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THE CURRENT STATE OF LITHUANIAN PENSION SYSTEM AND DISCUSSIONS ON ITS REFORM

Research Report
P98-1023-R

This research was undertaken with support from the European Union's Phare ACE Programme 1998. The content of the publication is the sole responsibility of the authors and it in no way represents the views of the Commission or its services.

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SUMMARY

The paper gives an overview of the current Lithuanian pension system and presents the debates on the introduction of the funded pillar. The latest developments show that participation rates in the social insurance are still declining. This poses the coverage and eligibility to benefits problem, which in turn means the increase in old-age poverty in coming years. Paper gives a short description of the types of pension in Lithuania, eligibility requirements, payment options, indexing and taxation rules. It presents the existing framework of third pillar pensions and analyses the reasons for non-use of it, main of which is the unfavourable taxation regime. The second section is devoted to the ongoing debates on the pension reform in Lithuania, its political background and policy proposals. The Government proposal to start a pension reform since 2003 (later since 2004) by diverting a portion of the current social insurance contribution rate to private pension funds raised hot debates in the Parliament. After long period of consultancy and estimation of possible transition costs, the Parliament decided in favour to voluntary provisions offering some type subsidies or other tax encouragements. However, this decision was achieved formally, so there is a great possibility that debates will be renewed after Presidential or general elections. The author of the paper express her opinion on the future of the pension system in Lithuania and argues that now it is favourable moment to introduce mandatory savings for old age as the surplus in social insurance budget is envisaged in coming years. She also makes a reference to previous Phare funded project which came to almost the same policy proposal package.

I DESCRIPTION OF CURRENT PENSION SYSTEM

There are two types of pensions in Lithuania: social insurance pensions based on contributions and financed from the separate social insurance fund and state pensions payable from the state budget. Both types of pensions operate on the pay-as-you-go basis.

1.1 Social insurance pensions

Social insurance pensions were introduced in 1995. Before that pensions in Lithuania were based on the soviet law of 1956. According to it pensions were calculated taking into account the average wage of the person during the last 12 months of work, with the amount of pension set simply as 50% of that. There was no linkage with contributions, while some still were paid but to the general budget of the SSSR, and pensions were administered by trade unions and local (municipal) governments jointly. In 1991 the separate social insurance budget was created, and in 1995 a package of laws on pensions came into force.

In 1995 the Lithuanian pension system was reformed towards the social insurance principles prevailing in modern societies. A clear linkage between insurance records, the covered wage, contributions paid and benefits was established. A new pension formula was introduced, and all early retirement privileges were abolished. The retirement age, which used to be 55 for women and 60 for men, started to be gradually increased to 60 for women and 62.5 for men.

Social insurance pensions are paid from the separate state social insurance fund independent from the national (state and local) budget and are based on the amount of contributions paid and the length of the coverage. They constitute more than 90 % of Lithuanian pensions, thus by far the largest part of the Lithuanian pension system**.** In 2000 social insurance pension outlays amounted to 34,2 per cent of the state budget. In comparison, state pensions accounted for 2,24 per cent and social pensions for 1,2 per cent of the state budget.

The state social insurance fund is governed by a tripartite council representing employers' organisations, labour unions, and the government. The fund is financed by a 31% employer contribution on the wage bill plus a 3% employee contribution on their individual wages (the rates were 30 % and 1 % before year 2000). Social security contributions are used to finance pensions (old-age, disability and survivorship), short-term benefits (sickness and maternity), as well as unemployment and health insurance partially.

1.1.1 Coverage

Persons employed under labour contracts as well as civil servants and self-employed persons are subject to the state social insurance. While people working under labour contracts are insured to all types of social insurance (pensions, unemployment, sickness and maternity leave, labour accidents), self-employed are subject only to pensions insurance. However, even amongst pension insurance there is a difference depending on the social groups. The pension coverage requirement and structure of benefits are different for self-employed.

Until January 1, 2002 the self-employed were obliged to insure themselves not to full social insurance pension but to basic amount, which is flat (138 LTL or 40 Euro currently).

Now the law is amended and part of self-employed insure themselves to full pensions. Only farmers and people working under so-call licenses (which allow lump sum income tax payment) still are subject to the basic amount of pension.

1.1.2 Contribution rate

The social insurance pensions contribution rate for people working under labour contracts and similar to them (like civil servants) is 25% of the payroll. The share of it payable by the employer comprises 22.5% and left 2.5% is payable out of the salary of the insured person.

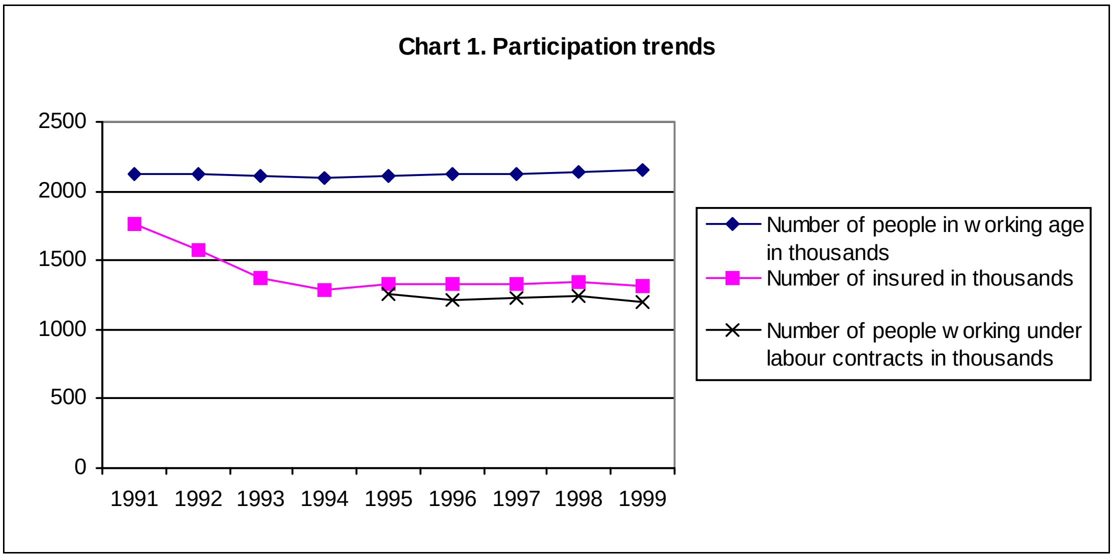
As self-employed people used to be insured to flat amount only, the contribution rate for this group is set as the half of the basis amount (69 LTL or 20 Euro monthly). Since 2002 this contribution rate is payable only by farmers and people working under licenses.

The contribution rate for self-employed people, who insure themselves to full pension, depends on their annual taxable income. If it was less then 3 times of average insured income (see below **D**), owners of sole proprietorships and others pay only 50% of basic pension. If the annual taxable income was more, self-employed have to pay not only for basic pension but for supplemental part as well. The contribution rate for this part is set at 15%, the taxable base is the same as for income taxes. However, despite a very short time of these provisions being in force there are several amendments registered in Lithuanian parliament to change them and to diminish the contribution rate for this group of self-employed. So it is very likely that the contribution provisions for self-employed will alter again.

1.1.3 Participation

In 2000 there were 1137.4 thous. persons insured by full pension insurance. That comprises 52.6% of labour force in working age. If young people studying in education institutions and the disabled in working age were disregarded, this percentage would amount to 61.2%. 123.9 thous. were insured for basic pension, that is 6.7% of people in working age able to work or 9.5% of all insured by the state social insurance. 2001 saw ever declining figures of insured – only 1112 thous. were insured to full insurance.

The participation rate in state social insurance is declining.



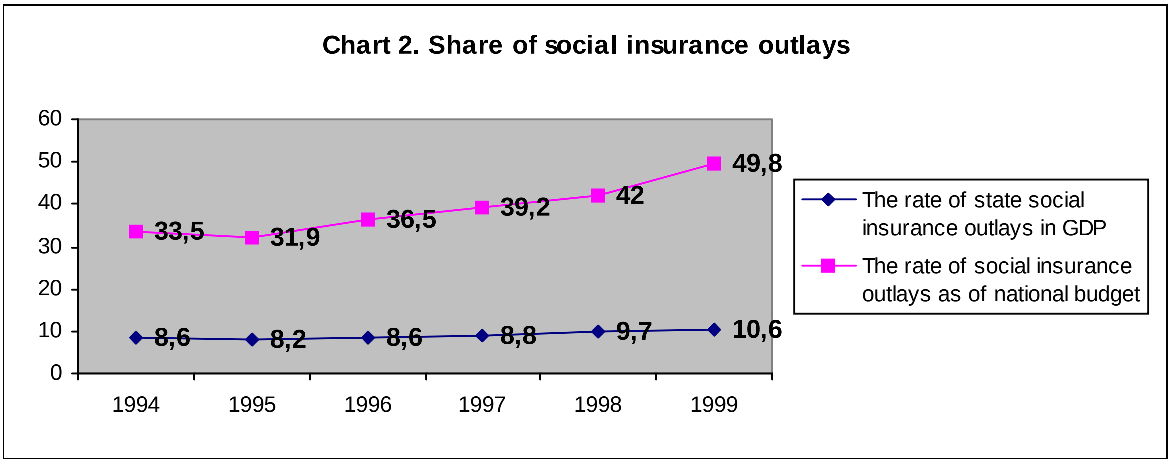
Source: The Board of the State Social Insurance

Table 1. Participation rates

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Number of people in working age (thous.)	2127.6	2119.7	2108.3	2101.9	2110.8	2121.3	2121.8	2135.8	2148.3
Number of insured by the state social insurance (thous.)	1764.3	1572.8	1373.8	1286.8	1331.6	1325.	1325.0	1345.5	1320
%	82.9	74.2	65.2	61.2	63.1	62.5	62.4	63	61.4
Number of people working under labour contracts					1258.6	1220.1	1222.5	1246.4	1201
%					94.5	92.1	92.3	92.6	91

Source: The Board of the State Social Insurance

Approximately 300 thous. persons are subject to social insurance but not insured. Only 1 thous. insure themselves voluntary. People not paying contributions will loose the entitlement to social insurance pension. They will be the most likely recipients of social assistance in the old age. The declining participation rates pose a serious coverage problem in coming years.



Source: The Board of the State Social Insurance

1.2 Types of social insurance pensions

There are three types of social insurance pensions: old age, disability and survivorship. The contribution rate of 25% covers all these types of pensions. Self-employed persons were insured for all types of pensions but for the basic amount only. Now only farmers and persons working under licenses will receive basic pension (today most of them still have full insurance for the years worked in soviet time). Other self-employed will be eligible to full pension, if they pay full contribution rate (50% of basic amount plus 15% on taxable income).

Survivorship pensions are paid along with the old age or disability pensions while the person eligible for old age and disability pension has to choose one of them.

1.2.1 Old age pensions

Eligibility

Person is eligible to an old age social insurance pension if he/she meets two requirements: reaches a retirement age and has a minimum length of the obligatory insurance record.

The retirement age under the law is set at 60 years for women and 62.5 for men but it will be reached step by step adding six months per year to existing retirement age for both genders. In 2001 the retirement age was 57.5 for women and 61.5 for men, in 2002 – 62 for men and 58 for women.

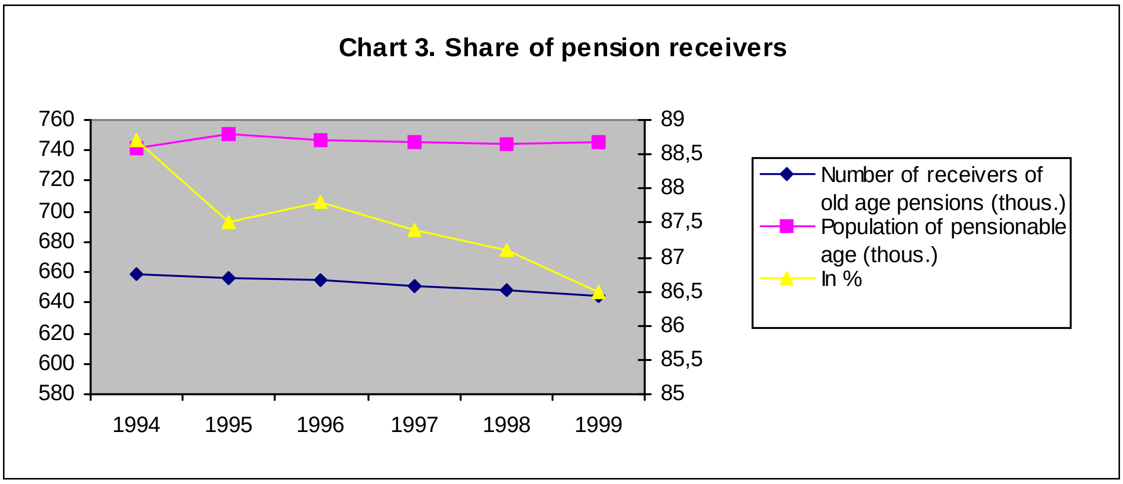
The minimum obligatory length of social insurance record is set at 15 years.

These two requirements are decisive. The person not fulfilling the minimum insurance record requirement is not eligible for any type of pension from the state social insurance – there are no partial pensions. As there are no early retirement pensions – the person has to reach the required retirement age.

The period of working under the labour or similar contract is counted for social insurance record only if social insurance contributions are paid on not less than monthly minimum wage. If contributions are paid from less than the minimum wage, the insurance period is reduced accordingly. There is a concern that due to that requirement those people who worked for less than minimum wage will not be eligible for any pension, even if they have paid contributions for quite a long period. This is particularly sensitive for those who worked in shadow economy. This adds to the coverage problem, which could be acute in the future.

The period of receiving sickness, maternity and unemployment social insurance benefits is treated in the same way as the period of earning income. The state pays social insurance contributions for mothers rising children up to three years age and for persons in military service in the same amount as for self-employed people, so these periods are counted for social insurance pensions but for basic amount only.

Out of all social insurance outlays (4581 mln LTL in 2000, 4451 mln. LTL in 2001) over 70% are going to pension payment, and old age pensions comprise 74% or 2428 mln LTL (2362 mln.LTL or 73% in 2001) of that amount.



Source: The Board of The State Social Insurance

Table 2. Pension receivers

	1994	1995	1996	1997	1998	1999
Number of receivers of old age pensions (thous.)	658.4	656.8	655.3	651.0	647.9	644.6
Population of pensionable age (thous.)	742.2	750.3	746.7	745.1	744.1	744.9
%	88.7	87.5	87.8	87.4	87.1	86.5

Source: The Board of The State Social Insurance

Pension formula

Social insurance pension formula consists of two parts: basic amount and supplement part. The basic amount is set by the Government and it cannot be less than 110% of minimum subsistence level which is also set by the Government. Today the basic pension comprises almost a half of average pension.

The basic amount is almost flat for all insured. Only those who do not fulfil the requirement of so-called obligatory length of social insurance record receive accordingly diminished amount of basic pension. The obligatory length of social insurance record, which entitles the person to receive a full pension, is set at 30 years for both genders. After reaching this limit, basic amount do not increase any more.

The supplement part of pension is calculated multiplying the length of personal social insurance record by the coefficient representing the previous wage of the insured person, and by the average insured income in the economy (that is the average income on which the social insurance contributions were paid), and increment coefficient.

The whole old-age pension **P** is calculated according to the following formula:

$$P = B + 0.005*S*K*D,$$

where

B stands for basic pension (or part of it if the recipient does not have the obligatory social insurance period);

S stands for a person's social insurance record of working under labour or similar contract;

K stands for the so-called ratio of a person's insured income, which is calculated by dividing the annual income earned by the insured by the country's average annual wage. According to the law, **K** cannot be higher than 5. The ratio **K** is calculated based on the social insurance fund's data recording the person's insured income: the personal earned income from which social insurance contribution were paid is divided by the average insured income **D** of a given year (see below) and the average of such coefficients for the whole period is calculated.

D stands for the insured income which is calculated as the average of the earned income in economy from which pension insurance contributions are collected, as well as of sickness, maternity and unemployment benefits. The State Social Insurance Board approves the annual and quarterly average insured income. The annual insured income is used to calculate the rate of a person's insured income (**K**), and the quarterly insured income is used to calculate the pensions to be paid.

The ratio 0.005 means that 0.5 percent of the monthly wage of the employee is added annually to the supplementary component of the future pension.

The limit of 5 for coefficient K means that personal earnings only up to the amount of 5 average wages in the economy are taken into account then calculating pension. However, there is no “ceiling” on the amount of the wages subject to the social insurance contributions. This and rather big flat component make the pension formula highly distributionary.

The average income (brutto) replacement by pension rate is 36 percent, while for higher earners it could be as low as 12 percent. The average old age pension of non-working pensioner amounted to 313 LTL (or 90 Euro) in 2000 (318 Lt in 2001). Majority of old age pensioners (66%) receive pension from 200 to 350 Lt. The average pension is paid to 18% of pensioners.

Payment of pensions

In order to promote later retirement there is a provision in the law that a pensioner having the obligatory social insurance period can postpone his application for pension benefit. In this event the pension shall be increased by 8 percent of the amount calculated at the moment of application for each full year as of the date of the eligibility for the pension.

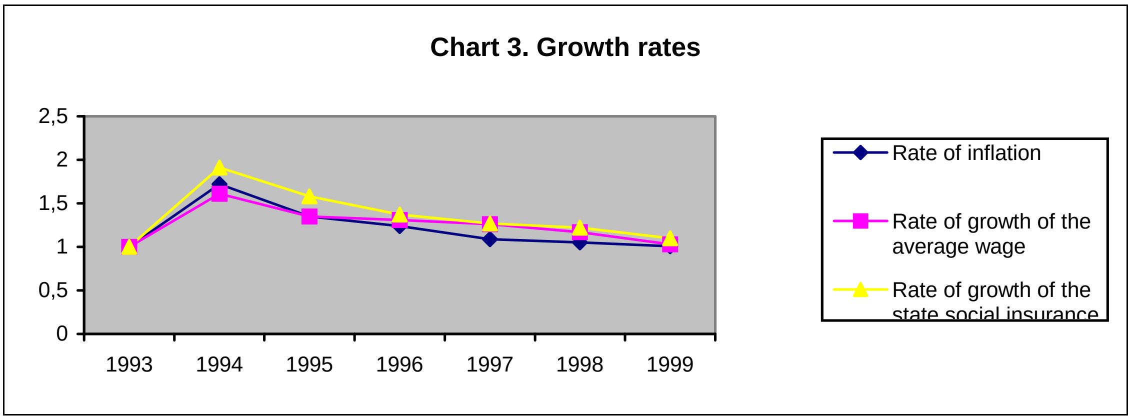
State social insurance pensions are paid on a monthly basis during the rest of life of a person and for two more months after his death as a funeral grant. The size of the funeral benefit is affected neither by the number of dependent persons nor by his financial situation.

The law does not require to terminate employment in order to qualify for state social insurance pension. The benefits to working pensioners are paid subject to the amount of their earnings. Individuals who earn not more than 1 minimum wage are eligible to receive the full granted pension. Benefits for those who earn more are restricted. If the wage exceeds 1,5 minimum wage, person receives only basic amount of pension.

In 2000 15.6% of old age pensioners were still working. Since 2001 more restrictive rules for payment of benefits to working pensioners were adopted and this number diminished to 11.3%.

Indexation

Two components of social insurance pension reflect two ways of indexing pensions. The basic amount is to be increased according to the level of inflation. The supplemental part of pension having the average wage in the economy in its formula reflects the growth of wages. The benefits are recalculated every quarter of the year and adjusted to the changes in so-called average insured income, that is the average earnings on which social insurance contributions are paid. While there is a theoretical possibility to both increase and decrease in pension size, the diminishing of pensions was never used so far.



Source: The Board of The State Social Insurance

Table 2. Growth rates, in %

	1993	1994	1995	1996	1997	1998	1999
Rate of inflation	1	1.72	1.35	1.24	1.09	1.05	1.008
Rate of growth of the average wage	1	1.61	1.35	1.31	1.26	1.17	1.03
Rate of growth of the state social insurance outlays	1	1.91	1.58	1.37	1.27	1.22	1.1

Source: The Board of The State Social Insurance

1.2.2 Disability pensions

The right to receive a disability pension, pension formula, indexation and payment of disability pensions are based on the same grounds as in case of old age pensions. The only difference is the length of minimum and obligatory social insurance period, which are less and depend on the person's age. For persons under 23 years of age the only fact of social insurance matters. The lacking social insurance coverage up to the retirement age is granted. Then calculating personal pension it is considered as the person would be working up to the retirement and earning the same wage as in average before the disability.

Depending on the degree of the incapacity for work, there are established three disability groups. The disability group is recognised by the special state commission. The amount calculated according to the above mentioned formula makes up the disability pension for the disabled of Group 2. The supplement in the amount of 50 per cent of basic pension is paid to the disabled of the most severe Group 1, and only half of the disability pension for the disabled of Group 2 is paid to the disabled of Group 3.

In 2000 disability pensions amounted to 591 mln LTL or 18% of all social insurance pensions outlays (in 2001 they grew up to 614 mln. Lt and constituted 19%). Out of 173 thous. of receivers of disability pensions 31 thous. (18%) were working. The average pension of non-working disabled is a bit lower and comprises 288.6 Lt or 84 Euro (in 2001 it stayed almost the same). Almost a half of receivers of disability pensions (47%) are in 51-65 age group. The most frequent disability group is II (64% of cases).

The steady rise in the number of disability pension receivers makes a great concern. The number of disability pension receivers increases partly due to the increments in the retirement age and situation in the labour market: people in pre-retirement age find easier to apply for disability then to be gainfully employed. The Government adopted a concept of the reform of disability recognition and granting benefits, which should take place in 2004. It is expected that the reform will change the eligibility criteria and disability recognition will be based on person's employability rather than on the status of health which is the case today. On the other hand, employment encouragement programs are adopted which should help to solve the problems of such people.

1.2.3 Survivorship pensions

The spouse and children of the deceased are eligible to receive the social insurance widow/widower or orphans' pension, if a deceased was entitled to state social insurance disability or old-age pension or was drawing such a pension. The additional requirement for widows or widowers is to bring up the children under 18 years old (if studying under 24 years old) of the deceased person or to be in retirement or pre-retirement age (5 years till the retirement age).

The widow/widower's and orphan's pension is calculated in the same manner as the disability pension for a deceased person. It is paid in the following way: 50 per cent of its amount goes to the widow/widower, 50 per cent of its amount is divided equally among the orphans (if there is only one orphan, he/she is awarded 25 per cent of the pension's amount). Upon the death of an old-age or disability pensioner, the deceased person's pension is divided to his/her survivors and orphans in the same manner.

In 2000 234 thous. persons received some kind of survivorship pension (in 2001 there were 241 thous. of such persons). The outlays of these pensions amounted to 224 mln. LTL or 6.8% of all expenditures for pensions (in 2001 228 mln. Lt or 7% respectively). 48.5% of widow/widower's pension receivers get their own old age pension from the state social insurance budget as well.

One can notice that the expenditure on survivorship pensions is growing. Rinsing expenditures reflects the compounding character of these pensions, which were introduced since 1995 only. Before that the breadwinner loser's pensions were granted which were paid to widows/ widowers as only one pension not as a supplement.

1.3 State pensions

Along with the universal social insurance pension scheme there are special state pensions financed from the state budget. They can be paid along with the social insurance pensions. However, the restriction of 150 per cent of average wage in Lithuanian economy applies to the sum of both pensions.

The state pension can be awarded if person reaches the retirement age or becomes disabled with exception to military service pensions, which can be paid earlier.

State pensions are: I and II level pensions for prominent people, pensions for military service and policemen, pensions for persecuted persons, pensions for academicians, President's pension.

I and II level state pensions are granted for persons for their special merits in culture, economy, sports, state governance. They are granted under the resolution of a special commission. First degree is paid in amount of four (552 Lt or 160 Euro), and the second degree state pension - in amount of two base pensions (276 Lt or 80 Euro).

Pensions for military service and policemen are granted after these persons reach statutory retirement age stipulated in the regulations or become disabled. The size of the pension depends on the last monthly wage of the eligible person and is about three times the average size of the social insurance pensions. It is paid long life.

Pensions for persecuted persons are granted to those who were deported from Lithuania during the Soviet occupation or became victims while defending the independence of Lithuania. The size of pension is either 0.75 or 4 base pension depending on the case of suffering.

Pensions for academicians are granted for scientists worked at the state research or higher education institutions. The size of pension depends on the length of service. They were introduced as a compensation for low wages paid in soviet high schools.

Since 1st January, 2001 there are some restrictions to working recipients of the state pensions. I and II level pensions and academician's pensions are not payable to working pensioners, pensions for military service and policemen are paid only in one third.

State pensions can be inherited in the sense that survivorship pensions are paid to the spouse and children of the deceased state pensioner. The only exception is pensions for academicians, which are not paid longer if a recipient dies.

State pensions are indexed by increasing the base amount or basic salary in case of pensions for military service and policemen. The base amount is set by the Government and should be increased along with inflation.

State pensions are paid along with social insurance pensions if person is eligible for them. However, only one state pension can be granted to one person.

The largest number of state pension recipients and largest amount spent are that for pensions of persecuted persons. 14% of old age pensioners receive this pension along with the social insurance pension.

1.4 Tax regime

All pensions are tax-exempt. Contributions are in most part exempt as well. Employer pays the major share of social insurance contribution (22.5% for pensions) and deducts it from profits, only 2.5% are paid out of the person's wage. This part, employee contribution is taxable by personal income tax.

State pensions are tax-exempt, while no contributions are collected to finance them.

1.5 Third pillar provisions

In Lithuania there are no occupational employer sponsored pension schemes. The private life insurance offers the supplemental pensions but this market is just developing. There are almost 200 thous. long-term life insurance contracts signed up to date, however only small part of them deals with pension insurance (about 700). These benefits do not effect the pension system significantly as they provide for additional security in old age for very small number of people.

The legislation providing for establishment of third pillar supplemental pension funds is in operation since 1st of January 2000. It is based on joint stock companies law. These funds operate on the basis of contribution accumulation in individual accounts and are managed privately. Every legal or natural person, local or foreign, can establish such fund if it fulfils licensing requirements set up by law. Supervision of private pension funds as other capital market participants is handed over to the Lithuanian Securities Commission.

Pension funds are open. They operate as financial institutions. Every pension fund can have several separate pension schemes (programs), which differ by the investment strategy and participation conditions. Employers can establish their closed pension program within the particular pension fund.

However, so far no single pension fund was set up in Lithuania. It was due to rigid regulation established in the Law. There was a requirement to provide the participants of the pension program a minimum investment return yearly. In early 2001 this requirement was repealed and some other improvements made.

Still there is too small market for the supplemental pension insurance in Lithuania and this is another reason for the non-existence of private pension funds. The mandatory contribution rate is rather high (34%), wages are low, practically there is no space for the supplemental insurance. In addition, benefits from pension funds are in less favourable tax regime than other life insurance products.

Contributions to the individual accounts in the private pension funds are tax-exempt up to the 25% of annual personal income. Up to the same amount the employer can deduct his contributions on the behalf of the employee. Benefits from the pension funds are taxable on the same grounds as other income. However, life insurance products enjoy non-taxable contributions up the some reasonable ceiling and fully non-taxable benefits.

Some part of non-existence of supplemental provision for old age could be assigned with the Government disposition to reform the pension system and to introduce some kind of mandatory fully funded pensions. While this trend was repeatedly declared since 1994, the exact position still is not clear.

II. PENSION REFORM PROPOSAL

The establishment of voluntary pension funds was regarded as a test for later introduction of mandatory private savings for old age. However, this did not happen. For many reasons Lithuania has not seen the proposed model in operation. Social security experts and politicians as well started to talk about the necessity of introducing mandatory provision or to make another pension reform.

2.1 Political discussions on the introduction of mandatory funded pensions

The first attempt to consider such a reform was made in a group of social security experts gathered by the Ministry of Social Security and Labour in 1999. It presented to the Ministry proposals for pension reform, which entailed possible pro’s and con’s for partial privatising of the pension provision.

Later on the special working group prepared a Pension Reform Concept, which was adopted by the Lithuanian Government in April 2000. It entailed the creation of so-called three-pillar pension system. The concept indicated the main problems of Lithuanian pension system and proposed to introduce a mandatory saving but not increasing the total social insurance contribution rate. The Government set up a working group for the preparation of the reform White Paper. The group consisted of Lithuanian social security and finance experts both from state and private institutions.

Following the Concept the Pension Reform White Paper analysed in depth ways and possibilities for pension reform in Lithuania, formulated concrete proposals for organising the second mandatory saving pillar, and modelled the pension system development according to different scenarios. It was presented to the Government in October 2000.

In the fall of 2000, Lithuania had general elections and the new coalition government was formed. The government committed itself to the preparing and implementing of the pension reform. The Action Plan was adopted. As the first step the Law on the Pension System Reform was drafted and presented to the Parliament.

The Government's pension reform proposal was such: since January 1st 2003 to introduce a mandatory contribution-defined second pillar financed by a diversion of 5 percentage points of the existing social insurance contribution for insured under 40 years of age. Insured between 40 and 50 may choose whether to participate in the second pillar or not. The contribution rate for the funded pension is the same for all age groups, that is 5%. The total social insurance contribution rate is not increased. Persons above 50 years old stay with public pension pillar.

Mandatory accumulation is executed by the same type of open pension funds as stipulated in the Law on Pension Funds. However, some more strict requirements may be applied. For example, the relative rate of return would be required. The supervision of mandatory pension funds is concentrated in the Securities Commission, while the Ministry of Social Security and Labour may also play some role.

As regards the first pillar, it is touched only in that part that the first pillar social insurance pension will be reduced for switchers to the new pension system proportionally contributions paid.

The estimated cost of transition to the multi-pillar pension system was about 1% of GDP, if two thirds of insured in age group of 40-50 switched to the new system. It was proposed to finance the contribution gap occurring in the social insurance budget by the inflows from the privatisation assets partly, special purpose WB loan and the state budget means.

The pension reform proposal actually competes with so-called savings restitution program. The saving restitution program was adopted in 1997. It was executed in 1998-1999 step by step for different groups of population and recovered people's savings lost in soviet banks in the time of regaining the Independence of Lithuania and introduction of national currency. The program used privatisation means. In 2000 due to extremely bad situation in public finances the program was frozen for two years leaving uncovered liabilities to major group of population.

The Government's proposal raised hot debates in the Parliament. Mainly they were related to the means of the financing the reform and possibilities to fulfil other state obligations such as the completion of the savings restitution program and co-financing EU accession programs.

In July 2001 the ruling coalition of liberals and social-liberals fell, and a new coalition of social democrats and social-liberals formed the new Government. Social democrats questioned whether it was necessary to introduce mandatory private savings into the state pension system and to privatise the system partially. One of their social experts proposed to offer better initiatives for voluntary provisions and called it a pension reform. Lithuania was thrown back into the debates on "voluntary or mandatory private pension provision" of

1998-1999, and a new working group was created but with no results. All parties involved retained their opinions and no compromise was achieved.

The Parliament ordered a presentation of the full picture of the state obligations and prospects to fulfil them in the coming ten years. The Ministry of Finance released the opinion that it would be possible to proceed further with the savings restitution program and to implement a pension reform. It appeared that the main contraries could be accommodated. However, the scope of the reform should be a bit reduced.

The Ministry of Social Security and Labour adjusted the reform proposal. It reduced the age group for mandatory participation in the new system from 40 to 30, and postponed the starting date of the reform for one year. However, this did not suppress the "voluntary-mandatory" debates.

Opinion in Parliament was not unanimous. Symptomatically, the Social Affairs Committee supported voluntary provision very actively, while the Budgetary Committee stood for mandatory private pensions. These debates disclosed that it was not only financial concerns that differed, but that there were clear ideological differences as well. People with clearly formulated social-democratic views disliked changing the social security system itself, in fear of its privatisation and therefore weakening. On the opposite side, it was felt that voluntary provision actually meant that contributions for social security would be increased as people or their employers would pay additional amounts. This seemed to be better, even in case the subsidies for the third pillar would be approximately as large an amount as for coverage of the gaps after the introduction of the small second pillar[2].

Eventually, Parliament supported the opinion of the Social Affairs Committee. However, it was achieved by very formal procedures, and not by consensus or conscious decision. The Government, that is the Ministry of Social Security and Labour has to present the version of the draft law supporting the creation of strong third pillar provision for old age savings. It is estimated to start to be implemented from January 2003. Preparations for the second pillar provisions, if any, will be postponed.

Lithuanian employers are actively taking part in debates over the pension reform. In 1994 already they wanted to establish their own pension funds with unlimited tax deductions on contributions and no regulation on investments. Fortunately, the Government resisted to such approach. It is a concern that such proposals will be presented again taking the advantage of indecision and incomprehension of current politicians.

In the fall of 2002 Lithuania will experience presidential elections. The President will have the power to appoint a new Government. Depending on which candidate supported by which political parties wins, the Government may change. The year 2004 will also see general elections for the new Parliament. It may well be that the issue of radical pension reform will be raised again.

[2] If 20% of insured would receive state subsidies as were proposed by Social Affairs Committee, it could amount to over 120 mill. LT for the state budget – the same amount if 20% of insured would divert 5% of their social insurance contribution to private accounts or 50% of insured would take 2% out of their social insurance contribution.

2.2 The starting point for pension reform

Demographic forecasts of the Lithuanian population show some favourable periods for the pension system in the years ahead. Starting in 2004 and continuing up to 2010, the ratio of the working age population to retirees will improve. This will be due to the rather large cohort of workers born during the time of high fertility rates in 1960 and 1970s who will be in labour market, and the low numbers of persons born during the Second World War who will reach the retirement age. It is anticipated that for several years the pension system could be in surplus.

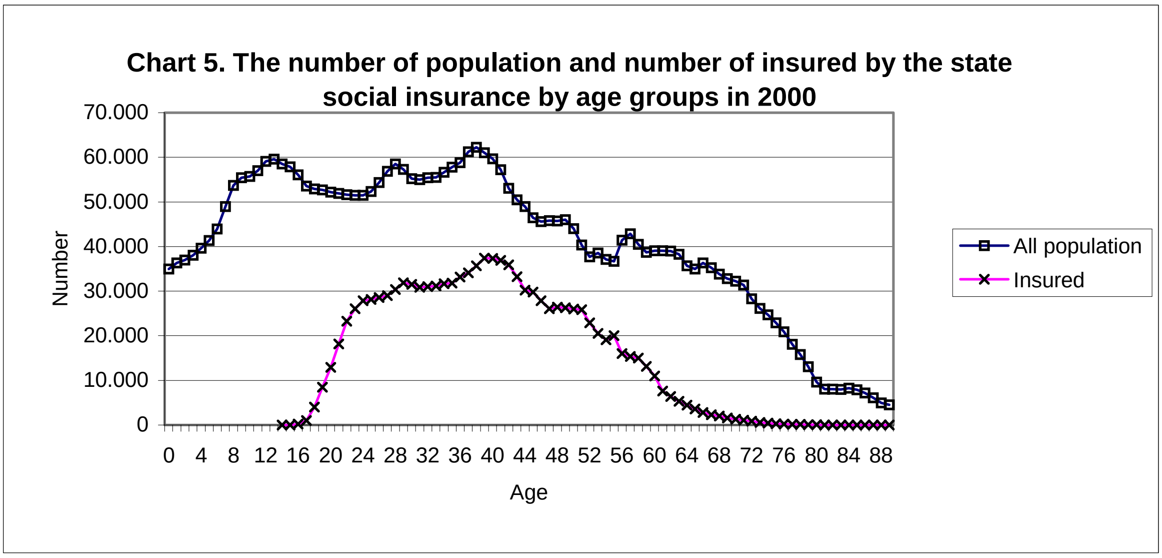
However, this improvement will not last long. From 2015 the pension system balance will go negative. It will experience a deficit of as much as 1.5% of GDP in 2055. This actually means the lack of one fifth of the inflows to the system per year, as pensions currently consume about 7.5% of GDP. Pensions are quite low (the average replacement rate is 34%), so it is very likely that the surpluses will be spent to raise benefits. This in turn means that the future deficits will be even higher.

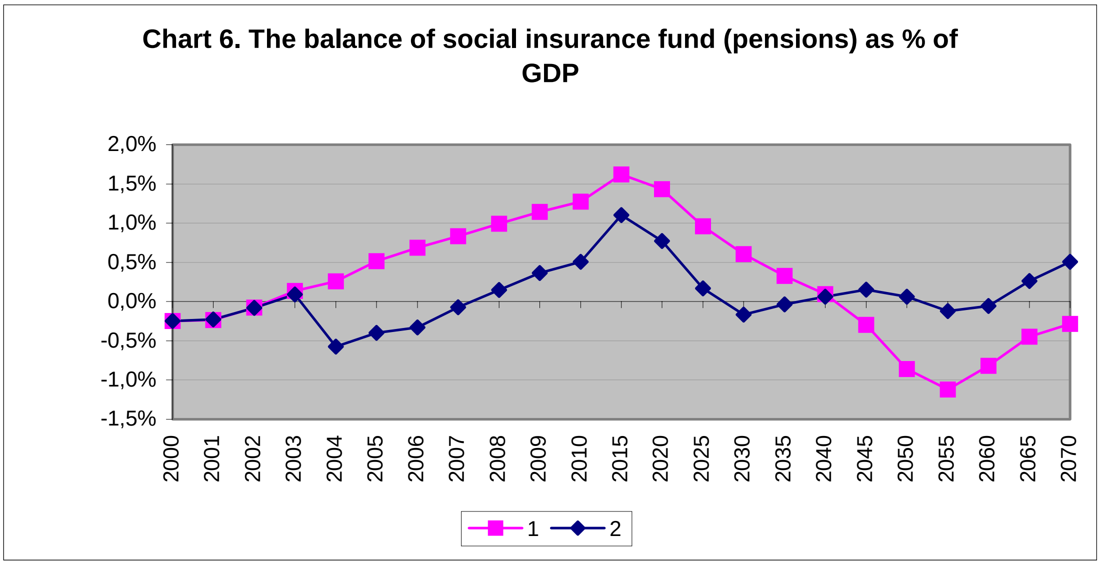
The question arises if it is possible to use predicable surpluses to cover future deficits in the system. It would be wise to reserve these monies. However, having state managed reserves one could hardly avoid spending them according to political pressures (raising pension expenditures among it). In practical terms, there is no other means to protect the money and to make it fully earmarked for pensions than to channel it into individual accounts where it will be untouched up to someone's retirement. Such individual reserves would diminish state social security liabilities and ease the burden of old age provision for future generations. A balance should be found between the interests of current pensioners who await benefit increases, and the expectations of current workers (contribution payers) to receive at least modest pensions when they retire.

It would be wise to use the expected surpluses in the system for lowering the contribution rate, increasing the lowest pensions and to introducing a funded pillar in the system. Social security contribution rate desperately needs to be lowered, as it is the main reason for tax evasion. On the other hand, the pensions are very low, people do not trust the system. The government feels constant and strong lobby to introduce an extraordinary pension from the general budget for more and more particular groups.

The temporary surpluses in the PAYG system could cover part of the transition cost due to transfer of the part of the social insurance contribution rate into individual savings. The start from transferring a part of the contribution into the individual funded schemes would make people familiar with the instruments of savings for retirement. It would allow to take a part in individual provisions almost for everybody not only the well-off. Later on, when the deficits rise, it will be more difficult to introduce pension reform.

The graphs below illustrate the contemporary demographic profile of the Lithuanian population and the possible balance of the future social insurance pension system under two scenarios.





The line 1 shows the balance of the state social insurance fund, if no pension reform is taken but the retirement age is increased up to 65 for both genders. The line 2 shows social insurance data if pension reform is launched since 2004 and insured up to 40 are contributing 5 per cent of their current wages.

2.3 The future of the pension system

It is already felt that social insurance system has to be modified. Social insurance principles are applied in very strict (or even purist) sense nowadays in Lithuania. This will lead to ever shrinking coverage of the future system. More and more people will be left without any pension because they will not meet eligibility criteria, mainly the insurance record requirement.

As new forms of engaging in income gaining activity take place, the social insurance evasion will not be less. It inevitably will become more spread, as social insurance is hardly applicable to these new forms of activity. Social insurance, as it is applied in Lithuania, was suitable in the situation when people relied on their employers, worked in big factories in defined working place for regularly paid wage. The purpose of social insurance was to provide for dependant worker a compensation for a wage not received due to so-called social risks – old age, disability, sickness, unemployment, maternity leave. Now the labour market is much different.

People lacking social insurance for old age will have to survive either on the state provided social assistance or rely on their personal arrangements. This could bring about the state with practically a minor pension system and poverty of people in old age. Inevitably something will be done in order to meet better the needs and expectations of people.

The tax base for the old age security will be broadened, including not only income from labour as an employee but other gainful activities as well. The basic approach - contributions from the labour earnings in order to get a replacement of such earnings when retired, will be altered. This could lead to the social taxes rather than contributions with not so strict linkage to benefits.

Taking into account the demographic situation (ageing population, emigration which could aggravate the social insurance system dramatically) it does not seem very likely that the state could be able to provide benefits in line with the income previous retirement. In addition, there is a doubt if it is sole state's obligation to provide a good retirement for all worked people. Persons seeking more well being in their old days should bear some responsibility for that by themselves. State run pay-as-you-go system will provide modest, basic benefits with the rest accumulated by people themselves in any private provisions.

One of the reasons to have differentiated benefits is to ensure the contribution-benefit link and therefore to make it more attractive to pay contributions. However, if contributions are levied on all income they become more like tax and this linkage is not so essential.

The contribution-benefit link should be ensured via private arrangement for retirement. The state could support such arrangements and consider these expenditures as a part of the pension system. The support may be needed due the well-known myopia of the human being.

The future of the Lithuanian pension system could be a modest state provided pension pillar supported by taxes rather than contributions and private funded pensions, mostly individual and mandatory. State pensions could be based on the coverage requirement that means keeping some record of social tax payments. People not paying taxes would fall into social assistance network.

Very similar opinion was expressed by Phare research group consisting of Finnish, Danish and Lithuanian experts under the research project Lithuanian Pension System: Alternatives and Proposals for the Future[3]. In order to solve coverage and coming poverty in old age problem they proposed to increase substantially the basic pension amount (up to 40%) and to make it universal, that is available to every citizen in old age. At the same time the increase in retirement age should be preserved until it reaches 65 years old. Earnings related part of pension should be gradually switched to the private mandatory system (starting from 2% contribution rate and reaching 10% over 20 years). The way of financing of pensions should be altered – the payroll tax lowered and the value added tax increased to fill the gap.

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[3] Jukka Lassila, Romas Lazutka, Audronė Morkūnienė, Svend E. Hougaard Jensen. Lithuanian Pension System: Alternatives and Proposals for the Future, A Summary Report by PHARE Study Group, 2000, Phare ACE Program.

The study group analysed the welfare effect of such changes by using overlapping generation model. It showed that age groups 30-50 may suffer small welfare losses, below 3 %. Retired people should gain substantially mainly due to the increase in basic pension. Interestingly, the working age population suffers the least if the policy package is implemented without any transitional period, that is immediately. This is due to cuts in the contribution rate, which bring increases in wages.

Another problem, which was touched by this research, was tax and contribution evasion. As pensions are supposed to be financed by increased VAT, the evaders also start to "participate" as they pay VAT. However, they do not gain any entitlements. On the other hand, they will be eligible for increased basic pension.

The simulations show comforting result that even the maximum losses to current taxpayers seem to be tolerable, of the order of 2-3% of the consumption stream during the remaining lifetime, if transition to an effective funded system and at the same time considerable alleviation of the problem of poverty in old age takes place.