Nicholas A. Barr

Income transfers in Russia : problems and some policy directions

Originally published in Economics of transition, 1 (3). pp. 317-344 © 1993 Blackwell Publishing.

INCOME TRANSFERS IN RUSSIA:
PROBLEMS AND SOME POLICY DIRECTIONS

Nicholas Barr

Department of Economics,
London School of Economics and Political Science,
Houghton Street, London WC2A 2AE, UK

tel: 071-955-7482; fax 071-831-1840

May 1993

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ABSTRACT

The decision to move to a market economy sets in train two major forces.

- The fall in output has led to a reduction in personal incomes and created a fiscal crisis.
- A widening earnings and income distribution is a result of wage and price liberalisation, and is an inherent part of the reform. The change leads to rising unemployment and increased poverty. It also has major administrative implications.

Thus, by its very nature, the reform process creates forces which require a major reshaping of the social safety net to address three major issues: poverty relief, cost containment, and strengthening administrative capacity. Of the recommendations, five are paramount.

- The minimum level of the major benefits should be at or above subsistence and, at least in the short run, should be fully protected against inflation.
- Cost containment implies that, in the short run, benefits above the minimum should be protected only to the extent that resources permit; and, to the maximum extent compatible with political realities, the right to combine full old age or invalidity pension with more or less full-time work should be withdrawn for individuals below normal retirement age.
- Administrative capacity should be strengthened. In particular, the administration of cash benefits requires modernisation. Such a process is crucial both to ensure effective benefit delivery, and to containing costs.
- Social insurance and pension contributions should be shared between worker and employer, with the worker's contribution appearing on his/her payslip.
- Short-run problems should be addressed in a manner consistent with long-run policy design. In particular, as soon as economically and administratively feasible, the relationship between social insurance benefits and individual contributions should be strengthened.

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Nicholas Barr[2]

1 THE BACKDROP

This paper describes the system of cash benefits[3] in Russia in mid 1992 (i.e. at the start of the reforms), assesses the arrangements then in force, and suggests some policy directions. The main conclusion is that the system requires extensive reshaping to meet the needs of a market economy: key areas like unemployment benefit and poverty relief need to be expanded, with cuts elsewhere, e.g. to reduce the extent of early retirement. The recommendations are not intended as a rigid blueprint, nor to guide Russia towards any specific model of income support, but to suggest a foundation on which the country can build a system which corresponds to its specific needs, and to economic and political developments.

Since all the republics of the former Soviet Union inherited broadly the same cash benefit institutions, much of the diagnosis, though not necessarily the policy suggestions, is applicable also to those countries. In that sense, the coverage of the paper is broad. However, some important topics receive little discussion. There is no attempt to quantify the costs and savings of the proposed measures, mainly for lack of the necessary data. The impact of the transition on women should be acknowledged even though (again largely for lack of data) it is not discussed explicitly: evidence from central and eastern Europe shows that they suffer disproportionately from unemployment, and cutbacks in medical spending affect women and young children particularly. A third area which is treated only very lightly is implementation: it is important, as this paper attempts, to formulate a coherent policy strategy; but the best strategy is little use unless it can be implemented, both administratively and politically.

Forces shaping the transition. The move to a market economy in Russia, as in other transition economies, sets in train two major motive forces.

The fall in output has been particularly dramatic. Its first effect, discussed below, is a reduction in personal incomes. In addition, because of the sharp decline in the real wage base and in profits, it creates a fiscal crisis. The obvious implication for the social safety net is the imperative to contain expenditure.

A widening earnings and income distribution is a result of wage and price liberalisation, and is an inherent part of the reform (indeed, a major purpose of the reforms is to allow a wider distribution of earnings). The change has at least three major implications for the social safety net.

- Unemployment rises, both because of the output collapse and because of the inherited misallocation of labour. Structural rigidities (e.g. the absence of a housing market) hamper speedy redeployment of labour.

- Poverty increases, both because of changing relative wages and prices, and because of the output collapse. Disadvantaged groups include people facing declining real wages, rising relative prices (e.g. because subsidies on basic commodities are withdrawn) and/or declining real cash benefits.

- Administration of benefits becomes more complex. Under the former, fairly flat distribution, benefits could be targeted at specific <u>groups</u>, e.g. families. With a widening distribution, benefits must be targeted also by <u>income level</u>. The resulting system has greater coverage and more complex targeting, thus requiring more sophisticated administration.

Objectives. The cash benefit system has many possible objectives (Barr, 1992a, section II); and objectives can, and should, differ across countries. In the Russian context, however, four stand out.

- <u>Poverty relief</u>. The combined effects of benefits should address unemployment and poverty by ensuring that everyone receives an income at least equal to subsistence. Given the fiscal crisis, it is argued below that poverty relief should be given primacy in the short run over other aims such as income smoothing.

- <u>Macroeconomic efficiency</u>. The system should not contribute to budgetary imbalance.

- <u>Microeconomic efficiency</u> has at least two aspects: minimising adverse incentives, and cutting expenditure which makes little or no contribution to stated policy objectives.

- <u>Administrative efficiency</u>. The award of benefit should (a) be accurate, (b) be timely, (c) go to those who are entitled to them, (d) not be subject to abuse, and (e) be administered as cheaply as possible subject to achieving (a)-(d).

The role of the social safety net. Though the safety net can be defined in different ways, there is some agreement about its major components: income support; employment services such as labour market information; programmes to increase the quality of labour, including education and training; direct employment activities, such as public works; and ensuring adequate funding and provision of health services.

The social safety net has obvious distributional and political objectives. But it also has fundamental efficiency functions: through direct investment in labour; and because, by protecting low-income workers and unemployed individuals, it makes a major contribution to labour mobility and hence to the efficient operation of labour markets. The contribution of cash benefits to economic reform rests on two fundamental principles:

- wages and employment should be largely market-determined in the interests of efficiency (though tempered to some extent by other objectives through the effect, for instance, of various ILO conventions);
- the cash benefit system, not wages, should be the major vehicle for protecting individuals and families from poverty.

The twin targets of efficiency and equity require dual instruments -- a genuine labour market and a system of cash benefits. In addition to its other roles, the efficiency function of the cash benefit system is that it largely liberates the labour market from the pursuit of distributional objectives. Not least for this reason, safety net arrangements are an integral and permanent part of all the OECD economies. Though the need for such measures is particularly acute during economic transformation, such institutions will remain a permanent part of the landscape (for discussion in an OECD context, see Barr (1992a)).

2 BRIEF DESCRIPTION OF THE SYSTEM

This section gives a snapshot of the system in mid 1992, looking in successive sections at unemployment and related benefits, sick pay and maternity benefits, pensions, family benefits, and social assistance (i.e means-tested benefits of last resort).[4]

Total spending on these benefits (Figure 1) in 1991 was 10 per cent of GDP. This figure, however, should be treated with considerable caution, since significant but unquantified expenditure occurs at enterprise and local level; the total is therefore no more than a lower bound. Of cash benefit spending by the central authorities, over half was on old age pensions, 16 per cent on family support, and 8 per cent on sick pay. Under 3 per cent was on social assistance and, as of late 1991, virtually nothing on unemployment benefit. The remainder was on disability and survivors' pensions and on a variety of smaller benefits.

2.1 Unemployment Benefit

The Employment Fund began to collect contributions in July 1991. Its revenues derive mainly from a 1 per cent employer payroll contribution and from budgetary transfers.

Eligibility under the 1991 Employment Law depends on (a) evidence that the individual has recently worked, and (b) that he/she is actively seeking work. In practice, however, the law awards benefit on the basis of (b) alone. New entrants are eligible; and there are circumstances in which a housewife with no recent labour-force connection may be eligible for the minimum benefit. Recipients lose benefit if they refuse two appropriate job offers. The law is not clear about the treatment of voluntary quits or dismissal for disciplinary reasons.

Unemployment benefit for individuals with at least one year of service is paid at 75 per cent of his/her previous wage for the first three months of unemployment, 60 per cent for the next four months, and 45 per cent for the next five months.[5] Benefit is normally payable for a maximum of 12 months. There is a minimum benefit, equal to the minimum wage, and a maximum equal to the individual's previous wage. Benefit is not indexed, but the minimum benefit is uprated quarterly in line with price changes. Since benefit is based on the previous year's wage, a result of rapid wage and price inflation is that most recipients get the minimum benefit.

Reform proposals in early 1992 involved various draft laws, including the possibility of a flat-rate benefit (possibly with more than one tier). There was also discussion of the introduction of income-tested unemployment assistance.

Administration raises two noteworthy points. First, the role of Employment Offices is changing rapidly from one of slotting scarce workers into plentiful vacancies into one of calculating and paying unemployment benefit. Second, as discussed further in section 3.5, administrative methods are old-fashioned.

2.2 Social Insurance Benefits

In Russian usage, the main social insurance benefits are sick pay and maternity benefits, paid out of the Social Insurance Fund, created in 1990 (prior to which benefits were paid out of the budget). Pensions are paid from the Pension Fund which is administered separately.

The Social Insurance Fund, organised by the Federation of Independent Trade Unions of Russia, derives its main revenues from a payroll contribution of 5.4 per cent in 1992. Contributions and benefit payments are normally administered by the enterprise. The Fund ran a significant surplus in 1991, mainly because benefit uprating lagged behind inflation, whereas contributions, being based on wages, kept pace.

Sick pay and maternity benefit, on the face of it, are generous. Benefit for ill-health which is not work-related is between 60 and 100 per cent of the individual's wage, depending on length of service. Sick pay for work-related illness/injury and maternity benefit is 100 per cent of the individual's wage. Where ill-health is not work-related, benefit is paid from the social insurance fund; benefit for work-related illness/injury is paid entirely by the employer. There is no formal indexation, benefits being uprated on the basis of negotiations between the social insurance authorities and the government.

2.3 Pensions

Prior to the reforms all pensions were paid from the budget, with no notion of a pension fund (the idea of which was regarded as bourgeois). The absence of any worker contribution was regarded as one of the victories of socialism. The Russian Pension Fund began operation in 1991. It organises the Fund, and is responsible for collecting contributions. It is theoretically an independent body whose Chairman reports to the Supreme Soviet (i.e. Parliament); as discussed in section 3.3, however, there is a lack of clarity about who, if anyone, controls the Fund.

The Pension Fund's revenues derive from an employer payroll contribution of 31.6 per cent in 1992, plus a 1 per cent worker contribution. It also receives a budgetary transfer to pay for family benefits. The Fund pays for the various pensions; for the social insurance benefits (e.g. maternity benefit) of non-workers; and for various family benefits (discussed in section 2.4). The intention is that pensions should be self-financing from contributions.

Old age pensions are awarded on the basis of two sets of eligibility conditions. Contribution conditions generally require 25 qualifying years (20, women). The definition of qualifying years is generous. Pensionable age is normally 60 (55, women), but with major exceptions: civil aviation pilots, artists such as ballerinas, teachers, and medical workers can retire provided only that they satisfy the contribution condition, regardless of age. There is no retirement condition. Individuals may receive a full pension and continue to work full time.

Benefits depend on previous earnings and length of service. There is a minimum pension equal to the minimum wage, and a maximum pension. The law on uprating is unclear and, at least during the early part of 1992, pension increases were ad hoc. An individual who does not have even 5 years' service is eligible for a social pension which, for old age pensioners, is two-thirds of the minimum pension.

Disability pension is based on a threefold classification. To qualify for Group 3, an individual must either be suffering from a long-term medical problem (e.g. have lost a limb) even if work capacity is unimpaired, or have lost part of his/her working capacity. Individuals in Group 2 must be unable to work in normal conditions. Individuals in Group 1 are unable to work and, in addition, are not able to look after themselves. The Group 3 disability pension is 30 per cent of the individual's previous wage, and not less than two-thirds of the minimum pension. Groups 1 and 2 receive 75 per cent of their previous wage.

Survivors pensions, subject to contribution and other conditions, are awarded to children, the surviving spouse and, in limited circumstances, surviving parents and grandparents. Benefit for a single dependant is payable at the same rate as the Group 3 invalidity pension, rising with family size.

Reform proposals are mainly concerned with finding ways of increasing pensions. Given the high rates of inflation, coupled with a fiscal crisis, in the first half of 1992, most pensioners received only the minimum pension, which was broadly protected against inflation.[6] It is proposed to restore real pension differentials as soon as possible. A completely separate set of proposals, discussed in section 3.7, concerns the introduction of private, funded pensions.

Administration is generally of the pencil-and-paper variety, and is based on the assumption of zero inflation and that pensions, once awarded, would never need to be changed. As discussed in section 3.5, inflation has created major administrative problems.

2.4 Family Benefits

Most, though not all, family benefits are paid out of the Pension Fund, generally financed by a budgetary transfer.

Child care allowance is awarded to all children under six, normally at 45 per cent of the minimum wage per child, and at 60 per cent of the minimum wage for a child under 18 months if the mother had previously worked for at least one year. The benefit is normally administered by the enterprise.

The allowance for children aged 6 and over, introduced in April 1991 in the face of early price liberalisation, is awarded to children between 6 and 16. It is paid, out of the local (raiyon[7]) budget at a rate of 25 per cent of the minimum wage. There is a variety of other family benefits, for instance for single-mothers.

2.5 Social Assistance

All OECD economies have a system of social assistance, i.e. an income-tested benefit of last resort. There is no such system in Russia. The closest to anything nationwide are the two Funds discussed below. Since they are still emerging, the following description is only very approximate.

The Fund for the Social Support of the Population consists of a federal fund (not yet in use in mid 1992) and local funds. The local funds are the major source of emergent relief: about 300,000 people received free meals in early 1992; food baskets and second-hand clothes are distributed; overnight shelter is provided for the homeless. The main revenue sources of the Fund were 10 per cent of privatisation proceeds, revenue from lotteries and the like, and income from commercial activities of the funds. In addition they received a once-and-for-all payment of 4.3 billion roubles from the assets of the former Communist Party. The Fund operates in 40 territories. About half operate as part of the Ministry of Social Protection, and about half as part of the administration of the President of the Russian Federation.

The Supreme Soviet's Fund for Social Protection is financed by a budgetary transfer of 1 billion roubles. The Fund is controlled by the Committee on Social Protection of the Supreme Soviet.

3 ASSESSMENT

The major issues and policy suggestions centre round poverty relief; cost containment (i.e. areas in which benefit could be reduced without compromising the goal of poverty relief); incentive effects; ease of administration; the overall structure of the system; and the role of private pensions.

3.1 Strategic Issues

Before turning to an assessment of cash benefits specifically, three background problems require discussion. All have ramifications much wider than social policy, but are acutely relevant to understanding the cash benefits context.

Governance and financial control. Central government financial control is, to say the least, uncertain, a dramatic example being its inability to control monetary expansion by the central bank during 1992. Similar problems arise with cash benefits. The Government may make proposals to the Supreme Soviet, for instance about raising the minimum pension. On a number of occasions the Supreme Soviet has overruled the Government by raising benefits further, and the Ministry of Finance is not able to overrule such decisions.

There are two separate causes of this problem. First, the division of powers is unclear, i.e. a constitutional matter. Second, and separately, the nature of resource constraints is not always clear: for instance, there is no requirement that expenditure proposals should be considered jointly with ways of financing them. For the purpose of this paper, these problems are not discussed further, but simply regarded as constraints on policy making.

Because powers are unclear, co-ordination is weak both within the executive and between the executive and the legislature. As an example, the Ministry of Social Protection, the Ministry of Labour, the Pension Fund, and the Committee on Social Protection of the Supreme Soviet (i.e. Parliament) are all involved in the organisation of pensions, though with no clear demarcation about who has control over what. A similar problem arises with the Fund for the Social Support of the Population, where some of the local funds are an arm of the Ministry of Social Protection and others are controlled by the President's office.

The broader issue is that powers are not organised in a way which makes co-ordination possible (a) within the executive, and (b) between the executive and the legislature; and (c) there is no clearly-defined and explicit division of powers between the executive and the legislature. In consequence, (d) there is little if any financial control over the behaviour of the extra-budgetary funds, particularly the Pension fund. Government can state a policy intention, but it does not necessarily have the power to carry it out. These issues of governance generally, and financial control in particular apply across the whole range of government activities.

Political aspects of transformation. Though this is not the place to discuss political aspects in any detail, the politics of unemployment should not be underestimated. Prior to 1938 countries like Poland, Hungary and the former Czechoslovakia were part of mainstream Europe, democratic, industrialised, marketised; post-1989 reform in those countries has largely meant the reconnection with their own history -- made all the easier because that part of their history is still sufficiently recent for many people to remember it. Unemployment in those countries is thus part of living memory. The former Soviet Union is totally different: it was never democratic; it has never been marketised; and it has never known industrialisation except under Communism. Unemployment is thus something completely new, and the political will to implement the reforms (particularly when coupled with the governance issues just discussed) cannot be taken for granted.

Lack of data and financial analysis. A third background problem is the lack of important data. Specific to cash benefits, data are lacking (a) on the extent of poverty, and (b) on major aspects of expenditure.

Establishing the objective of poverty relief begs the question of how poverty should be defined and measured. The problems are well known (see Atkinson, 1987, 1991a). In many ways there has never been a concept of poverty in Russia (for detailed analysis, see McAuley, 1979). Discussion and estimation focused on what was called the 'social minimum', which is not the same as a subsistence minimum, but is higher.

The social minimum had at least three strategic problems as a poverty line. First, it was close to average income: given such a generous definition, statements that in early 1992 eighty per cent of Russians were poor should not be surprising. Second, the composition of the food basket on which the social minimum was based was inappropriate, being weighted more to meat products than its western European counterpart.[8] Third, the social minimum was inadequate in the way it accounted for differences in family size: the food basket was the average across all family sizes and types, thus giving all members of the family equal weight. Although estimates of adult equivalents vary, all agree that the maintenance of a given standard of living for a family of four requires less than four times the income of a single individual.

Once a poverty line has been defined, it can be measured by investigating how many people are poor (the headcount measure), by how much they fall below the poverty line (the poverty gap), and for how long. The data requirements for all three measures are substantial, involving up-to-date information on the distribution of income, and data on household size and composition, ideally in the form of a microdata set. Even where data are available, they may be inaccurate. Informal activity and production for own consumption, are frequently understated; and transfers between households are hard to capture in official statistics.

Notwithstanding these difficulties, the importance of measuring the extent of poverty need not be laboured. Historically, the existence of poverty was not officially acknowledged, and attempts to measure it were few. Work is under way on (a) developing a quantified definition of a subsistence minimum for families of different size, and (b) on conducting a systematic survey of income and other relevant characteristics. Very preliminary estimates from this work suggest that up to one third of the Russian population were below the poverty line in the later part of 1992.

There are parallel data deficiencies on the expenditure side. In the cash benefits context, information on expenditure on the different benefits are grossly inadequate (hence the incompleteness of the data on which Figure 1 is based). In addition, there is as yet little capacity to project costs or analyse the implications of policy alternatives.

3.2 Holes in the Social Safety Net

Poverty relief may be incomplete for three strategic reasons: the level of some benefits may be too low; there may be gaps in coverage; and some people may not receive all the benefits to which they are entitled.

Inadequate benefit levels. In principle, the minimum level of the major benefits and the level of most family benefits were tied to the minimum wage in early 1992. In practice, the minimum pension was supplemented by ad hoc additional payments and rose above the minimum wage; nevertheless, it remained below the poverty line throughout 1992. In the absence of better data, the ability to comment on other benefit levels is limited. Evaluation should take account of the broader context, including declining subsidies and the effect of lags in payment, which can severely erode the purchasing power of benefits during rapid inflation.

Gaps in coverage arise partly from missing benefits and partly because of lack of co-ordination between different parts of the system. Arguably the biggest gap is the absence of a system of social assistance. The transition is putting significant strains on all aspects of the previous system: benefit may be too low for large families; unemployment benefit stops after 12 months; the minimum level of all benefits comes under inflationary pressure; and there are individuals and families who, for whatever reason, are not eligible for any of the contributory benefits, or are eligible only for a partial benefit. If the minimum wage is at the poverty line, then the social pension, which is two-thirds of the minimum wage, is by definition inadequate. The weakness of most local arrangements in dealing with such cases leads to a large and growing hole in the social safety net.

A second source of gaps are the inadequate links between benefits. Until the end of 1989, virtually all cash benefits were administered by local (raiyon) social security offices. Increasingly, as the reforms proceed, there are multiple organisations involved, paying benefits out of the Employment Fund, the Social Insurance Fund, the Pensions Fund, and various social protection funds. Gaps arise if the linkages between the different benefits are incomplete, a topic discussed further in section 3.6. Another aspect of linkages is whether benefits are awarded on an individual or a family basis. Unemployment compensation is awarded to individuals (i.e. benefit does not vary significantly with family size), and can therefore fail to keep a family with little or no other income out of poverty.

The links between Republics are also inadequate. The major problem is the transfer of Union pension rights across Republics. There is no information readily available to facilitate transferability. A firm with headquarters in Moscow might well have made a central contribution for all its workers in all its branches. The result now, is that its former workers in (say) Ukraine have no Ukrainian contributions record.

A final problem under this head is incomplete cover in the private sector. Policing is necessary to ensure that contributions are paid for workers in private-sector employment. This is becoming an increasing problem as the private sector grows.

Non-receipt of entitlement. Not everyone who is potentially entitled to benefit may receive it (see Atkinson, 1989, Ch. 1). Take-up can be incomplete either, on the demand side, because people do not apply for benefit or, on the supply side, because they apply for benefit and are wrongly refused. People may not apply for benefit, first, because they may not be aware of their entitlement. Second, there may be transactions costs such as queuing and completing forms. People who apply for benefit may be wrongly refused. Benefit officers may interpret regulations strictly or may be unaware of certain entitlements; the problem is compounded when eligibility criteria are not fully specified or are hard to measure. There may be discrimination, either in the rules, or in their implementation.

There is no quantitative evidence about take-up in Russia. However, there have been problems, both with pensions and with local social assistance, where the receipt of benefit has been affect by fiscal and/or liquidity constraints. Some raiyons, particularly in low-income areas, were unable to pay pensions[9] or to award social assistance to applicants who would normally have been regarded as eligible. In addition, if the award of social assistance continues to be local and discretionary, some families may have benefit wrongly withheld.

Absence of data. Poverty relief may be defective, finally, because of ignorance of the system's failures, hence the earlier stress on the importance of collecting the data necessary to assess the extent of poverty and the effectiveness of benefits in relieving it.

3.3 Problems of Cost Containment

To release resources for poverty relief, care is needed to avoid unnecessary benefit expenditure.

The level and duration of benefit. Key issues include the level of family allowance, the minimum level of the major benefits, and uprating in the face of inflation. A family with four young children can receive family support of twice the minimum wage. This is high by OECD standards. Such arrangements are understandable historically, when the distribution of earnings used to be relatively flat, with differences in family size accommodated by generous family benefits. Such a policy will become increasingly inappropriate as reforms widen the earnings distribution, with wages taking over a larger part of the family-support function.

The connection between the minimum benefits and the minimum wage is a continuing problem. As discussed in section 3.1, financial control in setting the level of the minimum pension is questionable. More generally, the minimum level of some benefits (e.g. unemployment benefit) is tied to the minimum wage. Such a procedure intensifies political pressure on the minimum wage (i.e. both workers <u>and</u> benefit recipients want to see it increased), and reinforces problems of financial control. The pressure would be lessened if minimum benefits were instead tied to a poverty line.

Uprating raises further problems. Benefits are generally uprated in line with average earnings, raising three questions. First, should benefits be increased in line with wages or prices? Tying benefits to an earnings index reduces expenditure when real earnings fall, but also reduces the minimum benefit; when real earnings rise, an earnings index increases real spending. Thus, tying benefits to earnings can fall foul of the poverty relief objective if real earnings fall, and of the cost containment objective if real earnings rise. A second question is whether the entire benefit should be indexed. If so, the poverty line is protected and so are benefits above the poverty line; such indexation, however, may not be affordable in the short run. The alternative is to uprate only the minimum benefit. This may be the only way of affording poverty relief, but means that over time almost everyone is pulled down to the minimum benefit. A third question is whether uprating should be automatic. Automatic indexation can conflict with macroeconomic objectives; an alternative is to subject benefits to periodic review.

Ease of access to benefit assumes particular importance in the context of retirement and invalidity pensions. The normal pensionable age of 60 (55 for women) is young in OECD terms; and significant numbers of people are eligible for pension even earlier. Access is easy in at least three ways: early retirement is extended not only to miners, but to sizeable other groups, who can continue to work close to full time with no loss of pension; and years of work whilst receiving pension count as years of service for the purpose of pension calculation, thus further increasing the pension.

Invalidity pensioners are numerous for two separate reasons. Because of poor safety at work, many individuals have genuine and serious ill-health. This problem requires separate remedial action. Second, access to benefit is relatively easy, not least because the authorities typically have little power to police access. Western experience suggests that rising unemployment will put increasing pressure on invalidity pensions.

The combination of work with receipt of benefit. Pensioners can work full time with no loss of benefit; indeed, as already mentioned, the pensions of those who continue to work increase over time. This is true even where a recipient of invalidity pension has not lost any earning capacity. As a result, over 20 per cent of pensioners in 1992 also worked. These arrangements are understandable in their historical context, given pervasive labour shortages under the old system. In the present context, the arrangement is expensive (a macroeconomic problem), creates inappropriate incentives to early retirement (a microeconomic problem) and is horizontally inequitable as between different groups in the labour force.

3.4 Adverse Incentives

Incentives for individuals. The prevailing view (Atkinson and Micklewright, 1991; Layard, Nickell and Jackman, 1991) is that the replacement rate should not be given undue emphasis as a determinant of the level or duration of unemployment. Two factors are regarded as more important: other aspects of the benefit structure, such as the fact that unemployment benefit is cut off after (say) 12 months; and the existence of active labour-market policies. Such analysis, however, is not necessarily applicable to the Russian situation. The replacement rate in Russia is higher than in the OECD -- up to 100 per cent for sick pay, and 75 per cent for the first three months of unemployment, though ameliorated (from an incentives viewpoint) by high inflation which results in most people receiving only the minimum benefit. Quite apart from cost considerations, it is implausible to argue that such high replacement rates create no labour-supply disincentives.

A separate problem is that unemployment benefit is based on previous wages. In hardship areas, these include various enhancements, such as the Northern coefficient (see footnote 5), so that wages in those areas can be up to four times their level elsewhere. The effect is to reduce labour mobility.

Incentives on the contributions side. In most of the OECD, social insurance/ pension contributions are shared between worker and employer. Though the theoretical importance of such sharing is debatable,[10] an explicit worker contribution gives both a political and a financial signal.

The political signal is about responsibility, and is particularly important during the transition: that the state is responsible for establishing the general framework of social protection, but that the individual, through earnings and contributions, is substantially responsible for him/herself. Where, as at present, contributions are paid by the enterprise, workers face neither a signal about where the costs of benefit lie, nor any incentive to moderate their claims. Everyone thinks that benefits are paid by someone else; thus there is no political pressure to contain costs. There is an exact parallel with fee-for-service medical care financed by insurance: if the insurance company reimburses medical expenses in full, neither doctor nor patient has any incentive to economise; the result, in many countries, has been largely uncontrolled increases in medical spending (Barr, 1992a). With a worker contribution, in contrast, any increase in benefits results instantly in increased contributions. The resulting financial signal is that it is the worker who pays, at least in part, for social insurance benefits.

Incentives for institutions. The size of social insurance/pension contributions may have incentive effects on enterprises. Contributions for unemployment benefit, sickness and maternity benefits and pensions result in a 39 per cent employer payroll tax. On a wage of 100, the contribution is 39/139 or about 28 per cent. Such a heavy burden can interfere with the competitiveness of enterprises. It might be argued that with real wages so low this is not a major problem. This view, however, overlooks other problems caused by high contributions. These include the incentive against new employment; the incentive for worker and employer to collude in fraud, e.g. by declaring a lower wage than the worker actually receives; the incentive to unofficial employment; and the substantial distortion in the relative price of labour and capital. There are three ways of reducing the contribution: by financing through general taxation benefits like family allowance which do not relate to any insurable risk; by reducing benefits; and through sharing the contribution between worker and employer.

The incentive structure facing different levels of government. A problem arises when (a) the criteria for the award of benefit involve judgement, and (b) the judgement is made by one level of government, whilst the funding comes from another. For example social assistance is largely administered at a local level. If it is funded by central government, localities could award benefits taking no account of their costs.[11] Standard solutions include cost sharing between different levels of government, either through matching grants or via a system of block grants from central to local government. Both approaches give the awarding authority an incentive to moderate costs.

3.5 Administrative Weaknesses

This section concentrates on administrative issues which reflect the viability of the entire system.

Unemployment benefit. The speed of change is facing Employment Offices with a series of very major administrative problems, starting with inadequate staffing levels and equipment. Employment Office staff are used to job search and to some extent to job creation. They have no experience of calculating, paying or monitoring unemployment benefit. The 1991 staffing ratios are likely to be inadequate as unemployment rises. Equipment is poor. Employment officers lack detailed instructions about how the legislation should be interpreted, leading to different interpretations in different localities.

A second set of problems results from the complexity of the 1992 Employment Law, which causes a large amount of unnecessary work in calculating each person's pension. First, the employer has to copy the individual's entire work record from his/her Work Book to the application for benefit. Second, the benefit formula is complex, being based on the previous year's earnings. The effect of high inflation, however, is to put virtually all recipients onto the minimum benefit. Thus the calculation is complex, yet everyone receives broadly the same benefit. Third, the the maximum duration of entitlement to unemployment benefit is increased by one week for each year of service over 25 (20 women). This creates a major administrative burden because it requires calculation of years of service for each applicant. Since the calculation is done at the time of the initial application for benefit, it is unnecessary for the significant number of recipients who find a job before benefit expires.

There is little effective enforcement of contributions, and inadequate control mechanisms. The absence of internal audit and enforcement means that Employment Offices are unable to say which enterprises in their area are in arrears with contributions. It is therefore not surprising that the Employment Department faces collection problems. On the benefits side, there is little policing of the actively-seeking-work condition, nor of whether someone is really unemployed. Problems with both contributions and benefits are likely to worsen as the private sector grows.

Processing claims is slow, typically taking one month for unemployment benefit to be transmitted to the individual through the savings bank system. This implies a lag of six weeks from the time the person first became unemployed.[12]

Social insurance and pensions. The major administrative problems with unemployment benefit arise from the rapid evolution of events. In the case of social insurance and pensions, many of the problems are the result of an old-fashioned administrative structure ill-equipped to deal with rapid inflation.

The absence of individualised contributions and benefits is a central deficiency. Benefits in the past had two characteristics so far as administration is concerned: (a) they were mostly long-term (family allowance, pensions); and (b) most non-pension benefits were administered by the enterprise along with wages. A major implication of (b) is the extent to which the social insurance/pension authorities are ignorant of individual records. All but the smallest enterprises pay social insurance contributions <u>en bloc</u> for their employees. The social insurance authorities <u>have no knowledge whatever about individual contribution records</u>. When an individual approaches retirement he, with the aid of his employer, must put together a dossier of his entire work record in order to establish his contribution record. For the same reason, apart from unemployment benefit, the social insurance authorities generally <u>have no knowledge of individual recipients of short-term benefits and family allowance</u>.

Administrative infrastructure is very limited. Premises are inadequate, as is the availability of photocopiers, computers, and telecommunications. Virtually all records are of the pencil and paper variety. The main method of getting short-term benefits to recipients is through the employer. For benefits such as pensions the main vehicle of payment is the postal system: the postman carries a list of pensioners and the entitlement of each, together with a sack of cash.

Again, the law is unnecessarily complex. The initial pension calculation is based on length of service and the individual's previous wage. The individual's service record is copied (by hand) from his/her Work Book to the pension application. Pension entitlement is then determined, almost always manually, by the local (raiyon) pensions office, based on years of service calculated to the last day. During times of high inflation, almost everyone receives the minimum pension, or close to it, so that the procedure makes little difference to the final pension.

A second source of administrative complexity is that additional years of work, even where someone is already receiving pension, add to length of service; in addition, as wages rise, the wage base on which the pension is calculated rises. The combined result of these two factors is that pensioners may apply for their pension to be reassessed three times in every 24 months. This feature of the system is complicated, and hence costly; in the short run it is also mostly unnecessary, since the answer is almost always the minimum pension plus a small addition for extra years worked.[13]

3.6 The Structure of the System

The components of the cash benefit system should not only be internally consistent, but should fit together into a coherent whole. Problems arise in respect of the linkages between different parts of the system.

The nature of social insurance.[14] Two issues stand out: the relation of contribution to benefits; and the nature of social insurance. The importance of exact adherence to actuarial contributions within a compulsory social insurance scheme is open to discussion[15] though, as discussed in section 4.6, that does not mean that the relationship between contributions and benefits can be ignored.

On the nature of social insurance more generally, there is confusion between its two very different roles: its efficiency function as an insurance device to enable the individual to redistribute to him/herself over the life cycle; and its redistributive role, as a device to protect individuals from poverty. The confusion has several manifestations. First, there is the unsystematic relation between contributions and benefits, e.g. the fact that some groups can retire early on a full pension with no extra contibutions. Second, the Pension Fund bears the burden of benefits which have no relation to insurable risks, for example the social pension paid to individuals with an inadequate contribution record, and various family benefits. Third, individuals with no contributions record can be eligible for unemployment benefit, e.g. school leavers and, in certain circumstances, housewives.

The nature of social assistance. As discussed in section 2.5, there is no general system of social assistance. Attempts to design a system are hampered by the divided responsibilities of the Ministry of Labour and Employment (responsible for those who are active in the labour market) and the Ministry of Social Protection (responsible for the non-active population). In a market economy such a division is not tenable. A major demand on social assistance will be from individuals whose entitlement to unemployment benefit has expired, or from recipients of short-term benefits such as sick pay, who are nevertheless below the poverty line. In addition, working families may be poor. Effective poverty relief requires a benefit of last resort which is not categorical, i.e. one for which the major eligibility criterion is poverty, and which therefore covers both the active and non-active population.

Given the new demands on social assistance, it is important to distinguish two very different client groups: (a) traditional clients, i.e. those who, by virtue of (emotional or physical) ill-health, or because of old age, are unable to care for themselves; and (b) the 'new' poor, who are able bodied, and whose major problem is the lack of a job and the lack of income. The traditional group requires individual social care from skilled (and scarce) social workers. The new group do not require social work; they need income support and help in finding a job. A streamlined system is necessary to prevent the demands of the latter group taking social workers away from those who really need them.

Inadequate linkages. The relation between unemployment benefit and the other benefits has yet to be fully worked out. Thus emerging unemployment leads to situations which the existing regulatory system does not cover, and which are therefore solved in a piecemeal way. More generally, the pressures on sick pay and disability pension will increase as unemployment rises; and the unemployed may also be eligible for early retirement.

3.7 The Role of Private Pensions

Private pensions became part of the agenda in December 1991, with a Presidential Decree on Non-State Pension Funds which sought to establish a framework for private pensions. This section sets out the background against which such schemes should be evaluated. The intention is not to discourage the development of appropriately designed complementary private schemes, but to stress the importance of introducing the necessary regulatory framework and to comment on the sequencing of reforms.

The role of private pensions in industrialised countries. All western European countries have fully-articulated state-run Pay-as-You-Go (PAYG) pension schemes,[16] generally financed by earnings-related social insurance contributions. State pension spending is a substantial part of GDP throughout the OECD, topped up by private pensions, usually funded, and frequently run on occupational lines. Similarly, most of the countries in Latin America have well-established pension systems, most of them run on PAYG lines (see McGreevey, 1990, Chs 4 and 6). State PAYG schemes, particularly outside the OECD, have had financing problems of precisely the sort faced by Russia, mainly as a result of promises which have proved fiscally unrealistic. These problems (as in Russia) have led to a search for better ways of financing pensions and, in particular, to advocacy of funded pensions as a solution.

State funded schemes, however, have not fared well. The conclusion of an international survey of such schemes was that they 'offer powerful evidence that this option may only invite squandering capital funds in wasteful, low-yield investments [which] should give pause to anyone proposing similar accumulations elsewhere' (Rosa, 1982, p. 212). A study in Latin America concluded:

> 'In general, pension reserves have not been invested in [Latin America and the Caribbean] in instruments with the highest economic returns; social insurance institutions have not been designed to play the role of financial intermediaries, their personnel lack experience in this field and no investment plans have been formulated. Capital markets are poorly developed in the region and inflation has had a pervasive effect on the value of the reserves (Mesa-Lago, 1990a, p. i).'

Of eight representative countries in the region, only Chile had a significant positive real return. Most of the rest 'had negative yields as low as -21 percent annually, hence decapitalizing the reserves (Mesa-Lago, 1990b, pp. i-ii).'

Private funded schemes exist in all OECD countries as a complement to continued high spending on state schemes. Their performance has been sensitive to overall economic developments. In particular, they are sensitive to the effects of unanticipated inflation.

One explanation of the prevalance of PAYG schemes is a politically irresistible dynamic, particularly in the face of inflation, forcing countries progressively away from their original intention to have funded schemes. It is well known, both for theoretical reasons and empirically, that such funded schemes are vulnerable to sharp inflation, particularly in the face of common shocks like oil crises (Bodie, 1990). A completely different line of argument explains the prevalance of PAYG in terms of economic theory (Barr, 1992a). The central argument is that state intervention in such areas as cash benefits and health care may be justified not only by any redistributive goals one may (or may not) have, but because, for technical reasons, private markets (particularly insurance markets) would produce such services inefficiently or not at all.

This body of theory both explains and justifies the general shape of cash benefit and health care systems in industrialised countries. Not least because of the inflation risk, private pension schemes in western Europe are typified by four characteristics. They may be <u>optional</u>, in that the individual can choose to remain entirely within the state scheme. They are <u>supplemental</u>, in that they replace only part of the state pension. They are <u>constrained</u> in two ways: individual choice is limited, e.g. by being limited to a (possibly small) number of approved schemes; and the conduct of pension companies is regulated to protect consumers. Finally, virtually all private pension schemes are <u>subsidised</u> in that they enjoy (usually substantial) tax advantages. In addition, because of the uninsurable inflation risk, the state may give private pensions at least a partial guarantee, e.g. through indexed government bonds. Note, however, that though the underlying pension is organised on a funded basis, the inflation guarantee is PAYG.

The problem of pension finance in Russia, as elsewhere, is the cost of the existing pension regime. However, it is important to avoid the argument: 'PAYG schemes have problems; therefore the solution is funding.' The word 'therefore' does not follow in logic. In reality, both PAYG and funding face the same problem, namely how to divide national output between workers and pensioners. It is therefore not surprising that neither approach is a complete solution to pension finance. With PAYG, the problem manifests itself in political pressures to pay higher pensions; with funding, political pressures arise when inflation reduces the capital of pension funds, leading to erosion over time of the funded basis of pensions (as shown by the Latin American experience).

Major issues in the design of private pensions. Of many issues which arise, three stand out: the role of regulation, protecting pensions against inflation, and operational aspects.

Regulation has a central role, not least in the interests of consumer protection in an area in which, even in western countries, consumers are generally not well-informed. Regulation of pension funds (like other financial institutions) is taken for granted in OECD countries.[17] The same argument gives a case, at least initially, for restricting consumer choice, for instance by allowing individuals to choose between regulated pension companies, but not to manage their own pension portfolio.

A major policy question is the extent to which pensions can or should be protected against inflation. Though there is controversy about explanations, the facts are clear. Bodie's (1990, p. 36) survey points out that 'virtually no private pension plans in the US offer automatic inflation protection after retirement'. Gordon's (1988, p. 169) cross-national conclusion is that 'indexing of pension benefits after retirement ... presents serious difficulties in funded employer plans'. Private pensions in the West have experienced problems with inflationary shocks even in the absence of structural change. Without intervention by the state or some other benevolent entity, individual pensioners face the entire inflation risk.

The inflation risk is even greater during fundamental structural change and in an economy with no experience of financial markets. For both reasons, uncertainty about the prospects of pension portfolios during transition will be high. There are two ways of addressing the issue. First, internationally diversified pension funds can resist purely domestic inflation.[18] This, however, largely defeats the purpose of private pension funds as sources of domestic investment and as actors in domestic capital markets. Alternatively, the state could offer at least a partial guarantee. But this greatly reduces the the potential budgetary saving from a move to private pensions. The argument for ensuring that pensioners receive at least some protection is twofold: horizontal equity suggests that pensioners should not face substantially more inflation risk than wage earners; and the collapse of private pension schemes during the infancy of a market economy puts at risk the political consensus underpinning the reforms. If a guarantee is ruled out for budgetary reasons, the argument for heavy regulation of private pensions and their initial introduction on a small scale is greatly strengthened. The issue of what guarantees might be offered, at what cost and to whom merits further study.

Turning to operational aspects, the management of private pension funds is complex. So, more generally, is the operation of financial markets. Both sets of activities require (a) the necessary operational expertise and experience, and (b) the expertise to construct an appropriate regulatory regime. These activities require planning and operational skills which do not yet exist on any scale in Russia.

4 POLICY DIRECTIONS: RESHAPING THE CASH BENEFIT SYSTEM

4.1 The Strategy for Reform

The reform strategy suggested here is derived directly from the economic effects of transition. As discussed in section 1, the two key shaping forces are (a) the output collapse, leading to a fiscal crisis, and (b) the prospective widening earnings and income distribution, leading to increased unemployment and poverty. Thus there are three strands to reform.

- Poverty relief requires expansion of the system to fill in gaps, particularly at the lower end of the earnings distribution.

- Cost containment is pursued by adopting policies to reduce the level of benefit, particularly at the higher end of the income distribution, and also to reduce the number of recipients.

- Enhanced administrative capacity is needed to implement a more complex benefit system. Because of the severity of administrative constraints, individuals with implementation experience should be involved at the design stage. This recommendation applies not just to cash benefits, but in all areas.

Policy under each of these heads, to the maximum extent possible, should address short-run problems in a manner consistent with long-run policy objectives.

The first two strands of the strategy, it should be noted, are simply the twin aspects of targeting. Benefits should (a) go to everyone who needs them (to ensure that there are no gaps) and (b) at least up to a point, should go only to those who need them (to ensure that the benefit system does not 'leak' excessively).[19] The need for a targeting strategy is acute, because a widening income distribution necessitates targeting not just by group, but also by the income level of individuals and families.

So far as cash benefits are concerned, the strategy just described translates into four specific sets of actions. Given the fiscal crisis, poverty relief should have primacy over other aims of cash benefits, such as income smoothing, until output growth resumes. The first leg of the action plan, therefore, is to protect the poverty line fully, but in the short run to protect benefits above the poverty line only to the extent that fiscal resources allow. The second leg is to develop the benefit system to cope with new needs. In particular, this implies strengthening unemployment benefit and social assistance.

The poor can, in principle, be identified in two ways: through an income test, or via indicators of poverty, i.e. possession by the individual/family of one or more characteristics which are highly correlated with poverty and easily observable (for fuller discussion, see Barr, 1993, Ch. 11). Examples are unemployment, ill-health, old age, and the presence of children in the family. The third leg of the action plan is to use indicators wherever possible to minimise the need for administratively costly and intrusive income testing. Thus the minimum level of the major benefits should be at least at the poverty line.

Income-tested social assistance in the short run should be used only as a benefit of last resort. Such a system, the fourth leg of the plan, is vital for two reasons. It acts as a safety net for recipients of other benefits who, for whatever reason, remain poor, or for individuals not entitled to other benefits. Second, as discussed in section 4.4, unemployment benefit, for incentive reasons, should not normally be paid for longer than X months. That, however, is possible only if there is an underpinning system of social assistance.

4.2 Governance and Funding

Governance. As discussed in section 3.1, the governance of the various parts of the cash benefit system remains fluid. Though it may be appropriate for bodies such as the Pension Fund to be independent as to the detailed disposition of their revenues, the overall spending of the various funds must be amenable to macroeconomic control. Put another way, the central government should have the power to impose a global budget constraint on the Funds, even if they are independent in respect of spending within that total.

Funding sources. Greater clarity is needed about which benefits are insurance benefits (hence funded by contributions), and which have major solidarity goals (which should therefore be tax funded). For example, pensions, bearing an explicit relation to contributions, should be paid out of the social insurance fund. Benefits paid for reasons of poverty relief and solidarity should be tax funded, e.g. the social pension, family allowance, social assistance, and the costs of training/retraining. In the longer-term, as discussed in section 4.6, risks which are in principle insurable, such as unemployment, sickness and old age, should be financed by contributions, with an explicit link between each individual's contribution and the level of his/her benefit.

Monitoring and data collection. More and better data are needed. Trends in poverty, the characteristics of the poor, and the effectiveness of the benefit system in relieving poverty, require monitoring. More systematic data are needed on the revenue of the various Funds and on expenditure on the different benefits. The absence of such data makes it impossible even approximately to estimate the potential savings from the recommendations made below. A capacity to project the costs of different policies needs to be developed.

4.3 Poverty Relief: Areas for Expansion

The major areas for policy development are unemployment benefit, poverty relief and the inter-relations between the two.

Unemployment benefit. The legislative framework, funding arrangements and administration must all be adequate for whatever level of unemployment emerges.

Flat-rate benefits have short-run advantages in terms of reduced cost, improved incentives and ease of administration. To minimise political pressures, the benefit should be tied to the poverty line rather than to the minimum wage. In the short run, sick pay should be paid at the same flat rate or, at least, at less than the 100 per cent replacement rate for many recipients.

The duration of benefit should be finite for incentive reasons. Such a provision, however, should not be put into effect until social assistance can provide poverty relief for those whose entitlement to the insurance benefit has expired. Not least for administrative reasons, the duration of entitlement to unemployment benefit should not for the time being depend on length of service.

Funding. Once the worker becomes unemployed, he/she should (a) receive only unemployment benefit (not his/her previous wage), and (b) the benefit should be paid from the Employment Fund.

The speed of initial payment requires improvement, both for unemployment benefit and pensions.

Poverty relief. Key reforms include the development of a parsimoniously realistic poverty line, the development of a system of social assistance, and the systematisation of coverage.

The development of a poverty line has already begun. As discussed in section 3.1, the previous system had nothing that in the West would be recognised as a poverty line. Notwithstanding the many well-known difficulties with any definition of a poverty line of X roubles/month, work under way in 1992 on the development of a poverty line should proceed with urgency.

The minimum level of all the major benefits (unemployment benefit, sick pay and the various pensions) should not be below that poverty line; and family allowance should be a fraction (say 50 per cent) of that poverty line. All such benefits should be fully protected against price inflation. The ideal qualitative relativity of the different benefits as earnings decompress and the fiscal situation improves is poverty line < minimum unemployment benefit < minimum wage < average wage. In the short run, the relativities should be kept under review to create the best balance between the conflicting needs of poverty relief and the minimisation of adverse incentives.

Developing a system of social assistance is a complement to the development of unemployment benefit. The system should be as wide-ranging as possible; it should provide an acceptable level of income; it should be flexible; it should allow individuals to move from one category to another without loss of benefit; it should be simple to understand and administer; and, so far as possible given current political realities, it should be a national system.[20]

The design of such a system requires a set of sequenced decisions. (a) What categorical tests if any will there be? (b) How will the minimum level of income be set? This requires both a decision on the basket of goods and on how families of differences sizes are treated. (c) Which incomes will affect benefit? This is particularly important if benefit is based on the family unit, since the income of one member may exclude the rest of the family from benefit. (d) Who will operate the benefit? Will it be a new operation (this will increase administrative costs and complicate the system for the claimant), or will it be an addition to current administration (which reduces administrative cost but adds to the complexity for benefit offices)? (e) What are the legislative requirements, the procedural instructions and the staff recruitment and training needs? The design work should lead to implementation as soon as possible.

It should not be imagined that developing such a system will be easy. Income testing is administratively complex even in an urban, monetised environment, and is even more difficult in rural areas where people have significant income in kind. For reasons both of institutional capacity and fiscal constraint, a nationwide system of social assistance may be ambitious. A short-run fallback position is through block grants from the central and oblast government to the raiyons tied to expenditure on social assistance, which would be organised on a discretionary basis in each raiyon.

An example of what is possible (and one of very few good local schemes) is that established in March 1991 in the Taganrog raiyon in the Rostov-on-Don oblast. In contrast with most existing schemes, the Taganrog system pays benefits in cash and, subject to an income test, on a continuing basis (i.e. not just single payments). The scheme is city funded and city managed. It receives a monthly transfer from the city of about 15 per cent of the city budget. Eligibility is independent of labour-force status. Benefit is paid to those who are not working <u>and</u> to the working poor. The latter are eligible provided <u>either</u> both parents are working <u>or</u>, for up to two months, to a non-employed parent who is looking for work. In general, therefore, benefit is paid to the working poor only if both parents are working. Benefit is intended to bring family income up to a benchmark level which is raised on an ad hoc basis. Benefit is reassessed every 6 months and is renewed as long as the family conforms with the income criteria. In April 1992 there were 300,000 recipients, about 5 per cent of the city's population. Of that total, about 120,000 individuals were in families with at least one working member (i.e. the working poor). There are also a number of benefits in kind, notably free canteen meals.

<u>Coverage</u> requires expansion in several ways. Most benefits are awarded on an individual basis. If the minimum benefit is adequate, it addresses individual poverty but not necessarily family poverty. To fill the resulting gap, recipients of unemployment benefit and the other major benefits should be eligible for social assistance, where benefit is awarded on a family basis. Subject to administrative practicality, social assistance should also be payable to individuals in work. As

Atkinson (1991b) points out, such broad eligibility reduces the risk faced by individuals who wish to become self-employed.

Gaps can arise also where cover in the private sector is incomplete. The problem is not one of eligibility, since most benefits are symmetrical as between workers in the state and private sectors, but of improving policing to ensure that there is no large-scale evasion of contributions in respect of private-sector employees. A third source of gaps can arise where there is inadequate linkage between different benefits, an area on which further work is needed.

Benefits in kind can have a significant role, though their general usefulness should not be overstated. In-kind redistribution generally has two possible aims: to alleviate absolute shortage, e.g. by giving out food directly; or to constrain the consumption of the poor to types of consumption which policy makers regard as appropriate, e.g. through food stamps or housing vouchers. On the former aim, the consensus on famine relief (Ravallion, 1987, 1991) tends towards income transfers rather than direct transfers of food, though there may be a case for limited direct transfers of food during the transition if shortages become acute. Food stamps and the like, however, are generally not successful if their aim is to constrain the consumption of the poor. The group aimed at is large; the commodity is easily traded, even if the law specifies otherwise; it is fungible with other forms of family spending; and significant administrative resources are needed.

Two possible arguments remain. One is that, in political economy terms, it may be easier to redistribute in kind. The argument has to be recognised; but its strength should not be overestimated. A final argument is a strong one: in limited circumstances direct in-kind transfers are both well-targeted and non-transferable, particularly where there is a 'captive' target. One target group is infants and pregnant and lactating mothers: nutritional supplements, health checks and medicines can be delivered at maternity clinics, with attendance encouraged, for instance, by making it a condition of receipt of family allowance. Similarly, young children can be given free milk, meals, and health checks at school. More generally, carefully-targeted family support, particularly for nutritional and medical purposes, can be a useful complement to cash benefits in addressing emerging poverty. Such benefits are aimed at a precise and largely captive group, and they are not readily tradeable; they can therefore combine good coverage with cost-effectiveness (see Grosh, 1992).[21]

The relationship between unemployment benefit and poverty relief requires further study. The links should be smooth, but the dividing line clear. For instance, unemployed school-leavers and the long-term unemployed should not receive unemployment benefit but should be eligible for social assistance; if possible, so too should the working poor. Social assistance will thus cover many of the 'new' poor discussed in section 3.6. The system will need to be able to check that unemployed people are seeking work. An alternative approach, at least for certain classes of beneficiary, is to make receipt of unemployment benefit and/or social assistance conditional on taking up training, or on participating in public works programmes, e.g. to rebuild deficient infrastructure and for environmental improvement. These and other active labour-market policies, however, do not offer a blanket solution, and should be implemented only after careful study (see, for instance, Flanagan, 1987; Layard, Nickell and Jackman, 1991, pp. 472-82; Layard and Philpott, 1991).

4.4 Cost Containment and Incentive Structures

Improved poverty relief should be financed by savings elsewhere in the system.

Restricting eligibility would be helpful in a number of areas. All the suggestions, however, have to pass the test not only of good policy design but, much more difficult, also of political feasibility.

Unemployment benefit should no longer be awarded to new entrants to the labour force. Where relevant, they should be eligible for social assistance.

Sick pay could be funded by employers during the initial period of absence from work for all health-related reasons, since employers generally have more information than the state to guard against abuse. Such cover could by financed by the employer out of his own resources or by taking out insurance. The authorities would establish minimum standards for such schemes and provide sick pay for individuals whose entitlement to the employer benefit had expired.

Disability pension should not be paid to individuals who suffer no loss of earning capacity. Compensation in such cases should generally take the form of a lump-sum payment. The proposal is not to withdraw invalidity pension generally, but only where earning capacity is unaffected.

Early retirement raises problems both of policy and politics. As discussed in section 3.3, the ratio of pensioners to workers is high because pensionable age is low by OECD standards. The facts are clear. Policy, however, is a difficult balance between different objectives. In the medium term, pensionable age should be increased, with early retirement only on the basis of an actuarially reduced pension or actuarially higher contributions. This would remove artificial incentives to early retirement, improve the equity of the system as between different groups of workers, and ease administration. Short-term policy is more difficult. The argument for raising the pension age is the substantial cost savings. There are two arguments for caution: increasing pension age might not be politically feasible in the short run; and, as western experience shows, the effects of long-run unemployment, especially for the young, are debilitating. In the short run, therefore, a case can be made for encouraging older workers to retire; this would simultaneously assist restructuring and open up jobs for younger people.

Combining work with receipt of pension also faces a conflict of objectives. On the one hand, the ability to combine continuing work with a more or less full pension is costly. This suggests that there should be a retirement test, at least for people below normal retirement age. Note that an effective retirement test creates savings in two ways. If a person does not retire, there is a saving in pension payment; if he/she does retire, a job is released which can be filled by an unemployed person, thereby reducing expenditure on unemployment benefit. The retirement test could be phased out in the medium term, particularly if benefits, at least at the margin, are related to the individual's age at retirement. The argument against a retirement test is that early retirement makes it easier to make older workers redundant, and thus assists restructuring. This suggests that, rather than impose a retirement test, there should be a change-of-job test,[22] whereby individuals who retire but find another job would be allowed to keep their pension, either wholly or in part. An even stronger case can be made for allowing people who become self-employed to keep their pension.

It is important to be clear what is being attacked and what is not. The problem is not the outcome, early retirement, but the process leading to that outcome, in particular the absence of any clear connection between the contributions paid by an individual and the benefit he/she receives. The problem can be resolved in the medium term through a closer relationship between contributions and benefits. In the short term, however, there is an acute conflict between restructuring and employment for the young on the one hand, and cost containment on the other.

Family allowance. If family allowance is to follow mainstream OECD systems, the following changes should be phased in as the earnings distribution widens:

- family allowance should be retained as a non-income-tested benefit;
- the level at which benefit is paid should be lowered, and its award restricted to children not older than 16 (or not older than 18 if in full-time education);
- the benefit might be included in taxable income for income-tax purposes once the income tax system is in place; and
- the system should be complemented by income-tested family support.

Uprating in the short run should normally be related to changes in prices rather than earnings. Benefits tied to earnings cause problems with the poverty relief objective if real earnings fall, and with cost containment if real earnings rise. During the early part of the transition scarce resources should be concentrated on protecting the minimum benefit.

Improving incentives. As discussed earlier, the high replacement rates for unemployment benefit and sick pay should be reduced. Flat-rate benefits are a useful transitional device for incentive reasons as well as for cost saving and administrative ease. Incentives can be improved also on the contributions side. In particular, as soon as possible, the social insurance and pension contribution should be divided between employer and the individual worker (with the worker contributions appearing as explicit deductions on his/her payslip). Worker contributions give a vital signal that benefit increases come ultimately out of workers' pockets. Herein lies a key instrument in the politics of pension finance.

4.5 Administration

Unemployment benefit. A number of measures could be introduced quickly to simplify and improve administration, whilst still achieving the benefit's policy intention.

Simplifying the law is essential. The arrangements which took effect in July 1991 awarded benefit for a maximum of 12 months, plus one week for each year of service over 25 (20 women). The assessment of length of service requires large quantities of historical information, and is time-consuming, error prone and subject to challenge by aggrieved applicants. If withdrawal of the provision is not possible for political reasons, alternatives would be to require the enterprise to calculate the individual's years of service (the Employment Office needs only to know the result not the details of the calculation), or to defer the calculation until an individual has been in receipt of unemployment benefit for 11 months. In the longer term, as administrative capacity allows, there is a case for allowing older, long-service workers a somewhat longer maximum duration of benefit.

Staff levels and training require improvement. Numbers of staff will need to be substantially increased if unemployment rises sharply. The content of training should reflect the changing role of the service to one where the Employment Office assists the individual to find work rather than, as previously, being responsible for finding him/her a job. Ongoing work on both aspects should continue to be given priority.

Regulations are necessary to supplement the law. Employment officers lack detailed briefing/instructions about how the legislation should be interpreted and administered, and about how best to approach operational problems. Ongoing work to rectify this deficiency should be given priority.

Pensions. Significant change is needed to make it possible for the authorities to administer pensions during a time of rapid inflation.

Simplifying the law, again, is a priority. The basis of pensions on length of service, particularly the recalculation of length of service of individuals already in receipt of pension is administratively costly. The introduction of a retirement test would save greatly in both benefit and administrative costs. Alternatively, for cost saving, incentive and administrative reasons, people might receive only the minimum pension whilst they continue to work.

Enterprises could assist further in administration. At present, they complete a complicated form setting out the work history of the claimant. However, the only information the pension office requires is (a) total length of service in years, months and days, and (b) information on the previous wage. The enterprise could save the local office effort by passing on only those two pieces of information, plus other minimal information such as name, work book number and date of birth.

Staffing improvements are needed, particularly larger numbers of staff, since the structure of pensions was designed for an era with no uprating.

Social assistance. Since the law has not yet been drafted, it is too early to discuss administration in any detail. However, social assistance, like any income-tested benefit, requires major administrative resources. The plea in section 4.1, that someone with administrative experience be included from the start of the legislative design process, therefore bears repetition.

The design of the system should distinguish the two separate jobs of (a) social workers, whose highly-skilled job it is to help families with problems, and (b) benefit officers, who would assess benefit on the basis of detailed regulations. The latter task would require relatively little training. It is by no means clear that the two functions should be carried out by the same people. Given the potentially large numbers of claimants of social assistance whose entitlement to unemployment benefit has expired, a streamlined assessment procedure is needed, possibly by treating claims from the unemployed separately.

4.6 A View to the Medium Term

Policy

The relation between contributions and benefits. The short-term strategy described in sections 4.3 and 4.4 concentrated scarce resources on protecting the minimum benefit. In the case of social assistance, this should continue in the longer term. In the case of social insurance benefits, however, such a policy breaks the link between contributions and benefits. As soon as conditions permit, the relation between contributions and benefits should be strengthened. The relationship need not be strictly actuarial, but it is important that social insurance benefits are related, at least at the margin, to individual contributions, and that contributors and beneficiaries perceive this to be so.

There are at least three reasons for restoring the relationship: on horizontal equity grounds; to minimise distortions to individual retirement decisions; and because of the strong incentive to evade contributions if workers do not see a clear relationship between contributions and benefits. It is important that some of the impetus to enforce contributions comes from incentives rather than administrative activity, not least because policing contributions, particularly in the growing private sector, will be a continuing problem.

In the medium term, therefore, a closer relationship between contributions and benefits should be a key component of the social insurance strategy. Poverty relief should increasingly be based on social assistance and, possibly, on other tax-funded benefits.

Improving the structure of benefits has several aspects. First, to ensure that demands on the Employment Fund for unemployment benefit do not crowd out training and other active policies, the finance of unemployment benefit should be separated from that of training. Since the latter is not even in principle an insurable risk, it should be tax-financed. In the medium term, as unemployment starts to fall, the dependence of unemployment benefit on budgetary finance should be reduced. A second area of improvement is the links between different benefits. Gaps arise if there is no smooth transition between unemployment benefit and social insurance. The links between employment services and social assistance in the case of unemployed recipients of social assistance should also be kept under review. Third, funding methods, the contribution regime, and benefit structures should be symmetrical across occupations, between the social and private sectors, and between spouses. An implication is that workers in different industries and occupations should generally pay the same contribution rate and receive benefit under the same formula.

Private pensions. The starting point for private pensions is work on an appropriate regulatory framework for such a system, and on the role of the state, if any, in guaranteeing private pension funds. Design work should involve individuals with experience of running pension funds. The resulting system, as throughout the OECD, should be complementary to a well-articulated state scheme, and constrained in the sense that private pension funds should be regulated and individual choice limited, at least initially.

Expectations should be cautious about the scale and speed of any resulting gains. As explained in section 3.7, private pensions are not a solution to the short-run budgetary crisis. Their real advantages are more microeconomic. They include increased individual choice, the supply of long-term capital and also of institutional actors to infant capital markets, and the diversion of resources to private investment. They may also eventually reduce budgetary expenditure and contribute to economic growth, though the evidence on the latter two aspects is controversial.

Administration

Individualising the systems of contributions and benefits. The reform process will necessitate a move from enterprise-based to individual-based benefits and contributions. At present, enterprises administer most short-term benefits, creating confusion about the respective roles of wages and benefits, and imposing a substantial compliance cost, which will harm the competitiveness of private-sector firms, especially in an international context.

On the contributions side, if the social insurance/pension authorities are to administer benefits, they need to know about individual contributions. This is not at present generally the case. Automating contributions and benefits would lead to two sorts of saving: administration per se would be cheaper; and automation would open up policy options, particularly for cost containment through better targeting, which are not possible with manual administration.

Relations with the public become increasingly important as the central authorities increasingly take over benefit administration from the enterprise. Offices should look at how they provide information to current and potential beneficiaries. The information should be easily understandable by people who may not be particularly well-educated, or used to being responsible for their own claims. Forms should be easy to understand and complete (if not, staff may need to spend more time helping claimants with their claims). There should be help for people to collect information about previous employment (and hence contributions). The authorities should gear up to give such additional support and, where possible, should simplify procedures.

Delivery of benefit through cheaper and more effective methods than cash from the postman should be explored, e.g. money orders or vouchers cashable at post offices or banks.

5 CONCLUSION

Key recommendations. The recommendations set out above are intended to reshape the system (a) to provide effective and affordable poverty relief in the short run, and (b) to provide a foundation for medium-term development in the light of political and economic outcomes. Of the recommendations, five stand out.

The minimum level of the major benefits should be at or above subsistence and fully protected against inflation. The aim should be to set unemployment benefits and the major social insurance and pension benefits at a level not below the poverty line for an individual; social assistance should be defined relative to a family poverty line.

Cost containment implies that, in the short run, benefits above the minimum should be protected only to the extent that resources permit; and the right to combine full old age or invalidity pension with more or less full-time work should be withdrawn for individuals below normal retirement age.

Administrative capacity should be strengthened. In particular, the administration of cash benefits urgently requires modernisation through an integrated process of policy development and upgraded delivery, including computerisation. Such a process is crucial both to ensure effective benefit delivery, and to containing costs.

Social insurance and pension contributions should be shared between worker and employer, with the worker's contribution appearing on his/her payslip.

Short-run problems should be addressed in a manner consistent with long-run policy design. In particular, as soon as economically and administratively feasible, the relationship between social insurance benefits and individual contributions should be strengthened.

Affordability of the social safety net. Finally, is the social safety net, even if reshaped along these lines, affordable? In addressing the question, it is important to distinguish between public costs and social (i.e. economy wide) costs. Put crudely, if the state ceases to pay a wage to a worker who is producing little or nothing, and instead pays him or her a lower unemployment benefit, there is a net saving, though the absence of the necessary data makes quantification impossible. However, as a rough order of magnitude, assume (a) that the marginal product of redundant workers in their former job was zero, and (b) that they previously earned the average wage. Gross savings are then the number of redundant workers times the average wage times the average duration of unemployment. Since the replacement rate for unemployment benefit is less than 100 per cent, it follows (unless training costs are high) that the gross savings to the enterprise sector will be greater than the gross costs of unemployment benefit. From the viewpoint of the economy as a whole there is a net saving from paying unproductive individuals unemployment benefit lower than their previous wage, and additional savings from improved enterprise efficiency.

The problem is that most of the costs fall on government and most of the savings accrue to the enterprise sector, so that more rapid adjustment has major budgetary implications. The general point, however, is valid: that public expenditure on the social safety net should be viewed alongside the resulting direct and indirect saving to the enterprise sector. Viewed in this light, it should be clear that income support, quite apart from its distributional objectives, has a key role in assisting the efficiency objectives of the reform programme. For both efficiency and equity reasons, reform is not possible without an effective social safety net.

NOTES

1. This paper is a revised and shortened version of Income Transfers and the Social Safety Net in Russia, Studies of Economies in Transformation No. 4, Country Department 3, Europe and Central Asia Region, The World Bank. The views expressed are the author's and should not be attributed to the World Bank or to its member countries. I am grateful for material provided by and helpful comments from Timothy King, Ralph W. Harbison, Robert Liebenthal, Jan Rutkowski and Alan Thompson, and to hard pressed Russian officials. My thanks are due also to Gary Burtless Bruno Laporte and two anonymous referees for detailed comments on an earlier version. None of them should be implicated in remaining errors.

2. Department of Economics, London School of Economics and Political Science and, from 1990-1992, Human Resources Operations Division, Central and Southern Europe Departments, Europe and Central Asia Region, World Bank.

3. The term 'social security' is avoided because of its ambiguity. In US usage it refers to retirement pensions; in the UK it refers to the entire cash benefit system; and in mainland Europe, in accordance with ILO usage, it refers to all cash benefits plus health care. The term cash benefits is used throughout.

4. A somewhat more detailed description is available from the author.

5. Unemployment benefit, like virtually all other benefits, is increased by the application of a 'Northern coefficient', whereby higher wages and benefits are paid in what are regarded as hardship areas.

6. Such statements can only be very approximate, not least because of the difficulty of measuring inflation when relative prices are changing rapidly, and when the availability of goods varies.

7. Russia is divided into 84 Oblasts, each of which has significal local powers. Each Oblast is divided into Raiyons, of which there are over 2000.

8. For instance, it contained per capita consumption of meat products for men of 64 kg per year (6.2 ozs/person/day). Of total daily calories, about 30.7 per cent derived from fat, of which over half was animal fat.

9. During the summer of 1992, with rapid inflation and a consequent shortage of cash, President Yeltsin, visiting a number of Siberian towns, was reputed to have had a planeload of cash, specifically for paying wages and pensions, as part of his entourage.

10. In strict analytical terms, the incidence of the contribution depends on the relative factor and product demand and supply elasticities and is independent of where the contribution is legally imposed. In theory, therefore, it does not matter how the contribution is shared between worker and employer. For further discussion, see, for instance, Stiglitz (1988, Ch. 17).

11. This is another example of the third-party payment problem.

12. An individual who loses his job does not become eligible for benefit until the twelfth day, and so does not receive any payment for about six weeks.

13. In macroeconomic terms, it is equivalent to earnings indexation of pensions. In administrative terms, however, the task is huge, since pensions are uprated in line with the individual's wage, not the average wage. The scale of the problem is large; in 1992, over twenty per cent of pensioners also had a job.

14. 'Social insurance' is used in this section in its OECD sense of all contributory benefits, including unemployment benefits, sick pay and pensions.

15. See Barr (1992a, section II (B)).

16. With a PAYG scheme, current benefits are financed by current contributions. With funded schemes, pensions are paid out of previously-accumulated reserves.

17. Regulatory structures are under review in several western countries, e.g. in the UK after the collapse of the Maxwell empire, and the USA in the wake of the savings and loan problems. For disturbing claims about the vulnerability of private pensions in the USA, see Bartlett and Steele (1992, Ch. 9).

18. Though this is not the case for a common inflationary shock such as an oil crisis.

19. The two aspects are sometimes referred to as horizontal and vertical efficiency, respectively.

20. The history of the Poor Law in the UK, in particular during the interwar period, is instructive as a case study of the problems of local financing of social assistance, as is the history of the US 1935 Social Security Act as an example of how to reimpose some central control on a local system (see Barr, 1993, Ch. 2).

21. The approach is not foolproof, however, e.g. the (non-trivial) difficulty of guarding against pilfering and of policing quality.

22. I am grateful to Tony Atkinson for pointing out this important distinction.

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FIGURE 1