THE POLITICAL ECONOMY OF PENSION REFORM IN LITHUANIA OR WHY PENSION REFORM IN LITHUANIA HAS BEEN DEBATED SO LONG?

PRACTICAL LESSONS IN PENSION REFORM: SHARING THE EXPERIENCES OF TRANSITION AND OECD COUNTRIES

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SUMMARY

This paper describes the pension reform process during the 1990s in Lithuania and summarises the arguments of some of the key players. Following the introduction of a separate social insurance budget in 1991, a pension reform package was enacted in 1995, mainly consisting of a new pension formula, an increase in the retirement age and abolition of early retirement privileges. Negotiations over the establishment of pension funds in Lithuania lasted until 1999, when eventually a special law regulating pension funds was adopted. Although in force since 2000, no single pension fund has been set up in Lithuania so far. Reasons include a rigid regulation; the small Lithuanian market; and an unfavourable tax regime. As a consequence, there are almost no prospects to sell pension funds products, while the life insurance market is growing rapidly. Since 1999, the introduction of a mandatory fully-funded second pillar has also been under debate. Although a Pension Reform Concept has been adopted by Parliament and an Action Plan was prepared in 2000 on the basis of the White Paper on Pension Reform, the reform proposals have been altered and partly postponed by three subsequent governments since 1999. In particular, the mandatory versus voluntary character is still under discussion. In addition, the pension reform proposal actually competes with the so-called savings restitution program, particularly in relation to the issue of financing the transition costs (estimated at around 1% of GDP). The presidential elections in fall 2002 and general elections in 2004 might well put the issue of radical pension reform again on the agenda.
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1. Pension reform of 1995 and debates on private pension provision

1. After regaining independence in 1991 Lithuania started to consider its own pension system. It did not seem feasible to continue with the Soviet pension law of 1956. At that time all pensions were calculated according to the average wage 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.

2. In 1991 the separate social insurance budget was created, and in 1995 a package of laws on pensions came into force. Politically it was essential to have a system, which differed from the Soviet type and resembled the Western European systems. Thus, the Lithuanian pension system was reformed towards the social insurance principles prevailing in modern societies.

3. 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. While the new system 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, and even encourage employees to press their employers to pay contributions in full. However, this did not prove to be the case in the following years. Due to strictly applied social insurance principles and the expanding informal sector and forms of self-employment, coverage was constantly and still is shrinking.

4. The first debates on the introduction of private pension provision in Lithuania started as early as 1994, together with preparations for pension reform. However, the main concern of the Ministry of Social Security and Labour (the Ministry) and the Government at that time 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 (previous communists) was ruling and naturally the social-democratic views preserving the social insurance principles prevailed.

5. As part of the wave of reform to the pension system and following the tradition of Western Europe, the major employer organisations expressed an interest in having their own savings vehicles – employer-sponsored pension funds. However, there were no legal provisions to establish such units at that time. Under the pressure from employers, the first group for the drafting of a law on supplemental pension insurance was created under the auspices of the Ministry in the fall of 1994. It was headed by a representative of the major employer organisation in Lithuania (Industrialist Confederation).
6. After the general elections in 1996 the conservative party (Lithuanian Motherland Union) gained a majority in the parliament. Before the elections it had signed a memorandum of mutual collaboration with the Industrialist Confederation, which imposed some obligations on the government to consult about its decisions with employers. This was the main reason why the drafting of the legal basis for pension funds operation took so long. The major employers very actively attempted to make pension savings a source of cheap money for their enterprises. They drafted their own version of the law on the supplementary 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 very non-transparent.

7. At the same time, from the beginning of 1994, a private liberal oriented non-governmental organisation the Lithuanian Free Market Institute started to advocate private pension provision. It had a joint project with Hudson Institute, USA, one part of which was to formulate proposals for the introduction of a funded component into the pension system and to make the Lithuanian public better informed about private provisions and pension reforms worldwide. The active promotion of these ideas had a crucial influence on the pension reform process in Lithuania. The Free Market Institute became a very significant player.

8. In Lithuania there were some knowledge about pension reform in Chile at that time, but this information was very scarce and contradictory. The liberals admired this reform, while the social democrats thought it was too exotic to be followed and not applicable to the country aspiring to become a part of unified Europe.

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

10. The World Bank played a rather active role in formulating reform proposals in Lithuania. In the fall of 1994 the first World Bank 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’s position on private pension provision became one of the conditionalities for the structural adjustment loan. However, one should acknowledge that the World Bank never really pressed the government to make a specified pension reform along the lines discussed in the “Averting the Old Age Crisis”.

11. Among the Lithuanian public the opinion prevailed that the advanced European countries had 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 ways to adopt European models to the 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 not Lithuania. The World Bank involvement in this advocacy was regarded as a selfish action. One can still encounter this opinion in Lithuania nowadays.

12. However, in trying to adopt the desired Western Europe pension model, major legal problems arose. As opposed to the employers’ approach, the Lithuanian Free Market Institute (LFMI) advocated that in order to have a transparent and safe system a separate legal entity for pension accumulation was needed. The Institute was successful at publicising the issue and persuading the general public that it would be dangerous to follow the employers’ approach. However, there was no definition of legal entity suitable for such type of savings in Lithuanian legal system. A long learning and debating process started.
13. At the beginning of 1996 the LFMI presented its own draft proposal on pension funds based on the co-operative approach. This choice was heavily influenced by the experience of Hungary who already had voluntary pension funds in operation. Actually the same expert who was involved in the creation of Hungarian system advised Lithuania.

14. The Ministry of Social Security and Labour was not very active in this process. It focused on increases to current benefits. In 1995 it seemed too early to make any adjustments to the just reformed system. In 1997 due to unjustified increases in social spending the deficit of the social insurance fund rose, and the Ministry was mostly concerned about that. Social security experts who led the reform process at the Ministry were very sceptical about private pension provisions. Thus, it was no surprise that the Ministry took a passive position, and the most active private pension promoters were non-governmental organisations who had no real power to change the system.

15. This led to the situation where the Ministry eventually fell into dilemma – two drafts on private pension funds were presented at the same moment. The LFMI’s draft was much more transparent and took into account the interests of participants of pension funds, while the Industrialist Confederation’s 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.

16. The Ministry did not take any decision and, as it is usual in such situations, followed a smooth approach - created another working group consisting of the parties involved to “merge” the two drafts. Since these drafts were based on absolutely different approaches and represented different interests, the work took a long time. Actually more than three years were spent in vain. Due to its passiveness, the issue became very much of an inconvenience to the Ministry as it was criticised from both sides. Industrialists bought large spaces in dailies for articles describing the inefficiency of the state pension system, while the Free Market Institute arranged international conferences advocating the advantages of the funded pensions and claiming the Ministry was doing nothing.

17. At that time the Ministry of Finance was not involved in the process at all. While the Ministry of Social Security and Labour felt it lacked competence in this quite new and more financial than social issue, it could not give up as politically the responsibility for making any pension reforms was clearly assigned to it.

18. During the debates the Free Market Institute came up with a new version of the draft law on pension funds. It was based on the joint stock companies’ law, pension funds assumed to be another kind of separate and open profit-making financial institution, where participants would be clients. In 1999 the Ministry of Social Security and Labour, perhaps feeling stuck with the issue, finally handed the drafting of the private pension provisions over to the Ministry of Finance. It realised that it was much more a financial issue, with the possible consequence of people claiming back their money, and its responsibility could be too large to support one or another type of draft law.

19. 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 of potential problems as well. Lithuania had bad memories relating 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 unusual to voluntary savings.
20. Finally, the special law regulating pension funds was adopted in 1999. Savings in pension funds were offered a favourable income tax treatment – up to 25% of wage could be exempted from the personal income tax and profit tax, if it was diverted to accounts in the pension funds. However, the benefits were supposed to be taxed.

21. Employers were not interested in the issue any more, as there was no reduction in social security contributions. Trade unions supported the proposal, since they expected that additional pension savings would result in benefits in line with European standards. However, their position was a bit contradictory. Trade unions counted very much on the employers’ participation, but opposed the introduction of the release of social insurance contributions, which would be enjoyed by employers mostly.

22. Interestingly, the World Bank regarded the Lithuanian law on pension funds as one of the most clear-cut and well written. It was even proposed to duplicate it in other transition countries.

2. The Law on Pension Funds

23. Since the 1st of January, 2000 the Law on Pension Funds, which provides for the establishment of private fully funded pension funds has been in force. These funds operate on the basis of contribution accumulated in individual accounts and are managed privately. Every legal or natural person, local or foreign, can establish such a fund if it fulfils licensing requirements set up by law. Supervision of private pension funds as of other capital market participants is handed over to the Securities Commission.

24. Pension funds are open and 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.

25. However, so far no single pension fund has been set up in Lithuania. At least three reasons led to this situation: rigid regulation established in the Law, the small Lithuanian market for supplemental provision, and an un-equal tax regime. There was a requirement to provide participants in 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 a market for supplemental pension insurance in Lithuania. The contribution rate in the mandatory system is rather high (34%), wages are low, and practically speaking there is no space for supplemental insurance. In addition, benefits from pension funds are in a less favourable tax regime than other life insurance products.

26. Contributions to individual accounts in private pension funds are tax-exempt up to 25% of annual personal income. Employer can deduct contributions on the behalf of employees up to the same amount from profits. Benefits from pension funds are taxable on the same basis as other income. However, life insurance products enjoy non-taxable contributions up a reasonable ceiling and benefits are fully non-taxable. Not surprisingly, the life insurance market is rapidly growing in Lithuania, while there are almost no prospects to sell pension funds products.

3. Radical pension reform proposal

27. 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.
28. Social security experts and politicians as well started to talk about the necessity of introducing mandatory provision or to make another pension reform. 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.

29. However, the Ministry was not really interested in doing a radical reform, as it clearly realised that there was no money to cover the transition costs. The right wing Conservative Party won the elections in 1996 by promising to restore the savings lost in Soviet banks during the turmoil of regaining of Lithuania’s independence and the introduction of the national currency. This restoration was financed by the assets obtained from privatisation. Starting in 1997 some groups in the population, mainly the electorate of conservatives, had already received their savings.

30. The same source of money was pointed to as the possible source for covering the transition costs of the pension reform. So consideration of second pillar pension reform proposals was merely a reaction of the Ministry consistent with the right party’s thinking, rather than an intentional plan.

31. In the fall of 1999 after government crises, the new Government of the same ruling conservative party came into power. It was very much liberal and initiated several reforms in different fields. This Government was actually forced into these reforms, as Lithuanian public finances were in critical shape at that time, and the state started to undergo serious difficulties in borrowing on the international market. The previous government used to pursue thriftless budgetary policy increasing subsidies, social spending, and government investment. In addition, in 1999 Lithuania finally perceived the consequences of the Russian financial crises. The new Government introduced very restrictive fiscal policies and the savings restitution program was stopped.

32. Despite the bad shape of public finances, or maybe due to that, the Government started to talk about pension reform in the sense of the introduction of second pillar savings for old age. The main driving force, as for other reforms, was not a particular ministry but the Prime Minister’s office. However, there was only one year left before general elections in 2000. Any serious attempts to implement the reform were unrealistic. Therefore, the Government restricted itself only to the conceptual preparation of the issue.

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

34. The idea had almost no opponents from any political party or from social partners, but the question of transition cost was repeatedly brought up. Following the Polish example, Lithuanians decided to make a study on pension reform, exploring possible reform scenarios and implementation options, the so-called White Paper on Pension Reform. The Government set up a special working group to prepare 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, but the local experts provided the main input.

35. 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.
36. Approaching the general election, the Government, and especially the reform promoters, started to think how to ensure the success of the implementation of proposals. It was self-evident that the ruling conservative party would not be an election winner and the Government would change. In searching for political support from all parties a pension reform steering committee was set up. However, small parties unlikely to be in power and social partners only joined it. Interestingly, both employers and trade unions clearly supported the idea of introducing the second pillar, which was not the case later on.

37. 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 very strongly committed itself to preparing and implementing pension reform. The Action Plan was adopted, which entailed four main areas of the preparation for the reform: review and amendments to the legal basis, preparation of the administration system, creation of 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 for the co-ordination of the reform was laid with the Ministry of Social Security and Labour, while high ranked representatives from other state institutions like the Securities Commission and the Ministry of Finance participated as well.

38. The Government’s pension reform proposal was such: from January 1st 2003 to introduce a mandatory defined contribution, second pillar financed by a diversion of 5 percentage points of the existing social insurance contributions for insured persons under 40 years of age. Those 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 the public pension pillar.

39. The first pillar is untouched during the reform. As the pension reform of 1995, which introduced social insurance pensions, had already made parametric reform in the first pillar, there was no need to change it significantly. The retirement age is already being increased step by step, all early pension provisions are repealed, and indexation rules have been adopted. In 2001, another step to limit social security expenses was taken: the reduction in benefits to working pensioners, stricter rules for sickness and maternity leave insurance were introduced, and the increase in the retirement age was speeded up. These changes were received very painfully and the scope of any further parametric changes was now felt to be exhausted. The only change in relation to the introduction of the second pillar is a proposed reduction in the first pillar social insurance pension for switchers to the new pension system, proportionally with contributions paid to the first pillar.

40. Mandatory accumulation is to be achieved 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 purchase of life annuities is mandatory after reaching retirement age. The life insurance companies in the market but not pension funds will provide these annuities. 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.

41. 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 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, a special purpose WB loan, and from the state budget.

42. 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 executed in 1998-1999 step by step for different groups of population. In 2000 the program was frozen for two years. Now it is in operation again but in very limited scope.
43. Putting the pension reform proposal on the agenda in 2001 actualised the issue of what to do with the savings restitution program, which was the obligation of the previous Government. During the election campaign the majority of political parties declared negative opinions 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 for others. This program was one of the main reasons for the Conservative Party’s victory in 1996.

44. 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 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 fact, avoidance of spelling out the clear position on the savings restitution program became one of the political obstacles to reach consensus on the reform implementation.

45. In July 2001 the 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. Some of their key 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.

46. In this fight employers backed voluntary provision. Such position is understandable as only in voluntary private pensions could they expect their own pension funds and substantial tax and social contribution relief. The position of trade unions was not so clear. Perhaps due to fact that the organisation of trade unions were very fragmented or because they previously actively supported the idea of private pensions, it was not spelled out if they still were talking about the second or the third pillar.

47. The Ministry of Finance was actively supporting but not leading the process. The main actor on the scene was the Ministry of Social Security and Labour. 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.

48. 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.

49. 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.

50. 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 for a non-determined span of time.

51. 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, as no consensus upon this issue has been found so far.
ANNEX: THE STARTING POINT AND RATIONALE FOR 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. This is the most serious argument for the introduction of mandatory individual saving accounts for old age.

The temporary surpluses in the PAYG system could cover part of the transition cost due to transfer of the part of the contribution rate into individual savings. Later on, when the deficits rise, it will be more difficult to introduce pension reform. 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.

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.
In Figure 2, Line 1 shows the balance of the state social insurance fund, if no pension reform is undertaken but the retirement age is increased to 65 for both genders. Line 2 shows social insurance data if pension reform is launched from 2004 and the insured up to 40 years of age are contributing 5% of their current wages.