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# EVALUATION OF LITHUANIAN PENSION SYSTEM REFORM AND FINANCIAL CRISIS IMPLICATIONS

## 1. Introduction

In the late 20th century and at the beginning of the 21st century, the majority of the European Union (hereinafter – EU) countries and EU candidate members paid serious attention to the reform of the existing pension system. The aging population and declining birth rates in different (especially in the economically developed) countries began to pose a threat to the implementation of social security budget. Rising of old-age pension amounts and the decreased sum of contributions to the social security budget mostly forced governments to find solutions for social security budget balancing [Holzmann 2000; Barr 2000; 2004a, b; 2006a, b].

Therefore, by reforming pension systems countries endeavour that participants of social security system would have possibilities to switch a part of compulsory paid social insurance contributions from state social insurance scheme to private financial sector – private pension funds [World Bank 1994].

Lithuanian government anticipated that participants of the social security system would start to accumulate old-age pension on individual accounts in private pension funds. It seemed that temporary favourable demographic situation and balanced social security budget will enable gradual transfer of a part of the liabilities to the private sector obligations [Fultz 2003; 2004]. However, recent collapse of the global financial system and economic recession forced Lithuanian government to reduce financing of the pension system reform and put under question future development of the pension system reform.

Problem: There is no systematic assessment of Lithuanian pension system's results. In order to prepare possible development scenarios of the reform, it is

expedient to assess the extent of the pension system reform, to evaluate the performance of private pension funds and to grade the impact of reduced financing on the reform.

Object: Lithuanian pension system reform.

Goal: Analysis of social and economic reasons of Lithuanian pension system reform, evaluation of the results of the reform, grading the impact of reduced finance and providing possible solutions for further development of pension system reform.

Methodology: comparative analysis, logical and systematic analysis of literature.

The analyzed topic is actual, because achieved pension system's results are evaluated in the initial phase of the pension system reform. Moreover, proposals, which could be successfully adapted to the subsequent development of the pension system reform, are provided in the article. The article also considers a political risk and its influence in the recent period, when financing of the pension system reform was reduced. The publications of world's well-known social economy researchers, Lithuanian pension system reform laws and statistical data are analyzed in the article.

## 2. Objectives and initial results of Lithuanian pension system reform: above expectations

Implementation of Lithuanian pension system reform was determined by economic and social conditions. Declining birth rates and high emigration caused a decrease in workforce and social security tax payers. Increasing average life expectancy suggested growth in the number of the pension recipients. Therefore, it might lead to social security budget-balancing problems in a long term. The reform of pension system was needed to solve possible future problems. Particularly, the changes in funding sources of pension were needed. Diversification of social and economic risks between public and private sectors was needed.

Change of the existing pension system so that retired persons would receive more benefits than before is the long-term goal of the pension system reform. It was described in the conception of pension system reform. Moreover, the pension system reform was aimed at reducing redistribution of social security budget.

Pension system reform act authorized voluntary choice for persons of any age insured in social insurance to participate in the pension system reform by joining private Pillar 2 Pension (hereinafter – P2P) fund or remain only in public social security system. However, after a person had already moved a part of social contributions to private P2P fund, the withdrawal from a private pension scheme was not allowed, unless the pension contract was terminated within 30 days of its conclusion.

The reform should financially balance the social security pension system so that it could function in the coming years without a financial deficit in the country

and encourage private savings market and reduce tax evasion. The core condition of the pension system reform was to ensure that future retirees would receive benefits from two sources – social security fund and private pension fund. Moreover, the pensions would be higher, and the state could ensure the continuing financial stability of private P2P funds [*Baltoji pensijų...* 2000].

By planning social security budget expenditures concerning the pension system reform minimum and maximum assumptions about possible participation rate were made. In fact, accumulation of old-age pension in private P2P funds was chosen by more people than it had been expected. Respectively, more premiums from the social security budget were transferred to private P2P funds.

In optimistic scenario, it was estimated that 40% (or ~395 thousand) of insured person, which may join private P2P funds, would choose to do it in 2004. However, optimistic forecasts have already been exceeded in 2004. Till the end of 2008 the number of participants exceeded the planned by more than a third, and private pension accumulation contracts have signed almost 957 thousand participants (Figure 1).

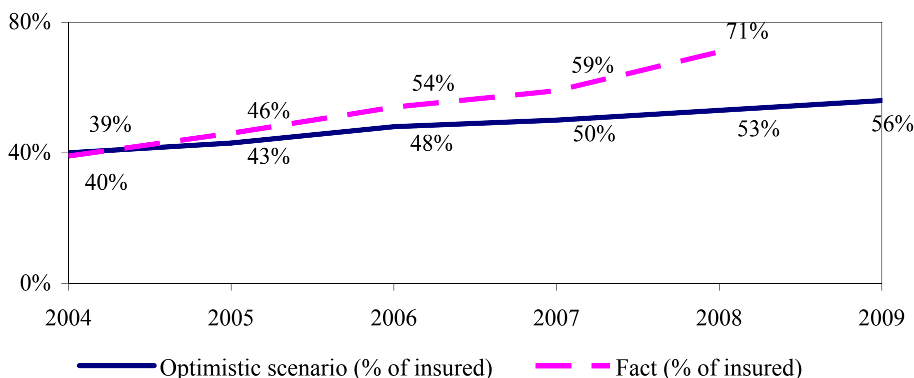


Figure 1. Participants of private P2P funds

Source: own elaboration, based on Ministry of Social Security and Labour data.

Faster than expected the pension system reform's development determined higher actual contributions from state social security budget to private P2P funds. Actual and planned contributions were almost the same in 2004. However, actual contributions to private P2P funds were 50% higher than planned at the end of 2008.

Investment management is another important aspect of private P2P funds and the pension system reform in general. Strict legislation requirements clearly defined investment management for the private P2P funds. It created business environment, which allowed reducing the risk of P2P funds investment activities. Additional opportunity for minimizing investment risks was given by the law to private P2P fund managers. Each pension accumulation company was forced to develop a conservative investment pension fund. The conservative fund should invest solely

in the Lithuanian, EU, OECD governments', European Central Bank's and other central banks' securities, bonds and other investment instruments with guaranteed return. Conservative fund benefits would be fully exploited if P2P funds participants transferred accumulated capital at least for several years until retirement to the fund. Investment return fluctuations were expected to be minimal in comparison with other pensions funds, offered by the same accumulation company.

Investment performance of private P2P fund has been monitored regularly since the beginning of Lithuanian pension system reform. In order to compare investment return accurately, private P2P funds should be classified according to the investment strategy. P2P funds' division, which was provided by Lithuanian Association of Financial Analysts, is widely used in Lithuania. It is based on evaluating part of investment in stocks, comparing to all investment portfolio of P2P fund. Most private P2P funds are "mixed" and invest in stocks' and bonds' markets. Association of Financial Analysts identifies four P2P funds categories, according to the degree of investment risk (or investment in the stocks market):

- government bonds (0% stocks) P2P funds,
- small part of stocks (up to 30% stocks) P2P funds,
- average part of stocks (30-70% stocks) P2P funds,
- stocks (up to 100% stocks) P2P funds [Finansų analitikų asociacija 2009].

Table 1. Analysis of P2P funds investments return 2004-2008 (in %)*

| Category of P2P funds | 2004 | 2005 | 2006 | 2007 | 2008 | Average |
|---|---|---|---|---|---|---|
| Government bonds (0% stocks) | 1.0 | 2.5 | –0.1 | 1.8 | 2.9 | 1.6 |
| Small part of stocks (up to 30% stocks) | 1.1 | 8.5 | 5.6 | 3.2 | –12.6 | 1.2 |
| Average part of stocks (30-70% stocks) | 2.3 | 11.6 | 6.9 | 3.0 | –22.7 | 0.2 |
| Stocks (up to 100% stocks) | 1.4 | 22.2 | 21.3 | 8.2 | –41.6 | 2.3 |
| **Lithuanian P2P funds** | **1.5** | **8.2** | **5.3** | **3.2** | **–17.5** | **0.1** |

* Calculations are based on unit-price changes.

Source: own elaboration, based on Association of Lithuanian Financial Analyst data.

It is possible to compare not only investment returns, but different investment risk indicators of private P2P funds from the same category. Pension fund investment returns and risks can be objectively evaluated only after several years. Firstly, P2P funds are long-term investment instruments, and fund managers should not seek short-term benefits, but long-term ones. Secondly, only after collecting long-term history of the investment results it would be possible to calculate reliable investment profitability and other indicators concerning P2P funds performance [Finansų analitikų asociacija 2009]. However, critics of the pension system reform argue that "we cannot wait for decades and find out that private P2P funds activity was unsuccessful" [Lazutka 2007; 2008a, b].

Concluding: first results of the reform show that participation rate was higher than expected and the start of the reform was successful. Existing financial institutions in the markets, state administrative and financial market supervisory institutions and moreover – aggressive sales and marketing activities of pension accumulation companies – are main factors which influenced successful start of the pension system reform.

## 3. Is there something to improve?

The goals of the pension system reform were setting out only the positive consequences of the reform. However, after execution and evaluation of pension system reform's first results it was possible to see not only positive effects.

World Bank Report on Lithuanian pension system reform maintained that current pension system sooner or later would "require difficult policy choices between higher contribution rates, older retirement ages and lower benefit formulas." Eventually pension expenditures are expected to increase from approximately 27% to 40-45% of participant's salary. This figure "can be construed as mandatory social insurance contributions or tax rate needed to balance the pension system revenues and costs." The report stated that "taxation of labour income at these levels is not likely to be feasible if the Lithuanian economy is to remain competitive and continue to grow" [World Bank 2008].

One of the negative consequences of the reform is that pension size is guaranteed neither by the state nor by the private P2P funds. Failure in investment performance directly influences P2P funds. There are no guarantees to the participants that decreased old age benefits from the state will be compensated by payments from private P2P funds. In other words, there is a risk that persons who accumulate old-age pension in P2P funds will not receive higher old-age pension and can receive even lower pension. Since the pension accumulation process was started in 2004 when all world economies and financial markets had positive trends, these types of risks were assumed as theoretical rather than practical. However, Lithuanian private P2P funds investment return was –20% in the period from 1.01.2008 to 31.03.2009 [Finansų analitikų asociacija 2009].

Legislation provides the opportunity to establish a pension fund that guarantees a yearly fixed investment return. However, none of the Lithuania private P2P funds guarantees a fixed return and the future of the pension (annuity) amount.

Uncertainty in the financing of the pension system reform is the main weakness of the pension system reform. In 2005 after evaluation of pension system reform National Audit Office of the Republic of Lithuania reported that "the government should project long-term sources of funding, which is needed for covering costs of pension system reform" [Valstybinio audito ataskaita 2008]. However, the government never had clear position on the pension system reform funding sources. According to

the Ministry of Finance, prolonging retirement age, increase of social security contribution rates or stable (but low) replacement rate are the main possible sources of financing in long-term perspective.

Looking at the pension system reform from a long-term financial stability it remains problematic, because currently all financial obligations (old-age pension for existing pensioners and payment of premiums to private P2P funds) remain for the government. Economic crisis and growing unemployment unbalanced social security budget. Moreover, revenues of social security budget are decreasing, because part of money is continually transferred to the private P2P funds. Commitment on private pension amount is not provided, but old-age pension from social security fund will be reduced for participants of private P2P funds. From this point of view, liabilities will be reduced for future retirees by the privatized old age pension part. Financial stability of the pension system reform might be increased by reducing social insurance scope [Lazutka 2007; 2008a, b]. World Bank Report on Lithuanian pension system reform maintains that “Lithuania’s pension system also suffers from considerable uncertainties” [World Bank 2008].

Uncertain growth of old-age pension size and the trend in government’s decisions to spend all collected social security premiums on current old-age pensions did not allow to use advantages of rapid wage growth in past decade and to accumulate surplus of the social security budget, which later could be used for mitigating unfavourable demographical changes.

It was suggested that surplus of social security budget should be used to further developments of the pension system reform in the next few decades [Lietuvos laisvosios rinkos institutas 2009]. However, recent financial crisis corrected the current situation.

Concluding: the beginning of the pension system reform was successful, but some aspects of the reform might be improved. Firstly, there is no guarantee for accumulated capital. It is possible to obtain smaller old-age pension from private P2P funds than from state social insurance if a pension accumulating company will show negative investment results. Secondly, uncertainty in financing sources might lead to the crash of the reform.

## 4. Effects of financial crisis to Lithuanian pension system reform

The financial crisis has affected Lithuanian pension system reform quite strongly. Firstly, fiscal problems are arising from the crisis. At the beginning of 2009 it was decided to reduce contributions to private P2P funds from 5.5 to 3.0% for two years. Moreover, reduction of contributions to private P2P funds from 3 to 2% for two years recently was approved by the government.

Recent changes seem to come from the fiscal side. Firstly, as a consequence of the crisis, social security budget balance has deteriorated and the government needs

to finance the deficit. Secondly, due to Euro Zone access (Maastricht criteria), the government does not want to take additional fiscal deficits, nor issue more government debt. Shifting contributions from second to first pillar will help in filling the "gap" in social security budget. World Bank pointed out these negative consequences of recent measures. Firstly, it will lead to contract-breaking with a society. It will increase expectations that changes may become permanent. Moreover, it will not be easy to reverse and reach premium levels which were declared for the participants of the pension system reform. Secondly, pension accumulation companies are likely to put less attention to management of pension funds [World Bank 2008].

Alternative responses to the crisis need to be found instead of decreasing contributions to private P2P funds. There are several possible ways of solving the problem. Firstly, old-age pension expenditure cuts for current retirees needs to be evaluated. Lowering or reversing indexation, while protecting the most vulnerable, might balance the social security budget. It is effective, but very painful solution. Secondly, new retiree flow might be decreased. It might be achieved by increasing retirement age or implementing more stringent disability approvals. It takes time to influence finances and may put additional pressures on unemployment program. Thirdly, contributions to social security budget might be increased. However, it may further reduce formal taxable wage bill, and create negative externalities for further economic recovery. Finally diverting contributions from other programmes (e.g. health) might be done. Of course it will have to be substantial to matter. Moreover, identifying and implementing expenditure cuts in other programmes may take time. Summarizing, there are possible alternatives decisions which lead to keeping the same contributions to private P2P funds level. It is important that current changes in the pension system reform are transitory.

The financial crisis has affected the investment returns of pension funds in different countries and Lithuania pension funds are not exception. However, a comparison of average investment returns shows that the situation is not so dramatic. Table 2 shows that investment performance of Lithuanian P2P funds is above average comparing to Central and Eastern European countries. Moreover, considering investment returns since inception, the situation is even less dramatic. For a person retiring tomorrow, the maximum loss of total pension is less than 1% of the pension. Considering that only 10% of the contributors to P2P funds are more than 50 years old,1 it seems that current financial crisis will not influence big number of old age pensioners, who accumulate additional pension in private P2P funds.

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[1] The retirement age is 60 years for women and 62.5 years for men. It means that there are still 10 years in which investments will be made.

Table 2. Investment returns' comparison of P2P funds in Central and Eastern European Countries*

| Country | Yearly investment return 2008 (%) | Average yearly rate of return from inception till 1st of January 2009 (%) |
|---|---|---|
| Bulgaria | –32.5 | –7.2 |
| Estonia | –34.7 | –3.1 |
| Hungary | –22.2 | –0.2 |
| Latvia | –26.9 | –8.7 |
| **Lithuania** | **–26.5** | **–0.5** |
| Poland | –18.5 | 5.5 |
| Slovakia | –9.8 | –2.8 |

* Calculations are based on changes of assets under management. It includes fees which are applied by different private pension funds.

Source: own elaboration, based on Association of Financial Analyst.

Concluding: current financial crisis is creating a need for a permanent adjustment. Firstly, holistic approach is needed. Secondly, more efficient and less painful long-term reforms should be implemented now to allow phasing out emergency measures as soon as possible.

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