The Right and Wrong Ways to Reform Pensions in Russia

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Introduction

The past decade of economic reform, or what has been labeled "economic reform," has taken a terrible toll on the Russian economy and the Russian people. None have suffered worse than Russia's elderly who have seen their pension benefits paid late and paid in rubles of declining real value. The first eight years of economic reforms left average pension benefits at the subsistence level. The last two years lowered them by another third. Bad advice, bad policies, bad enforcement, bad behavior, and bad luck all share the blame for the miserable state of affairs. Unfortunately, the situation could get worse if Russia squanders the opportunity to reform properly its financial institutions, including its pension system.

For an foreign economist, even one with a Russian name, to offer advice to Russians, after they've had more than their fill of outsiders' advice, is a sign of hubris for which I apologize in advance. But my views are, I believe, both more radical and more practical than those that have been offered by others. So maybe they're worth hearing.

A Vision

Let's imagine a world that the vast majority of Russians should, upon reflection, welcome and then ask what it would take to get there. In this world Russian tax rates are so low that collecting them is not a problem. In this world the Russia government doesn't print money to pay its bills and inflation is a thing of the past. In this world companies can set up shop in Russia in the course of a few minutes, rather than spend months dealing with red tape. In this world international competition eliminates the power of domestic monopolies and oligopolies and lowers the prices of goods and services facing Russian consumers to world levels. In this world Russians can cheaply and easily invest anywhere in the world they wish and bank, buy insurance, and purchase securities with any company, domestic or foreign, they'd like. In this world Russians can transact and pay their taxes in Euros or Dollars. In this world Russian pensions are safe because they are invested in financial securities all around the world. In this world the Russian economy is fully open to international trade and investment. In this world foreign companies can own whatever percentage of Russian companies they want and are eager to invest in Russia. In this world Russians understand that foreign ownership of a Russian company is effectively the reverse because it means that foreigners will pay Russians workers most of their revenues in the form of wages and pay the Russian government a significant share of what is left in the form of corporate income taxes. In this world Russia's elderly are not starving.

Achieving the Vision

This is a radical vision, but achieving it entails policies that are much less radical than cutting the living standards of ordinary Russian retirees by the magnitudes they've endured. President Putin's recent income-tax reform is a sign that the Russian leadership is ready to take the bold steps needed to rescue the economy. The income-tax cut just enacted is impressive, but still leaves Russian workers facing extremely high combined income, payroll, and value-added tax rates. Pension reform, to which I'll turn below, is a vehicle for dramatically lowering total effective tax rates on labor supply, but only f it is done right.

How can the rest of the vision be implemented? Here are some initial steps: Permit full foreign ownership of Russian companies. Permit foreign banks, insurance companies, and mutual funds to operate in Russia as branches rather than as registered (in Russia) subsidiaries of their parent banks, so they are subject to foreign supervision and regulation. Require all banks, whether domestic or foreign to purchase deposit insurance. Recognize the Dollar and Euro as legal currencies, and use Russia's foreign currency reserves to retire outstanding Rubles. This dollarization/euroization will eliminate inflation in Russia, close down the central bank, and put an end to the government's practice of printing money as a substitute for collecting taxes. Cut or eliminate all remaining tariffs and export taxes. Outlaw barter arrangements. Adopt U.S. or EU accounting practices, commercial codes, and bankruptcy law so that operating a company in Russia is no different from, and no more difficult than, operating in the U.S. or the European Union. Establish special courts to protect shareholder and creditor rights and to revolve bankruptcies. Set up on-line registration of new businesses so that the process takes only a few minutes, whether you are a Russian or a foreign citizen.

Am I Crazy or Just Naïve?

No doubt some World Bank or IMF staffer will read the above and conclude that I'm either crazy, naïve, or both. "Russia," they'll say, "is not Luxembourg. It's not ready or able to open up to the rest of the world. It already tried that and failed. No one wants to invest in Russia after it defaulted on its bonds and the banking system collapsed. No one trusts Russian courts or the government. Russia needs to develop its own financial institutions. It needs to keep its savings at home. It needs to find its own way. It needs to follow our advice."

Fortunately, I'm old enough not to care what anyone thinks of me (except my wife). But I hope the World Bank and IMF staffers reading this are young enough to care about my view of their views. The fact is that Russia has not tried to open its economy to international trade and finance to the degree I'm proposing. A second, and more important fact is that rapid economic growth requires massive amounts of foreign investment. The amount of domestic investment that Russia can mobilize based on its own national saving is a pittance compared to the amount it needs and the amount the rest of the world can provide. Having been badly burnt once, foreign investors won't come again unless they can control the companies in which they invest, know that they can operate as they do at home, realize that they will earn their Russian income in a currency they trust, face tax rates and tax collectors that are reasonable, and be able to repatriate their earnings when and as they like.

The third fact is that ordinary Russians won't begin investing in Russia until they see foreigners doing so. They also won't pay their taxes until the rates make sense and the penalties for non-compliance are clear. They won't deposit their savings in the banking system until it has international owners who they trust and a system of deposit insurance on which they can rely. They won't buy shares in Russian companies without shareholder protection. They won't purchase bonds from Russian companies without creditor protection. And they won't lend money to the Russian government until it has its fiscal and monetary houses in order.

In short, Russia has no alternative but to adopt the policies I'm proposing. Doing so would revolutionize foreign perceptions of the Russian government and its economy. Imagine the headlines were Russia to announce it was selling the government's controlling shares of Gazprom to the highest foreign bidder, that it was making the Dollar and Euro legal currencies, that it would no longer use the printing press to pay its bills, that it was inviting foreign banks, insurance companies, and mutual funds to operate branches throughout Russia and was, thereby, importing the world financial market (rather than trying to construct its own), that it was making further large cuts in tax rates, that it was outlawing barter, starting with state-owned enterprises, that it was dramatically cutting tariffs and export taxes, that it was letting and, indeed, helping Russians diversify their assets internationally, that it was phasing out its existing pension system and replacing it with a modern system of individual accounts, and that it was going, at long last, to play by international rules.

The Russian Pension Debacle

Let me now turn to the issue of restructuring Russia's pension system and indicate why implementing the above vision is critical to a successful reform. The Russian pension system is a mess. It not only delivers extremely low benefits, it also pays for them by levying an exorbitant payroll tax that costs workers more than a quarter of what they earn. Benefits are provided independent of contributions, so no one has an incentive to pay the taxes he or she owes. Since few employees and fewer of the self-employed pay their proper taxes, the rate needs to be very high to collect the necessary revenue.

As bad as things are, they are projected to get much worse. By 2050, Russia will be one of the oldest countries in the world, with only one worker for each retiree. Today there are three workers per retiree. Crude arithmetic suggests a tripling of the payroll tax if the current system is maintained and benefits grow with real wages. Of course levying an 87 percent payroll tax rate would be economic suicide. But cutting real benefit by two thirds is no solution either unless there is a very major private retirement benefit to replace the public one.

Private vs. Government Pension Contribution Rates

Before discussing how to get out of the current dilemma, let's contrast the current (employer plus employee) 29 percent payroll tax rate being used to finance the Russian state pension with the share of wages that workers would need to save on their own to finance their retirements, by which I mean being able to have the same living standard after retirement as before. In calculating the required saving rate, let's consider a 25-year old couple with two children. The couple plans to retire at age 62 and will experience a modest 1 percent per year real earnings growth through age 45. The couple plans to purchase a modest flat in five years and wants to accumulate an emergency fund at retirement equal to one year's earnings. Finally, assume that the couple earns a real return of 6 percent on its saving and can purchase an actuarially fair annuity at retirement. A 6 percent real return appears to be well below the market-weighted average annual real return on stocks and bonds sold in the major stock and bond markets around the world.

Given these assumptions, how much of its earnings does the couple need to save each year to maintain its living standard through retirement? The answer is 7 percent.[1] Thus to secure the retirement income of its current young workers, all the Russian government need do is have them contribute 7 percent of their annual earnings to a world-wide market-weighted index fund of stocks and bonds whose return is paid out in the form of an inflation-indexed pension. The fact that the 7 percent required contribution rate is miles below the actual 29 percent payroll tax rate is testimony to the size of the government's unfunded pension liability and its difficulty in collecting taxes.

The Transition Finance Question and the Other Envisioned Reforms

The transition finance question is how to come up with the 7 percent of pay needed to fund the proposed private accounts. An answer is to cut payroll tax rates by 7 percent, have workers invest these funds in the world-wide index fund, and have the government borrow to make up the loss in revenues. That sounds fine except for two problems.

First, the government will, in the future, have to raise taxes or cut expenditures to be able to repay not only the amount it borrowed, but also interest on the borrowing. Since the end goal is permanently cutting, not raising, payroll tax rates, and since the government has little leeway in the rest of its budget, there seems to be but one solution -- dramatically reducing the future state pension benefits paid to current young workers *relative to what they might otherwise have hoped to receive.* Note that if the economy grows, achieving this very large *relative* benefit cut can be accomplished by simply

[1] This calculation was made using Economic Security Planner (ESPlanner), a financial planning software package I co-developed with Jagadeesh Gokhale and B. Douglas Bernheim.

keeping pension benefits constant at their current real values and letting them become smaller and smaller compared to the pre-retirement wages of successive generations of retirees. This, of course, assumes significant growth in Russian real wages.

Is a dramatic reduction in their future government pension replacement rate something current workers would accept? Yes, if they are given something in exchange of greater value, namely cheap, easy, and safe access to the world capital market. If, on the other hand, Russian workers are forced to invest solely or primarily in highly risky domestic assets, including government bonds, they may well prefer to keep the existing system with all its problems.

The second question about government borrowing is who will lend. If the government forces the workers themselves to lend to it their private-account contributions, the entire enterprise will look like a shell game in which the government has simply relabeled "payroll taxes" as "retirement account contributions." So forcing workers to make these loans is a non-starter.

What about foreign loans? The ability of the government to secure foreign credits depends on the degree to which it a) implements the other policies outlined above and b) passes legislation that phases out the current public pension benefits over time, if not in absolute terms, then at least relative to the prior earnings of successive sets of new retirees.

What About the Currency Risk In Investing Abroad?

If Russia dollarizes/euroizes, as here proposed, its workers will face no major currency risk from investing abroad since there will be no Ruble to appreciate or depreciate in real terms. If the government maintains the Ruble, investing abroad would still be highly desirable since it represents a hedge against terms of trade and other shocks affecting the Russian economy; i.e., when the Russian economy does relatively poorly and workers' incomes fall, foreign currencies will appreciate vis-a-vis the Ruble, providing Russian workers with a capital gain on their foreign assets.

What About Capital Flight?

The key to making pension reform work is outgrowing the current system. And the key to outgrowing the current system is increasing foreign investment in Russia. In letting its workers invest abroad the Russian government will be saying in very clear terms that investment in Russia is a two-way street. Money can come in and also go out. This is what foreign investors need to hear and see. If Russia adopts my proposed pension reform and the other policies I advocate, the problem will be too much capital inflow, not too little.

This is not fantasy. With few exceptions, countries that have developed rapidly have done so by importing sizable shares of their capital and technology from abroad. We saw this is Korea, Thailand, Malaysia, and other Southeast Asian countries in the 60s, 70s, and 80s. We see this today in mainland China, which is importing capital from and through Taiwan and Hong Kong, and in Chile and The Czech Republic, which have, in recent years, complained of being overwhelmed with foreign investment.

To sense the size of the potential foreign capital inflow, consider the fact that the current market value of the entire Russian stock market is less than that one medium-sized international corporation. That fact should, by itself, make clear the risks involved in forcing Russian workers to invest only in Russia as well as the scope and need for foreign investment in this massive country.

What Are the Alternatives?

Are there any good alternatives to what I'm proposing? I don't believe there are. The World Bank offers two models: its Chilean three-pillar system and a notional defined contribution account system. One is worse than the next.

The World Bank's three-pillar model institutionalizes, in its first pillar, a large-scale pay-as-you-go system by setting up a minimum pension benefit that has, in practice, been set at very high levels relative to wages. Paying this benefit not only means locking in high payroll tax rates forever; it also means that much of a workers' old-age income is unrelated to, or only loosely related to, their past contributions. This generates a large work disincentive, which is one of the key problems pension reform is meant to solve.

The Bank's second pillar entails payroll tax cuts and equal-sized contributions to private accounts in competing private pension companies. The private pension companies then invest the vast majority of their assets in government bonds. This is worse than a shell game because the workers have to pay their pension companies for the honor of handing the same wages to the government the workers were previously handing the government on their own. What's more, its not clear whether the cuts in projected benefits provided by the old systems that occur as part of these reforms is sufficient, in present value, to cover the reduction in payroll tax revenue. Stated differently, it's not clear how the debt the government issues, and forces the pension funds to buy, will be serviced. Because the first pillar is such a killer and the second pillar looks like the same old tax, just dressed with different words, workers are unlikely to have any spare funds to contribute, on a voluntary basis, to the Bank's third pillar, the voluntary pension system.

The Bank's notional defined contribution alternative leaves out private accounts on the grounds that the domestic financial market is not sufficiently developed to support such a system. This, of course, ignores the world financial market and tells the developing country that, even though they are part of the world and have the same right as any other country to use the world financial market, they won't be allowed to do so.

While the notional defined contribution system offers some automatic adjustments for lifespan extension and provides much tighter linkage, at the margin, between contributions and ultimate benefits, it locks pay-as-you-go finance in place for the indefinite future. The reason is that benefit levels are set relative to wages, so as the economy grows, so do the country's unfunded pension liabilities. The result is very high payroll tax rates, with their major labor supply disincentives, for as far as the eye can see.

What Are the Specifics?

The specifics of the pension plan I recommend are provided at the end of this paper. They include features that protect non-working or low-earning spouses, that help the poor, that protect the disabled, that lower the costs of investing, that limit the risk in choosing when to annuitize accumulated assets, that provide survivor benefits for those who die young, and, most importantly, that eventuate in a zero long-run payroll tax rate.

Conclusion

Pension reform, if it is to be successful, can't be done in isolation. It needs to be accompanied by major policies that foster economic growth and that restore international confidence in the Russian economy and its policymakers. Opening up the economy fully to international trade and investment, utilizing the international financial market, adopting a sound currency, rationalizing the tax structure, eliminating the red tape facing new companies, demonstrating that Russian capital flows are a two-way street, and giving workers cheap, easy, and safe access to the world capital market in exchange for their claims on the current bankrupt state pension system – all this is the path ahead.

In contrast, preventing full foreign ownership of domestic assets, maintaining existing trade barriers, trying to rebuild one's own banking, insurance, mutual fund, and regulatory systems, investing exclusively at home in government bonds and in a limited number of Russian companies, continuing to print money whenever convenient, and letting the pay-as-you-go system grow with the economy – all this is the sure path to continued Russian economic misery.

The Russian Personal Security System (PSS)

- A Framework for Reforming Russia's Public Pension System

- ***The 29 percentage-point payroll tax used to finance Russia's public pension system is reduced immediately to 22 percent.***

- ***Workers contribute 7 percent of their earnings (up to a ceiling) to PSS accounts.***

- ***Married workers' PSS contributions are shared 50-50 with their spouses, so that each spouse has an equal-sized PSS account.***

- ***The government matches PSS contributions on a progressive basis to help the poor.***

- ***PSS balances are invested by an established, international investment company, chosen through a competitive bidding process, in a world-index fund which holds all the equities and debt instruments being traded in established international financial markets in proportion to their share of the valuation of the world's financial market.***

- ***The PSS establishes individual PSS accounts for each worker and sends each worker quarterly statements. The PSS accounts represent private property. Contributions to PSS accounts are not subject to income taxation, but withdrawals from PSS accounts are taxable.***

- ***Starting at age 57 and continuing for 10 years, PSS balances are gradually annuitized on a cohort-specific and inflation-protected basis. At age 62 workers begin receiving annuities*** *from account balances annuitized prior to age 62. Between age 62 and 67 workers receive additional annuities each year based on that year's annuitization of remaining account balances.*

- *Workers who die prior to age 67 bequeath their non-annuitized account balances to their spouses, children, or other designated beneficiaries.*

- *The government makes contributions to the PSS accounts on behalf of disabled workers.*

- *The government contributes 7 percent of all unemployment consumption to the accounts of unemployed workers.*

- *Current retirees receive their full current public pension benefits. These benefits are indexed against inflation.*

- *Current workers receive, upon retirement, a real monthly benefit from the existing public pension system that is declining share of their pre-retirement earnings, where the fraction declines to zero over successive sets of retirees.*

- *Payment of public pensions during the transition is financed by a) the ongoing 22 percent payroll tax, b) financial assistance from the World Bank, the IMF, and other international lenders, and c) government domestic and international borrowing.*

- *Actuarial calculations are prepared showing that the present value of the ongoing 20 percent payroll tax will suffice to cover the present value of the ongoing benefit liability of the old system. These calculations will also show when the 20 percent payroll tax rate will be terminated.*