A TALE OF TWO COUNTRIES: RUSSIA AND THE UNITED STATES FACE PENSION REFORM

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Russia and the United States are facing similar demographic pressures, leading to a reevaluation of traditional government-run pay-as-you-go (PAYGO) old-age pension programs. Russia's problems are more acute and have already led to a major default on benefits, while in the United States, small changes in taxes and benefits have preserved the system's solvency so far. But in both countries, PAYGO systems are ultimately unsustainable and should be replaced by fully funded systems based on savings and investment.

Russia's Crisis

The Russian population is among the most rapidly aging in the world. The population age 60 and older has more than doubled since 1960. Pensioners now make up more than 19 percent of the population.[1] This changing demographic has put an enormous strain on Russia's existing pension system.

That system is a traditional PAYGO system, not a savings or investment system, but a simple transfer from workers to retirees. The payroll taxes from each generation of workers are not saved or invested for that generation's retirement, but are used to pay benefits for those already retired. The current generation of workers must then hope that when their retirement comes, the next generation of workers will pay the taxes to support their benefits, and so on. If all other things remain constant, this type of system can provide benefits that grow roughly at the rate by which the overall economy grows.

[1] "Russia Badly Needs Pension Reform," World Bank Transition Newsletter, Jan/Feb 2003. The aging of the population comes despite declines in Russian life expectancy, due largely to a dramatic decrease in birth rates.

Unfortunately, as we have seen, other things are not remaining constant. The ratio of workers to retirees is shrinking rapidly, placing an ever-growing burden on workers. As recently as 1990, there were 2.28 workers for every retiree. Today there is only 1.78. Within 20 years, there will be only one worker paying taxes to support every worker who is retired and receiving benefits.[2]

Today the pension portion of the Russian payroll tax is as high as 28 percent of wages.[3] This makes the payroll tax in Russia, as in the United States, the largest tax faced by the average worker, a significantly greater burden than traditional income taxes. However, many Russian workers may not be aware of the magnitude of the burden they face, because, as a carryover from the Soviet system, the payroll tax is assessed entirely against the employer. In reality of course, most economists agree that the worker ultimately bares the cost of such taxes through lower wages or other forms of compensation. Still, in the short term, the allocation of taxes creates two problems. It reduces work agitation for reform. And, it creates an enormous incentive for evasion and noncompliance by employers. The gap between official and actual contribution rates is huge, adding to the system's funding problems.

Despite this high tax rate, benefit payments have repeatedly been reduced or suspended. The crisis came to a head in 1998, by which time the program was in arrears by an estimated 30.5 billion rubles.[4] This backlog was eventually paid off, but primarily

[2] "Privatization Looms: Pensions in Russia Start Saving," *The Economist*, August 27, 2003

[3] United States Social Security Administration, Social Security Programs Throughout the World: Europe (Washington: Social Security Administration, 2002), pp. 172-176.

[4] A. Kuznetsov and O. Ordin, "Pension Reform in Russia: A General Equilibrium Approach," Economic Education and Research Consortium, 2001.

at the cost of slashing benefits. In fact, the average replacement rate fell from 36 percent of pre-retirement wages to 28.5 percent.[5]

Today, the Russian pension system runs a small surplus. But solvency is not sustainable. Given the future one to one worker-to-beneficiary ratio, payroll taxes would ultimately have to increase to as much as 65 percent of wages.[6] The portion of Russian GDP being consumed by pension payments would double, from roughly 5 percent today to more than 10.3 percent.[7] Clearly the program's unfunded liabilities are extraordinary, well beyond the ability to fix through the traditional methods of tax increases or benefit cuts.

Other Problems of PAYGO Systems

While the fiscal unsustainability of Russia's pension program has clearly been the chief motivating factor behind the program's reform, there are other problems with PAYGO Social Security systems that also need to be considered.

For example, in both countries, Social Security taxes are already so high relative to benefits, that Social Security has quite simply become a bad deal for younger workers, providing a low, below-market rate-of-return. This poor rate of return means that many young workers' retirement benefits are far lower than if they had been able to invest those funds privately. Estimates put the rate of return for a 40 year-old Russian worker at

[5] Mikhail Egonovich Dmitriyev, "Should the Pension Reform Program be Changed?" Carnegie Moscow Center, 2003.
[6] S.A. Afanasiev, "Pension Reform in Russia: First Year of Implementing," Institute for Economic Research, Hitotsubashi University, Tokyo, Japan, 2002.
[7] Nikolai Roussanov, "Russian Pension Reform," National Bureau for Economic Research, January 10, 2001.

between 1.8 and 2.7 percent.[8] This is far less than the return that could be earned through private investment in world capital markets. Indeed, Laurence Kotlikoff of Boston University estimates that if Russian workers were able to invest just seven percent of their wages in a world-wide, market-weighted index of stocks and bonds receive better benefits than can be provided by the current Russian retirement system.[9]

The current low rate of return translates directly into low benefits. The minimum Russian pension now provides only about 79 percent of the sustenance level.[10] Low-income workers, who rely heavily if not exclusively on state-provided pensions for their retirement are therefore among those most disadvantaged by PAYGO retirement programs.

Perhaps most importantly, under a PAYGO system workers have no actual ownership or other legal right to their pension benefits. Their benefits are ultimately dependent on the decisions of politicians and can be changed, reduced, or taken away at any time. The Russian default of 1998 is certainly testimony to that. Additionally, because workers have no property right to their benefits, those benefits are not inheritable. As a result workers who die young are prevented from passing their "savings" on to their heirs. In this context, it is worth noting that the life expectancy of Russian men is now a year less than the retirement age.[11]

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[8] Evsey Gurvich, "The Distributional Impact of Pension Reform in Russia," New Economic School Working Paper, 2002.

[9] Laurence Kotlikoff, "The Right and Wrong Ways to Reform Pensions in Russia," National Bureau of Economic Research, December 1, 2000.

[10] Ibid.

[11] "Pension Reform in Russia: A New Stage," *Johnson's Russia List*, July 31, 2003.

Russia Faces Its Crisis

With the collapse of its PAYGO system in 1998, Russia was forced to reexamine the basic structure of its retirement system. While benefit reductions succeeded in restoring the program to temporary solvency, more fundamental reforms were clearly necessary. As a result Russia began to transition from its PAYGO system to a funded system.

As mentioned earlier, the pension portion of the Unified Social Tax (UST) was 28 percent of wages.[12] However, as of January 2002, that amount was split into two parts, both administered by the State Pension Fund (SPF). Half (14 percent of wages) is used to provide a basic pension, a flat rate amount designed to provide basic retirement income. The other half provides for a "mandatory insurance pension," split between an "insurance pension," and a "funded pension." The insurance portion continues to be funded on a PAYGO basis, although it establishes notional, or unfounded, accounts for workers. The funded portion provides a defined contribution benefit based, at least in theory, on investment in real capital assets. The ratio of insurance to funded pension depends on a worker's age. Workers born prior to 1956 do not participate in the funded program. Workers born between 1957 and 1966 pay two percent of wages into the funded system, and 12 percent into the insurance system. Workers born after 1966, pay six percent into the funded system, eight percent into the insurance system.

[12] The overall Unified Social Tax, including health and other provisions, is 35.6 percent of wages. "Main Features of Russian Pension Reform," PIO Global Asset Management, 2003.

Initially, the money invested through the funded system was to be managed by the SPF itself. However, beginning in January of this year, workers could choose to have their funds managed by the private sector.

However, implementation of the new program has been hampered by bureaucracy and resistance from some officials within the government.[13] In particular, workers have not been educated about the new system, and in many cases have not been informed about their option to have a portion of their funds managed privately. In addition, few private companies have been licensed to manage the funds. Officials are also seeking to limit the number of banks that can participate in the program.[14] As a result, only about 700,000 Russians have chosen the private option, out of some 38 million eligible workers.[15] Still, officials remain optimistic, predicting that as many as 3 million workers will switch in the next few months.[16]

Next Steps

Conceptually, Russia is on the right track. It has recognized the basic flaw of PAYGO Social Security and begun transforming its pension program, at least in part, to a funded system. Further, it has begun to allow individuals to privately invest a portion of

[13] Dmitri Dokuchaev, "Pension Reform: First Stage Completed," *Moscow News*, December 30, 2003. The Ministries of Finance and Economic Development appear to be particularly reluctant to implement pension reform, delaying needed regulations and sometimes even disregarding statutory law. The officers of the State Pension Fund have also been less than helpful.

[14] "Pension Funds Head Does not Want to Transfer Savings to Private Companies," *Russia Daily Journal*, February 5, 2004.

[15] Vremya Novostei, "Private Companies Obtained Minor Part of Russians' Pension Accruals," *Economic Press Review*, February 3, 2004.

[16] "Russians Ignore Pension Reform," *News From Russia*. http://www.gateway2russia.com/st/art_205531.php.

those funds through individual accounts. This actually places Russia ahead of the United States on the road to pension reform. But the reforms are far from complete.

First, the Russian government must actively and aggressively act to remove regulatory and bureaucratic impediments to pension reform. As part of this, workers must be made fully aware of their options and of the benefits of private investment. This education process should focus not just on the mechanics of shifting funds, or even on the higher returns and benefits that can be earned through private investment, but should let Russians know of the advantages and independence that comes with ownership and accumulation of wealth. One of the primary reasons for the success of pension reform in Chile was the public education conducted by Jose Pinera during the reform debate.[17]

In addition, while in the absence of overall banking reform, some regulation of proposed money managers is necessary, to the degree practicable there should be open market access for banks and other institutions that wish to manage workers' funds. Regulatory foot dragging to the licensing of such institutions should cease. Proposals to limit the number of participating banks should be scrapped.

Continued SPF management of the funded portion of the pension program is undesirable for several reasons. First, SPF has heavily invested its assets in government securities of the Russian Federation and its constituent members.[18] This actually undercuts the goal of having a funded system, since government securities do not represent an actual asset of the government, but merely a legal claim against future tax revenues.

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[17] Jose Pinera, *El Cascabel al Gato* (Santiago: Editorial Zig Zag, 1991).
[18] Afanasiev, "Pension Reform in Russia."

In many ways, the SPF is creating a system analogous to the United States' Social Security Trust Fund. Surplus U.S. Social Security taxes are used to purchase government bonds, which are held by the Trust Fund, and are theoretically available to pay benefits. In reality, however, those bonds will eventually have to be repaid by taxpayers. As the Clinton administration's fiscal year 2000 budget message explained it:

> These [Trust Fund] balances are available to finance future benefit payments and other Trust Fund expenditures—but only in a bookkeeping sense. …*They do not consist of real economic assets that can be drawn down in the future to fund benefits.* Instead, they are claims on the Treasury that, when redeemed, will have to be financed by raising taxes, borrowing from the public, or reducing benefits or other expenditures. The existence of large Trust Fund balances, therefore, does not, by itself have any impact on the Government's ability to pay benefits.[19]

Despite this, even the bond-invested portion of the Russian system remains superior to the U.S. Social Security Trust Fund and to the insurance pension since it establishes a property or legal right on behalf of the beneficiary. Thus, workers are better off, even if the government has not actually solved its funding problem.

Having the SPF invest more heavily in shares of Russian companies would not necessarily be a wise move either. Investing in capital assets other than government bonds would help solve the long-term financing problem, since presumably the increased supply of private capital would lead to an increase in private investment and therefore economic growth. However, allowing the SPF to acquire additional shares of Russian companies raises significant questions of corporate governance, government control of industry, and government interference in the marketplace.

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[19] Executive Office of the President of the United States, Budget of the United States Government, *Fiscal Year 2000*, Analytic Perspectives, p. 337.

It is far better, therefore, that funds be managed by the private sector. Moreover, restrictions on the types of investment allowed by private sector managers should be considerably loosened. In particular, the limit on investment in foreign owned companies and indexes should be raised or eliminated.[20]

Second, the size of the private investment accounts should be rapidly increased, eventually phasing out the insurance pension altogether. Ultimately a worker's entire retirement income should be provided through individual accounts, although there may be reason to leave some elements of the basic pension in place as a welfare "safety net." On the other hand, the "insurance pension" is particularly problematic. The "notional" links between benefits and contributions is tenuous and the program continues to operate on a PAYGO basis. Given demographic realities the program will ultimately require large subsidies from the government's general revenues, or it will be forced to reduce benefits.

To the degree that the more rapid shift to a funded system increases short-term "transition costs," those costs can be financed through a number of mechanisms, including a) the ongoing portion of the payroll tax; b) general revenue transfers financed through reductions in expenditures by other areas of government; c) financial assistance available from the World Bank and other institutions; and/or domestic or international government borrowing.

Finally, Russia must move forward with reforms in other segments of its economy and legal system. As Nikolai Roussanov, a former advisor to the Duma, currently with the University of Chicago, has pointed out, "Without full protection of property rights,

[20] Currently foreign investment is limited to 5 percent of assets managed, rising gradually to 20 percent by 2010.

well-functioning courts, prudential oversight and necessary financial market regulation, even the most well-designed pre-funded system will be a disaster."[21]

The United States: Crisis on the Horizon

Although the United States Social Security system has not yet reached the crisis situation that Russia faced in 1998, the storm clouds are gathering on the horizon. The same demographic factors that toppled Russia's pension program will eventually overtake the U.S. system. In 1950, there were 16 workers for every retiree; today there are 3.3. Within 20 years there will be roughly two.[22]

Therefore, while the U.S. Social Security system is currently running a surplus, that surplus will turn into a deficit within the next 14 years.[23] That is, by 2018, Social Security will be paying out more in benefits than it takes in through taxes. In theory, Social Security is supposed to continue paying benefits after 2018 by drawing on the Social Security Trust Fund. The Trust Fund is supposed to provide sufficient funds to continue paying full benefits until 2042, after which it will be exhausted. At that point, Social Security benefits will have to be cut by approximately 27 percent, nearly as large a reduction as that seen by Russian pensioners.

However, as noted above, the Social Security Trust Fund is not really an asset that can be used to pay benefits. Any Social Security surpluses accumulated to date have been spent, leaving a Trust Fund that consists only of government bonds that will

[21] Roussanov, "Russian Pension Reform."
[22] The 2003 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, Social Security Administration, (ftp://ftp.ssa.gov/pub/OACT/TR/TR03/tr03.pdf).
[23] Ibid.

eventually have to be repaid by taxpayers. Therefore, within a very few years, the United States will find itself unable to meet its existing Social Security obligations. At that point it will face the very unattractive prospect of raising taxes to near Russian levels (the current Social Security payroll tax is 12.4 percent of wages. It would have to rise to more than 18 percent to maintain Social Security's solvency) or significantly reducing benefits.

In the United States, the rate-of-return for an average worker today is barely two percent.[24] This low rate of return translates to low benefits, especially for low-wage workers. One out of every eight American retirees lives in poverty despite Social Security.

The United States has also seen reductions in benefits, increases in the retirement age, etc., most recently as a result on the 1983 Greenspan Commission. The lack of property rights in Social Security benefits was explicitly delineated by the U.S. Supreme Court in the case of *Flemming v. Nestor*, in which the court stated, "To engraft upon Social Security a concept of 'accrued property rights' would deprive it of the flexibility and boldness in adjustment to ever changing conditions which it demands." That decision built on a previous case, *Helvering v. Davis,* in which the Court had ruled that Social Security is not a contributory insurance program, stating that "the proceeds of both the

[24] Orlo Nichols, Michael Clingman, and Milton P. Glanz, "Internal Rates of return Under the OASDI Program for Hypothetical Workers," Social Security Administration Actuarial Note no. 144, June 2001.

employer and employee taxes are to be paid into the Treasury like any other internal revenue generally, and are not earmarked in any way."[25]

Political Gridlock

Because the United States Social Security system has not yet reached the degree of crisis experienced by Russia in 1998, U.S. politicians have been much slower to address the problem.[26] Despite warnings from various academic experts, presidential commissions, and the trustees of the Social Security system itself, the program remained extremely popular, especially among senior citizens who vote in disproportionate numbers. Most politicians regarded the program as—in the words of Tip O'Neill former Speaker of the U.S. House of Representatives—"the third rail of politics."[27] Touch it and your political career died.

However, in recent years, the political landscape has changed, with younger workers in particular far more skeptical of Social Security and willing to discuss changing it. President Clinton launched a very high profile debate on the issue in 1998, holding discussions around the country, and warning that the system was unsustainable in the long run. Further, President Clinton pointed out that there are only three ways to keep

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[25] Flemming v. Nestor, 363 U.S. 603 (1960). For a fuller discussion of this issue, see Charles Rounds, "Property Rights: The Hidden Issue of Social Security Reform," Cato Institute Social Security Paper no. 19, April 19, 2003.

[26] The closest that the U.S. has come to a Russian-style failure of its Social Security system was in 1983. At that time the systems reserves were exhausted and its income was insufficient to meet payments. The program came within weeks of defaulting on benefit payments. At the last minute a compromise was brokered under the auspices of Alan Greenspan. Taxes were increased and benefits were reduced. At the time, changing the system to allow for private investment was not seriously considered.

[27] Referring to the portion of the Washington subway system's track that conducts the electrical current.

Social Security solvent: a) raise taxes; b) cut benefits; or c) get a higher rate of return through private capital investment.[28] Although nothing happened as a result of Clinton's actions, in part because of the Lewenski scandal, he helped set the stage for the debate to come.

During the 2000 presidential campaign, George Bush took a very strong stand in favor of reforming Social Security by allowing younger workers to privately invest a portion of their Social security taxes through individual accounts. After winning election, President Bush appointed a bipartisan commission to look at ways to reform Social Security. The commission recommended three proposals for reform, all of which included individual accounts.[29]

Unfortunately, the commission's recommendations were overshadowed by the tragedy of 9/11. Public debate in the United States shifted to terrorism and the War in Iraq. Social Security moved to the back burner. However, recent warnings by Federal Reserve Chairman Alan Greenspan, and the onset of another presidential election, have once again made Social Security a subject of attention.

Next Steps: United States

As mentioned, several proposals have been put forward in the last few years to begin moving the United states towards a funded Social Security system. Most of these would

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[28] William Jefferson Clinton, Speech to the Great Social Security Debate, Albuquerque, New Mexico, July 27, 1998.

[29] *Strengthening Social Security and Creating Personal Wealth for All Americans: Report of the Presidents Commission to Strengthen Social Security*, Washington, December 2001. For more analysis, see Andrew Biggs, "Perspectives on the President's Commission to Strengthen Social Security," Cato Institute Social Security Paper no. 27, August 22, 2002.

give workers the opportunity to privately invest a small portion of their Social Security taxes through individual accounts. However, most of those proposals are half measures that would leave the United States with a mixed system, little better off than Russia is today. With this in mind, the Cato Project on Social Security Choice has developed a proposal to give workers ownership and control over their retirement funds. This proposal would allow workers to divert their half (6.2 percentage points) of the payroll tax to individually owned, privately invested accounts.[30]

Conclusion

Demographic changes have made traditional PAYGO pension programs unsustainable in both the United States and Russia. Russia, faced with immediate crisis, has seized this historic opportunity to begin transforming its pension system to a system based on savings and investment, giving workers greater ownership and control over their retirement funds. If Russia is able to overcome bureaucratic resistance and administrative hurdles to expand these market-based pension reforms, it will find itself far better situated to care for the retirement needs of its aging workforce.

At the same time, the United States needs to follow Russia's lead and come to grips with the need to reform its national retirement system. The United States should allow younger workers to privately invest at least a portion of their Social Security payroll taxes through individual accounts.

[30] Michael Tanner, "The 6.2 Percent Solution: A Plan for Reforming Social Security," Cato Institute Social Security Paper no. 32, February 17, 2004.