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ARMENIA SOCIAL TRANSITION PROGRAM
14 Մուղղուկյան, Երևան 14 Sundukyan, Yerevan
Telephone: (3741) 27-31-75/6/9
E-mail: rvaughan@padco.am
*PADCO Inc., in collaboration with Abt Associates, AIHA, Counterpart
International, QED, AMEG*

REPORT No 21

**LEGAL ANALYSIS:
TWO ALTERNATIVE DRAFT
LAWS ON MANDATORY SO-
CIAL INSURANCE**

Prepared for
The Ministry of Social Security of Armenia
Prepared by
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PLANNING AND DEVELOPMENT COLLABORATIVE INTERNATIONAL
Development Solutions for the 21st Century

PREFACE

Under USAD Contract No. 111-C-00-00-00114-00, PADCO is providing assistance to the Government of Armenia on social sector reform issues. Under Task 1A:T1, PADCO is reviewing the existing legal framework for social insurance and proposals for reform of this legal framework.

Reform of social insurance is a priority for the Government of Armenia. In 1999, the Government of Armenia adopted a framework law on “Mandatory Social Insurance” and submitted it to the National Assembly of Armenia for consideration. In response to criticisms of the draft among Armenian experts and from international donors, an alternative draft was prepared by *Personnel Consulting*, a Czech consulting firm under contract to USAID.

The GOA has not strongly supported its own draft law but has not submitted the alternative draft to the national Assembly. The GOA must decide in December 2000 whether to include the existing draft in its list of laws for priority consideration in the next session of the legislature. It has been urged by the World Bank not to include the draft law on the list but has not received from the World Bank the detailed reasons behind this expression of disapproval.

At the request of the Ministry of Social Security, the Armenia Social Transition Program prepared this legal analysis of the GOA draft framework law and the alternative framework law. It is the conclusion of the AST legal specialists that neither law is suitable for consideration by the National Assembly. Both laws omit important issues that should be addressed in any effective framework law and both embody serious flaws. Instead, the AST team recommend that the GOA focus its efforts on developing the enabling legislation for the five separate component parts of the proposed social insurance system. But the GOA should also clarify certain overall principles for the design of these individual laws.

This report was prepared by Anna Nechai, legal consultant to the AST Program.

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1. INTRODUCTION

Two different laws to reform the mandatory state pension insurance system have been drafted. The draft law on “Compulsory Social Insurance” was approved by the Government of the Republic of Armenia and submitted for consideration to the National Assembly of the Republic of Armenia in 1999. The goal of this draft was to describe the main aspects of all types of compulsory social insurance in the republic, that’s why the project was prepared as a “framework law,” containing significant number of norms having references to another legislative acts. These norms do not refer to concrete laws regulating each type of social insurance, as these laws didn’t exist when the draft was developed.

The second draft law on “Compulsory Social Insurance” was developed at the beginning of 2000 at the request of the Ministry of Social Security by experts of Personnel Consulting company, supported by the United States Agency of International Development (USAID). The purpose of the alternative draft was to improve the draft law developed by the Government, as well as broaden its norms determining the legal status of Social Insurance Fund and Social Insurance Fund management procedures. The first section of this report analyzes the government draft. The second analyzes the draft prepared by “Personnel Consulting.”

2. ANALYSIS OF GOA DRAFT LAW ON MANDATORY SOCIAL INSURANCE

2.1. INTRODUCTION

In this draft law, Article 7 defines five types of mandatory social insurance:

1. Pension Insurance (old age, disability pensions and pension for loosing the family income earner);
2. Insurance for temporary inability to work (including pregnancy and birth of a child)
3. Unemployment insurance;
4. Insurance for job related accidents and professional illnesses;
5. Health insurance.

However, the draft states, in Article 15, that how these insurance systems are to be administered and financed will be defined in other “corresponding laws and normative acts.” The omission of these important issues from the framework law was due to objective and political factors.

The objective factor is that different procedures for collecting revenues, determining eligibility, and allocating benefits are envisioned for each of the components. That’s why it is reasonable to define them in separate special laws. The political reason for its vagueness is that while the law was being drafted, the Government of Armenia failed to develop any overall conceptual approach to the operations of the proposed system of mandatory social insurance system. That’s why drafters were unable to include essential characteristics of the system and its component parts in the draft.

But the situation is no longer the same now. Today, the Government of Armenia has made significant progress in drafting separate special laws for the individual components of the mandatory social insurance system. For example, the Government of Armenia has approved and submitted to the National Assembly the draft Law on “Health Insurance”. It has also adopted a conceptual strategy of pension insurance and a concept paper on the Law on “Compulsory Pension Insurance”.¹ The Ministry of Social Security is now drafting concept papers for laws on insurance for temporary disability (including pregnancy and birth of a child), for unemployment insurance, and for insurance on job related accidents and professional illnesses.

Today, therefore, there is a stronger possibility of law drafting and discussing concrete issues on different types of social insurance. So, the necessity of “framework law” adoption is becoming less and less relevant. Besides this, there are other reasons why the adoption of a framework law cannot contribute to the implementation of social sector reform. These reasons are discussed in the following subsections.

¹ See other reports in this series prepared by the Armenia Social Transition Program.

2.2. USE OF STATE BUDGET FOR SOCIAL INSURANCE FINANCING

Several articles of the draft law describe the possibility of use of state budget funds to pay for Social Insurance Fund activities. For example:

1. Point “b” of the article 21 the insurance capital of social insurance fund may be formed from the state budget.
2. Article 22 allows any deficit arising when insurance contributions to the SIF are insufficient to meet **planned expenses** to be covered by state budget funds.

Article 21 is unexceptional – many countries provide state budget funds to supplement social insurance contributions for specific categories of citizens (the poor, the indigent, etc). But article 22 would eliminate any incentives to the prudent operation of social insurance funds.

The conversion of social assistance programs into social insurance programs means that insurance payments shall be covered by insurance contributions of citizens and their employers. This means that revenues from insurance contributions must be carefully managed to cover benefits paid to those covered by insurance. To achieve this, carefully developed financial models (known as actuarial models) must be used. In other words, the Social Insurance Fund should not be permitted to pay out more than it collects. Benefits must always be kept within the revenues earned by the insurance system.

So, the situation described in article 22 would not occur if the social insurance system is properly managed. The only case when it is reasonable to use state budget funds to pay for Social Insurance benefits would be during planned periods of transition from one system to another – for example, most countries finance the introduction of mandatory accumulation pension systems by issuing state debt to provide supplementary funding during the initial years of the change. For example, during the implementation of pension reform in Poland and Ukraine, World Bank experts advised the country governors to use the issuance of state debt during the transition (including for the costs of covering deficits in the “solidarity” system). To avoid the situation described in the article 22, fund contribution and payment sizes shall be based on strict actuarial calculations that meet international standards. Armenia does not yet have the capacity to perform reliable actuarial projections for its social insurance funds. The AST Program has begun a project to support the development of an actuarial model of the state pension system, to train GOA actuaries, and to develop a permanent actuarial education program in Armenian education institutions. This will allow the better management of state insurance systems and should allow the abandonment of the approach outlined in Article 22. In fact, social insurance reforms should not be implemented until the capacity to make reliable financial projections is fully developed within the GOA.

2.3. ANNUAL CHANGES IN INSURANCE CONTRIBUTION RATES

Article 23 of the draft on “Insurance Contribution Sizes” states that insurance contributions shall be determined annually until the adoption of The law on the State Budget. This means that social payment sizes, also paid by legal entity entrepreneur may also change annually. This violates the principle that taxes should be stable in order to encourage enterprises to move out of the hidden economy. It also discourages prudent management of the social insurance fund by eliminating the discipline to ensure benefit payments do not exceed revenues.

Uncertain taxes make it impossible for enterprises to properly plan their operating and capital expenses – and deter the evolution of a business credit market. That’s why the annual changes in tax rates and compulsory payroll contributions required from legal entities destabilize economic development and its emergence from the shadows. That is the reason why the countries with developed industry avoid annual changes of payment sizes without even paying attention to the fact that social payments in these countries are mainly made by employees (withheld from salaries and wages) and not by the employers.

2.4. THE ABSENCE OF NORMS REGULATING ASPECTS OF SOCIAL INSURANCE ADMINISTRATION

The draft not only leaves a number of questions unsolved and but also gives birth to new ones. So, for example, it does not determine the legal status of the Insurance Fund (in the sense of money). It does not define its relationship to the state budget, if it is a “state property” though asserted separate from the state budget, if it has reserve funds, who audits its expenses etc. In fact, point 3 of article 25 states that the operation of the fund shall be regulated by the law on the fund. Thus, the draft is only a “framework” not only for social insurance types but also for defining what institutions shall manage social insurance.

Consequently, the adoption of the draft law on “Compulsory Social Insurance” submitted to the National Assembly by the Government is not reasonable.

3. LEGAL ANALYSIS OF DRAFT LAW ON COMPULSORY SOCIAL INSURANCE PREPARED BY PERSONNEL CONSULTING

3.1. INTRODUCTION

This draft law is the improved version of the one discussed, but it is also “frame” from the point of view of social insurance types. The main issues that make this draft different from the former one are:

1. It provides a more detailed description of the legal status of the Social Insurance Fund as an Institution and the basic principles for fund management;
2. It specifies that payroll contributions to the SIF should be based on actuarial calculations of the fund’s audited financial position; and
3. It describes how new payment and benefit distribution procedures would be implemented.

These clarifications partly eliminate the defects of the former draft law. But several important issues remain unresolved. These are discussed in the following subsections.

3.2. ELIGIBILITY OF EMPLOYED PENSIONERS FOR PENSION

Article 22 (parts 2 and 3) of the draft law states that insurance payments shall not be allocated to the employed with the exception of those employed receiving partial disability benefits. This would effectively exclude employed pensioners from receiving pension benefits.

The question of the eligibility of employed pensioners for pension has different solutions in different countries. In the former USSR and NIS, for example, employed pensioners were eligible for pensions or for a portion of their pension benefits if their salary did not exceed the maximum pension. If working pensioners are to receive no benefits, few will continue working after pension age.

3.3. RULES FOR BENEFIT INDEXING

The indexing of benefit payments is defined by Article 25 – an important step forward. But Article 25, part 1, states that indexing is not automatic but depends on Government decree and part 2 states that increases from indexation shall be financed by the state budget. This is likely to preclude the implementation of indexing benefits since the Government has no right to spend budget funds on purposes not defined in the law on the state budget. Therefore “pension indexing” can be implemented only if the annual state budget envisages index payments in advance – which is rare. If the state budget were to include an expenditure article for “social payment indexing,” it is unlikely to correspond to real economic and inflationary trends in the subsequent budget year. If indexation were implemented, a larger and larger share of pension payments over time would be transferred to the state budget, with the SIF responsible only for the basic pension payment. This is the exact opposite of what should be done. Ideally, social pensions – pensions paid to people retiring without adequate work history to entitle them to a full work-related pension – should be paid from the state budget as a welfare, or social assistance payment. Work-related pensions would be paid by the SIF. Thus, the indexing provisions proposed in the draft would drive the fund in the opposite direction from that envisaged in the law to create true social insurance payments.

Social payment indexing should be automatic and paid by the SIF, which should be responsible for paying full work-related pensions. Indexing is usually based on increases in wages of the workforce – usually not at 100% of the latter but at some fraction, depending on what is feasible as calculated through actuarial projections. As wages and salaries increase (in real or nominal terms), contributions to the SIF increase as well. This provides the SIF with the resources to increase payments of pension benefits. So, increases in benefits is financially feasible a quarter after wages have increased.

3.4. DETERMINATION OF THE MINIMUM AND MAXIMUM CONTRIBUTIONS TO THE SIF

Under Article 28, the minimum size of social insurance contributions would be equal to contributions from someone receiving the minimum wage. This is a standard international practice. The maximum contribution is defined as “seven minimum contributions.” However, it is necessary to explore the financial basis for this.

Placing caps on maximum contributions for a single individual is usually based on actuarial calculations. Two considerations usually enter into capping contributions:

1. **The necessity to restrict future contributions paid to the fund in light of caps placed on maximum pension benefits.** What the Fund can pay in pension benefits depends on its revenues: the greater the revenues the higher the possible pension benefits. However, beyond a certain wage it becomes more and more difficult for the Fund to collect contributions because of the growing incentive for avoidance. Thus, most countries cap contributions or the income subject to contribution payments.
2. **The desire to encourage increased compliance among higher income people.** One of the features of any “solidarity” pension system is its implicit redistributive element. Low wage workers receive a pension on retirement that is disproportionately large relative to their past contributions. This subsidy is financed through the policy of paying high wage workers benefits that are disproportionately low compared with their past contributions. But there are limits to how much redistribution can be implemented. The less the return on past contributions to high wage workers the greater the tendency to avoid contribution payments. Hence the necessity of capping contributions. An alternative to a cap, recently proposed by the Ministry of Finance, is to reduce the contribution rate due on wages above a certain level.

So, the calculation of the maximum payment should not be based on the minimum payment, as proposed in the draft, but on the average salary in the country. But at exactly what point on the wage scale contributions are capped or rates reduced should be based on actuarial calculations.

3.5. DETERMINATION OF SOCIAL INSURANCE CONTRIBUTION SIZES

The draft includes a number of articles on the size of contributions to the SIF. Article 30, for example, repeats existing payment size norms and principles. This means that the adoption of this draft shall hinder the reformation of the existing pension insurance “solidarity” system.

3.6. FORMATION AND USE OF THE RESERVE FUND

Articles 38, 42, and 47 cover the creation and use of the reserve fund for Social Insurance Fund. Many provisions, however, present serious problems. The draft fails to define the rules under which such reserve funds would be created. Contributions by the SIF into a reserve fund should not be permitted until all arrears and other debts have been paid off in full. But this is not stated in the law.

Article 47 opens up the possibility or even the necessity of investing money held in reserve funds to protect it against loss of value through inflation or devaluation. But this creates internal contradictions. One is that the purpose of reserve funds is for use when contributions fall short of required payments (although there must be some actuarial evidence that this is temporary). This means that the assets of the reserve fund shall be highly liquid – often in the form of savings accounts of reliable banks. But investing reserve funds may mean that the assets cannot easily be liquidated. Even the liquidation of short-term government securities presupposes an efficiently working securities market. The rational solution of this problem is the creation of two reserve funds - an operational one and a strategic one, or two different sub-accounts of the same reserve fund. The operational fund should always be held in liquid assets – funds on bank deposits – and its size shall not exceed expenditures of the Fund for a short period, say one and one half months. Any revenues collected that actuarial calculations predict will not be needed in the short-term would be held in the strategic fund. Because Armenia faces much uncertainty over demographic projections of its population of beneficiaries and contributors, the SIF may need large strategic reserve funds at some time in the future. Such funds must be carefully regulated and open to public scrutiny. The draft law fails to insist on this.

Sub point “c” of the first part of article 47 states that “all the decrees related to reserve fund investing” are made by the SIF Administrative Council. This is inappropriate. All regulation of investments must be the responsibility of financial regulatory agencies. But article 45 of the draft law that creates the Administration Council states that it will be comprised of:

- 6 Government representatives
- 3 representatives of the employers
- 3 representatives of the insured

The draft law does not determine any qualification requirements (as for example stock exchange experience, asset management skills, finance knowledge etc.) of Council members. The draft has no order of selection of employer and representatives of the insured. This raises the following questions: who shall be considered the representative of the employers? Shall it be the officially registered Employers Association? And what if they are several in Armenia? Who shall be considered representatives of the fund beneficiaries? Generally, trade unions have been used for this purpose in the past. But with the proliferation of trade unions, which trade union would be selected for the Administrative Council? Finally, the draft law does not specify what agency would have the authority to answer these questions. All these issues should be defined in the draft law if it is to be implemented in a safe and effective manner and if it is to minimize the possibility of fraud and abuse.

The proper regulation of reserve fund investments is a very important issue. Large losses may be incurred to the detriment of future pensioners. Inadequate regulatory oversight by experienced financial experts will lead to significant abuse by the Administrative Council. They may be tempted (or compelled) to invest money in large state or private enterprises in response to the demands of special interest groups. No one would be held personally responsible for such actions, because the decision is a “collective” one. Therefore, we recommend that the law define all the rules and procedures of such investments and prohibit the implementation of reserve funds until independent financial regulatory agencies are in place to enforce appropriate investment rules.

3.7. LEGAL STATUS AND ORGANIZATIONAL STRUCTURE OF SOCIAL INSURANCE FUND

This draft, unlike the GOA version, includes articles that define the legal status, organizational structure and management of the Social Insurance Fund. Yet unsolved questions remain. The issues that should be regulated by the law are as follows:

1. legal status, management, and use of the “Social Insurance Fund”. For this purpose, the following issues should be addressed:
 - define the budget of the Social Insurance Fund, how it is to be determined and the purposes for which revenues may be used (this is partially achieved in this draft);
 - procedures for receiving and holding fund money, depository definition and its liabilities (this is not addressed in the draft);
 - procedures for allocating fund revenues among different insurance funds (this is partly implemented in the draft),
 - definition of organizations responsible for paying insurance benefits and their distribution to beneficiaries (not addressed in the draft);
 - procedures for auditing the accounts of the SIF and the publication of audited financial statements (see below);
2. legal status, rights and liabilities of the institution(s) responsible for managing the Social Insurance Fund. For this purpose, the following issues should be addressed:
 - definition of central and local management, as well as internal and external control bodies for the institution.
 - main provisions of its statutes, procedures for setting up the institution, how its statutes may be amended, and other issues (not defined by the draft);
 - concrete and detailed procedures for the appointment or election of all management and control bodies of the organization, as well as qualifications required for appointees and reelection procedures (no definition in the draft);
 - rights and liabilities of the organization (the definition in the draft is incomplete and inadequate);
 - rights of internal and external accounting (the definition in the draft is incomplete and inadequate); and
 - relations of this organization with other state bodies, including the rights to provide and receive information – about the database of the insured, for example (no definition in the draft).

So, the draft gives no solutions for the Social Insurance Fund status, its management and use.

3.8. PERIOD OF ACTUARIAL CALCULATIONS

Article 41 requires the Social Insurance Fund to design and submit actuarial projections of Social Insurance Fund 3 years to 10 years into the future and submit these projections to the Government and National Assembly. However, actuarial calculations for only 10 years are not adequate to ensure the stability of the fund. The SIF is responsible for paying (pensions in particular) those who start working at the age of 18 and subscribe to the Fund until they retire at the age of 63 (women) or 65 (men). The fund is, therefore, responsible to those people for nearly one half a century. After that, it will pay pensions to them for an average of about 17 years. That is why international standards require actuarial calculations for a period of 75 years.

3.9. STATE GUARANTEE FOR THE FINANCIAL STABILITY OF THE FUND

Article 41 of the draft states that the “state guarantees the financial stability of Social Insurance Fund”. This means the state budget is responsible for benefits if Social Insurance Fund cannot make payments. This requires the creation of a reserve fund against this contingency. The state’s contingent liability is minimized by conducting careful actuarial projections and by strict auditing and control of the fund’s operations. Otherwise, “social insurance” – financed based on insurance principles – and “social security” – financed from general revenues to the state budget – disappears. The only justified case of the use of the “state guarantee” for paying capacity is described above in point 1 – to special categories of people who are unable to pay their contributions into the insurance funds.

3.10. AUDITING COMMITTEE SELECTIONS AND AUDIT RESULTS’ PUBLICATION.

Article 50 of the draft sets the rules for creating an audit committee. However, there is no definition of the term of appointments nor the reelection rules of the Auditing Committee. This places auditors in an “unstable state” and subject to political pressure. Auditors should be as independent as possible if they are to implement their tasks honestly.

In addition, Articles 50 and 51 do not require the publication of audit results. They are submitted only to the Administrative Council and to no one else. These reports are not even submitted to the GOA, even though the state, under article 41, guarantees the payment capacity of the budget. This is unacceptable and in violation of sound financial practice throughout the world. Audit reports on the SIF and its actuarial projections for 3, 10, and 75 years, should be published annually for all citizens to read in a timely manner -- before preparation of the annual SIF budget for the next financial year.

4. CONCLUSIONS AND RECOMMENDATIONS

The main conclusion of this legal analysis is the adoption of either of these drafts in its present form would be inappropriate for the development of a sustainable system of social insurance in Armenia. Neither draft is complete – omitting important principles for the design of social insurance systems. And both draft contain serious flaws that, if enacted, would create serious problems in implementing the system.

Instead, we recommend that the Government of Armenia concentrate on the development of separate laws for each of the five separate types of social insurance specified in the framework law. But the Government should continue to elaborate some principles related to financing and administration that should be common to all five laws. The issues that urgently need elaboration are:

1. To distinguish between social insurance and social assistance. Social insurance is a contract between people paying into funds (or, in most cases, employers paying on behalf of the individual) in which the individual agrees to make regular payments to the fund and the fund agrees to pay benefits in the event that the beneficiary suffers adverse economic events (unemployment insurance) or suffers injury or illness (health insurance, invalid insurance, and workers compensation). The individual is entitled to benefits only to the extent that they (or their employer) have made the necessary payments. Social assistance is the right of an individual to receive money or services from the government that guarantee a minimum subsistence and basic services necessary for life. Thus the poor receive family benefits, those who have never worked may receive a “social pension.” In general, payment for social assistance should be from general budget revenues, while social insurance payments are made from a dedicated fund.
2. To define the basic principles for the collection of contributions to and the payment of benefits from social insurance funds. Laws should define the basis for calculating the contributions required to

- provide insurance coverage, what agencies should be responsible for collecting those revenues and distributing the benefits, and how these financial operations should be audited and managed.
3. To define the principles of the management of money by insurance funds. Separate social insurance systems should not be financed from a single fund. They should be managed as wholly separate financial operations. Procedures for managing money (including the investment of reserve funds or temporary surplus funds) should be tightly regulated by independent financial regulators. All financial operations of social insurance funds should be audited by independent auditors and the results made available to the public.
 4. To define the principles for setting social insurance benefits and contribution rates. Social insurance contribution rates and benefit levels must be determined based on actuarial projections that meet international actuarial standards. Funds must be “in balance” in the long term – although annual surpluses and shortfalls must be accommodated through the use of reserve funds. If social insurance funds are required to make social assistance payments (social pensions to people who failed to meet the minimum work experience criteria, or health care costs to indigent people, for example), then these obligations must be included in the actuarial projections and the fund required to set other benefits at a level to ensure overall balance.
 5. To define the system for appointing those responsible for administering social insurance funds. There will always be political pressure on social insurance funds to spend surpluses for the benefit of those in political power – to raise pensions just before elections, for example. This pressure can be minimized by creating governing boards of funds that must meet certain professional qualifications (in terms of financial expertise) and by holding them fully accountable for the financial performance of the funds.

Defining these principles according to good international practice does not guarantee that the resulting systems will meet all the objectives set for them by political leaders or that beneficiaries will immediately receive higher social benefits. But it will reduce the possibility of social insurance reforms resulting in serious financial and social problems.

Drafting the component laws according to these principles will not be an easy task. It is irresponsible to create a vague and inconsistent law with the hope that it may be amended in the future. The laws should be drafted carefully and with proper consideration to many basic issues – only some of which have been raised in this and in the other companion papers prepared by the Armenia Social Transition Program.