

EU2-200001869

ORIGINAL: RUSSIAN

## **KEY ELEMENTS OF REFORM IN THE SOCIAL SPHERE (other than education and culture)**

The financial crisis of August 1998 led to a significant decline in government social spending in real terms in all the major areas. At the same time, the number of citizens in need of social support grew appreciably.

The existing system of social protection for the population turned out to be ill-suited to operating under those conditions. It offers limited opportunities for the redistribution of resources to benefit the most needy households and it is based on a system of universal social transfers, subsidies for goods and services, as well as categorical benefits. Under this sort of system, the bulk of social transfers go to households that are not classified as needy.

Judging from household budget survey data, the growing gap in the underfunding of social programs, combined with the shrinking ability of the federal center to assist in the interregional evening out of social spending, led to an increase in the regressive nature of social transfers, which did even more to weaken their orientation toward needy households compared to the pre-crisis period.

The effectiveness of a number of social protection efforts, such as the payment of benefits for children and the funding of employment programs, reached a critical level and they stopped having a meaningful effect on the position of the vulnerable segments of the population at which they are targeted. Given the level of government funding that has been maintained in the post-crisis period, the current system of social protection, which is characterized by an extensive system of categorical benefits and universal social transfers, is not capable of performing the majority of functions assigned to it.

Resolution of the accumulated social problems requires profound structural reforms in the social sphere, which would provide for the redistribution of social spending to benefit the most vulnerable segments of the population while at the same time reducing social transfers earmarked for the benefit of well-to-do families.

Household budget survey data show that social policy measures that were undertaken at the federal, regional, and municipal levels after the crisis are inadequate. They not only did not narrow the gap between the social obligations imposed on the state by law and the resources actually earmarked for their fulfillment, but in a number of cases they actually contributed to a further widening of this gap (in the payment of social benefits, for example). This gap has grown to such an extent that it would be entirely legitimate to raise the question of the degeneration of the “social state,” as it appears in the Russian legislation, into a “virtual social state,” in which not a single social function is carried out in the form in which it is provided for by law due to a lack of funding.

A characteristic feature of a “virtual social state,” in the direction of which Russia moved rapidly in the post-crisis period, is the segregation of social policy according to the “socialism for the rich—capitalism for the poor” principle that is typical of many Third-

World countries. The volume of resources earmarked for the needy is clearly insufficient to provide any appreciable easing of their position, while the bulk of social transfers end up in the hands of high- and middle-income citizens. These groups have little need for social protection, but they wield sufficient political weight and influence to stand in the way of decisions that would lead to a redistribution of social transfers for the benefit of poor households.

Judging from all the evidence, Russian society is still not ready to openly acknowledge the fallacy of this model of social protection, and the inconsistency between social guarantees set down by the legislation in force and the country's economic capabilities and actual social needs of its citizens. A further demonstration of this can be seen in particular in the fact that the pre-election economic platforms of the leading political parties and blocs, which on the whole are relatively realistic in the area of economic policy, continue to be openly populist with regard to social policy matters.<sup>1</sup>

The current social policy model, however, due to the fact that it is extremely ineffective, can hardly be sustained over an extended period of time. Over the next few years there should be a gradual adaptation of social policy and social legislation to the tighter budgetary constraints.

This sort of adaptation can occur within the framework of a gradual transition to the "subsidiary state" model. Under this model the scale of universal social transfers will be limited (including as a result of stricter targeting of social payments and expansion of formal copayments by the public for a number of health care services and education). In this process, the bulk of social transfers will be earmarked for low-income categories of the population. Implementation of this approach will require that a whole set of structural measures be carried out in the social sphere over the next few years. A list of the most important of these measures in the main areas of social policy (other than education and culture) is provided below.

### **1. Reform of the system of providing social benefits, payments, and services**

A program of measures aimed at cutting budget subsidies to producers of goods and services, as well as benefits and payments provided on a categorical basis, and at providing targeted payments to needy families, should form the foundation of reforms in the sphere of social support for the population.

As the household budget survey data indicate, a universal conversion to targeted principles of social assistance in the form in which it is called for under the new federal legislation adopted in 1999 is not feasible in practice in connection with a shortage of

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<sup>1</sup> M. Dmitriyev. Parliamentary Elections in Russia: The Economic Programs of the Leading Parties and Blocs. Carnegie Moscow Center Briefing, Vol. 1, No. 11, November 1999.

financial resources. Practical introduction of the targeted approach will require the introduction of more substantial restrictions on both the size of payments and on the makeup of the recipients of benefits.

This means that besides the assessment of household income and consumption, additional criteria need to be applied to weed out potential recipients, based on qualifying indicators that point to their relatively lower level of social vulnerability, including the application of indirect methodologies for evaluating the applicants' need. Such approaches may vary substantially among the different regions depending on the budgetary capabilities of the territories, the structure of the population, the standard of living, specific aspects of employment, and local traditions. In connection with this, it makes sense to shift the authority to determine the amount and forms of social support to the regional and municipal level.

A top priority in the social services sphere is to broaden the choices available to citizens and to provide for diversification of the forms in which such services are provided, based on active efforts to draw the private sector into this process. Specifically, this entails:

- equal access to government funding for governmental and nongovernmental organizations providing social services;
- development of self-supporting social services in those spheres in which the conditions required for this exist;
- gradual divestiture of institutions in the publicly funded network that provide social services, and conversion of these institutions to funding based on the principles of contracting to fulfill state social orders;
- introduction of a system for the licensing and regulation of the activities of governmental and nongovernmental organizations providing social services to the public;
- broader freedom of choice for citizens utilizing free or subsidized social services, including through the introduction of special social accounts that grant their holders the right to receive free or subsidized services of a certain value based on a list that has been agreed upon in advance, from any organization that is licensed to provide such services;
- combining government funding with private charitable resources, including through the employment of mechanisms involving state social orders and social accounts for citizens;
- greater cooperation with religious organizations with a view to increasing their contribution to providing social services to unprotected categories of citizens;
- targeted efforts to develop volunteerism in the social service sphere.

## **2. Reform of pension security**

The financial condition of the pension system in the Russian Federation underwent a number of significant changes in the period following the 1998 crisis. In the post-crisis period the decline in the size of the pensions awarded in real terms occurred at a faster rate than both personal money income and wages earned, which serves as the basis for the calculation of insurance premiums paid to the Russian Pension Fund.

The steep decline in the ratio between the minimum pension and the minimum subsistence income for a pensioner made it impossible to maintain the differentiation of pensions that was in effect in the pre-crisis period. While the ratio between the average pension awarded and the minimum pension was 1.72 from April 1998 through March 1999, by the fourth quarter of 1999 it had fallen to 1.46 as a result of the more rapid indexing of minimum pensions. In February 2000 this ratio was supposed to fall to approximately 1.37 in connection with an additional 10-percent increase in minimum pensions above and beyond the overall 20-percent raise in pensions.

The impossibility of a significant differentiation of pensions over the medium term is hindering the introduction of a system of retirement savings accounts, which are called for under the Pension Reform Program for the Russian Federation that was adopted in May 1998. Projections based on various scenarios show that under the new economic conditions a substantial increase in the differentiation of pensions funded from a pay-as-you-go system will be difficult for a long time to come, since it is capable of freezing the minimum pension at a level below 80 percent of the minimum subsistence income for a pensioner for a prolonged period, in connection with insufficient receipts of insurance premiums paid to the Pension Fund.

In light of this, with the resumption of economic growth and an increase in real revenues going into the Russian Pension Fund, a reasonable approach would be not to increase the pension differentiation that currently exists, but to provide for an equal increase in all pensions, with the aim of bringing the minimum pension closer to 80 percent of the minimum subsistence income for a pensioner as quickly as possible, as called for under the Pension Reform Program that was approved in the pre-crisis period.

The differentiation of pensions will have to increase in the future, although it would be preferable for the primary factor in this increase not to be the pay-as-you-go component, but the savings component of mandatory state pension insurance.

The impossibility of introducing a retirement savings account system in the foreseeable future creates the need for a direct, gradual increase in the standard retirement age. The proposed pension reform option calls for a gradual increase in the retirement age by 5 years for men and women over a 10-year period, starting in 2002. This proposal is consistent with similar decisions adopted in recent years in Georgia, Kazakhstan, and

Moldova. Over the next ten years the plan is to establish the same retirement age for men and women by raising the retirement age for women to 65 over this period.

Over the next few years the average replacement rate for state pensions funded on a pay-as-you-go basis can be maintained at a level of approximately 30–34 percent, which, judging from all evidence, will be achieved in February 2000. Actually, this assumes an indexing of state pensions based on wages during the period in question, which will make it possible to bring them more quickly up to the level of the minimum subsistence income for a pensioner.

In the more distant future (in 5–7 years), when significant pay-outs of state savings-based pensions begin, the emphasis should be on maintaining the overall replacement rate for state pensions funded on both a pay-as-you-go and a savings basis at approximately 33 percent.

As actuarial calculations show, in order to maintain the replacement rate at the level of 33 percent, the rate of insurance premiums earmarked for the current funding of state pensions can be maintained at the level of 27.7 percent for enterprises based on a single rate for employers, given the current base for assessment of insurance premiums. This rate is in line with proposals to reduce the aggregate payroll tax burden, which call for the establishment of an overall rate of 35.4 percent for enterprises on insurance premiums paid to social extrabudgetary funds.

As called for in the Pension Reform Program, this scenario also provides for the establishment of a single rate for contributions to personal pension savings accounts opened with the Russian Pension Fund, for all citizens regardless of their age. In the process of introducing mandatory insurance savings contributions, the rate of which is supposed to rise gradually from 2 percent to 8 percent over the first 4 years following the initiation of the reform, the rate of contributions to the pay-as-you-go system will fall by the amount of savings contributions. According to the actuarial calculations provided, this decline will not result in a shortage of funds for the payment of pensions funded on a pay-as-you-go basis, thanks to an increase in the collection rate of insurance premiums through the personalization of their savings component, and also in connection with the initial phase in raising the retirement age and reforming the early retirement process.

Considering the consequences of the financial crisis and the status of financial markets, elements of mandatory savings-based financing of pensions may be put into place no earlier than 2002, depending on the development of at least the minimum necessary economic and organizational-technical conditions for the investment of pension reserves. The appearance of these conditions is tied closely to the resumption of economic growth. With regard to procedures for the investment of pension reserves, no major deviations are planned from the current Pension Reform Program. It is assumed that insurance premiums recorded on personal pension savings accounts with the Russian Pension Fund will form the pension reserves to be invested through a system of authorized investment companies (management companies).

There is a proposal to consider, among the additional measures to make adjustments in the Pension Reform Program, the possibility of pursuing alternative approaches to funding early retirement through a system of insurance to cover actual disability at a special earlier retirement age. In connection with the basic opportunity to choose alternative approaches for the reform of early retirement pension security, two possible approaches are presented in this paper.

The first of the possible options involves the gradual transfer of payment of the majority of early retirement pensions to professional pension systems (PPS), which is called for under the Pension Reform Program for the Russian Federation; it has a number of shortcomings, which are made even worse by the aggravation of the economic crisis. This does not create insurmountable obstacles to the implementation of this particular part of the reform in the form in which it is provided for under the Program, although it does make sense to consider alternative approaches that would be more consistent with the post-crisis situation.

The second reform option entails a gradual transition to insurance to cover people who have become disabled and have a minimum amount of time on the job under special working conditions, and also in regions of the Far North and areas with equivalent status. This means that early retirement with a pension under the existing rules is permitted only for people who have accumulated the minimum amount of time on the job under special conditions, which is required for early retirement, prior to the entry into force of this law. From the moment this law enters into force, the right to receive an early retirement pension would be granted only to people who have accumulated a minimum amount of time on the job under special conditions, but who have not reached the standard retirement age, and have been declared disabled in connection with occupational illness or employment in regions of the Far North and areas with equivalent status, following the established procedure.

According to the available estimates, when the transition to a new system of early retirement pensions is completed in its entirety, expenditures of the Russian Pension Fund on the payment of early retirement pensions to employees who meet the established criteria will not exceed 0.2 percent of GDP. Additional rates for payroll insurance premiums for employees covered by this type of insurance will remain at around 1 percent in the majority of cases. This is approximately 10–20 times less than the expected insurance burden under the first pension reform option, which calls for the payment of early retirement pensions to all insured persons, regardless of actual disability.

The choice between the available options for reforming early retirement must take into account both economic and political limitations. Implementation of the second of the proposed options could run up against serious political obstacles. From the standpoint of social justice, rationality, and sustainability of the pension system, however, the second option, which is based on granting early retirement pensions only to persons who have actually become disabled, is preferable without a doubt.

Within the framework of the new pension reform program, a set of long-term measures should be outlined to develop a system of private pension funds and supplemental voluntary pension insurance in general, taking into account prospects for normalization of the situation in financial markets and gradual broadening of opportunities for the reliable investment of pension savings.

### **3. Policies in the area of labor relations and employment**

A top priority in the reform of labor relations and employment over the medium term is to increase the flexibility of the labor market and the mobility of the work force in order to achieve a high degree of balance on the labor market, and thus provide for the highest level of employment possible.

One of the key policy priorities in labor relations is a reform of labor legislation aimed at increasing the mobility of the work force and reducing latent processes in the labor market. Meeting these goals will require expansion of the role of contractual regulation of labor relations, primarily through a broadening of the role of individual labor contracts, some simplification of the procedure for their termination at the employer's initiative (while preserving the requisite level of protection for the employee's rights and interests, of course), expanding the sphere of application of fixed-term individual labor contracts, and broadening the range of issues regulated directly by contracts.

Development of collective labor relations with the participation of trade unions as employees' representatives at the level of enterprises and organizations, where socio-economic conditions of employment activity are more uniform than at the sectoral and regional level, is an essential condition for increasing the flexibility of the labor market. At higher levels (at the territorial, regional, sectoral, professional, and federal levels), a social partnership may develop in the form of bilateral and multilateral consultations, including consultations in an institutionalized form (such as trilateral commissions, socio-economic councils, and so forth). Decisions adopted at these levels cannot be binding upon organizations that are not direct participants in the consultations and that have not given their express consent to the adoption of the decisions in question.

Another key element of labor reform is the formation of effective institutions and mechanisms that provide for adherence to individual and collective labor contracts and effective settlement of individual and collective labor disputes. The formation of a quasi-judicial, independent system of chambers to deal with labor disputes, operating on a self-supporting basis and capable of providing for the rapid and informed review of all petitions involving labor disputes, seems to be a promising option.

The required amendments and additions to the current labor legislation are so diverse that they need to be effected in stages, over a period of several years. This means that it would be preferable to execute them not in the form of a new version of the Russian Federation Code of Labor Laws, but in the form of a sequence of federal laws that could subsequently be combined into a Code of Labor Laws. Top priority should be assigned to the

preparation and adoption of draft federal laws “On Individual Labor Contracts,” “On Social Courts in the Russian Federation,” and “On Amendments and Additions to the Russian Federation Law ‘On Collective Contracts and Agreements.’”

In the area of employment policy, primary attention should be devoted to increasing the level of employment in the formal sector of the economy, reducing long-term unemployment, and encouraging the unemployed to engage in a more active job search. A stricter approach to granting persons unemployed status with the right to unemployment benefits could facilitate this: mandatory participation in community service for at least a minimum required time, broadening of the concept of “suitable employment” and a requirement that the unemployed person must consent to take such a job, checking the financial status of the unemployed person’s family, including a check to determine the ownership of property that would provide for a sufficient level of income (for example, through the leasing of property or growing produce on a personal auxiliary gardening plot).

Procedures involving mass layoffs also need to be made more realistic. The current procedure, established by the Federal Law “On Employment in the Russian Federation,” for all practical purposes cannot be carried out and it forces enterprises experiencing an objective need to lay off a large number of their employees to circumvent the legislation, including nonpayment of wages and placing employees on long-term unpaid administrative leave. There is a fundamental need here to reduce the amount of severance benefits paid by employers—from the three months under the current legislation, since the three months of compensation is prohibitive for employers, who are forced to resort to mass layoffs in connection with economic difficulties.

An important condition in increasing the proportion of registered employment is a reduction in the payroll tax burden, the upper limit of which is now in excess of 75 percent. It is expected that one of the consequences of reforming the tax system and social extrabudgetary funds will be a reduction in the aggregate rate for income taxes and contributions to social extrabudgetary funds by more than half (to 35 percent), while at the same time substantially expanding the tax base, which will make it possible to compensate to a significant extent for the unavoidable decline in real revenues from income taxes and insurance premiums that will occur under such a reform.

#### **4. Reform of health care and social insurance**

The transition from a budget-based funding system to a mandatory medical insurance (OMS) system is the heart of health-care reform in Russia in the 1990s.

From an economic standpoint, the condition of Russian health care in the late 1990s is characterized by two key problems:

- an imbalance between government guarantees of free medical care for citizens and the financial support for these guarantees;

- the introduction of a health-care financing system has not been completed, and there is an eclectic combination of elements of the old and new financing systems.

The main problem is the lack of financial support for government guarantees of free medical care for the population. From 1991 through 1999 government spending on health care fell by a factor of approximately 2 in comparable terms. Meanwhile, there was no change in government guarantees of free medical care for citizens.

As calculations show, given the existing budgetary constraints, if further degradation of public health care is to be prevented, the need to cut back government guarantee programs cannot be avoided. From our perspective, the least painful option for cutting back the program while preserving the principles of equal access and free medical care for all Russian citizens is to reduce by 50 percent the duration of inpatient care provided in the event of planned hospitalization (this accounts for approximately 30 percent of total inpatient care). This will lead to an increase in the waiting period for planned hospitalizations. But by almost doubling the amount of care provided at daytime care facilities and through home health care services, we could substantially lessen the potential negative impact of the proposed measures. Such measures will make it possible to reduce the cost of the government guarantee program by approximately 10 percent, with minimum social impact on the public.

At the same time, the proposed cutback in the government guarantee program will not entirely eliminate the deficit in the public health care system. The following options may be considered as additional ways to address this problem:

- either the introduction of copayments for middle- and high-income segments of the population for inpatient medical care provided under the government guarantee program, by a total of up to Rub 13 billion in 1998 prices;
- or a significant redistribution of mandatory insurance premiums for social and medical insurance in favor of medical insurance (using almost 6 percent of the 7 percent aggregate tariff for health care purposes, which could be earmarked for these purposes as part of tax reform) and a corresponding fundamental revamping of the system for the payment of temporary disability benefits, shifting part of this function to employers and doing away with all other uses of social insurance funds.

Assuming that a balance is achieved in the volume of government guarantees and government financing in the health care system, it will be possible to preserve and provide for further development of the current mandatory medical insurance model. Further development of the mandatory medical insurance system requires implementation of the following measures:

- Elimination of dual management in the financing of medical care provided under mandatory medical insurance programs: mandatory medical insurance funds in all constituent territories of the Russian Federation would be turned into the sole managers of resources

earmarked for the financing of mandatory medical insurance programs. Fulfillment of this task will require, at the least, that federal legislation establish uniform requirements for government authorities of constituent territories of the Russian Federation and local self-government authorities regarding the procedure and size of payments to mandatory medical insurance funds for people who are not employed, and at the most, introduction of the corresponding earmarked transfers from the federal budget and budgets of the constituent territories of the Russian Federation to mandatory medical insurance funds, or assignment of a fixed share of general tax revenues to mandatory medical insurance funds.

- Introduction of national requirements governing the extent and quality of medical services that must be provided to patients in the event of various types of illnesses (medical protocols), with a level of detail sufficient for the uniform assessment of costs necessary to treat the respective illnesses.

- Establishment of a balance between requirements governing the extent and structure of medical care specified by the respective government guarantee program and financial resources, and adherence by the state to its obligations to provide program financing. Then the effective use of resources can be demanded of other participants in the system. Moreover, it is unrealistic to expect that competition will develop among insurers without resolving the problem of balance.

- Universal introduction of per capita financing of medical insurance organizations from mandatory medical insurance funds and allowing insurers to retain as income a certain proportion of the difference between the volume of resources received by them and their spending on providing medical care in accordance with the mandatory medical insurance system. This will ensure that they have a financial interest in controlling costs by providing for more efficient organization of medical care.

- Stricter requirements for the operation of medical insurance organizations.

- Support for participation by insurance companies in managing the organization of medical care provided to the insured.

- Providing for transparency in the spending of mandatory medical insurance resources by mandatory medical insurance funds, insurance companies, and medical organizations: introduction of federal requirements for published reports, and for the procedure involved in furnishing information to citizens and the mass media.

Implementation of all of the innovations referred to here will entail considerable expense, and the required institutional costs are high. But if these steps are not taken, insurers will not be operating effectively, all the criticism will be justified, and then from an economic standpoint it would make more sense to simplify the existing mandatory medical insurance model.

It seems, however, that the requirements referred to above can be met given political will on the part of the federal center, combined with a flexible regional policy. Over the short term, the possibility of further innovations in the mandatory medical insurance sphere can be anticipated in regions that are the most prepared for this in institutional respects. For the rest of the regions, at the initial stage it would be preferable to establish clearly defined criteria under which a simpler model for organizing mandatory medical insurance could be used.