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Asatryan, Zareh

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By Zareh Asatryan, Mannheim/Freiburg

Abstract

In this short article, I discuss some of the political economy aspects of the ongoing pension reform in Armenia. The focus is on two opposing forces—taxpayers' quite significant resistance to the reform vis-à-vis government's imperative to reform due to fiscal constraints—that are likely to shape the outcome of the reform. The discussion is centered around a fiscal contract where the government is forced to make democratic concessions in return for the taxpayers' commitment to comply with its new institutions. I argue that this conflict may push Armenia into a virtuous circle of development.

Beginning January 1, 2014, Armenia is implementing a large-scale pension reform. Like many developing and developed countries, Armenia is changing its existing pay-as-you-go pension system—where benefits to the elderly are paid directly out of current taxes and social security contributions—to the World Bank's popular multi-pillar system. Under the new system, young employees will be forced to save an additional amount out of their income, which together with contributions from the state will be managed by private funds until the workers' retirement.

This move can perhaps best be seen as one of the last steps of the radical market-oriented reforms of the transition period. In large part designed by the World Bank's liberal economists, and most prominently applied in Chile in the beginning of the 1980s, the reform is said, among others, to restore financial sustainability, to generate long-run growth, to improve work incentives, and to ensure a fairly carefree life for the elderly. This positive list of benefits can be extended for several more lines, followed by at least as many valid objections and drawbacks, which have been thoroughly discussed and painfully debated in a massive research effort by economists.

Therefore, rather than providing a discussion of the arguments for and against the multi-pillar pension system, which many authors have already covered (see, for example, Holzmann and Stiglitz 2001), in this short piece I concentrate exclusively on some of the political economy aspects of the ongoing reform in Armenia. My aim is to contribute to the public debate by offering some theoretical explanations of the ongoing processes, and, importantly, to show that this reform can have much wider implications for Armenia, its economy, society and institutions, than merely being a sectoral reform in the area of social security. In particular, given the scale of the social implications of the reform, I start by discussing the objective and subjective reasons behind the resistance to the reform. Next, I proceed to explain the government's ability and motivation to reform given the expected resistance. In the last part, I offer several cautious predictions on whether, and in which direction, the status quo might change as a result of this, as I claim, unusual interaction of social and economic forces.

Resistance to Reform: Populism, Backwardness, Lack of Trust or a Poverty Trap?

Similar to many countries, especially ones with high poverty rates, the reform in Armenia was met with a fairly substantial and, as this article goes to print, ongoing opposition. These include: acts of discontent by more or less organized labor groups (since there are essentially no functioning labor unions in Armenia, the protesters are employees of large companies working, for example, in the IT, railroad, energy, mining sectors, etc); an unprecedented coalition against the issue formed by all of the four (otherwise rival) non-governmental parties in the parliament; a ruling by the Constitutional Court to temporarily block the implementation of the mandatory pillar until a final decision is made; and, importantly, protests by a broader social movement of mainly young, educated and well paid employees, in the end being the driving force behind the former three.

This state of affairs is not surprising since the reform (and especially its mandatory pillar) directly affects a sizeable share of the population (especially young people), and is perhaps one of the most radical changes in Armenia's short history of economic reforms, certainly in the area of social security. Briefly, the reform directs that from January 1, 2014, all workers under the age of 40 will have to enter the new system and will have to pay an additional amount of at least 5% of their income. In economic terms, this is a saving that under government regulation, will be privately invested in local and foreign assets and, with certain guarantees and profitability, will be returned to the contributor after retirement. Let us call this the government's view.

In contrast, a wide portion of the population refuses to see it this way and neglects the possible efficiency-enhancing effects brought by the reform. Most often the contributions are essentially viewed simply as additional tax on income by the revenue maximizing "Leviathan" government. Given the country's weak institutions, as well as the prevailing levels of poverty, there is not much faith in the idea of a supposedly improved social and economic situation that will arrive only after decades, nor is there much consideration of more sustainable public finances or higher medium- to long-run investment.

Such resistance to reform has been long recognized by economists. There are several rational and behavioral (both universal) explanations for the population's bias towards the status-quo (for a recent overview, see Heinemann and Grigoriadis 2013). For the former, Fernandez and Rodrik (1991) and Alesina and Drazen (1991) explain resistance by considerable uncertainty—possibly coupled with risk-aversion—regarding the distribution of gains and losses from the reform. Limited or heavily discounted time-horizon is another source of (rational) resistance to reforms which realize their benefits only in the long-run (Werding and Konrad 2012). The rationally ignorant voter's lack of incentives to gather costly information (Downs 1957) is a further source of bias towards keeping the status quo. The recent rise of behavioral economics—that questions mainstream economists' core assumption of rationality—provides further arguments that are due to voters' richer set of behavioral responses rather than merely based on their (narrowly defined) self-interested rationality (e.g. Caplan 2011, Kahneman 2011).

Whether objective or not, this discussion points to the fact that there is an essential gap or asymmetry between the government's and the taxpayers' view. The government wants to help workers save for a better future without having any monetary reward itself (quite the contrary, since the government is subsidizing a share of the mandatory contributions), while the workers essentially see the reform as taxation (or, more strongly, expropriation) of income which is subject to the constraints of what social scientists call the fiscal contract. That is, the taxpayer has no incentives to voluntarily pay the additional "tax" unless there is a bargain, which involves demands of compensation from the state in the form of public goods, such as roads, schools and hospitals, but also semi-public goods such as "voice" (i.e. representation) in the political process.

Motivation to Reform: Fiscal Imperative or Political Kamikaze?

Given such resistance and no rewards for the government (at least in its public choice view), why is then the government trying to push for the reform? In a speech on February 15, 2014, President Sargsyan announced that over 80% of the population are against the reform, then went further to admit that this can be a major threat to the governing party's popularity rankings, but insisted on the reform nevertheless.

Where is this generosity coming from? I argue that a major factor explaining such "benevolent" behavior is the revenue pressures on the budget. The current pay-as-you-go system, largely being based on the Soviet old-age pension scheme, cannot survive sustainably in the current market conditions. In many countries around the world, two of the most important problems are the demographics of aging and the maturation of the existing schemes. Armenia is not an exception. First, there was an increase in life expectancy from less than 68 in the beginning of the 1990s to almost 75 years today. Second, it is now about the time when post-WWII baby-boomers enter their retirement age.

But other than these universal problems, Armenia has to overcome more fundamental difficulties, largely associated with the fiscal burden of the transition. There are several factors especially affecting the supply side, which seriously question any possibility of sustaining, not to mention, developing, the old pension schemes. First, the labor force was burdened by negative growth rates in the 1990s, limiting the size of the generation that now enters the labor markets. A negative net migration balance of over thirty thousand people annually in the intra-census period of 2002–11 is the second major factor (MPC 2013). Finally, high unemployment rates and a large informal sector shrink the amount of the feeding population further. With around a third of the population below the national poverty line, it seems that something has to be changes in the country's social security programs.

These arguments imply an age dependency ratio of 44% in 2012 down from its peak of 60% in the mid-1990s, and projected to decline further. In other words, for every potential worker in 2012 there were more than two dependents (of ages younger than 15 or older than 64). This estimate is, however, likely to be biased upwards, since it does not count the unemployed (including around half of the workforce busy in the agricultural sector) and also the temporary work migrants. In addition, the global crisis which has hit Armenia badly with an over 14% decline of GDP in 2009 has generated further pressures for post-crisis fiscal consolidation policies. So whereas the pension reform has been high on the political agenda for years, it was finally implemented in 2014, a time when the country has just ended the electoral cycle.

What's Next?

Now the poor fiscal situation described above needs a radical treatment, and the government has selfishly decided to opt for it. The social resistance, however, threatens the implementation and the future sustainability of the reform. Given the interaction of the two conflicting forces, there are four hypothetical equilibria that could emerge: there are two "exits", when either the government reverses the reform at least for some time, or the taxpayers start paying the additional amount without opposition; and two further cases when the reform is implemented, either through force with no consideration of the implied social cost (i.e. the authoritarian case), or the government sticks to the plan by trying to internalize the taxpayers' bias (i.e. the democratic case).

In case of the two exits not happening as well as no violence—indeed three very likely events—the democratic case suggests that the government will have to reconsider the fiscal contract, which implies compensating the losers of the reform at least to a certain degree. Such a situation is not unique to Armenia or to the context. Typically most economic reforms are thought to generate some losers who, for example because of rational and behavioral reasons discussed above, will have incentives to invest into reform-resistance (Rodrik 1996). At the same time, however, the overall pie should increase so that the government is able to make the reforms sustainable by redistributing from those who gain the most to the ones most negatively affected. In economic terms, this should yield to a Pareto improvement, where at least some are made better-off without hurting anyone.

Both in the political economy and policy literature, there is evidence that many (even non-democratic) countries regularly compensate those most affected to ensure sustainability of the reforms (these are not unique to the area of social security only, but also include reforms on trade liberalization, fiscal consolidation, other structural reforms, etc.). Since the imperfect government subject to public-choice constraints has to select the losers, it will at the end most likely pick the special interests involved rather than those really most affected (e.g. Olson 1965). Likewise in Armenia, announcements to increase the salaries of public sector workers by 40–60%, or those of the best teachers by 3–4 times, or special tax breaks for the young are excellent examples of concessions from the state in an attempt to buy political support. The compensation of special interests involved is, however, likely to give rise to favoritism, which obviously is not the first-best solution.

A Window of Opportunity for a Virtuous Circle?

Depending on the degree of resistance, such attempts to literally buy political support may or may not be enough. Note, however, that the extra amount of at least 5% of income to be raised—or an additional increase in the total tax burden by at least one fifth—is quite substantial. Again, since the taxpayer (rightfully or not) sees the pension contributions essentially as a tax on income, she will in return require the provision of more public goods in an amount likely to be proportional to the taxed revenue, that is by a fifth. But since this "tax" does not generate extra budgetary revenue, the government might be forced to compensate the fiscal contract by alternative means, such as through democratic concessions in the form of more representation, higher accountability, less corruption, or broadly speaking, better institutions. So I argue that in the case of the exits as well as violence not happening, there is a real opportunity of starting a virtuous circle of development.

This proposition is perhaps new to the context of pension reforms and certainly so to the case of Armenia, but it is well grounded in the literature on taxation and state-building (for a recent survey, see Bräutigam, Fjedstad and Moore 2008, Besley and Persson 2011). Joseph Schumpeter once famously quoted that taxes not only helped create the state, they helped to form it. Scholars often cite historical episodes of wars from the Glorious Revolution of 1688 to the war for independence in the US and the Napoleonic wars later in the 18th and 19th centuries to support such claims. Since wars are expensive, states need to facilitate extra fiscal capacity to finance these needs. However, for the people to comply with the new institutions, governments are forced to make democratic concessions based on the fiscal contract. In early modern Europe, for example, representative government first came about when monarchs were forced to give up some of their authority to legislative institutions in exchange for the ability to raise new taxes (see, for example, Tilly 1985, Acemoglu and Robinson 2012). In more contemporary economics, both theoretical works and empirical tests generally confirm the hypothesis that democracies exchange taxes for representation (see, for example, Boix 2001, Ross 2004, Besley and Persson 2009, etc.).

To sum up and to conclude, the idea of the virtuous circle is both quite simple and fairly plausible. On one side, the revenue imperative stimulates institution-building by the government. In our context, in the need to create more fiscal capacity (because of demographic trends, transition, financial crisis, etc.) the Armenian government has an incentive to reform the obviously unsustainable pay-as-you-go pension system in favor of creating more sustainable institutions of redistribution and, more generally, stronger state-capacity. On the other hand, raising more revenue gives rise to the need of re-bargaining over the fiscal contract. This need grants incentives, or, to put it more strongly, imperatives, to the government for cooperation and compromise with the ongoing social pressures in exchange for the ability to effectively enforce the new contract. Hence the virtuous circle, which may in the end improve state-capacity and advance institutions of representative democracy.

Information about the author and references are overleaf.

About the Author

Zareh Asatryan is a PhD candidate at the University of Freiburg and a researcher at the Centre for European Economic Research (ZEW) in Mannheim. His main fields of research interest are related to topics in political economy, public finance and development.

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