Pension Reform Gets Under Way

Changes in the system for providing retirement income promise benefits all round

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Pension systems are among the main subjects for debate in all countries' social policies. It is worthwhile remembering that a state social security system is a rather new phenomenon (not more than a hundred years old) and that in earlier times income in old age used to be an individual's personal or the community's concern. The strengthening of the role of the individual in his pension planning is evident, and is the only reasonable trend in today's pensions policy all over the world.

Lithuania introduced a pay-as-you-go pension scheme in 1995, rather late compared with countries such as Germany or France. But this made us think about the system's advantages and disadvantages from the point of view of present labour patterns.

Over its eight years of existence, the Lithuanian pensions system (Sodra) has suffered a budget deficit for most of the time, and only in 2001 did it show a small surplus. The ratio between employees and pensioners is constantly decreasing across the country.

Social insurance contributions in Lithuania are today at 34 per cent. Thirty-one per cent is paid by the employer and 3 per cent by the employee. Twenty-five per cent is allocated to pension insurance. For a long time, the average pension in the country was 320 litas per month; in 2003 it was 330 litas.

The idea of private pensions has been debated for a long time, and became a perennial topic in Lithuania for numerous reasons: the high rate of social insurance contributions, low benefits, negative demographic trends, avoidance of social insurance contribution, political risks, etc.

The first draft law on private pension funds was prepared in 1995. In 1999 the Law on Pension Funds, introducing voluntary saving, that is in addition to the 34 per cent mandatory social insurance contribution, was adopted, and amended later in 2001.

The amended law was favourable; however, voluntary pensions didn't evolve. Meanwhile, the market for cumulative life insurance was and still is growing, although it remains comparatively small.

The main reason for this is people's low incomes, in addition to the high social insurance contribution (the average income per household member was 350 litas in 2002). Under such circumstances, it was clear that a voluntary scheme, which would manifest itself only in terms of tax benefits, would not bring about any considerable changes in people's behaviour and the structure of their pensions. Therefore, another type of reform was needed.

Pension reform aimed at introducing mandatory fully-funded saving with private pension funds (called the second pillar) was scheduled for 2000, but was postponed several times.

Finally, in the autumn of 2002, the Law on Pension System Reform was adopted. The law lays down the following rules: from the beginning of 2004 every employee will have the right to direct 2.5 per cent of his social insurance contribution to a chosen private pension fund. This share will be increased annually to reach 5.5 per cent in 2007. People will be allowed to enter into a private pension system freely, and no restrictions will be imposed on age.

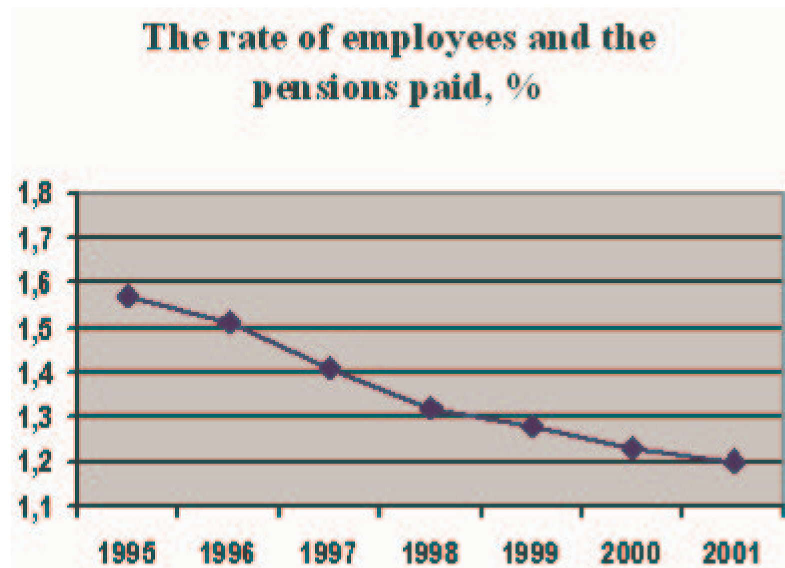
The reform will not entail any changes in the payments to present beneficiaries of the pay-as-you-go system. Contributions will be tax-exempt, while benefits will be subject to taxation. The accumulated funds will be an individual's private property. The funds' assets will be kept separate from the assets of the fund managers, which will rule out embezzlement.

There is only one risk: a drop in the value of the equity. But this risk will be minimised by the long period of investment, investment regulations and close supervision. However, these factors will definitely increase administration costs, and thus decrease investment returns. Participants in pension funds will have the chance to choose the pension programme which best meets their needs in terms of returns and risk.

Some argue that the reform is too modest to encourage any special changes, because private funding is optional and the rate of the contributions to go to private pension funds is just 2.5 per cent. As for the size of the contribution, it would be safer to make it larger to ensure the reform's success (at least to 5 per cent).

But bearing in mind the pressure of time, it is most important to start the reform with the right model in the first place. Then it will be easier to speed it up once the reform has been launched.

The market also supports the reforms. In the spring of 2003 some companies announced their readiness to offer pension products.
Pension reform in Lithuania is designed to achieve two major goals: to create a financially viable pension system, and to create opportunities for better retirement provision for future pensioners. Another goal of the reform is to improve institutional investment and the capital market. If well implemented and accepted by the people, the reform will have wider positive effects on society, such as an increase in individual responsibility for a person's own future and a decrease in the political risks in the area of social security.



Source: Social Security Fund (Sodra)