

So, since 2001, with the Federal laws "On mandatory pension insurance in the Russian Federation" № 167-FL and "On state pensions provision in the Russian Federation" № 166-FL, national pension system began operate on the principles of mandatory pension insurance in conjunction with the development of voluntary private pension provision. The pension system of Russia began to form as a combination of social insurance mechanisms, operating on the basis of state and non-state financial institutions aimed in their activities at maintaining the acceptable level of employees' income after their employment finishing.

However, the past decade did not witness the celebration of the insurance fund model, since the growth rate of the labor pension lagged significantly behind as the rate of wages' growth and so the growth of economic indicators' volume.

**Table 1.** Dynamics of the ratio in growth rates of average monthly nominal gross wage and the average monthly pension in Russia

Years	Growth rates of average monthly nominal wages, %	The growth rate of designated pension, %
2000	100	100
2001	145,7	138,2
2003	247,3	212,2
2005	384,8	308,3
2007	611,4	447,4
2008	777,7	552,4
2009	838,4	750,5
2010	942,3	1076,8
2011	1051,0	1004,7
2012	1197,7	1111,7
2013	1339,9	1218,1

**Source:** Calculated by the author according the official statistics. According to data of official statistics (see tab.1), in the last decade the rate of growth of the accrued pension lagged significantly behind the growth rates of average monthly nominal wages. In other words, the development of the system of compulsory pension insurance cannot serve as an illustration of its balance with the wages' growth rate.

We should not forget that the amount of accrued pensions in 2008 began to exceed the subsistence level. So, if in 2007 the living wage on average per capita per month for retirees was \$ 4091 rubles, and the average amount of accrued pension was only 3682\$, in 2008, for the first time the average size of the accrued pension exceeded the minimum subsistence level and amounted to 4546,3 RUB (Russian Regions, 2010). In 2013, the subsistence minimum per month for pensioners amounted 6023 rub. and average size of the appointed pensions amounted 10030 rub. Thus, the ratio of average monthly pension to the subsistence minimum in January 1, 2014 was 166,5 %. (Regions of Russia, 2013).

In this regard, today, the question about the institutionalization of share in national GDP , allocated for pension

insurance is quite keenly debated. It is quite natural, that these indicators should be determined depending on the social, economic, and demographic and climatic conditions of society's life activity. So, according to experts (Roik, 2008), this share in the period 2011-2015 should be at least 10-12% of GDP, while today it does not exceed 6%.

If we mention the funded pension model, we should not forget its huge resource investment. Social protection mechanisms become catalysts or batteries of investment activity of economic entities and their corporate culture. Market relations form a completely different psychology how to form the savings that is reflected in the indirect parameters of growth in the share of pension savings in the GDP, which creates special incentives for the development and improvement of the investment market and the stock market as a tool of their formation and growth. As a result the national pension system becomes not just a component of the social economic development, but also its active part, and its financial resources and the level of development of the pension provision become the key macroeconomic indicators. In addition, the choice of national institutional model of pension provision and its effective functioning are always due to the fundamental components of society's life support, where the pension is treated as part of total income. Therefore it is important to estimate the aggregate amount of funds on pension's provision as share in total public income generated as a result of the redistributive processes (see tab. 2).

**Table 2.** Dynamics of pensions' proportion in per capita monetary income of the population

	1990	1995	2000	2003	2005	2007	2009	2010	2011	2012	2013
The share of pensions in per capita income, % population, percent	52,6	47,0	36,1	33,8	31,3	29,2	36,6	40,1	39,8	39,4	39,7

**Source:** Is calculated by the author according to official statistics

However, as it is evidenced by these statistics, the share of pensions in total income of the population over the last twenty years has decreased significantly. So, if in 1990 before the reform of the pension system, the share of pensions in total income had been 52%, in the period of reform of the pension system by 2002 this indicator had decreased to 30-33%, reflecting the adverse macroeconomic trends. In recent years, before the implementation of the new pension reform, the rate has reached 39-40%.

Thus, it can be stated that for all its benefits funded pension system has its own characteristics, which manifest themselves in certain negative social and economic consequences. First of all, this concerns the direct dependence of cumulative component of the mixed model on macroeconomic parameters of the country's development, when the existence of the economic instability, reflected in high inflation, falling of GDP growth, reducing of employment and wages, destabilization of investment growth factors and declaration of state guarantees generate significant economic and social risks for its functioning.

In addition, the cumulative component requires a much longer period of adaptation covering at least 20-30 years, during of which the insured employees will be able to build pension savings, sufficient to provide for their retirement. In other words, the prerequisites for the successful functioning of the funded component are parameters such as the sufficiency of insurance contributions' rate directed to the funded part of pensions, the low level of financial and other risks in accumulation and investment of pension savings.

The most important not only economic but psychological factor of market nature of the pension system's funded component is the entire responsibility's passing for the pension level of the citizen from the state to the insured persons, which should not just be aware of the importance of retirement savings for their future existence after working age, but also to take the necessary action for it.

### 3.4 The necessity of the mixed pension provision system's temporarily storing in Russia is justified

However the realities of the modern socio-economic development of Russia do not allow abandon completely the pension provision's distributional model toolkit. This is due primarily to the fact that the dominant mass of current retirees have earned their right to pension according to previous legislation, and to realize their right to a pension is possible only through current funding. In addition, the storage part of future pension payments will have quite significant nature for persons who have the right for it, only after the enough long period of time of their insurance contributions. So, after ten years of pension reform starting, the special part of individual personal accounts, which records the payments to the funded part of labor pension, belongs only to less than 70% of working citizens.

The current mixed model of pension provision includes an insurance component based on effective mechanisms of accumulation and targeted use of financial resources generated within the Institute of insurance relations. Institute of insurance relations in the framework of the mixed model is based on the regulations of the Federal law "On mandatory pension insurance in the Russian Federation", which are not only enshrined the main regulations of the pension insurance relationships, but also identified the mechanisms how to form their financial resources. In accordance with that legislation insurance contributions within the compulsory pension insurance are included in the unified social tax. In addition, the relations participants' rights and obligations in this type of insurance were specified, including the enshrining of the right of the insured to obtain insurance provision in the amount equivalent to the amount of contributions that implements one of the basic principles of compulsory social insurance.

Negative aspect of the pension provision's modern state is the trend of the weakening of insurance principles in the provision of retirement pensions. This is evidenced by structural changes in their composition. Over the past ten years since the reforms' start the basic part of labor pensions has increased 4.5 times, while the insurance part on average only 30%.

#### **4. Discussion**

To the problems' research of the domestic pension system' formation and development the works of Agaptzov S. (2007), Courtin, A. (2009), Roik, V. (2008), Soloviev A. (2007) and other scientists are dedicated.

To the defects' analysis of pre-existing domestic distributional pension system's model and the justification of the institutional structure of the modern pension system in Russia the works of V. Bochkarev (2002), A. Shafigullin, A. Grunichev & L. Mishin (2004), L. Wolfe (2002) and others are devoted.

The problem of parameters' predicting in national pension system's development are considered in the works of Agapova T. (2007), Baboshkin A. (2002), Kiselev & Sabitov (2004) and others.

However, the formation problems of methodological framework of institutionalization's processes of the Russian population's pension system remain very poorly known.

#### **5. Conclusion**

Thus, the carried out institutional analysis allows us to draw some important conclusions about the nature and results of the organizational-economic and legal transformation of the national system of pension provision. It must be recognized that the operation of the hybrid pension model in the first decade significantly improved the financial situation of pensioners. This is because the formation of the new model was hampered by the incompleteness of the legal and institutional bases of functioning of obligatory pension insurance's system, the formation of which was, in itself, an important outcome of social changes, inevitable in the conditions of transition to market relations. In these circumstances, the government was forced to use the distribution models' toolkit and has taken a number of measures to increase the size of labor pensions, mainly due to the growth of their basic parts. In addition, regular indexation of the base part according to the rate of inflation in the country contributes to the achievement of the basic retirement pension to the subsistence minimum.

The results of the first decade of functioning of the new pension model was characterized by the need to adjust the reform decisions taken in the beginning, as well as making a number of additional changes, which allow to determine the initial period of reform as the period of formation of the fundamentals of the new model and its initial testing.

Conceptual conclusion based on the analysis results is that the domestic pension institutions' system reform is not provided with the methodology of the process of institutionalization that would allow it to have a truly evolutionary nature, aiming at various combinations' accumulation of the world and domestic historical experience of pension provision, while unreasonable institutional reforms' forcing can cause enormous financial and political damage. The elements of the funded component can be organically and in a timely manner integrated in the logic of the existing mixed system, so that eventually they can become objectively demanded by it.

#### **6. Recommendations**

The conducted analysis allows us to substantiate the need to develop a methodological platform of the institutionalization process of the pension system in Russia that could serve as a basis to develop conceptual directions in development of the pension system, its institutions, forms and methods of its improvement that need to be considered as a basic component of the state social policy in this area.

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