

### Special Issue: How the proposed tax reform impacts the current pension reform.

**Fact:** On April 8, 2004 the Government discussed measures for completing the tax reform in 2004-2005 and the drafts of federal laws improving the current tax legislation, including the amendments to Article 24 “The Unified Social Tax” of the Tax Code.

Of all proposed solutions, the following approach to the problem of the UST reduction was found the most expedient:

ANNUAL WAGE, RUR	CURRENT		PROPOSED	
	UST RATE	COMPONENTS	UST RATE	COMPONENTS
< 100,000	35.6%	14% to Federal budget (to finance basic part of pension)	26%	6% to Federal budget (to finance basic part of pension)
> 100,000 < 300,000	20%	14% to obligatory pension insurance (to finance insurance & accumulative parts of pension)	26%	14% to obligatory pension insurance (to finance insurance & accumulative parts of pension)
> 300,000 < 600,000	10%	4% to Social Insurance Fund	10%	3.2% to Social Insurance Fund
> 600,000	2%	3.6% to Obligatory Medical Insurance Fund	2%	2.8% to Obligatory Medical Insurance Fund
effective rate	29.4%		24.1%	

This approach implies that:

- the UST rate would be reduced starting from January 1, 2005.
- the UST reduction should be tied up with certain measures in the areas of pension, medical and social insurance which are being developed at the moment.
- the Federal Law “On obligatory pension insurance in the RF” should be amended in the part of insurance contributions, paid to finance the obligatory pension insurance (i.e. the insurance and accumulative parts of pension). So only contribution, paid by employers in favour employees of 1967 birth year and younger to finance their accumulative part of pension paid, shall be regarded as obligatory ones. The rate for such contributions in 2005-2007 shall be 4% of the annual wage, and starting from 2008 – 6% of the annual wage.
- along with the obligatory contributions it is proposed to sanction employees of all ages to pay voluntary contributions to finance the accumulative part of their state pension at the rate of 4% of the total employee pay. If the employee pays such voluntary contributions the state will pay him additional RUR 2,000 annually (the cost of insurance year in 2004 – RUR 1,008 multiplied by two). It is intended to exempt such voluntary contributions from the Personal Income Tax (PIT).

The Ministry of Finance together with the Ministry of Economic Development and Trade and the Ministry of Social Development and Health were instructed to elaborate the generally approved amendments and within two weeks to submit them to the Government for further introduction to the Duma.

**Fact:** On April 21, 2004 Mikhail Zurabov, Ministry of Health and Social Development, presented to the Government a bill “On amending the legal acts of the RF in connection with the introduction of supplementary pension insurance”.

The system of supplementary pension insurance – another new concept of the current pension reform – should be based on the abovementioned voluntary contributions, paid at the employee’s expense at the rate of 4% by the employer, simultaneously with the payment of obligatory insurance contributions to obligatory pension insurance.

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An individual may become a participant of the supplementary pension insurance by signing an agreement for supplementary pension insurance with an insurer. The SPF, NSPFs and life insurance companies are proposed for the role of such insurers. It is important that the funds (RUR 2,000 per year), paid by the state to encourage voluntary contributions, should be included in the pension capital for calculating the final state pension (please see the November issue of our Newsletter "Calculation of Pension Entitlement").

The Government instructed the involved departments and ministries to finalise the bills of federal laws, related to the concept of supplementary pension insurance, within two weeks.

**Background:** If the proposed concept is approved by the Duma, starting from 2005 no obligatory contributions for financing the accumulative part of pension shall be paid by employers for employees of 1966 and older. At present no such contributions are paid for men of 1952 birth year and older and women of 1956 birth year and older. Employers will be still paying 14% to obligatory pension insurance in favour of such employees, but the division between the insurance and the accumulative parts will be 14% and 0%, and not 12% and 2% as it is now.

VOLUNTARY contributions shall be made on voluntary lines. At present employees cannot pay voluntary contributions to create the accumulative part of their state pension on their own. Voluntary contributions can now only be paid to an NSPF or an insurance company to create a voluntary pension.

The scheme below illustrates the relation between the age (birth year) and the rate of obligatory and voluntary contributions to finance the accumulative part of the state pension:

Age in 2004	Birth year		Rate of <b>OBLIGATORY</b> contributions to finance the accumulative part of pension	Rate of <b>VOLUNTARY</b> contributions to finance the accumulative part of pension
	MEN	WOMEN	CURRENT	PROPOSED
37 y.o.	Age group "A" 1967 b.y.		Increasing from 3% in 2002-03 to 4% in 2004, to 5% in 2005 and 6% in 2006 and further on	Increasing from 4% in 2005-07 to 6% in 2008 and further on
38 y.o.	1966 b.y.	1966 b.y.	2% of annual wage	0% of annual wage
47 y.o.	Age group "B" 1957 b.y.			
48 y.o.		1956 b.y.		
51 y.o.	1953 b.y.			
52 y.o.	1952 b.y.	Age group "C"		

This is ~ 28m people, or 68% of the 41m people currently entitled to a new pension

4% + ~RUR2,000 (the cost of the insurance year multiplied by two)

At present employers are obliged to pay obligatory insurance contributions to finance the accumulative part of pension for around 41 million employees (age group "A" + age group "B") – that makes these employees entitled to a new three-component pension (basic + insurance + accumulative parts). The number of the age group "B" amounts to 28 million people, and these people can get deprived of the accumulative part of pension in 2005.

**Comment:** The tax reform is planned to be completed in two years and costs the budget RUR 268bn (~USD 9bn) next year. The proposed changes in the pension system should help the budget to cope with the losses of income. So the 2%, re-allocated from the accumulative part to the insurance part, shall be used by the State Pension Fund (SPF) to pay its current liabilities (e.g. pension payments). Unlike the funds, allocated to the insurance part, the funds paid to the accumulative part (so-called "pension savings") should be invested via asset managers and NSPFs. By the most modest estimate, owing to such re-allocation the SPF will be annually receiving extra half billion dollars which could be spent on its current needs.

In case the Duma approves the proposed plan of actions, the age group “B” will be entitled to a state pension, consisting of basic and insurance parts same as the age group “C”. Only the age group “A” will be entitled to a three-component pension. Therefore, the first new three-component pensions will be paid in 2022 and not in 2012 as was expected.

It is not decided yet who will be managing the voluntary contributions and whether the incentives, proposed by the state (RUR 2,000, PIT exemption), will suffice to persuade people to virtually partially finance their state pension and by this pull up the replacement ratio (salary to pension) closer to the international standards. It is just evident that the implementation of the pension reform and the introduction of the new three-component pension could be shifted in time again.

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**The following sources were used for the issuance of this Newsletter:** Kommersant-Daily, Vedomosti, fundshub.ru, pensionreform.ru, nlu.ru, securities.com, pensioner.ru, government.ru.