

Russia:
Note on Social Protection
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A. Background

1. Since the beginning of transition in 1991, output, real wages and labor productivity have fallen steadily, and officially measured GDP has declined by some 50%. At the same time, inequality has increased – over the 1991-98 period, the Gini coefficient¹ increased from 0.26 to 0.45; fewer people are receiving a larger share of a smaller cake. Adjustment has occurred mainly through wages, and it is only recently that layoffs have become significant: survey-based unemployment is currently estimated at some 12%. As a result, poverty has increased from approximately 10% of the population in the late 1980s, to a consumption-based poverty rate of 37.7% in first quarter 1999. (This includes a jump from 23.8 percent in 1998, reflecting the impact of the financial crisis in August 1998).² The majority of the poor are workers with unpaid wages, as well as the unemployed; in addition, poverty is high among certain groups of pensioners (i.e. the elderly living alone) and families with children, making the vulnerability and long term social implications of children growing up in poverty a particular concern.

B. The Social Protection System

2. In Russia, the formal system of social protection includes labor pensions, unemployment compensation, family allowances, sickness and maternity benefits, and housing allowances. There is no explicit poverty benefit; instead there are numerous categorical benefits and privileges in cash and kind, few of which have any specific poverty targeting function. In addition, there is informal support ranging from private plots that allow people to engage in home production, to help that people receive from friends and relatives outside the household.

3. The formal social protection system absorbs about 12% of GDP and accounts for close to 30% of household income. Labor pensions, sickness and maternity benefits and unemployment assistance are financed through extra-budgetary funds, supported by payroll taxes, currently at 34% of the aggregate wage bill. Family allowances are a universal benefit financed from local revenues and supplemented with federal transfers. Such transfers are in the form of unconditional block grants covering a range of government obligations, of which family allowances are a designated (but not enforced) priority. Housing allowances and categorical benefits and privileges are funded entirely from local resources.

4. The current system has not been able to cope well with the demands placed on it by transition, and while the system has undergone numerous structural improvements, it still is unable to offer adequate protection to poor and vulnerable groups:

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¹ A standard measure of inequality, ranging between 0 (perfect equality in the sense that each quintile in the income distribution has the same share of total income) to 1.

² These data are based on the Russian Longitudinal Monitoring Survey (RLMS), a nationally representative household survey involving some 6,500 households. RLMS data show significantly higher poverty rates than the official Russian family budget survey (FBS). While the FBS is more extensive than the RLMS, and in itself represents an extremely rich potential source of data, its design has the result that the lower part of the income distribution is not adequately represented by the survey, and consequently it tends to understate the situation. This deficiency has recently been corrected, and future results should be more comparable to the RLMS.

- (a) Benefits are low: the unemployment benefit averages only some 15% of the subsistence minimum; family allowances average 12% of the subsistence minimum for children; until recently, the minimum pension was at 45% of the elderly subsistence level – however, adjustments in the recent past, most recently in February, have raised to minimum to some 50% of elderly subsistence. With further planned indexation adjustments, the minimum pension would reach some 60% of elderly subsistence by the end of the year 2000. The average pension would be at 95% of elderly subsistence.
- (b) The system is badly targeted, and what assistance is available often does not reach households below the poverty threshold - some 20% of poor households receive no benefits at all, yet almost four out of five non-poor families receive public transfers; while some 40% of the population is poor, 68% is eligible for various benefits and privileges; and the bulk of housing subsidies, which are income-tested, still go to the non-poor;
- (c) The system does not address well the needs of the working poor: while pensioners, the unemployed and families with children do have recourse, albeit inadequate, to programs specifically tailored for their needs, the lack of a targeted poverty benefit leaves many working poor outside the safety net;
- (d) Resources are inadequate: it would require an estimated additional 4-5% of GDP to raise all poor households to subsistence levels; it is unlikely that an additional transfer of that magnitude into social protection is tolerable;
- (e) Two of the main elements of Russia's formal social protection system - the public Pension Fund and the Federal Employment Services, though which resources equivalent to 7% of GDP flow - need major strengthening to improve efficiency, financial management and transparency. Another vehicle – housing allowances, absorbing another 3.7% of GDP - requires a fundamental overhaul to reduce its financial cost and improve targeting;
- (f) The public pension system, in spite of pension increases and improved payment performance in the recent past, will begin to experience chronic and growing deficits in the not too distant future; this will require tackling difficult structural issues such as increasing the pension age and reducing special privileges;

C. A social protection strategy

5. A medium term social protection strategy for Russia should support transition and economic growth: it should provide protection against income risks (prevent and alleviate poverty); and it should contribute to the efficient operation of labor markets and in that way facilitate the process of enterprise restructuring. As there is little scope for increasing resources for social protection, the challenge is how best to apply existing resources through: rationalization/elimination of programs; targeting of benefits to the neediest groups; and drawing on savings from such measures to bring benefits to more meaningful levels.

6. **Poverty relief.** An immediate concern is the provision of adequate poverty relief to the most vulnerable groups of the population, including in particular the working poor. Russia does not currently have a coherent social assistance scheme. Instead, it has a large number of categorical benefits and privileges. None are adequately funded, and most are universal, i.e. awarded on the basis of a specific contingency without either a contributions or income test. Many of these benefits and privileges are federally mandated, but remain unfunded. Or only partially funded. For instance, in the city of Tver, some 50% of the population is eligible for various unfunded programs, mandated by the Federal Government. Targeting and consolidating benefits and privileges should be seen as central strategies for poverty relief. Targeting is likely to yield more improvement in the efficiency of social expenditures than

any other fiscal measure. The Government has launched a number of initiatives in this direction. It has recognized the principle of poverty targeting as a priority for social policy and is in the process of developing appropriate approaches to targeting.³ In the meantime, the principle of targeting of family allowances has been accepted and relevant legislation passed. Beyond targeting, the Government is reviewing social benefits and privileges with a view to their gradual rationalization, i.e. consolidation and/or elimination. This includes a review of housing allowances, which account for about 3.7% of GDP (about 35% of municipal budget expenditures) and, while targeted⁴, show a high level of errors of inclusion (i.e. benefits go to non-poor households). Here, significant improvements in targeting may well be achieved by changing the selection procedure to incorporate appropriate proxies for poverty status.

7. **Unemployment benefits.** When unemployment insurance is provided, the aim should be to facilitate reinsertion into the labor market (job shifts), while not imposing either high tax rates on contributors or creating work disincentives. In the current Russian unemployment benefit system, none of these elements are present. The tax rate is modest at 1.5%, and benefits are too low to either facilitate job shifts or create work disincentives, nor do they prevent workers from falling into poverty on separation from employment. Moreover, the current system mixes the principle of insurance with the principle of poverty alleviation. By extending the benefit to workers with no or no immediate previous history of insurance contributions, the system works as a quasi social assistance program. Lastly, the current system is inefficient in redistributing Employment Fund resources between surplus and deficit regions, resulting in frequent non-payment of benefits.

8. Under current circumstances, the unemployment benefit functions as another insufficient and underfunded poverty benefit. It is legitimate to ask if it should be maintained or if the resources should be incorporated into a general poverty benefit. At the very least, the unemployment benefit system might be simplified by the introduction of a flat-rate benefit available only to those workers with immediate previous work history in a job for which an employment tax is paid. Its level would have to be determined by the availability of resources, but its stricter application might allow a more generous flat benefit to be paid. This should be considered, if it is found that by doing so, at least for a limited period of time, it can be used as a safety net to spur enterprise restructuring (see para. 15 onwards below). Additional financial space might be created by converting implicit wage subsidies to enterprises into explicit time-bound assistance, through more effective use of Employment Fund resources, and through further restrictions on eligibility and duration of benefits. The Government is already undertaking measures along these lines, and they should be encouraged. Recently, legislation has been passed that tightens eligibility criteria for unemployment benefits, a new redistributive formula is being developed for the Employment Fund, and following a financial management review of the Fund mechanism, it can be expected that the use of Fund resources will be better monitored in the future.

³ The practice of targeting is widespread in Russia at the regional level, as local authorities are faced with insufficient resources to pay benefits to all eligible persons. However, means-testing, i.e. income testing is not straightforward in Russia: because of the enormous difference between reported income and consumption, traditional means-testing methodologies do not work. Moreover, where there is no strong tradition of tax compliance and a heavy reliance on informal sector activities, means-testing is likely to be prohibitively expensive. In such circumstances, income testing should be viewed as an ultimate goal, while an intermediate approach might focus on eligibility based on a households combined score for different risk factors for poverty. Already, in Russia some areas have adopted a system of means-testing based on a formula for income, which captures some forms of income from assets.

⁴ A burden limit is applied, where municipalities make payments to utilities on behalf of households whose combined utility expenditures exceed a certain share of their income. In most municipalities in Russia this is set at 15%. The targeting efficiency of burden limits to a large extent depends on the correlation between household income and the share of utility expenditures in household income. In Russia, the high level of errors of inclusion would indicate that the correlation is weak.

9. Centralization of the Employment Fund has been considered on a number of occasions – for better control of resource use, especially for active programs, and a more balanced distribution of benefits. This no longer seems urgent, as these concerns are in the process of being addressed under reform initiatives currently under implementation.

10. More generally, any consideration of reshaping basic structure of income support for the unemployed should of course be guided by the Government's perception of current and emerging labor market trends and social changes and should be consistent with a strategy aimed at trying to restore the labor market income of the unemployed, rather than simply offsetting some of their income loss.

11. **Pensions.** There should be little doubt in anyone's mind that Russia needs to reevaluate its current public pension system. Underlying demographics, current retirement ages and the likely economic path of the country indicate that the system will experience chronic and growing deficits in the not very distant future. There is little scope for raising the contribution rate, and increasing the compliance rate, while important, will not be sufficient to resolve the fundamental imbalances in the system. That will require tackling difficult structural issues such as the pension age and special privileges. Otherwise Russia will be trapped in a situation of continuous low pension benefits.

12. Projections indicate that without any changes in current policy, the revenue-expenditure balance of the Pension Fund will gradually deteriorate. The gap between expenditures and revenues would reach some 2% of GDP around 2008 and progressively increase.⁵ Significant improvements could of course be obtained by raising the pension age and eliminating special privileges. Raising normal retirement ages for women from 55 to 60, or introducing incentives in the PAYGO system to encourage women to work longer; and removing the subsidies implicit in early retirement provisions would greatly ease the medium-term perspective of the Pension Fund - revenues would exceed expenditures until about the year 2025. This could translate into an average payroll tax rate reduction of over 3%.

13. A reform should at least do the following: facilitate people's efforts to shift some of their income from their active working years to old age, by saving or other means; redistribute additional income to the old who are lifetime poor; and provide insurance against the many risks to which the old are especially vulnerable. It would also be desirable that whatever public pension system there is also supports the broader economy by being sustainable and not imposing an excessive fiscal burden. Currently, neither element is adequately present in the system. At the same time, the initiative of the Pension Fund to implement a system of individual worker accounts so that an accurate history of contributions can be maintained, can be expected to strengthen the link between contributions and benefits in the perception of the workers and improve incentives to comply with payroll payments for pensions.

14. In the area of pensions, an approach encompassing (i) social solidarity inherent in the public pay-as-you-go system currently in place in Russia, and (ii) growth-supporting funded schemes has much to commend it. In the medium term, this would involve reform of the PAYGO system by raising the retirement age and restricting privileges, ensuring a reasonable minimum pension, and strengthening the link between contributions and benefits. It would also involve the introduction of a modest mandatory funded scheme. In the near-term however, given the tight economic situation the introduction of a flat pension as an affordable temporary solution to PAYGO system problems merits consideration. While this does mean a delinking of benefits from contributions, it by and large reflects the current structure of the

⁵ The assumptions underlying the estimates are based on standard demographic projections for Russia, including a gradual fall in the mortality rate; long-term productivity growth of 3.5%, and average wages increasing at a somewhat faster rate than GDP to reach 40% of GDP around 2050; current indexation policies are maintained; no change in budget transfers, including no extra-ordinary transfers; a gradual improvement in collection rates from 22% to 24% of GDP; and a stable contribution rate.

general scheme, as well as a pragmatic approach to current constraints. For the medium to long term, structural reforms of the PAYGO system will need to be undertaken to rebuild a scheme with differentiated pensions at adequate levels. The system dependency ratio (the ratio of contributors to beneficiaries) needs to be lowered, compliance improved, wage indexation reconsidered, and governance strengthened. In light of the situation on the financial markets, this may not be the time to introduce a mandatory funded scheme. Well-functioning publicly sponsored and private funded schemes will require effective regulatory institutions and financial markets that offer a variety of debt and equity instruments.

15. **The Social Insurance Fund.** While the Social Insurance Fund serves a number of important functions, notably the provision of sick pay and maternity support, attention should be paid to the role of this Fund. Currently, it directly and indirectly absorbs 5.4% of the payroll and runs a perennial surplus. This has given rise to expenditure patterns by enterprises and workers that would seem to bear little relationship to what should be the main functions of the Fund – the provision of short-term benefits and, possibly, the management and administration of occupational hazard. A financial management review of the Fund, as well as a review the Fund's core functions is currently being undertaken. This could very well form the basis for a revisiting of the role of the Fund, including the development of appropriate legislation for it, as well as a potential reduction in its share of the payroll tax.

16. **Labor markets.** While a major focus of social protection strategy is to ensure that the safety net is able to protect the needy, it also needs to be restructured to support economic reforms, especially enterprise restructuring. A very important element of successful transition is enterprise restructuring, when previously unproductive resources are freed for use in more productive parts of the economy, involving as one important aspect job destruction and job creation. In successful transition economies this has occurred. So far, it has only taken place to a limited extent in Russia, where the so-called soft budget constraint has been largely maintained in the enterprise sector - there has been a reluctance to apply bankruptcy legislation in order to restructure or liquidate enterprises. Important reasons involve:

- (a) Insider dominance among shareholders;
- (b) Formal obstacles to firing as set out in labor legislation are high, as are the direct costs of laying off workers (extended severance pay and payment of back wages);
- (c) The enterprise-based social benefits system, which raises wage/benefit replacement costs to workers;
- (d) Lack of an adequate social safety net to protect displaced workers from poverty and facilitate their reentry into new jobs: the unemployment benefit is low, essentially insignificant as a tool for transition, information and advisory services of the employment offices are weak. Consequently, the Government has been reluctant to pursue policies leading to layoffs by public entities or businesses, and workers have been reluctant to take the risk of seeking new opportunities.

17. Under these circumstances, a transition and growth-promoting social protection program will need to focus on the following elements:

- (a) Improvements in *unemployment benefits/severance pay* arrangements. While there may be only modest scope for increasing the unemployment benefit, even as a flat benefit, an adjusted unemployment scheme might be combined with budget-financed severance pay schemes whereby workers would be eligible for one-off payments conditional on enterprise restructuring or closure. Offering an administratively simple and adequate compensation package may be a useful way to facilitate genuine enterprise restructuring. At the same time, there is no doubt that typically the scale of compensation payments required for a large enterprise restructuring and divestiture program lies beyond what can

be afforded from regional budgets. Therefore, there is a strong case for the federal government to step in and offer attractive packages to reformist regional governors. Beyond these approaches, which should be broadly valid on a national scale, specially designed interventions may be necessary in situations where reform initiatives address major structural distortions, such as economically devastated areas, single companies towns, Northern restructuring etc.

- (b) While *active labor market programs* (training, job search assistance) often are seen as an important facilitator in job transitions, they should be approached with caution, as the international track record with outcomes from active programs is mixed at best. When considering active programs in Russia, labor market analysis at regional and local levels that reflect changing demand and supply conditions should inform the design of job search assistance and training programs. Moreover, considering resource constraints (in most regions the financial resources are insufficient to allow any support beyond benefit payment), the Government will need to consider what the right spending balance between benefit payments, development of labor market institutions and active programs should be. Thus, current programs need to be carefully evaluated, and any new or redesigned ones should have in-built evaluation mechanisms.
- (c) Small businesses tend to be major sources of employment in mature economies, and *small business development* should be an important consideration in a labor market strategy that aims at developing entrepreneurship, increasing employment and channeling resources to more productive activities. Currently, the bulk of such activities in Russia may be taking place in the informal sector. While this is not necessarily undesirable in early transition, the share of the informal sector in Russia is particularly large, and it is growing. This serves to accentuate problems that business face in the formal sector, especially in the form of cumbersome regulations and high taxation, and lack of access to capital and business advice.
- (d) *Legal framework*. The legal system in the Russian economy is very limited in its ability to enforce the law. As such, reform of labor legislation is not the solution to the immediate problem. However, work on reforming the labor code, is very important as it lays the groundwork for, and helps facilitate, the eventual introduction of a market economy, and well-regulated market enforcement mechanisms. The new labor code should pay particular attention to facilitating restructuring of enterprises by promoting job creation through reducing the costs of hiring and firing workers. For hiring policies, it will be important to reduce excessive benefits associated with employment, as well as to eliminate current restrictions on the use of fixed-term employment. The law need not define the conditions for fixed-term work, nor prescribe the duration and maximum number of successive contracts. To facilitate layoffs and firings, and therefore to stimulate new hires, the labor code should ease the conditions on firing, such as use of current vacancies for re-hiring the worker if his/her current job is no longer required, or the current requirement for sign off by trade unions.