

# Latent Aspects of the Funded Pension System-2



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## Accountancy

Have you ever tried to check with the accounting department how much you are paying for your income tax? In some countries, individual taxpayers must file an annual income tax return by themselves and, while reporting, they realize how much have been paid to the state for public goods and services. "I am a taxpayer". This statement made by the citizen awakens in him/her a sense of ownership and reminds the civil servant or a public official that they are called to serve the citizen. Civic consciousness is the anchor of any civilized country.

In Armenia, citizens do not file tax return; they do not compute the income tax. This function is reserved for the employer, in particular, for the company's accounting. However, how many accountants provide details on salary calculation and the amount of income tax paid while paying a salary to the employee? The accountant is the only point of contact between the state; i.e., tax legislation, and the employee. Meanwhile, when the government makes changes to the tax or pension system, it ignores the accountant and forgets that the relationship between the state and its taxpayer (citizen) is insured by the accountant.

In Armenia, perhaps everyone knows that the lack of knowledge of legislation does not free one from liability, whereas, for some reason, it is considered that any change in legislation automatically results in public awareness. There has never been a case when with any change in the law on income tax it is simultaneously ratified that the employer or the accountant is obliged to inform the employee about that change. It is also not specified what mandatory information should be provided to the employee in these relationships. The impression is that the government wants to keep the information on income tax a secret not to make a taxpayer angry. It could be considered that the government initially assumes that its citizens are irresponsible, as no one likes to pay taxes.

When the funded pension system was introduced, and no one was concerned about what information to provide, accountants routinely started using labels to which they were accustomed: 'deductions', 'withholding', '5% of your salary will be withheld additionally'. This customary action did not reflect the essence of this change, which is: "You will save 5% of your salary, and the government will add another 5% towards your saving." While learning accounting, there was no funded pension system. Moreover, there was no Insurance Fund for Servicemen, and therefore, the accountant will consider any such change from the standpoint of additional tax and tax category, rather than from the perspective of state and employee relations. Accountancy was not considered as a partner in introducing the funded pension system.

## Investment Duration

The lack of financial literacy in Armenia is not an accounting issue. Saving, investing and managing money, counting profitability and balancing the family budget, essential capacities in the modern world, still are not widely spread in Armenia. There are misconceptions in this regard as well. There are three levels of money management: short-term, mid-term and long-term. In Armenia, the most widespread and the easiest level is the short-term; if you want to ensure short-term income, deposit your money with a bank. There are also limited tools for a medium-term management of money, namely government and private bonds. Nevertheless, the active management of money in medium-term is not so easy in Armenia; there is no stock market. Some are trying their luck at international stock markets as brokers. Stocks are long-term investments, but they are only for serious actors. Typically, individual brokers treat shares in the same way as short-term or medium-term investments. And this triggers formation of a wrong opinion, according to which it is impossible to



19 Sayat Nova  
Yerevan 0001  
Armenia

Tel.: +374 10 582638  
Fax: +374 10 527082

mail@ichd.org  
www.ichd.org

find long-term investments, so it is impossible for pension system managers to manage money for a long time. In fact, for an individual long-term investments are the pension funds. If you wish to invest your money for a long-term, invest it in pension funds. Why invest particularly in pension funds? Because it is impossible to invest for a long-term with the mentality of “depositing”.

Long-term investments are also big in size. Thus, one can make a deposit of 100 million drams, but what to do when the savings are one milliard, one hundred milliard, and a trillion drams? Try to call a bank and tell that you wish to make a deposit of one milliard drams; moreover for a long term... Therefore, our knowledge of short-term investments creates an illusion about management of large amounts of money over a long period of time. Whilst, the pension managers work with other knowledge and tools.

### **Macroeconomic Policy**

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The funded pension system brings with itself new risks and opportunities and managing those introduces new features to macroeconomic policies. Thus, if the government contributes to the funded pension by putting in from internal debt, and if the interest rate of this debt is equivalent to the actual income of the funded pension, then the interest on the debt to be covered by our next generations will neutralize the revenue from the funded pension. In this sense, we simultaneously accumulate a future tax burden. The income distribution function of fiscal policy is also changing: depending on the nature of the levied taxes, the state's participation in the funded pension system can make redistribution either fair or unfair. The only document in Armenia, which addresses the fiscal policy from the future perspective, is the MTEF (mid-term expenditure framework), which, however, covers only three years. Similarly, the government's debt management strategy is short-term, where pension reform is referred to as a source of debt financing.

### **What to Do?**

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1. From now on, while implementing reforms, consider and take into account the immediate implementers, particularly employers and accountancy.
2. To outline fiscal policy, taking into consideration the predictable demographic trends and the long-term perspective of the funded pension system. Particularly, consider the real and cost effects of the latter, rather than make mechanical calculations.

### **Finally**

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Perhaps this is also forgotten. The Central Bank is usually spoken of as a defender of the interests of commercial banks and an organization that ‘pampers’ their monopolistic position. Meanwhile, introduction of the funded pension system, in addition to CMTPL, forms the first serious financial institution competitive with the banks in the financial system, which will become a serious actor in the future. If today some part of the funded pension is deposit in the banks, then there is a necessity to consider the development of other financial instruments. Often it is the restrictions imposed on managers that influence decisions on where to invest. For example, in countries prone to high inflation it is exactly the short-term inflationary insurance that makes pension fund managers rely on short-term high-yield instruments such as bank deposits. If today, strict conditions for managing the pension funds are defined by one criterion, cautiousness, tomorrow we will need to see how these guarantees influence the managers' behavior and hence, ensure optimal development of prospects and management of risks in the financial market through a well-designed policy.

*This paper has been elaborated based on the opinions passed by the participants of various discussions within the project “Improving Communication Strategy of the Monetary and Financial Sector”.*