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## **Why pension reform in Lithuania has been debated so long?**

Research Report  
P98-1023-R

December 17, 2001

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 author and it in no way represents the views of the Commission or its services.

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## **Why pension reform in Lithuania has been debated so long?**

The first debates on the introduction of private pension provision in Lithuania started in early 1994. At that time the state pension system was reformed in line with the social insurance principles. While it was based on social solidarity and therefore implied substantial redistribution, it had a link with previous earnings of the insured as well. It was believed that the earnings-benefit link would ensure a strong initiative to participate in the system, even encourage employees to press their employers to pay contribution in full.

The main concern of the Government and the Ministry of Social Security and Labour in particular was the introduction of the new state social insurance pensions payable from the separate budget and financed from the contributions. For the creators of the new system any private provisions seemed to be only additional. At that time the democratic labour party was ruling and naturally the social-democratic views preserving the social insurance principles prevailed.

On the wave of the reforming pension system and following the tradition of the Western Europe, the major employer organisations expressed an interest to have their own savings vehicle - employer sponsored pension funds. However, there were no legal provisions to establish such a unit at that time. Under the pressure of the employers the first group for the drafting a law on supplemental pension insurance was found under the auspices of the ministry in the fall of 1994. It was headed by the representative of the major employer organisation in Lithuania (Industrialist Confederation) at the Government.

After the general elections in 1996 the Conservative Party (Lithuanian Motherland Union) gained the majority in the Parliament. Before elections it signed a memorandum of mutual collaboration with the Industrialist Confederation, which imposed some obligations to the Government to consult its decisions with employers. It was the main cause why the drafting of legal basis for pension funds operation took so long. The major employers tempted very actively to make pension savings a source of cheap money for their enterprises. They drafted their own version of the law on the supplement non-governmental pension provision and presented it to the Ministry of Social Security and Labour. The draft explicitly favoured the employers' role in the private pension provision and was extremely non-transparent.

At the same time, from the beginning of 1994, the private non-governmental organisation - Lithuanian Free Market Institute started to advocate the private pension provision. It had a joint project with Hudson Institute, USA, one part of which was to formulate the proposals for introduction of funded component into the pension system and to make Lithuanian society better informed about private provisions and pension reforms worldwide.

There were some knowledge about pension reform in Chile but these data were very scarce and contradictory. The liberals admired it while the social

democrats thought it was too exotic to be followed and not applicable to the country pretending to become a part of unified Europe.

It was ten years after the Chilean pension reform and some results could be analysed. The World Bank issued the famous book “Averting the Old Age Crisis”. It was hotly debated among Lithuanian social policy experts.

The World Bank played rather active role in formulating reform proposals in Lithuania. In the fall of 1994 the first WB conference on supplemental so-called ‘non-government’ (at that time the word “private” was avoided) pension provision took place in Vilnius. It opened a later series of international events, which dealt with reform issues. In almost all of them the World Bank’s experts participated as speakers. Clarification of the government position on the private pension provision became one of the conditionalities of the structural adjustment loan.

Among the Lithuanian public the opinion prevailed that the advanced European countries had a supplemental private pension provision in one or another way which served as a remedy to make the living of Western retirees prosperous and financially stable. The traditional thinking pressed social policy makers to search for the way to adopt European models to Lithuanian environment. The model advocated by the World Bank (mandatory second pillar defined contribution plans) was considered as appropriate to the third world countries only but Lithuania. The World Bank involvement in the advocacy was regarded as a selfish action. This opinion one can still encounter in Lithuania nowadays.

However, trying to adopt so desirous Western Europe pension saving model the major legal problems arose.

As opposite to the employers’ approach the Lithuanian Free Market Institute (LFMI) advocated that in order to have transparent and safe system a separate legal entity for pension accumulation was necessary. However, there was no definition of legal entity suitable for such type of savings in Lithuanian legal system. The long learning and debating process started.

In the beginning of 1996 the LFMI presented its own draft on the pension funds based on the co-operative approach. The choice was heavily determined by the experience of Hungarians who already had operating voluntary pension funds. Actually the same expert who was involved in the creation of Hungarian system advised Lithuanians.

The Ministry of Social Security and Labour fell into dilemma – it had two drafts presented at the same moment. The LFMI’s draft was much more transparent and taking into account the interests of pension funds participants, while Industrialist Confederation draft law clearly favoured the interests of employers. The memorandum bound the ministry not to reject the industrialist’s approach. On the other hand, it clearly understood the responsibility for protecting participants’ interests.

The ministry did not take any decision and found another working group consisting of the parties involved to 'merge' two drafts. Since these drafts were based on absolutely different approaches and represented different interests, the work took a long way. Actually more than three years were spent in vain. The issue became very much inconvenient to the ministry and it was criticised from both sides – industrialists bought large spaces in dailies for articles describing inefficiency of state pension system, the Free Market Institute arranged international conferences advocating the advantages of the funded pensions and claiming the ministry for doing nothing.

During the debates the Lithuanian Free Market Institute came up with a new version of draft law on pension funds. It was based on joint stock companies' law, pension funds assumed to be another kind of separate and open profit-making financial institutions where participants would be clients. In 1999 the Ministry handed the drafting of the private pension provision over the Ministry of Finance. It realised that it was much financial issue and the responsibility of the Ministry could be too large to present one or another type of draft law.

The Ministry of Finance took the second draft of the LFMI as a background. The new working group was created from almost the same people. The employers did not further participate as they understood that there were no prospects to realise their interests in such a model.

However, the Ministry of Finance was very conscious as well. Lithuania had bad memories related to the bankruptcy of major banks in late 1995. In order to prevent any emergencies with the pension funds, which could be politically even more dangerous, the draft law on pension funds was written in a very restrictive manner with provisions not usual to voluntary savings.

### **The Law on Pension Funds**

Since 1<sup>st</sup> of January 2000 the Law on Pension Funds, which provides for the establishment of private fully funded pension funds is in force. 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 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. There are no occupational employer provided pension schemes as separate legal institutions.

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 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 to some reasonable ceiling and fully non-taxable benefits. The life insurance market is rapidly growing in Lithuania.

### **Pension reform proposal**

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

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

In the fall of 1999 new Government of the same ruling Conservative Party came into power. It was very much liberal and initiated several reforms in different fields. It started to talk about pension reform as well in the sense of introduction of mandatory savings for old age. However, there was only one year left before general elections in 2000. Any serious attempts to implement the reform were unrealistic. This government restricted itself only to the conceptual preparation of the issue.

In April 2000 after the new working group finished its job, Lithuanian Government adopted the Pension Reform Concept, which entailed the creation of so-called three pillar pension system. The concept indicated the main problems of Lithuanian pension system and clearly proposed to introduce a mandatory saving by splitting the existing social insurance contribution rate.

The idea had almost no opponents but the question of transition cost was repeatedly brought about. Following Pole's example Lithuanians decided to make a study on pension reform exploring possible reform scenarios and implementation options, so called White Paper on Pension Reform. The government set up a special working group for the preparation of the White Paper. The group consisted of Lithuanian social security and finance experts both from state and private institutions. The World Bank supported the idea as well.

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. The World Bank model Pension Reform Options Simulation Toolkit was used for calculations. The Paper was presented to the Government in October 2000.

In the fall of 2000, Lithuania had general elections and the new coalition government from liberals and social-liberals was formed. Not surprisingly the new government committed itself to the preparing and implementing of the pension reform very strongly. The Action Plan was adopted which entailed four main areas of the preparation of the reform: review and amendments to the legal basis, preparation of administration system, creation the supervision of pension funds, and launching a public information campaign. As the first step the Law on the Pension System Reform was drafted and presented to the Parliament. The responsibility of the co-ordination of the reform laid with the Ministry of Social Security and Labour while high ranked representatives from other state institutions like Securities Commission, Ministry of Finance participated as well.

The Government's pension reform proposal was such: since January 1<sup>st</sup> 2003 to introduce a mandatory contribution-defined second pillar financed by a diversion 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 will stay with public pension pillar.

The first pillar is untouched during the reform. As pension reform of 1995, which introduced social insurance pensions, already made parametric reform in the first pillar, there is no need to change it significantly. The retirement age is being increased step by step, all early pension provisions were repealed, and clear indexation rules were adopted. The only change in relation with the introduction of the second pillar will be reducing the first pillar social insurance pension for switchers to the new pension system proportionally contributions paid to the first pillar.

Mandatory accumulation will be 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 will be

required. The acquirement of life annuities will be mandatory after the reaching the retirement age. The annuities will be provided by the life insurance companies on the market but not pension funds.

The supervision of mandatory pension funds should be concentrated in the Securities Commission, while the Ministry of Social Security and Labour may also play some role.

The estimated cost of transition to the multi-pillar pension system is about 1% of GDP, if two thirds of insured in age group of 40-50 will switch 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, which is supposed to use privatisation means as well. The saving restitution program was adopted in 1997. It was executed in 1998-1999 and recovered people's savings lost in soviet banks at the time of high inflation of 1992-1994 step by step for different groups of population. The program used privatisation means. In 2000 the program was frozen for two years.

Putting the reform proposal on the agenda actualised the issue what to do with savings restitution program which was the obligation of the previous government. During the elections campaign the majority of political parties declared the negative opinion on it. However, having become a ruling coalition neither liberals nor social-liberals were so definite. It became a very politically sensitive issue as savings were restored for some groups of population and were promised later on for the others. This program was one of the main reasons for conservative party victory in 1996.

The Government's pension reform proposal was presented to the Parliament in late May of 2001. It raised hot debates. 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, co-financing EU accession programs. Actually, avoidance to spell out the clear position on the savings restitution program became one of the political obstacles to reach consensus on the reform implementation.

In July 2001 the coalition of liberals and social-liberals fell and the new coalition of social democrats and social-liberals formed the new government. Social democrats raised the issue if it was necessary to introduce mandatory private savings into the state pension system and actually in part to privatise the system. Some of their key social experts proposed to offer better initiatives for voluntary provisions and called it a pension reform. For a while Lithuania was thrown back into debates "voluntary or mandatory private pension provision" of 1998-1999, new working group was found but with no results. It was unable to issue one opinion but presented alternatives to pension reform: mandatory savings pillar which meant splitting the social insurance contribution rate or voluntary supplement to the state pension system.

Following debates in the Parliament, the Ministry of Finance was ordered to present the full picture of the state obligations and prospects to fulfil them in the coming ten years. It released the opinion that it would be possible to proceed further with 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. There was some danger that the contribution rate to the second pillar could be reduced as well but both ministries (Finance and Social Security) came to the agreement not to touch initial 5 per cent.

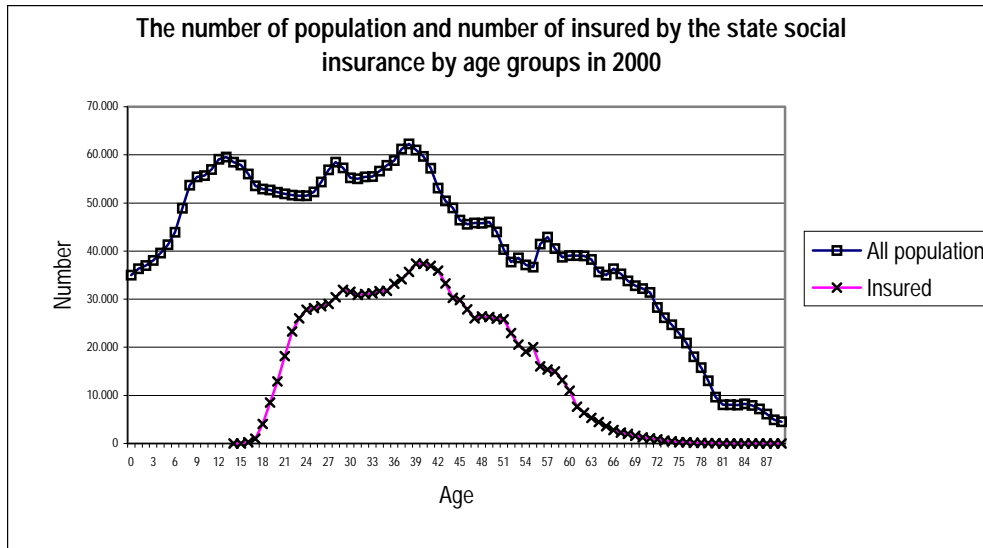
The postponing of the reform start is easily explainable. Political debates ate up at least half a year needed for the preparation. The worst thing is that there is still no clear vision on the administration of the new system. The Ministry of Social Security and Labour tends to hand social insurance contribution collection to the tax authorities while the Ministry of Finance still doubts. The Governments' position is not clear as well. The administration issue could really block the way for pension reform.

The Government will present the "adjusted" reform proposal to the Parliament in late November. There are little doubts that it will raise hot debates again. It is essential that the framework law on the reform be adopted in December of this year or February next year at the latest. Any further postponement of the decision could jeopardise the political will to engage in serious changes of the pension system. It might be that the reform proposal would not be approved in its initial shape.

In the fall of 2002 Lithuania will experience presidential elections. The President has a power to appoint a new government. The year 2004 is general elections year –a new Parliament will come. Up to this time the main preparation work should be completed in order not to reverse the reform trend.

### **The starting point of the reform and rationale to do it**

Demographic forecasts of Lithuanian population show some favourable period for pension system in the years ahead. Starting 2004 and later up to 2010 the ratio of working age population to retirees will improve. This will be due to rather numerous cohorts of workers born during the time of high fertility rates in 1960-70-ties, who will be in labour market and low numbers of persons born during the II World War who will reach the retirement age. It is anticipated that several years pension system could be in surplus.



However, this improvement will not be stable. Since 2040 the pension system balance will go negative even if the benefits would not be raised and the replacement rate would be frozen at a current very low (34%) level. It will experience deficits as much as 1% of GDP per year in 2055. In case the anticipated surpluses will be spent to rise benefits, the future deficits will be higher – up to 3.5% of GDP (if pensions rise for 30%). The case is very likely because nowadays pensions are low. Such deficits are really alarming, as now pensions consume about 7,5% of GDP. In the future a half of social insurance outlays will be lacking and that will cause a serious problem for the Government.

The question arises if it is possible to use predictable 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 it on the political pressure (rising pension expenditures among it). Practically 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. That is the most serious argument for the introduction of mandatory individual saving accounts for old age. The temporary surpluses in the p-a-y-g system could share a transition cost due to transfer of the part of the contribution rate into individual savings. These contributions would be used for individual retirement and ease the burden for the future working population.

The balance should be found among interests of current pensioners who await benefit increases and expectations of current workers (contribution payers) to receive at least modest pensions when they will retire. Pension reform can calibrate such politically sensitive balance.

The chart attached shows the balance of the state p-a-y-g pension system in case when no changes are undertaken and system is preserved as it is, when some steps to increase pensions are involved (replacement rate is being increased up to 45% until 2010) and when the pension reform is launched.

Pension reform line reflects the latest Government proposal, that is to channel 5 percentage points out of the current social insurance contribution rate mandatory for insured under 30 years of age, and on their discretion for those between 30 and 50. The reform starts since 2004. The replacement rate increases as in previous case, that is up to 45% until 2010.

