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AND

ITALIAN PENSION REFORM[†]

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Abstract

Canada has developed an extensive private pension system that accounts for more than half the government assisted resources available for retirement incomes. Private plans in Italy account for less than one percent of retirement resources, but it has recently provided pension reforms to encourage greater use of these plans. This paper examines these reforms in light of Canada's experience with its private savings plans. In general terms the Canadian plans available to firms and individuals are more integrated with one another than is allowed in Italy, and, as well, the private plans in Italy have less flexibility to address both pre-retirement cash needs and the ability to shift retirement assets between portfolio managers. There are also fewer post retirement options available in Italy. The greater choice and flexibility of Canadian plans are seen as attractive features to savers and further Italian reforms that provide these characteristics to retirement savings plans should lead to more rapid growth in Italian private plans.

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JEL Classification: G239, H550, J260.

Introduction

Over the last decade, a number of OECD countries have been reexamining the level of state support provided their senior citizens. A primary reason for doing so is that anticipated demographic changes had dramatic tax and expenditure implications if current programs were to be maintained. Specifically, the expected increase in the proportion of elderly in future populations would lead to a significant increase in the effective tax burden on working and tax paying citizens. Indeed, the tax effects could lead to substantial intergenerational conflicts such that large program cuts would be the consequence. Serious efforts to address the problems took place when the options available to governments were greater.

A major reason that such problems have arisen is that most national pension plans began as "pay–as–you–go" systems: promised pensions paid out now would be funded by taxes of the next generation rather than by some underlying assets purchased with taxes paid by current pension recipients. To mitigate this problem states have also encouraged, through tax incentives, the development of private pension plans operated by firms and/or individuals. These plans are generally fully funded so that, at any date, there are sufficient assets to cover any future pension liability. In effect, there is no significant transfer of income or wealth across generations with these plans and as such, no intergenerational issues arise that might make a plan non-viable.

Italy restructured much of its social security system during the 1990s. The reform enacted in 1992 contributed to cap spending. The mandatory retirement age was increased by five years, and the reference period on which contributions were calculated also was increased from five to ten years. It reduced the discrepancies between private and public sector and eliminated the traditional wage indexation mechanism by linking pensions to consumer price inflation. Finally, it doubled the number of years of contribution required for seniority pensions from 18 to 35 years. The 1995 reform linked benefits to the work – life contributions, rather than to a reference earning – period. This reform also introduced measures that discouraged the use of seniority pensions. Included as well were revisions to the legislation dealing with private pension plans in an effort to further encourage their development.

After more than six years, most of the implementing regulations were in place and private pension plans were beginning to be formed under the new system. However the growth of these pension funds in Italy is still lower than the level of growth expected by fund managers and government. Two causes can be identified: the lack of flexibility of the Italian pension system compared with foreign social security systems and the lower fiscal incentives.

In contrast, Canadian adjustments to the demographic change have been relatively modest. To handle the “demographic bulge”, the state pension plan payroll tax on individuals and firms was increased five percentage points to a combined rate of 8.6% and some reductions in government transfers to the elderly were made. A good part of the reason why the adjustments have been so modest is that Canada had earlier developed an extensive set of private plans at both the firm and individual level and these have handled a large amount of the retirement income that is sponsored by state taxation policy. These voluntary plans have a great deal of similarity to the plans that have recently been enacted in Italy, including the trattamento di fine rapporto (TFR), which is currently being considered as an additional retirement vehicle. In this paper we want to provide some information on the structure of the voluntary retirement plans in Canada and contrast them to those that have been recently initiated in Italy focusing on the flexibility and taxation issues. The next section provides a brief summary of the Canadian senior support system and in section 3 we compare it to recent developments in the Italian system. Section 4 provides a brief summary and conclusion.

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 at the firm and/or individual level. A formal separation between the first two pillars came in 1966 with the establishment of the Canadian and Quebec Pension plans (CPP/QPP) that provided a mandatory employment-based government pension plan as the second pillar. When established the plan was financed by a payroll tax of 3.6%, and benefits were limited to contributors. Thus, there was an attempt to achieve at least partial funding of the program. Contributions are currently 8.6%, up to the yearly maximum pensionable wage, roughly equal to the average industrial wage.[1] Until recently, the assets that could be held in the CPP were restricted to provincial and federal debt at rates favorable to the provinces.[2] In 1997 an investment board was established to invest in a broader range of assets including equities.

At the time of its formation existing retirees were not eligible for CPP/QPP benefits. As a result, there was the simultaneous introduction of the Guaranteed Income Supplement (GIS), a fully means-tested program available only to seniors with income levels deemed to be below the poverty line. This provided the first pillar of support for seniors and is financed from general tax revenues.

Prior to the establishment of these two programs, support for the elderly was provided by the Old Age Security program (OAS) established in 1927. This program generally provided a uniform benefit to all seniors and was funded on a pay-as-you-go basis using general tax revenues.[3] 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. Seniors with income below 36,000 Euros receive the entire payment while those with incomes above 60,000 Euros receive no net payments.[4] As a result it is now a fully means-tested program. With the removal of the universality condition on OAS, it and the GIS address the same issue of pillar one, that of 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 operating, the two programs now act as a single progressive transfer program to insure a basic minimum level of welfare for all seniors.

Canada has two types of private retirement savings plans that receive some government tax relief.[5] Company registered pension plans (RPPs) are funded from contributions of the company and, generally, the worker. The other plan is the registered retirement savings plan (RRSPs) that is available to all working individuals whether or not they also belong to a company-sponsored RPP.

Company RPPs had assets estimated at roughly €500,000 million in 1999.[6] The type of plan 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 some form of DC plan.

Locking in and vesting requirements for RPPs differ across provinces. Prior to the middle of the 1980s the most common regulation was that they must be in place within 10 years of employment and by age 45. At that time these were generally modified to two years in the pension plan. On termination of employment prior to retirement, the funds could be used to purchase a deferred annuity, transferred to another RPP, or placed in a "locked in" RRSP, which meant that the individual could not cash out the monies until retirement. These locking in requirements reduced the flexibility of the plans to address pre-retirement emergencies. In moving to these new regulations it was generally the case that the worker could receive up to 25% of the deferred pension's 1987 benefits if termination occurred prior to retirement.

If employment ended in retirement, the individual would receive an annuity from her employer or could purchase an annuity from an insurance company. In 1992 an additional option was provided. Specifically, the government allowed individuals to self direct the monies in their post retirement accounts using Life Income Funds (LIFs). These accounts are set up much like an RPP DC plan with choice except that, instead of allowing further contributions, there are rules specified about how the pension savings can be withdrawn. In particular, LIFs have two basic provisos. First there is a maximum that can be withdrawn in any year. This amount is set on the basis of what an annuity would pay, so that, effectively, the retiree 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 on past RPP contributions.[7]

The second government supported private savings plan is the Registered Retirement Savings Plan, established in 1957 to provide those workers not part of a company pension fund a comparable vehicle for saving for retirement. These are individual accounts held at registered financial institutions where the individual account holder makes the allocation decisions. Throughout its history there have been attempts to integrate RRSPs with 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 roughly €9000. An individual in a company RPP, where the combined contribution by worker and employer is less than this amount, can then 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 into an annuity, or allow 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 limits that are imposed on LIF holders.[8] Both LIFs and RIFs are subject to the same minimum withdrawal rate set by the tax authorities.

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.[9] It is, in fact, best characterized as a generalized saving plan rather than a retirement plan *per se*. 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 homebuyers 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.[11] An alternative description is that such programs partially transform the income tax into 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 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.[12]

CANADIAN SOCIAL SECURITY SYSTEM		
	Plans	Post retirement products available
1st pillar	OAS (1927), GIS(1966)	Means tested government transfers
2nd pillar	CPP/QPP (1966)	Annuity
3rd pillar	RPP	Annuity (provided by company or insurance company) LIF (since 1992)
	RRSP	Annuity Cash (subject to income tax) RIF (since 1992)

Canadian Voluntary Plans and Italian Pension Reform

In the recent restructuring of the Italian pension system there are two areas that appear quite similar to elements of Canadian voluntary pension plans, but also exhibit significant differences.[13] These are the TFR and the open pension plans available to individuals. The TFR (the so-called leaving indemnity fund) was originally created in 1975, both as a form of social security and as an inexpensive form of self-financing for firms. The fund receives mandatory monthly contributions which are currently equivalent to 7% of gross annual salaries, and which by law offer remuneration that is calculated as 1.5% interest plus 75% of CPI for certain categories of workers. Funds are paid out as a lump sum upon termination of employment on

both voluntary and involuntary basis.[14] Open plans are those available to individuals much like RRSPs in Canada.

From a Canadian perspective, what is interesting about these reforms is that they tend to limit choice relative to what has, or would be, done in Canada. For instance, converting the TFR into a mandatory pension plan rather than a voluntary one contrasts with Canada's actions limiting the amounts under the second pillar by removing the universality of OAS, a move that effectively reduced the amount of mandatory contributions to support seniors. Second, triggering a tax liability if one changes the open pension provider is in stark contrast to the Canadian RRSP program where the worker is free to transfer funds between suppliers at any time without incurring a tax liability. In particular there appears to be two elements that separate the Italian and Canadian approaches to pension savings. First, Italian pension reform is directed more toward maintaining or increasing the average level of pension income. In Canada the role of the state has been to provide a socially acceptable *minimum* level of income, and let the voluntary decisions of workers determine how much more they wish to save. Second, the recent Italian pension legislation is more focused on saving for retirement than is Canada's which, *de facto*, has subsidiary benefits beyond that of providing retirement income. In considering the consequences of these differing directions we see five areas where the structure of the Canadian voluntary plans can be contrasted with the recent Italian reform. These are (1) tax treatment of contributions and withdrawals, (2) coverage, (3) portfolio regulation, (4) withdrawal requirements, and (5) the effects on capital accumulation. We consider each of these in turn.

Taxation

For a savings plan dedicated to assist a worker over a relatively short spell of unemployment, treating the cashed accumulated savings as part of either taxable current income or have it taxed on consumption expenditures does not make much difference in terms of total taxes paid. If, however, the savings are to be spent over an extended period of time, the income tax base is annual income and the tax rate is highly progressive, then it would matter. In this latter case, from both an efficiency and equity point of view, it is more reasonable to tax the proceeds when spent. Such logic provides a rationale for both Canada's approach, which has the periodic withdrawals as the trigger for the tax, and Italy's initial tax treatment of the lump sum payments of the TFR as the trigger. If Italy decides to convert the TFR into a dedicated

retirement savings vehicle, the decision to tax withdrawals rather than the lump sum would be consistent with Canada's (and most other OECD countries) tax treatment. Note however, that by making the program mandatory, it limits the ability of the worker to tax average over her entire lifetime.

While Italian open pension plans provide more of an opportunity for this income averaging, the tax treatment of potential transfers from one open plan to another makes the Italian plans much less attractive relative to the Canadian RRSP plan. In particular, Italian tax law does not appear to distinguish between withdrawal from a given plan for consumption purposes and withdrawal to transfer funds to an alternative supplier. Either triggers a tax liability. In Canada, the latter does not. As a result, tax-averaging opportunities are not compromised by dissatisfaction with any specific supplier. This ability to tax average is regarded as one of the strengths of the Canadian plan.[15] Furthermore, a major benefit of this type of tax treatment is that it encourages competition and better quality among suppliers. If a customer can easily leave if she is dissatisfied, the supplier will put more effort into providing a desirable product.

Coverage

One objective of the senior support system for both Italy and Canada is that coverage is reasonably complete so that no individual or group "falls between the cracks". Furthermore, as the programs in place expand and are added to, it is desirable that the resulting system is coherent in that it treats all groups covered in a consistent manner. For instance, in Canada, a central reason the RRSP program was established was to provide every worker an opportunity to use a tax deferred mechanism to save for retirement. Further, because the registered pension plans sponsored by firms were voluntary arrangements, and benefits generally differed across companies, all workers were eligible to participate in the RRSP program. In permitting everyone to participate, an effort was made to ensure that the two plans were fully integrated so that whether you were or were not in a company-sponsored pension plan, your retirement savings opportunities were virtually the same. The open pension funds in Italy provide similar tax assisted opportunities to save for retirement for those without a company pension plan. In the past, a worker could not belong to both an Italian company pension plan and an individual open pension plan. However, since law 124/93 was passed, individuals can, as in Canada, enter both.

Nonetheless, fiscal obstacles continue to exist. Specifically, if an individual in an open plan wanted to change suppliers it would trigger a tax liability whereas moving her closed pension plan savings from ones former employer to her new employer does not. If open pension plans are meant to provide a pension savings vehicle for those not in closed plans, such treatment appears inconsistent.

The fact that the TFR is mandatory while the RRSP is voluntary suggests an alternative interpretation. In particular, in coverage and focus it is most similar to the Canadian second pillar programs of the CPP and QPP. Indeed, the amount of wage income that is to be contributed is more than three quarters that of CPP/QPP.[16] It is almost as if Italian pension reform is replicating *both* the second and third pillars of the Canadian system in one go. Furthermore, prior to the current reforms the Italian government provided about 14% of GNP in mandatory senior support compared to 5% of GNP provided by the Canadian Government. Because mandatory contributions to support ones retirement are substantially greater in Italy than in Canada, it means that the use of the voluntary opportunities to accumulate for ones retirement will be, by choice, much lower in Italy than they are in Canada.

Portfolio Regulation

There are two issues that are related to portfolio regulation. First, are there opportunities/requirements that encourage diversification and second, is there sufficient flexibility to allow for the use of retirement funds to handle individual durable purchases? As to the former, both Canada and Italy are in the process of moving toward a greater ability to diversify. In Italy's case, moving the former TFR assets to portfolios not run by the company is a major step toward increased diversification. It also removes an agency problem between workers and the firm, a problem that was made tragically clear in the recent Enron case in the United States. In that case workers were strongly encouraged by Enron management to hold stock in the company they worked for, apparently because it was a cheaper form of borrowing for the company. When Enron went bankrupt and workers jobs were put at risk, many of the pension assets they also held became worthless. The original TFR also was treated as a source of funding for the firm with the assets backing the TFR liabilities of the firm being the debt of the firm itself. In a sense, the worker's insurance fund – the old TFR, much like the Enron workers' pension fund – that was to protect him if the firm faced difficulties was the debt of the firm that

would be simultaneously at risk. Without state insurance backing those implied liabilities of the firm, the worker could not only lose his job, but the insurance against such an event would simultaneously be rendered worthless. As part of the retirement system the TFR is more likely to have a more diversified portfolio. Canada, on the other hand, limits the amount of RPP money that can be held in the assets of any one firm, including that of the sponsor, to no more than10%. This avoids much of the agency problem that Italians have faced with the old structure of the TFR.[17]

However, Canada is among a handful of OECD countries that has a national regulation that limits the amount of efficient diversification that can be undertaken by investing internationally. In particular, there is a regulation that limits the amounts of foreign property – securities issued by non-Canadian firms- to no more than 30% of the RPP/RRSP portfolio.[18] In effect, savers must hold at least 70% of their retirement portfolios in Canadian assets, assets that constitute less than 3% of the world's financial securities. Fortunately for Italy, it does not suffer from such a rule and Canada is slowly moving to remove this regulation.[19] Under the new Italian rules, there were relatively few limitations on the types of investments that pension plans may make. In particular, pension plans may invest in foreign mutual funds and other securities, subject to certain non-discriminatory asset allocation limitations. For example, investments in closed end funds are limited to 20% of the pension plan's assets and 25% of the closed-end fund's assets. No distinction is made between shares of a foreign closed-end fund or an Italian closed-end fund for purposes of these limitations.

Both Canada and Italy have provisions in their individual pension savings plans – RRSPs and open pension plans - that permit a limited use of retirement funds for domestic durable purchases. Housing can be financed in part through voluntary retirement accounts in either country.

Withdrawal Restrictions

On the surface, withdrawal restrictions appear quite similar between the Italian and Canadian plans. In either country one cannot access the cash in the TFR or an employer sponsored plan until retirement while, in principle, one can always withdraw funds from an open pension plan or RRSP. In practice, there are significant differences because of the cost and tax structures in the two countries. Consider first the withdrawal restrictions prior to retirement.

For RRSPs, the tax liability is triggered when the individual removes savings from the pension savings *system*. In open pension plans it is triggered when the individual removes savings from an individual supplier even if the individual would have wished to withdraw that money so that his pension savings could be placed with a different, more preferred, provider. While neither method of taxation restricts the individual from using pension savings to address short run financial problems, the more restrictive Italian system makes the open plans less attractive than the Canadian RRSP because one loses the flexibility to choose alternative suppliers. This adds to the risk of putting money in such plans and therefore decreases the demand for them.[20]

Not only is the flexibility to change suppliers at low cost a consideration in the attractiveness of pension savings plans, but the ability to withdraw money prior to retirement is as well. For Canada, the reforms of the RPP in the 1980s made the locking in requirements more stringent decreasing the flexibility of these plans. The withdrawal restrictions proposed for Italian employer sponsored pension plans, including the TFR will have a similar effect.. Nevertheless, because RPP plans are voluntary, it has meant that quite a few firms have decided not to offer their workers this form of benefit. What has occurred instead has been the establishment of "group RRSPs" where the firm negotiates with a financial institution to offer its workers access to RRSP portfolios at preferred rates. While more costly to administer than RPPs, the increased flexibility appears to compensate workers for this reduced return.[21]

Differences also arise in withdrawal restrictions once one retires. In both countries one can purchase an annuity, offered by the firm or an insurance company, upon retirement. In addition, with RRSPs, open pension plans and the monies in the TFR (for those workers who began their employment prior to 1993) the worker could also choose a lump sum cash payment instead. This choice triggers a tax liability, usually at a higher marginal tax rate than otherwise. As a result, most workers have tended to choose the annuity over this cash payment because doing so reduces the present value of their taxes.

Since 1992 Canadian retirees have been offered a third option. These are the RIF and LIF programs mentioned in section 2 above. These are effectively continuations of the RRSP and employer sponsored DC plans that workers had contributed to in the past but now, rather than make contributions, the individual is restricted to withdrawing funds – make negative

contributions - over their retirement years. These have proven to be very attractive products because the individual can continue to choose how she wishes to allocate her pension assets. Indeed, they tend to be preferred over annuities for those individuals that have become comfortable making past portfolio decisions while they were accumulating pension savings. We believe that as Italians become accustomed to making such decisions with their pension assets, the demand for such an option will grow and Italy will follow Canada in allowing this type of product.

Effects on Savings

The principal difference in Canadian voluntary plans and those resulting from the recent Italian reforms is the degree of liquidity, or flexibility, associated with the Italian products relative to the comparable Canadian ones. While the new TFR would be similar in many respects to Canadian RPPs, it is mandated whereas the RPPs are the result of voluntary negotiation between workers and the firm. Italian open pension plans impose significant costs if they are liquidated, whereas Canadian RRSPs can be cashed out or moved at any time at low cost. What are the consequences of these differences on the level of saving and on economic welfare? We can examine this by looking at two groups of workers: Those employed prior to 1993 that still have the option of taking out their TFR as a lump sum and those workers who no longer have an option of a lump sum payment on termination.

For those workers currently entitled to the cash payout when they leave the firm, the new TFR will be to their benefit since they retain the old option to take the funds as a lump sum or can use the potential advantages that the new system offers. In particular, if the worker chooses to use the new system, they now have a better opportunity to income average, thus reducing their lifetime taxes.[22] Those that do choose the new option of putting the funds in a pension account may have an increase in savings due to a higher expected return on their lump sum TFR than they would have received because the effective return on those pensionable assets accumulate tax free.

For workers first employed after 1993 – that do not have the option of taking the TFR as a lump sum payment – the pension reform may make them worse off. While they may benefit from the higher effective rate of return on mandatory contributions (by their employer) on the former TFR payments, the fact that those contributions are “locked in” if they become

unemployed means that they have less ability to smooth their consumption during difficult times. This provides a second motive for saving more: because the worker cannot get access to the funds until retirement she has fewer assets to handle emergencies if she loses her job prior to retirement. As a result, there is an increase in precautionary savings to handle such emergencies. This savings motive would be removed if the state initiates a new program that provides compensation if a worker leaves a firm before retirement age. Note finally that for these workers, as for the first group, the mandatory pension requirement under a converted TFR does not, in itself, generate increased saving. This is because the firm would be indirectly accumulating precisely the same proportion of their income in the form of a sinking fund to meet the employment termination liabilities accruing if the old TFR had remained in place.[23]

Finally, if the TFR had been extended to cover additional groups, such as the self employed, savings would be expected to increase. Not only would they lose liquidity because some of their previous savings will be diverted to the new mandatory pension but, for those doing little current savings, the amount that must be contributed may actually require them to reduce their current consumption. This would be especially true of the young, who generally have low incomes relative to their average lifetime earnings and therefore would be inclined to dissave to smooth their lifetime consumption. Finally, both the mandatory increase in savings and the need to further accumulate to provide for precautionary needs make this group worse off relative to both other workers in society and relative to the option of contributing to an open pension fund alone.

The encouragement of voluntary open pension accounts may also increase savings but is somewhat more problematical. In Canada there are at least two reasons they have been successful. First, because one can withdraw the funds in an RRSP at any time, they do not have any disadvantages relative to saving outside a tax deferred account. Because the tax deferral property of an RRSP effectively increases the return on assets, there is an incentive to use them to save with. Second, because of the steeply progressive tax system, there is a strong incentive to average taxable income over ones lifetime and avoid paying the high marginal tax rates in high income years. Thus there is the increased return that provides an incentive to save more. However, much of this saving is at the expense of taxes paid, which, *cet. par.*, implies an increase in government dissaving. One story that is gaining some currency is that, if the

government finds itself with less current revenue, it will decrease its consumption expenditure somewhat. The decrease in government expenditure represents real savings for the economy.

The structure of the Italian voluntary pension accounts should have a similar but more muted impact on Italian savings. Because of the high cost of entering and exiting such plans, they will have little in the way of a comparative advantage in addressing the precautionary need to save. Because the TFR will become a mandatory savings plan that is "illiquid" those individuals for whom the new regulations apply will choose to avoid those savings vehicles that also tend to limit their flexibility. In the event of full reform being implemented, annual TFR flows could be re-directed into various products (close/open pension funds and life pension products) and the worker would get the same tax benefits from the various products options. Thus, the simultaneous introduction of voluntary pension plans with limited liquidity and an increase in mandatory pension savings tend to work against one another and will keep the voluntary plans smaller than otherwise would be the case. Furthermore, this will impact most heavily on the young who do not have the option of a lump sum cash payment at employment termination. Given that, in Canada, the young are the age group least represented in RRSP plans relative to their income, it suggests that the young will be even less represented in the Italian open pension funds.[24]

Finally, there may be one additional source of increased saving, albeit small, following from the pension reforms. The structure of the old TFR had firms effectively being provided a subsidy by the state in insuring that, in case of bankruptcy, the government stood ready to provide the TFR payments to the workers who were thrown out of work. The subsidy accrued because much of the assets held to back the TFR were those of the firm itself which became worthless just when the liability was payable. Because of the greater diversification in the proposed restructuring of the TFR, the extent of this subsidy will be reduced.

Summary and Concluding Remarks

The structure of Canada's retirement savings plans is composed of three elements. One element, using the Guaranteed Income Supplement and the Old Age and Survivors programs, provides a social safety net to all seniors and is devoted to distributional issues rather than retirement *per se*. The second element provides, through the Canadian and Quebec pension plans, a mandatory pension plan to which every working Canadian must contribute. This, as in

most OECD countries, is partially pay–as–you–go and, as such, has had to be modified to address the forthcoming demographic changes. The third element consists of fully funded, voluntary, tax assisted savings plans that permit the individual to accumulate for his retirement either directly or through the firm for which he works. In Canada, this third "pillar" is large relative to the first two elements. RRSPs and RPPs together had more than €700,000 million of assets in 2000, which, on an actuarial basis, would generate between thirty-five and fifty thousand million Euros of retirement income annually. The combined expenditures of the first two elements (OAS, GIS, CPP and QPP) in 2000 were just slightly less than thirty five thousand million Euros. Voluntary retirement savings programs, in other words, constitute more than half the resources available for retirement income from government-assisted sources. Voluntary pension plans in Italy currently could provide less than 1% of government assisted resources for seniors.[25]

An important feature of the Canadian voluntary programs is that individual and corporate plans are fully integrated so that all Canadians are offered the same level of tax-assisted savings whether or not they belong to a company pension program. This integration is yet to be fully addressed in the Italian system where opportunities to save depend on whether or not a worker belongs to a company plan.

A second feature of the Canadian RRSP is that funds in them can be withdrawn at any time and at low cost. This permits tax averaging-- moving the tax base towards average lifetime income rather than current income. It also means that this plan can be seen as a general savings vehicle rather than one dedicated to retirement savings alone. The new regulations for open pension plans in Italy do not permit as great a use of contributions for pre-retirement expenditures. This difference will, *cet. par.*, likely lead to greater Italian savings, but at some cost to younger members who will be less inclined to do their savings using these vehicles than would a Canadian in similar circumstances.

One difference between employer plans operated as RPPs and individual RRSPs is that locking in provisions on the former means the worker is restricted from accessing it prior to retirement. Because employer pension plans are voluntary some firms have opted to offer their workers group RRSPs that are free of these locking in provisions. It appears that, for workers in these firms, the increased flexibility more than compensates for the increased costs and lower returns from these plans. The proposal for the TFR to be a mandatory pension plan means it has

similar characteristics as the locking in provisions of Canadian RPPs but pension regulation does not yet provide an opportunity to allow some workers the flexibility provided by the Canadian group RRSPs. This may be of some concern for those who began employment after 1993.

A fairly recent development in Canadian pension regulation is that, upon retirement, workers are no longer required to cash out or to purchase an annuity with their retirement savings. Rather, they now have the opportunity to continue to determine the asset allocation of their money in a tax-deferred plan after retirement and take periodic payments from these pension assets. This appears to be a quite popular option for workers retiring from DC plans and for those with RRSP assets. It seems that workers who have had the opportunity to make their own portfolio decisions while working feel more comfortable in continuing to do so once they have retired.

An important portfolio restriction in Canadian RPPs is that the liabilities of any one firm cannot account for more than 10% of the pension assets. This reduces the agency problem between the firm and its employees and leads to greater portfolio diversification. The proposed modifications in the TFR should provide Italian workers similar benefits. The Canadian foreign property restriction has decreased the ability of Canadians to diversify internationally, but has been eased in recent years. Fortunately such a restriction has not been imposed on the Italian system.

Overall, Canada's privately run retirement plans have served Canadians well. These have evolved over the last 50 years to permit greater choice and flexibility, characteristics that Canadians find highly desirable. It has also meant that adjusting to demographic change has been reasonably smooth for the government given that these plans are fully funded and constitute a major source of government assisted retirement income. Italy has recently begun placing greater emphasis on the use of private sector retirement plans that are similar to those of Canada. In this essay we have pointed out some of the major differences. It remains to be seen if Italy's plans evolve in a manner similar to that of Canada.

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[1] This 8.6% is the effective payroll tax, and is the sum of the worker and firm's contribution, of which the firm pays half.
[2] The QPP, on the other hand, permitted equity investments through its pension arm, the Caisse de Depot et Placement.
[3] Prior to 1952 payments were subject to a means test.
[4] Those with incomes between these two values receive proportionately less than the maximum.
[5] Contributions to these plans are deductible from taxable income but are included in taxable income when withdrawn from the plans. Legislation providing for this tax deferral was passed in 1919.
[6] Statistics Canada (2002), The estimate for RRSPs, excluding self-administered RRSPs, was €185,000 million. Investor Economics estimate self administered RRSPs at €100,000 million in 2000.
[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] Registered Income Funds were established in 1978.

[9] Note that if the funds are simply transferred to another RRSP supplier, no tax liability is triggered.

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

[11] If t is the tax rate, V is the initial tax deferred contribution, R is the rate of interest then if the account is cashed out at the end of T years, the individual will have assets of $(1-t)[(1+R)^T V] = (1+R)^T[(1-t)V]$.

[12] 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 deductibility of mortgage interest payments. As a consequence, paying off mortgages and/or consumption loans provides exactly the same tax advantages as putting money into these tax-deferred programs.

[13] Closed pension plans offered by companies are quite similar to Canadian RPPs and will not be discussed here.

[14] The Bank of Italy estimates that companies carry € 160,000 million of funds for self - financing purposes.

[15] Of course, Italy may have alternative income averaging mechanisms to compensate for this.

[16] Compare the 6.93% contribution rate for the TFR with the 8.6% contribution rate for CPP/QPP and note further that the Canadian contribution rate applies only up to approximately the average industrial wage!

[17] See footnote 14.

[18] See Fried and Wirick (1999) or Burgess and Fried (1999), (2002) on the nature and consequences of this regulation.

[19] Also, fortunately for Canada, most firms, if not individuals, can find a way around this rule by holding futures contracts on other countries' stock indices and backing these contracts with domestic assets. The futures contract, being only a promise to buy in the future has zero value as foreign property. Thus, exposure to foreign markets is substantially greater than foreign property in RPP plans. As one portfolio manager (for a nunnery) suggested: It is like having a deal with the devil (foreign capitalists) and never having to deliver on the contract!

[20] The high loading charges currently asked by open pension plans has a similar effect on demand.

[21] Typically a member of a group RRSP can access a family of mutual funds at a management expense ratio roughly 100 basis points below that available to a retail investor. An admittedly rough estimate is that group RRSPs have a management expense ratio between 50 and 100 basis points more than a comparable DC plan operating under RPP regulations.

[22] The mechanism by which they can opt for the new opportunities involves taking the lump sum payment and simultaneously investing the desired amount in an open pension plan which is tax deductible.

[23] Note however that moving the assets outside the control of the firm may lead to a more efficient allocation of the given level of resources.

[24] In fact, a breakdown reveals that only 11.1% of the individuals who subscribed for a fund are under the age of 30. New generations have seen their prospective benefits curtailed more significantly by the introduction of the new regime. Average contribution rates into private pension funds have been remarkably low, at around 4.5% versus a potential ceiling of more than

10%. These contribution rates will only allow young individuals to regain half of the benefits lost with the reform.

[25] Assets in voluntary plans in Italy are 340 million Euros for open pension funds and about 355 million Euros for private life insurance products in 2001 while closed pension funds total assets are 1144 million Euros in 2001.