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Canadian Retirement Savings Programs and Russian Pension Reform

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1. Introduction

One aspect of the current move toward tax reform in Russia is the reform of the pension system, a system that has been decimated by the events of the last decade. As a result, Russia effectively begins this reform with a clean slate. Canada, on the other hand, has a system of pension saving and support for Canadian seniors that has evolved slowly over the last century. Over that period Canada has had to grapple with many of the same pension and peripheral savings issues Russia is concerned with at the present time. While Canadians are well served by the plans now in place, the nature of the process was not without its problems and is still one of continuing evolution. This essay describes some of the major aspects of the Canadian savings plans and their past evolution to provide some historical perspective as Russia considers how to structure its own savings plans to best serve its citizens, both during and after the transition to a modern western style economy. If some of the missteps Canada has made in the past can be avoided, then Russia's move to a preferred system will be more rapid than otherwise. Avoiding those missteps, even knowing their consequences, may, however, be difficult, principally because they may have some appeal in resolving the transitional problems now confronting Russia. While the ultimate goal is to get a superior system of support for seniors, it is important to know whether or not compromises made for the transition can be reversed. In the next section I provide the basic background of the Canadian retirement savings plans. In section 3, I describe the views of Canadian pension industry practitioners on how the Canadian system can be further improved upon, and in section 4 I discuss some of the ways the Canadian system has responded to the types of problems that currently confront Russia. Section 5 briefly remarks on the current Russian pension reform and section 6 concludes.

2. The Canadian Retirement Savings Programs.

The Canadian system for the support of the elderly is often characterized as resting on three pillars: (1) a means tested, tax financed, minimum pension, (2) an employment based, mandatory pension plan to which everyone in the work force belongs, and (3) voluntary, fully funded retirement savings plans.

The first of these is handled by two government programs, The primary one, the Old Age Security program (OAS) is funded on a pay-as-you-go basis from general tax revenues and has been in existence since 1927. Until recently this program has been universally applied so that all seniors obtained the same dollar amount of benefits. However, beginning in 1989, the government, in need of additional revenue, restricted payments to more wealthy seniors by "clawing back" some, or all, of the benefits paid to them. As a result, seniors with income below $55,000 receive the entire payment while those with incomes above $90,000 receive no net payments.[1] As a result it has now become a fully means-tested program. The second program is the Guaranteed Income Supplement (GIS) which, from its inception in 1967, has been fully means tested and available only to seniors with income levels deemed to be below the poverty line. It, too, is financed from general tax revenues.

With the removal of the universality condition on OAS these two programs address the same issue, ensuring that a social safety net exists for senior members of the Canadian community. That there are two programs meeting this need is most likely because, at the time OAS was instituted, pillar two was not in place and OAS served as a proximate compromise to meet that need. With both programs in place, the two programs now act as a single progressive transfer program to insure a basic minimum level of welfare for all seniors.

For the second pillar, Canada has the Canadian and Quebec Pension Plans (CPP/QPP) which are mandatory, partially funded, plans for everyone in the workforce. Contributions are in the form of payroll taxes of 8.6%,[2] up to the yearly maximum pensionable wage, roughly equal to the average industrial wage. These programs began in 1967, and retirees at the time the program was introduced were not eligible for its benefits. Thus, there was an attempt to achieve at least partial funding of the program. When established the payroll tax was 3.6%. Until recently, the assets that could be held in the CPP were restricted to provincial and federal debt at rates favourable to the provinces[3]. In 1997 an investment board was established to invest in a broader range of assets including equities.

Canada's voluntary retirement savings plans can be divided into two types that receive some government tax relief.[4] Company retirement pension plans (RPPs) are generally funded from contributions of the company and, generally, the worker. The other plan is the registered retirement savings plan (RRSPs) that are available to all working individuals whether or not they also belong to a company-sponsored RPP.

Company retirement pension plans had assets estimated at $750 billion in 1999[5]. The types of

plans can be either defined benefit (DB) or defined contribution (DC). The former is the largest in both membership and assets because they are concentrated in the larger, more unionized, sectors. Small and medium sized businesses have tended to opt for DC plans.

Recent trends show a movement toward DC plans. The reasons for this movement are varied. From the firm's perspective, the regulatory environment is both more complex and more restrictive with DB plans. Further, the increasing mobility of the labour force over time has meant that DB plans are at a competitive disadvantage in attracting workers. After all, to hire and retain workers, the firm must provide an attractive package of both wages *and* fringe benefits, of which the pension plan is a major component. If a firm offers a DB plan, then wages and other benefits would have to be greater than otherwise to attract and retain workers. The reason DC plans are becoming more attractive to workers is at least twofold. First, with workers changing jobs more frequently, for a given contribution rate, the vesting and portability properties of DC assets are more valuable to the representative worker. Secondly, workers, and indeed all members of Canadian society, are becoming more comfortable in managing their own financial assets and holding equities.[6] The last 20 years have generated large surpluses in DB pension funds in Canada and those monies are not immediately available to workers. Workers have thus seen that the risk bearing that companies undertook to provide DB pensions paid off handsomely and they would have liked to reap some of those rewards for themselves.

Due to their larger membership and asset base, internal pension committees manage most of the assets in DB plans. DC plans, on the other hand, are more likely to have been contracted out to third parties in the financial industry to operate them. For the larger ones there are still some economies for the sponsor to run the plan, at least to the extent of choosing the set of available portfolios and doing some of the administration. Smaller plans often contract out both the administration and choice of portfolio offerings to a large group of pension plan suppliers. While many of these specialize in the pension fund industry, there are also major financial institutions such as banks and brokerage firms who compete for the market, mainly through the mutual funds which they offer to the retail public,

Until the mid 1980's, an individual who left a firm and whose pension was vested, could leave her RPP funds with the original firm, transfer those funds to her new employer's plan or transfer the funds into an RRSP, discussed below. Upon retirement, the funds would be converted to an annuity issued by either the company holding the individual's assets or an insurance company. In 1987 the opportunity to place RPP funds in an RRSP was restricted. In particular, a new category, a locked-in RRSP (LRRSP), was created and any monies transferred out of a former

employer's RPP could be put in either another employer's plan or these LRRSPs. The difference between these and regular RRSPs is that the latter can be cashed out prior to retirement whereas funds in LRRSPs must be held until retirement and then could only be used to purchase a retirement annuity. In a sense then, RPPs became mandatory retirement savings plans, where the company rather than the State determines the level of the pension, and this amount could differ across firms. Nonetheless, such an arrangement can easily be seen as one where the state mandates the minimum amount that must be set aside in a retirement plan and the individual worker can, if she chooses, transfer the remaining assets into an RRSP without the locked in provision. Further, a portion of RRSPs could also be locked in for those workers not participating in an RPP.

In 1992 additional options were added to the list of what workers could do with their pension savings. Prior to that time, annuities were the only permitted method of disposal of RPP savings. In 1992, governments allowed individuals to continue to self direct the monies in their post retirement accounts – Life Income Funds (LIFs) – subject to two basic provisos. First there is a maximum that can be withdrawn in any year. This amount is determined on the basis of what an annuity would pay, so that, effectively the individual is providing herself the annuity, bearing the risk and keeping any profits from a market that outperforms the implied discount rate of the annuity (generally set at the long term bond rate). The second proviso is that a minimum amount must be withdrawn each year so that the retiree cannot continuously use the tax deferral properties of past RPP contributions.[7]

Asset allocation restrictions on the portfolios held in company RPPs are minimal with the exception of the Foreign Property Rule (FPR) that limits the amount of foreign property that can be held in a plan. This limit was set at 10% of the book value of the assets during the 1970's and early 1980s. It has since been increased by increments so that it now stands at 30% of the book value of the portfolio. While there are provincial regulations dictating the maximum share of the pension fund that can be held in any one private security, prudential behaviour has ensured reasonably diversified portfolios across the country. In particular, there has been limited use of company shares as part of the pension fund[8]. If a firm wants to encourage worker ownership in the company, they use stock purchase plans, which are treated separately from the pension plan.

The second government supported private savings plan is the Registered Retirement Savings Plan that was established to provide those workers not part of a company pension fund a comparable vehicle for saving for retirement. Throughout its history there have been attempts to integrate RRSPs and RPPs so that members of either plan are treated fairly relative to the other.

For instance, the regulation setting the annual maximum that can be placed in these plans is fully integrated at 18% of wage income up to a ceiling of $13,500. An individual in a company RPP, where the combined contribution by worker and employer is less than this amount, can use the remainder of the limit to contribute to an RRSP. Further, the instruments that are available at retirement to RRSP and RPP members are quite similar. Both provide the option of converting the assets in the plan to an annuity, or allows the retiree to continue to administer her own assets. The one distinction here is that the RRSP equivalent to the LIF is a Retirement Income Fund (RIF) that is free from the maximum withdrawal limit that is imposed on LIF holders. Both LIFs and RIFs are subject to the same minimum withdrawal rate set by the tax authorities.

The portfolio holdings that are permitted are quite similar. The FPR applies equally to RPPs and RRSPs[9]. Also, if a mutual fund held in an RRSP has itself less than 30% foreign property, the entire amount in the fund counts as Canadian content and does not use up any of the foreign property allocation of the RRSP.

The principal difference between the structure of the RRSP and the RPP is the degree of flexibility available with the former that is not available in the RPP. Not only is the RIF product available to the RRSP member free of the maximum withdrawal limits of the LIF, but also funds in an RRSP can be withdrawn at any time, subject only to the proviso that the deferred tax liability is paid on the withdrawn funds. It is, in fact, best characterized as a generalized saving plan rather than a retirement plan per se. Thus, while saving for retirement is the primary use of RRSPs, it also turns out that it is used to finance major household expenditures. In particular, it is not uncommon for individuals to use some of their RRSP savings for purchasing a home, or for post secondary education for their children[10]. Indeed, it is possible under some circumstances for an individual to "borrow" from his RRSP to finance a home or a small business – in a sense, to take out a loan from oneself without triggering a tax liability. For instance, a given amount can be withdrawn tax free for first time home buyers provided the "borrowed funds" are paid back into the RRSP within 16 years. This is especially useful in circumstances where there are poorly developed financial markets, where risks are hard to access, and/or large amounts of collateral are required, such as the purchase of a home.

The "tax deferral " benefit provided by the RPP and RRSP programs can be shown to effectively allow capital income to accumulate tax-free. An alternative description is that such programs can be seen as approximately converting an income tax to a consumption tax. This is because monies pulled out of such programs will be spent (else they would not be removed) and any income not spent will, up to the limit allowed, be deposited in these plans because of the more favourable tax

treatment. This equivalence is not, however, exact if the income tax rate is highly progressive. In this case some individuals will choose to smooth out their taxable incomes so that they face a lower *average* tax rate. In effect, for those individuals who face a good deal of volatility in their income over time, the tax deferral property of the Canadian savings plans transforms the income tax based on annual income to one of an income tax based on average lifetime income. At the margin, at least, this should encourage greater risk taking and entrepreneurship.[11]

3. A Current Assessment of the Canadian Pension System

I have hoped to convey the view that the Canadian pension savings structure is an evolving institution. As such, there is some "baggage" from the past that has carried over to the present, as well as some past experiments that have been quite successful and are currently being built upon. This is especially so in light of the changing demographics that will place an increasing burden on workers for the benefits of the growing proportion of citizens that are retired. In this section I want to discuss some of the problems facing the Canadian system as seen be industry practitioners.[12]

The issue with the first pillar is that, in the process of evolution, programs that were put in place in one environment are difficult to remove. OAS is a case in point. It certainly had a role to play prior to the establishment of CPP/QPP. Indeed, it would have the same capital accumulation implications as this second pillar program since being financed from general tax revenue effectively transforms it into a pay-as-you-go retirement program. Further, given that there was some attempt to provide some backing to the CPP/QPP by limiting the eligibility of benefits to contributors, there would be a continued need to provide some assistance for those not eligible for that program.[13]

The Canadian solution was to remove the universality of the program by clawing back benefits to wealthier seniors and, while that meant a more targeted transfer program, it also meant high effective marginal tax rates for middle income retirees. The major concern is that the implied marginal tax rate can be substantially greater than 50% and this is seen as a negative inducement to save for a sizeable segment of the population.

A second issue now confronting the operation of these programs is the integration of the social safety net for seniors with that for the younger population of Canada. As it now stands, the safety net for seniors is, on balance, more generous than that for other members of society. This may

well be viewed as desirable by a majority of Canadians, yet it does not appear to have been the result of a conscious decision on the part of the government. Rather it seems that Canada has arrived at this position through the evolution of individual policies that addressed specific transitory issues in the past. Canada now may well be in the position of extricating itself from a number of these to achieve a more balanced approach to the social safety net for seniors and non seniors alike.

Canada's relatively late arrival, in 1967, to a payroll financed, government administered, mandatory pension plan meant it has avoided many of the problems connected with these programs. In particular there is at least partial funding of the CPP/QPP. I believe it is now widely recognised that the absence of full funding has negative consequences on capital accumulation and can be subject to significant problems if demographic features are poorly forecast or are inadequately responded to. However, even if CPP were fully funded, its return on assets would be generally less than that of a privately run fund because of political restrictions on the allocation of funds. The Canadian pension plan has, until recently been restricted to holding only provincial and federal debt. They can now hold other assets including equity, but there is still an overhang of billions of dollars of provincial debt that, by law, can only be reduced as those securities mature.

The issue for the future is whether the entry of CPP into the equity markets will continue to be at arms' length from the government and whether it will have an undue influence on the Canadian market. There are three ways to address this market influence issue. One is to have, at the outset, private suppliers of the mandatory income related pension plans. While this does not provide a guarantee that markets will be unaffected by these pensionable assets, it does provide some competitive pressure to the markets and would prevent the worst abuses of government interference in the capital markets. A second, but not mutually exclusive, alternative is to allow the managers of the fund the ability to hold an extensive amount of foreign assets.[14] This would relieve price distortions on equity prices and provide greater diversification benefits to the ultimate members of the economy for whom these programs are established. The third is to simply accept that there is a role for government allocation priorities with mandatory pension contributions. In the past, Canadians have tolerated that view but recently appear less inclined to do so. Canadian pension managers have suggested that, to the extent there is any increase in the second pillar, that it be privately run in a manner similar to existing voluntary programs.

The third pillar, of voluntary contributions through RRSPs and RPPs, has been the most successful aspect of the Canadian retirement savings system and indeed, will ultimately

constitute the bulk of the middle class's retirement income. Yet it, too, is not above criticism. For those in the pension industry there are two major problems with the third pillar, the limits on contributions and the Foreign Property Rule. I consider these in turn.

Contribution limits to pension funds and RRSPs have been frozen at $13,500 since the mid 1970s despite the increases in the price level and wage income generally (albeit for RRSP contributions one can now carry over unused contribution room from earlier years). The apparent reasoning behind this seems to be based on the assumption that, as it stands now, the dollar cap of $13,500 constrains those workers earning more than twice the average industrial wage.[15] While it may be that the policy is intended only to encourage saving by middle income workers, it has been argued publicly that it is assumed that this "tax expenditure" is very expensive to the government. As a result, the government has tried to limit accessibility to this highly popular program, and capping contribution limits at a low level is one mechanism to do so.

It is the case that (assuming expenditure patterns unchanged in the absence of the program) there is some decrease in the present value of tax revenue, but this is mitigated because the taxes are only *deferred* rather than eliminated. Nonetheless, there is reason to believe that these programs actually increase the efficiency and fairness of the tax system. In particular, in Canada, one of the major net recipients of government spending is the elderly, not only from transfers but also because of the age related medical expenses. Because the elderly will pay these deferred taxes, net transfers to this group will be reduced in the future, reducing the amount of intergenerational transfers. Further, given what many people regard as the systemic short horizon views taken by politicians, such programs as deferred taxation mitigate the burden placed on future generations. Finally, use of these deferred tax plans can be seen as converting an income tax system based on current income to one based on average lifetime income and/or consumption. Many would regard either of these as the more relevant basis to assess income inequality and, as well, they are more conducive for risk taking and capital accumulation.

The Foreign Property Rule is the second important problem identified by pension managers and, at its 20% level that prevailed until 1999, was costing Canadians between three and five billion dollars a year in extra regulatory costs and the inability to properly diversify[16]. The costs would have been greater still had the industry not been able to find a mechanism to mitigate much of its effect.[17] Furthermore, it turns out that any ostensible benefits from the foreign property rule are, in a world of international capital markets, minimal if individuals hedge their foreign investments into domestic currency. In that case, the participation in foreign securities markets will have no net impact on the exchange rate or balance of payments. This is because hedging the currency

creates an equal and offsetting capital inflow.[18] It is not the desire to diversify one's portfolio that causes capital outflows but rather a distrust of the central bank that is supposed to maintain the value of the currency. Given that savers have confidence in the domestic currency there is no effect on financing domestic investment of restricting retirement saving portfolios. Finally, because the FPR makes saving through RPPs and RRSPs less attractive the entire cost of the FPR falls on workers. In effect, it raises the cost of hiring workers, generating lower real wages (including benefits) and/or increasing unemployment. Thus, this type of policy helps neither workers nor the balance of payments. Yet it has an emotional appeal among nationalists, which, in turn, makes it difficult to remove.

4. Applying Canadian Experience

The primary purpose of a pension system is to provide financial support for the senior members of the community, and a good system is one that does so in a cost effective manner. Nonetheless, at one time or another tampering with the pension system has been used to address a variety of issues that policy makers believed to be important. During the past 50 years, for instance, the Canadian government has thought the pension system could be used to address, at least in part, the following five issues:

1. The poor state of support for current pensioners,
2. The need to accumulate capital,
3. The need for additional tax revenue or, at least, an assured source of demand for government debt,
4. The desirability of allocating capital to high priority projects and/or sectors, and
5. Stemming capital outflows and relieving pressure on the exchange rate.

Russian policy makers, I suspect, also regard each of these issues as pressing at the present moment. Can they also use the senior support system to address them, and what does the Canadian experience indicate about the consequences of doing so? After all, retirement savings plans, by their very nature, are concerned with the long run, and each of the above issues required a short run "fix." The trick is to insure that the emphasis on the short-run issues does not damage the long-run objective. I will indicate how, from the Canadian experience, some of those issues can be addressed with a long-run pension plan while others are inimical to a successful plan.

Support for current pensioners.

A common way pension plans have addressed this in the past has been to establish a pay-as-you-go pension system. The problems with this are that capital accumulation is retarded and

demographic shifts can cause difficulty with rational tax planning. Canada opted for a partially funded plan to avoid some of those problems and, to support the current elderly, used the GIS/OAS programs of pillar one. But even here there is a problem because there is inconsistency in the support levels for the elderly poor and for the working poor. The lesson from the Canadian experience is that support for the elderly should be integrated with that of the entire social safety net. Policy makers may well wish to provide greater support to the elderly, and the pension system does lend itself to such intergenerational targeting. However, one should be aware that removing entitlements in the future may be quite difficult, especially if the assistance is formulated as a universal plan which is not means tested.

Capital Accumulation

The literature is not yet clear whether or not tax deferred savings plans significantly increase aggregate national saving, including government saving. Mandatory, fully funded plans probably do while there is some ambiguity over fully funded voluntary plans. The political dynamic in Canada strongly suggests that voluntary plans, on balance, increase savings for at least three reasons. First there is simply the desire to avoid the current high tax rates on personal income.[19] Consequently personal saving is higher than it otherwise would be. Second, for many people, these deferred tax plans effectively transform the income tax to a consumption tax which also provides a greater incentive to save. The third reason is the political one that, if the government has the revenue, it can always find ways to spend it. Plans that defer taxes, in effect, force the government to adopt a longer planning horizon and not be as willing to undertake intergenerational transfers at the expense of future generations. Thus, government dissaving is reduced.

Government Finance: Tax Collection and Debt Placement

In an environment where the government is in need of additional tax revenues, it may seem counterproductive to offer tax deferred savings plans that, on the face of it, reduces current tax revenue. Income taxes on labour income appear to be one area where the tax is more difficult to avoid. Thus, there may be a special concern about exempting that income. There is however, an alternative way of viewing the issue. If the tax base that is regarded as fair is one based on average lifetime income, then *not deferring* taxes on income saved for retirement would be sacrificing fairness for expediency[20]. Alternatively, in the absence of these programs it is likely the government would want to institute an alternative means of tax averaging. Furthermore, to the extent that there is additional saving, it frees up resources that the government can obtain by issuing debt without inflationary pressure. That debt will be purchased directly with the new retirement savings or, if the savings are directed to other assets, then other asset holders are free

to purchase the new debt. In either case, there is an increase in loanable funds available to the government.

The Canadian tax deferral scheme is that the tax on labour is foregone now but the deferred labour income plus all investment income and capital gains are ultimately taxed at the prevailing tax rate when the funds are withdrawn. While the Canadian government has some difficulty in fully collecting taxes on investment income (especially income and capital gains generated on investments outside the country), it has no problem in doing so on RPP and RRSP savings. The reason for this is that such assets can be easily monitored because the institutions holding the assets must register with the government if they are to offer these plans. There is thus an incentive to fully report distributions if these institutions wish to continue offering these plans. Not only is some revenue raised better than taxes avoided, but also, over the longer term, a habit of paying taxes on investment income may carry over to paying them on assets not covered in these programs.

Allocating Capital

In Canada, monies in retirement plans represent a large and growing pool of funds that appears attractive to access for a number of capital projects the government from time to time believes are important. Fortunately, the government has generally resisted the impulse, and in the four notable cases where the Canadian government has interfered in a major way, only one could be considered "successful", two are presently being reversed and the verdict on the fourth is not yet in. The successful case is the use of the RRSP plans to provide a capital accumulation vehicle for non retirement purposes such as home buying and educational expenses for one's children. Both are regarded as high priority uses of funds. Canada has addressed this first by not imposing penalties (unlike the US) on RRSP funds withdrawn prior to retirement. Second, for certain uses – first time home-buying being the major example – the plan member can effectively borrow from himself without immediately triggering a tax liability. This option means that the registered plans are much more attractive to individual savers so that more funds are placed in these accounts to be used for the desired government objective. This allocation device is successful because there is a convergence between the government objective and that of the individual saver. By enhancing the program both the State and individuals can gain.[21]

The case where there is no clear conclusion on the program success is the QPP original mandate to use some of the pension savings to assist Quebec businesses. The Caisse de Depot has generally invested with the objective of enhancing the value of the fund. However, in those cases where the decisions have let the political objective dominate, it has generally led to controversy

with little, if any, meaningful benefit to Quebec savers.

For the two unsuccessful cases, the objectives of the State conflicted with either the objectives of the individual or other objectives of the government itself. The restriction of CPP monies to the purchase of government debt is a case where the restriction conflicted with other objectives of the State. In particular, in doing so, and at a subsidised rate for the provincial debt, meant that the return on CPP was less than it otherwise would be, and led, in part, to the problem of increased payroll taxes later in the life of those programs. Furthermore, in retrospect, the allocation of risk was likely distorted, with the State unable to exploit the opportunity to diversify risk. Instead it was required to choose a portfolio with lower returns than could otherwise be obtained while taking on the same amount of risk. The only gain presumably was that it was lending to itself at a subsidised rate. But that subsidy has to be paid by the state in any case, even if at a later date. If the subsidy did, indeed, cause the government to fool itself into thinking the cost of capital was lower than it actually was, then there was likely a misallocation of resources because of it. What the government now is recognising are two points. First, what matters are the consolidated accounts, and here there was no net subsidy. Second, and more important, is that financial assets are fungible. Each may have its own risk and liquidity characteristics, but financial markets price those differences. Had CPP held corporate debt and equity, and the government had issued debt on the capital markets instead of its being purchased by the pension plans, Canadian welfare would very likely have been improved. There would exist a demand for that government debt directly or indirectly from those agents who would have held the debt and equity that CPP would hold instead of the government debt. Absent the restriction, the pension plans would have a more reasonable mix of those risk and liquidity characteristics.[22]

The second, and more serious, unsuccessful attempt to direct the allocation of resources in pension plans was the Foreign Property Rule. Here the ostensible aims of the State were at odds with those of savers. In both the voluntary RPP and RRSP plans funds are accumulated by, and for, the benefit of the saver herself. If there are restrictions imposed on how these funds can be allocated, then they become less attractive relative to other savings and/or consumption choices and that source can easily dry up. The FPR imposed a significant cost on Canadian savers by restricting their ability to diversify and therefore generated a lower return for any given amount of risk bearing. To compensate for this, the financial industry developed an innovation that, at least for the larger RPP plans, got around the regulation, but at a cost.[23] In the end, then, the government attempts to control content in voluntary plans by restricting choice led to decreased Canadian welfare both by the increased cost of avoiding it or by binding on those who could not avoid it. In fact Canadian investment was also likely reduced rather than increased as the

regulation intended. In particular, work by Bartolini and Drazen (1997) suggests that the removal of capital controls on domestic residents actually increases capital inflows rather than causing the expected outflow. This may well have occurred in Canada in 2000 when the government increased the foreign content limit by five percentage points from 20% to 25%. In that year Canadian equity markets outperformed virtually all other equity markets of OECD countries.

Capital Flows and the Balance of Payments

One issue that has frequently been a concern of Canadian policy makers has been the balance of payments and exchange rate. The Foreign Property Rule on pension savings plans has often been justified by this concern. However, if the restriction is binding on pension savings then, for any given expected return on the portfolio, the risk borne by the saver will be greater with the FPR than without it. As a result, to avoid this additional risk the agent will hold lower risk assets and get a lower rate of return, but still have a riskier portfolio than if the constraint were not in place.[24] The restriction on foreign asset holding, in other words, increases risk, and reduces return, and ultimately tax revenue, making both the individual saver and the State worse off. Furthermore, there is an alternative that will have the same consequences for the balance of payments as the FPR but will provide at least some of the gains from international diversification. This alternative is to require that purchases of foreign assets must be hedged into Canadian dollars. In this case, of "covered foreign investment", the purchase of, say, some foreign equity of CDN$1000 sets up an offsetting capital inflow of CDN$1000 through the forward or futures dollar/ foreign exchange market so there is no exchange rate pressure. The individual investor, on the other hand, has the ability to diversify across a greater range of assets, thus earning a higher expected return (and the government, greater tax revenue) for a given level of risk bearing. That allows *some* of the diversification gains with no balance of payments impact, but it still leaves the investor with the inflation risk that comes from an unanticipated change in the exchange rate[25]. Thus, such a "hedging solution" is better for the saver than the equivalent foreign property rule but is not as desirable as allowing individual savers to hold the foreign assets in the currency of their choice.

5. Russian Pension Reform

Included in the current tax reform measures being undertaken in Russia is that of reforming the pension system. In the context of the Canadian framework, this reform has concentrated on the "second pillar", a mandatory plan for all workers. In a number of ways the proposed reform avoids problems that have confronted Canadian policy makers. For instance, the intention is that labor pensions will be fully funded, avoiding many of the problems that demographic shifts have

caused among OECD plans established in the last century. Also, the assets that can be held in the reformed pension plan can include both bonds and equity. To avoid the potential problems of the government dominating the domestic securities markets, the proposed reforms allow the government to contract out the control of the investment decisions to private suppliers. Further, beginning in 2004, the individual Russian can, if he chooses, place his mandatory savings directly with a private supplier, also reducing the impact of any individual agency on the domestic market.

The one area the new pension legislation has not yet fully addressed is the structure of any voluntary pension plans similar to those of Canada's third pillar. While there is a program, professional pensions, that is similar to Canadian RPPs, there is not the corresponding RRSP type plan that encourages individuals to accumulate retirement savings outside of the firm or the mandatory labor pension plan. At least one reason that such a program has not been regarded as high priority is that, to operate and to attract contributors, there must be a set of financial institutions in place that offer these plans and whom potential investors trust. At present there is, unfortunately, virtually no trust in either private or public financial institutions. The central bank lost its credibility because of the inflation throughout the 1990's. This loss of credibility appears to be one of the principal motivators in the allocation of assets by Russian savers. If it were not, then capital flight would not be a problem, nor would there be the accumulation of foreign currency by average Russians of the magnitude that appears to be the case. As for the potential private suppliers of pension plans, the 1998 default that led to the collapse of roughly half of the private banks, plus the perceived lack of accountability by firm sponsored banks, has led to a general mistrust of the private financial system. Again, the evidence that Russians have a preference for foreign cash under the mattress to foreign currency denominated bank deposits provides at least anecdotal evidence of this distrust[26]. In such an environment it may be quite difficult to encourage any savings through voluntary pension plans. Putting any restrictions on the ownership of foreign property in such plans would increase this difficulty to an even greater degree.

Despite the pessimistic appraisal of the financial system by the average Russian, the proposed pension reform of pillar two provides some hope that voluntary pension plans can potentially play a role in the Russian environment. Indeed, they may serve as a vehicle to reinvigorate the entire financial system. While such an outcome may take a considerable length of time it could be shorter than many believe. One reason for some optimism is that the mandatory pension contributions will, over time, provide Russians evidence that, at least for some types of financial intermediaries, private suppliers can be entrusted with one's savings.[27] If the same institutions are

then permitted to provide voluntary pension plans, their record with mandatory savings may encourage individuals to use these voluntary plans as well. However, for such a scenario to unfold positively, there must be some opportunity for these institutions to provide reasonable portfolio returns to their contributors, and that will depend in large part on the legal restrictions imposed by the government on their portfolios.

There are, I believe, three actions that the government can do to encourage the development of voluntary pension savings, of which two of them draw on Canadian experience. The first of these, and probably most important is *not* to impose any limitations on the amounts of foreign property that can be held in these accounts. At the present time a large proportion of Russians choose to hold their savings in foreign currency earning a zero rate of interest in preference to domestic assets. Even offering a tax deferment on domestic assets is unlikely to induce a significant number to convert their "mattress savings" to these assets. If, on the other hand, an individual can place this foreign currency into income earning foreign currency assets, the investor must necessarily be better off, even if that income is ultimately taxed.

Under the current Russian pension structure pension contributions are effectively taxed and pension benefits are not. The second element to encourage use of the voluntary plans may be to defer taxes on contributions and tax the payments out of these voluntary accounts as is done in Canada. The reason for this is that it would provide an incentive for Russians to convert some of their privately held foreign currency into these accounts. To see this, consider a Russian saver who is just making ends meet and is now offered the opportunity to contribute to a voluntary, tax deferred, savings plan with no foreign property restrictions. If he contributes, he will actually receive a tax *refund* in the current year. Furthermore, he can make this contribution without actually cutting his consumption by transferring some of the US currency under the mattress into this account. Further, because of scale economies, the money in the registered plan likely will be invested in income earning foreign currency assets rather than barren cash. The consequence of doing so is, in effect, to provide a tax rebate to the individual for converting his foreign currency into income earning foreign currency assets. This income will be taxed in the future when the individual withdraws it from the registered account[28]. Furthermore, if, as in Canada, the amounts that can be contributed are linked to earned (and reported) income, it may actually induce some individuals to move out of the underground economy

The third element in structuring a voluntary pension system is to provide domestic financial assets that are an attractive substitute for foreign currency. In particular, one of the reasons that foreign currency is so attractive is that it serves, at least in part, as a hedge against domestic

inflation. In effect, they protect the individual from being exploited, either intentionally or unintentionally, by the State through central bank policy. If the government were to issue inflation indexed bonds that could be held in (both mandatory and voluntary) pension accounts, then there would be a domestically issued asset that protects against the same risks that foreign currency does. Furthermore, if the minimum pension guarantee is, in fact, linked to the price index, then including an explicit inflation linked asset in pension portfolios represents a low cost method of insuring that such guarantees will be little exercised.

5. Concluding Remarks

Over the last half century the Canadian pension and senior support system has evolved to a stage where Canadians are well served by it. The first pillar provides a secure social safety net; the second pillar, a partially funded mandatory pension plan; and the third pillar of voluntary saving plans serves the middle class extremely well. There are, of course, perceived problems: The social safety net for seniors can be better integrated with that for the working poor. Expansion of the second pillar might better be served by the private supply of those pension services. The contribution caps of the third pillar might be increased to be competitive internationally, and the foreign property rule can usefully be eliminated. Nonetheless, those problems are being addressed. Integration of the social safety net is occurring at present and the flexibility of the available programs has meant that there are fewer political problems than in many other countries. The RPP structure of pillar three can be easily adapted to serve as the privately supplied portion of the second pillar. There is an ongoing debate in the pension industry on how best to address the contribution limit issue, and the government is becoming more amenable to changing it. Finally, the foreign property rule is being phased out, with half the increase in the limit occurring in the last two years.

On the face of it, the Canadian programs for senior support are similar to those of other OECD countries[29]. The element that I believe stands out in the Canadian system is its flexibility. The change in OAS from the equivalent of a pillar two program available equally to all Canadian seniors to a means tested, pillar one program is one example. The ability of RRSP funds to be withdrawn without a penalty, prior to retirement, transforms it to a general capital accumulation plan from one dedicated only to retirement savings is a second that has had positive results. The ability to move the RPP structure to the second pillar is a third. In building a system, this flexibility is something that has much to commend it.

A structure to provide senior support is a long-term program that is meant to influence the decisions of persons long before they become seniors. Such long-term programs occasionally

tempt policy makers to use them to accomplish short-run objectives. These may compromise the longer term objectives of the original program. The flexibility of the Canadian programs has minimized the impact of these short-run compromises on the long-run objectives.

The Russians appear to have learned many of the lessons of Canada and other countries in undertaking the current pension reform. To date they have concentrated their efforts on providing a mandatory plan for all workers. Emphasis on the State's role in encouraging voluntary retirement savings plans similar to those in Canada have had a lower priority in part because of the absence of a viable financial structure that instills confidence and trust on the part of savers. Over time that trust will slowly return, especially if the mandatory pension savings plans perform in a satisfactory manner and the voluntary plan provides both the ability of the plan member to hold assets in the currency of his choice and/or that the State provides an attractive alternative to foreign currency assets. The ability to hold foreign assets is one of the lessons from Canadian experience, where the FPR has far outlived any usefulness it might have had. This foreign property rule appears to have persisted for ideological reasons rather than for any economic reason. It has been quite costly to Canadians saving for retirement and these costs have been borne by the Canadian worker. Its influence extends far beyond retirement products and has likely made Canadian mutual funds more expensive that they otherwise would be. If I were asked to indicate which element of the entire Canadian program for senior support was *least* desirable for Russia I would say it was this Foreign Property Rule. If Russian policy makers insist upon using pension savings plans to address balance of payments and exchange rate problems then, *at most*, requiring currency hedged positions in a portion of the mandatory retirement savings plans will accomplish that end with less cost on the Russian saver than would a foreign property limit. Further, imposing any requirement on *voluntary* savings plans appears to me to be self-defeating. Indeed not imposing such restrictions on these plans should initially mean that barren foreign currency holdings held outside the plan will be drawn into such a plan and will ultimately have a positive impact on the current account and on tax revenue for the government. I would further argue that the basic problem that is causing any capital flight is the credibility of the Central Bank. Because central bank policy can completely destroy the real value of any retirement saving undertaken that credibility is essential if savers are to become willing to hold ruble denominated assets and not pay a premium for foreign currency assets. If policy makers want greater holdings of domestic assets in these savings plans, they must offer assets that are at least as attractive as foreign assets. One way to do that is to issue price indexed bonds. These can be available to all savers or, at a minimum, to pension savings plans.

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Endnotes

1. Those with incomes between these two values receive proportionately less than the maximum.

2. The effective payroll tax is the sum of the worker's and firm's contribution, of which the firm pays half.

3. The QPP, on the other hand permitted wquity investments through its pension are, the Caisse de Depot et Placement.

4. Contributions to these plans are deductable from taxable income but are included in taxable when withdrawn from the plans.

5. Fried and Wirick (1999), The estimate for RRSPs was $380 billion.

6. Currently over 50% of Canadians have some direct or indirect exposure to the equity market.

7. In some provinces, as initially structured, all monies remaining in these Life Income Funds when the agent turned 80 had to be converted to an annuity. That specific requirement is no longer operative as newer income products provide essentially the same conditions as a LIF but

without that requirement.

8. No more than 10% of the pension monies can be allocated to the firm's equity.

9. However, it is applied on the plan level for RPPs but on the individual level in RRSPs.

10. Indeed, there is now a "clone" program that is used specifically for education expenditures.

11. As a final remark on some of the tax implications, it should be noted that, given that Canada does not tax "housing services" from owner-occupied homes and, unlike the U.S., does not allow interest rate payments on mortgages to be tax deductable, then paying off mortgages and/or consumption loans provides exactly the same tax advantages as putting money into these tax deferred programs.

12. This draws heavily on the recommendations of the Association of Canadian Pension Managers (1999) to improve the Canadian system.

13. If the OAS program was meant to serve those not in CPP/QPP, it would have to continue at least 20 years beyond the start of those programs. But given the universality requirement, that would mean 20 years of seniors drawing both CPP and OAS and these pensioners will regard OAS as their entitlement despite the government's assumed intention to use it to assist those not on CPP. Removing programs from seniors who view them as entitlements can be politically very difficult indeed.

14. If these assets are hedged into Canadian dollars then, as I will argue below, there would not by any exchange rate pressure from doing so.

15. Caps to similar programs in the US and UK are roughly twice that level.

16. See Fried and Wirick (1999).

17. Futures contracts on foreign equities, when backed with Canadian securities, allow a pension fund to participate fully in the foreign equity market but not hold any wealth as foreign property. This is because the futures contract is a promise to buy in the future that does not entail holding any foreign assets now, and can always be liquidated without taking delivery of any foreign assets. More recently the same principle is being used on actively managed foreign funds using a Canadian third party to hold the foreign property and enter a forward contract between that party and the pension fund. These roundabout transactions are, of course, more costly to the saver or pension fund.

18. See Burgess and Fried (1999).

19. These are almost 50% at the margin for many of those using these voluntary programs

20. Furthermore, if the tax rate is not progressive, then the government would be sacrificing the fairness and the capital accumulation abilities of a consumption tax by not deferring.

21.In the case of Russia, with its less developed financial markets, a similar exercise might be to use these incentives for investments in owner-operated small businesses.

22.The same issue would hold true in Russia: If anything, the premium on government debt relative to private debt is likely greater than in Canada and, as a result, it would be welfare reducing to restrict pension portfolios to government debt.

23. Individual RRSP members also have the ability to avoid the regulation, but at significantly greater cost.

24. If, instead of the individual, a fiduciary such as the firm or a financial intermediary makes the portfolio choice, the same result occurs.

25. *Anticipated* changes in the price level are not a problem because of the interest rate parity condition: the futures contract will reflect the anticipated inflation rate/ exchange rate change imbedded in interest rate differentials.

26.The one exception to this distrust appears to be of Sberbank, the government run savings bank, which accounts for at least 70% of the deposits in the banking system.

27.This, of course, supposes that those private suppliers act in a manner that would justify such trust.

28. It is also quite possible that the present value of tax receipts will, in fact, increase because the "mattress" assets generated no tax revenue whereas the interest income on the plan assets will ultimately be taxed.

29. See, for example, Gollier (2000).