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Tuuli Koivu

Current issues in pension reform in the Baltics

Bank of Finland
Institute for Economies in Transition, BOFIT

Bank of Finland
Institute for Economies in Transition (BOFIT)

PO Box 160
FIN-00101 Helsinki
Phone: +358 9 183 2268
Fax: +358 9 183 2294
bofit@bof.fi
www.bof.fi/bofit

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Abstract

A deteriorating demographic situation, rising unemployment, difficulties in taxes, and a growing informal sector have created substantial difficulties during recent years for the pay-as-you-go (PAYG) pension systems in Baltic countries. For the purpose of guaranteeing solid pension systems, all three Baltic countries are implementing “three-pillar” systems, which supporters claim will be more robust to demographic changes. Latvia leads the Baltics in pension reform, having all pillars of the system working. Nevertheless, Baltic pension reform remains a politically thorny issue. This fact may delay plans to have three-pillar systems operational in all three countries by the beginning of 2003.

Keywords: Estonia, Latvia, Lithuania, Pension systems, Social security

1 Introduction

The Baltic states inherited pay-as-you-go (PAYG) pension systems from the Soviet Union. Under a PAYG, those who work pay the benefits of current pensioners. These systems rapidly became unsustainable after independence due to demographic shifts (aging populations with low birth rates), transition effects (rising unemployment), and lacked a strong link between contributions and benefits. Employees had little incentive to pay taxes, preferring instead to work in the growing informal sector.

The Baltic countries moved to reform their pension schemes in the mid-1990s with the proposed adoption of so-called “three-pillar” pension systems. The objective was to ensure long-term affordability of the welfare system while preserving an adequate social safety net for all. A scaled-down PAYG system would be the first pillar of the new arrangement. The second pillar would be a fully funded (FF) system of privately managed savings accounts, financed by a portion of the payroll tax. The third pillar would comprise privately managed pension funds based on voluntary contributions.

The main argument for the three-pillar model is its ability to cope with dynamic demographic situations. By raising the returns on savings, it preserves the real value of benefits without substantially raising contribution rates, even when the dependency ratio rises. In addition to providing income security, mandatory FF accounts may raise the aggregate savings rates and accelerate financial sector development. Conceivably, they can even spur economic growth by reducing distortions in the labor market and improving political stability. Critics point out that three-pillar systems may actually increase risks to the economy. Financing the transition from a PAYG system to a three-pillar system may cause problems, and institutions, particularly in transition economies, may be poorly equipped to implement reforms.

The earliest pension reforms in the Baltics involved downsizing PAYG systems. This involved raising retirement ages, eliminating extra benefits, and strengthening the link between contributions and benefits. Next, the third pillar, i.e. voluntary pension schemes, was created. At present, Latvia’s parliament has approved legislation for establishing mandatory pension funds (the second pillar), while Estonia and Lithuania are still working on legislation for this aspect of the new system. All Baltic countries would like to have their three-pillar systems in place and functioning by the beginning of 2003. This seems quite optimistic given the political controversies associated with pension reform and the simple fact that it is dependent to some extent on the success of long-term institutional reforms.

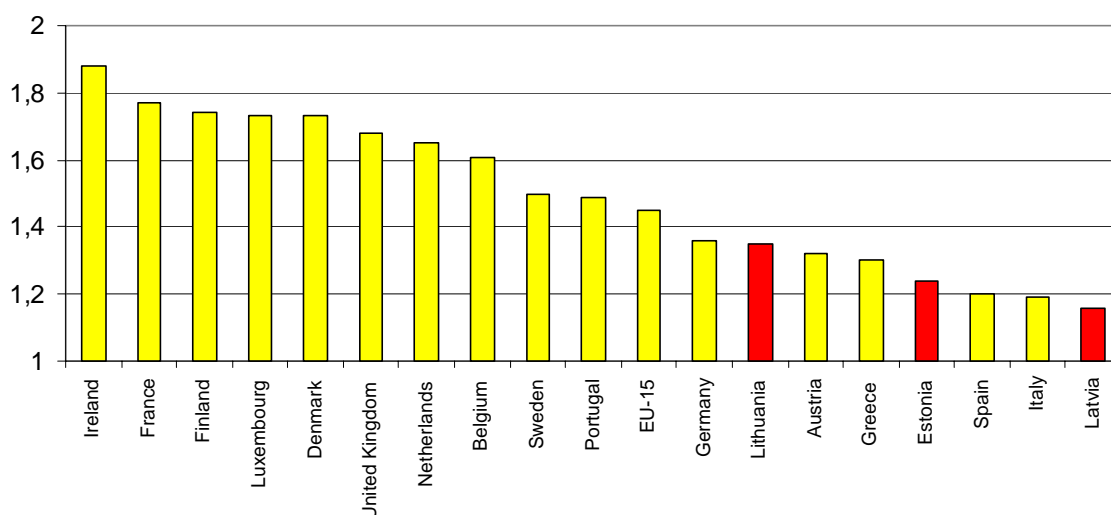
2 Pay-As-You-Go Pension Systems

Under the publicly managed PAYG pension system inherited from the Soviet Union, those who worked paid rather generous benefits to those on pensions. This redistributive approach raised the pension benefits for workers with relatively low labor income and decreased the benefits for workers with high labor income. This complex system of benefits only weakly linked contributions to pension benefits. The standard retirement age was 60 for men and 55 for women, but it recognized many categories of employees with special needs. For example, miners, workers in heavy industry, teachers, and police all enjoyed lower retirement ages. Moreover, early retirement was popular thanks to lax eligibility requirements. The pension benefit was normally based on years of service and earnings only during the final years before

retirement. Years of service included periods when a person was not actually at work, e.g. on maternity or child-care leave, involved in academic studies, or performing military service. As a result, benefit rules favored certain groups and led to large disparities in benefits among pensioners with similar education, work tenure, and pre-retirement incomes. The system also discouraged individuals from accumulating assets during working years, because saving to derive capital income was not allowed. (Schiff et al. 2000.)

Baltic PAYG systems were financially stable well into the 1980s thanks to favorable demographic circumstances and high employment. Most employees worked in state-controlled institutions, so tax collection was successful. The frailty of the system emerged after independence as it was swiftly overwhelmed by slight increases in the numbers of pensioners combined with very low fertility rates (figure 1). As the structurally induced high unemployment rates of early transition set in, revenues to pension systems fell. Baltic governments reacted by increasing contribution requirements, only to discover that, due in part to the weak link between contributions and benefits and the harsh social circumstances, they were encouraging both employers and employees to find ways to avoid tax payments. And there was another problem – decentralization and privatization of state enterprises undercut the state’s ability to enforce tax collection.

Figure1. Fertility rates in the EU and the Baltics in 1999



Source: Recent Demographic Developments in Europe 2000. Council of Europe, Strasbourg

It was soon apparent that Baltic pension systems had lost their ability to guarantee pensioners a sufficient standard of living. Indeed, nominal pension increases failed to match inflation until the latter half of 1990s when legislatures moved to protect the real value of the average pension. However, the real incomes of pensioners continued to lag real wages as political priorities shifted away from pensioners to education, infrastructure, and families. Last year, the average monthly old-age pension was just 1,500 kroons (95 US dollars) in Estonia, 60 lats (100 dollars) in Latvia, and 300 litas (75 dollars) in Lithuania. At the same time, the average gross monthly salary was 5,300 kroons (300 dollars) in Estonia, 150 lats (250 dollars) in Latvia and 1100 litas (280 dollars) in Lithuania. The average Latvian pension, for example, was well below the 80 lats subsistence minimum. As a result, workers that had taken early retirement or disability pensions went to work in the informal sector while drawing benefits.

3 Three-pillar pension system

To guarantee sustainable pension system in the face of an adverse demographic situation, the Baltics committed to three-pillar pension systems in the mid-1990s. The three-pillar systems were hoped to provide an element of insurance, while discouraging moral hazard and free-riding behavior. They also sought to downplay the redistributive character of the pension system and strengthen the relationship of benefits and contributions.

The first two pillars are mandatory and thus forms of compulsory saving. The first pillar, a scaled-down version of the earlier PAYG public pension system, was designed to offer a social safety net for the elderly while strengthening the link between activity and pension benefits. Given its limited scope, this scheme lowers the level of contributions compared its predecessor. The second pillar is intended to supplement first-pillar pension benefits through a privately managed funded system. It is to be financed through mandatory contributions taken out of wages. The third pillar consists of privately managed pension fund, where participation is voluntary. It is meant for high earners or individuals wishing to obtain higher income than provided by the compulsory pillars. Public involvement in third-pillar systems is limited to enforcement of regulations on investor protection.

Pension systems with privately managed second-pillars have been established, for example, in Australia and several Latin American countries. In United States and Canada, the second pillar is publicly managed, but otherwise similar. There are arguments both in favor and against the privately managed system. Arguments against rely on the possibility of adverse selection, while arguments in favor claim the system increases individual choice. The privately managed system in Chile has been relatively successful, although the state still guarantees a minimum pension for everyone (Barr 2000).

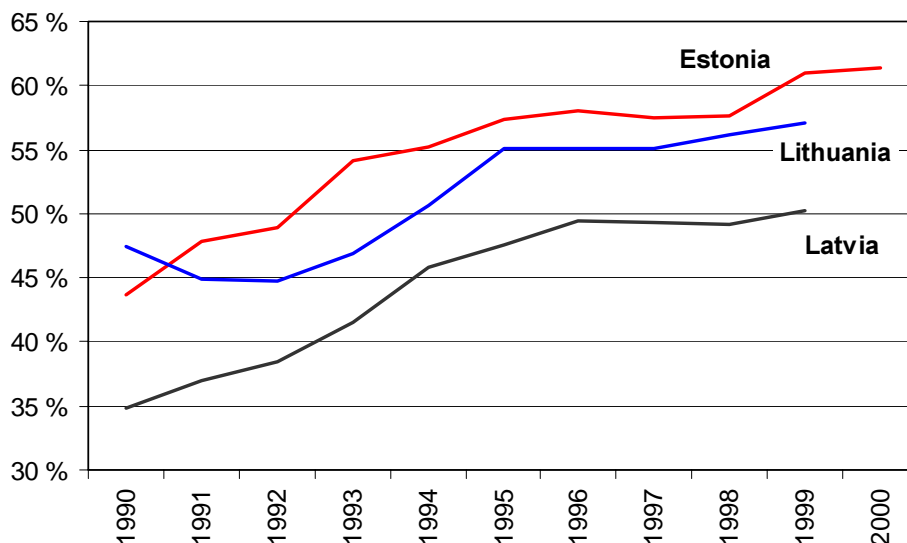
3.1 Advantages of three-pillar systems

Proponents argue that the three-pillar pension system offers both economic and political advantages. They see positive effects of pension reform extending far beyond a successful restructuring of a major public expenditure program, since it puts the economy on a permanently higher growth path than otherwise possible. They also note that the approach reduces labor markets distortions by establishing a close link between contribution and benefits. For these reasons, they expect accelerated financial market development and higher rates of saving and capital accumulation. They claim the funded system is more robust to demographic shifts, more transparent, and more politically independent than the PAYG approach.

3.1.1 Dealing with demographic changes

The demographic situation has deteriorated in the Baltics. Birth rates dropped significantly throughout the 1990s and the dependency ratio (number of pensioners divided by the number of people employed) in the Baltics is higher than in most major industrial countries. (Figure 2 and 3.) As a result, public pension expenditure has quickly risen (figure 4). In 1999, public pension expenditure in Estonia amounted to 8.6 % of GDP, in Latvia 12.3 %, and in Lithuania 7.6 % (Schiff et al. 2000). In 1998, EU expenditure on pensions averaged 12.6 % of GDP, with expenditures varying between 4.1 % in Ireland to 14.7 % in Italy.¹

Figure 2. System Dependency Rate

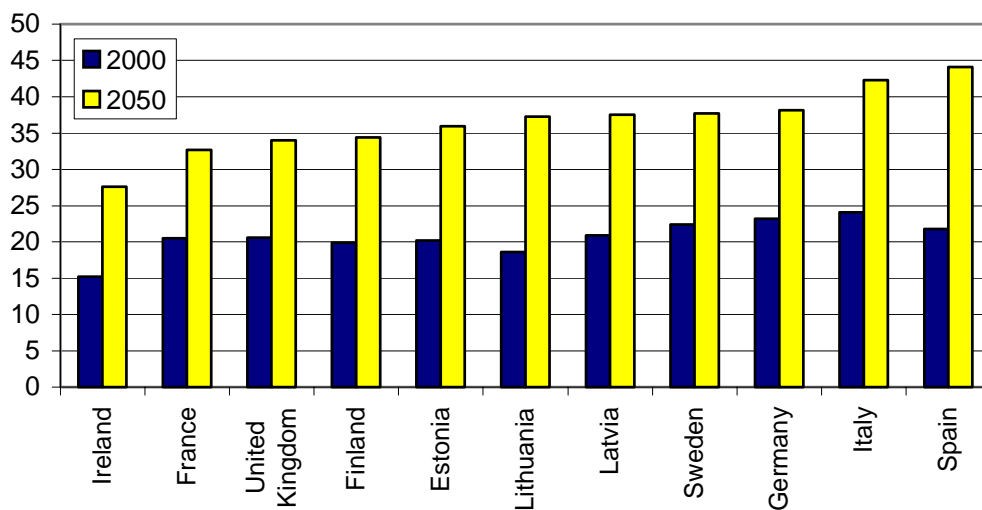


Sources: Lithuanian Statistics Department, Statistical Office of Estonia, Latvian Statistics Department

All three Baltic countries have had difficulties in recent years keeping their social insurance fund in balance. The situation is expected to deteriorate further as baby boomers born in the late 1940s and early 1950s begin to retire. In Latvia, there are currently around 400 people of pension age for every 1,000 people of working age. The number of pensioners is forecast to increase to more than 500 per 1,000 by 2050. In Lithuania, there are 745,000 persons of retirement age. In 2050, this will rise to 800,000 persons.

Three-pillar pension systems are expected to provide a higher rate of return on savings than the PAYG system, and thus allow the state to provide the present level of benefits without raising the contribution rate even as the dependency rate increases. The funded system will probably be fairer from the standpoint of intergenerational distribution than the PAYG system as everyone’s benefits are functions of their own contributions (Hemming 1998).

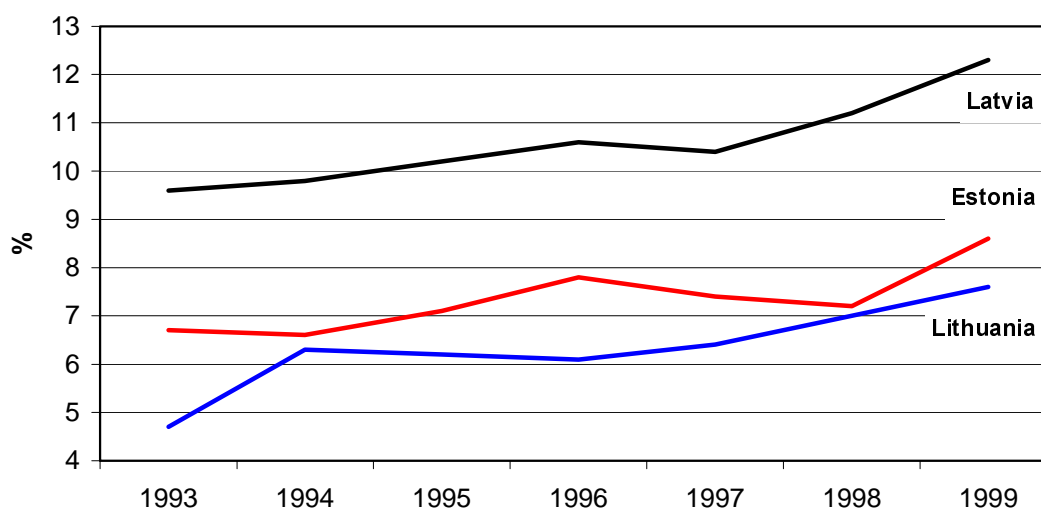
Figure 3. Proportion of persons 60 and older to total population in 2000 and 2050



Source: UN World Population Prospects: The 2000 Revision

In any case, the rate of return is to a certain extent influenced by demographic changes. If future generations are numerically smaller than current generations and their demand for capital is lower than the supply of capital from current generations, the price of capital, i.e. the rate of return, will fall (Schimmelpfennig 2000). If pensioner consumption exceeds worker saving, excess demand in the goods market may lead to price inflation and thus reduce the purchasing power of pensioners. These changes can be avoided by increasing output so that there is no excess demand for goods (and hence no inflation), or by assuring that wages rise and workers' demand for assets covers pensioner desire to sell assets (Barr 2000). Another approach is to allow international investment in countries where the demographic situation is more favorable than in the home country. In this case, the rate of return is subject to foreign exchange rates.

Figure 4. Pension expenditure, % of GDP



Source: Schiff et al. 2000

3.1.2 Reducing labor market distortions

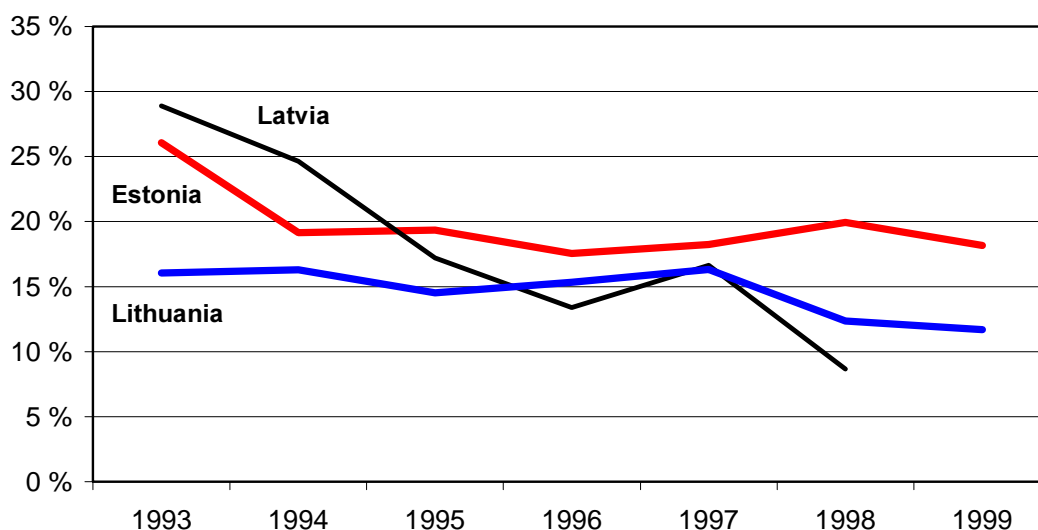
Increasing unemployment also drove contribution rates by impairing revenues to the PAYG system. At the end of 2000, the unemployment rate was 13.9 % in Estonia, 14.6 % in Latvia and 16.1 % in Lithuania. In addition to tough labor markets, generous early retirement provisions helped push workers out of the labor force, which led to a decline in labor participation rates. In 2000, the portion allocated to pension insurance was 20 % of payroll in Estonia, 27 % in Latvia, and 25 % in Lithuania (Zilite 2000). The PAYG system did not encourage workers to contribute into the system or pressure their employers to comply with social tax rules. High contribution rates also promoted the underground economy and tax avoidance.

By providing a clearer connection between lifetime contributions and pension benefits, the new system could help improve the efficiency of labor markets and accelerate economic growth in two ways. First, it would nudge labor back from the informal sector into the formal sector. A few models indicate this will contribute to higher economic growth when the formal sector uses more productive technology (Holzmann 1996). Second, the overall supply of labor might increase when payroll taxes decrease.

3.1.3 Increased national saving rates and capital accumulation

The saving rates in the Baltic countries have been relatively low (figure 5).² However, the three-pillar model is expected to stimulate saving, which could, in turn, increase investments in productivity-improving projects and raise output. However, theoretical and empirical studies on the relationship of saving rates and pension systems are ambiguous. Gale found evidence for the United States that increases in private pension plan savings are not fully offset by declines in voluntary saving. Studies elsewhere tend to be inconclusive (Barr 2000). For example, Loayza et al. (2000) found no evidence that a mandatory fully-funded pension system would increase the saving rates, despite extensive research on 150 countries over 30 years. One possible explanation is that when the rate of return on the obligatory second pillar is high, employees cease to worry about their future and stop making voluntary contributions.

Figure 5. Saving rates in the Baltics



Source: IMF: International Financial Statistics.

Mackenzie et al. (1997) find that contribution rates and workable strategies financing transition costs are critical to successful implementation of pension reforms. To maximize the impact on savings, the authors recommend that transition costs be financed by tax increases or maintenance of payroll taxes, and that contribution rates under the new system should be as high as possible.

3.1.4 Accelerating financial market development

Proponents of the three-pillar system claim it will accelerate development of financial markets. They cite Chile's pension reform, noting the positive development of the country's financial markets and improvements in the domestic savings rate (Holzmann 1996). In some cases, pension reform confers sufficient certainty to capital formation and productivity-enhancing investments that the economy may be placed on a faster economic growth path.

While the banking sectors in the Baltic countries are fairly stable and relatively functional, equity markets are still tiny and undeveloped. Pension reform is expected to accelerate development in this area.

Vittas (2000) observes that pension reform can benefit financial markets in many ways. One potential benefit accompanying the growth of institutional investors is the intensification of competition in the financial system. Also modernization of market trading demanded by institutional investors makes the financial sector more efficient and more profitable to users. Pension funds can stimulate financial innovation and support development of new forms of investment. Moreover, institutional investors tend to be concerned with how well enterprises are managed, which may promote efficient corporate governance and market integrity. In emerging countries with weak regulatory structures, the biggest long-term benefit of creating private pension funds may well be the establishment of new and robust regulatory agencies that have a strong positive demonstration effect on other segments of the financial system.

Vittas warns, however, that the above-mentioned benefits are not conferred automatically. Pension funds may have no impact on the efficiency of financial markets if they do amount to at least 20 % of GDP or hold at least 20 % of outstanding equities. Further, even when pension funds are substantial, constraining regulations may limit their impact on capital market development. For example, a requirement to invest their resources in non-marketable government bonds may constrain equity holding. Thus, regulations can harm the rate of return of the pension funds and eliminate stimuli for development of domestic securities markets. This is why a pluralistic structure is important if pension funds are to stimulate competition, encourage innovation, and promote efficiency. It may also raise the rate of return of the funds and prevent a single fund from dominating the financial markets. Finally, a pluralistic structure can help ensure that corporate governance and control are not dominated by a public institution or in a handful of private institutions.

Empirical results concerning the effect of financial sector development on economic growth are ambiguous (Tsuru 2000). Under the endogenous growth theory, development in financial sector may affect economic growth by increasing productivity of investments or savings allocated to investments by decreasing transition costs. The financial sector may also affect the savings rate and thus economic growth.

3.1.5 Greater transparency and reduced political risks

Holzmann (1996) identifies three ways in which a three-pillar pension system might increase political reliability. He argues that pension reform is time-consistent. Hence, credible reform that eases the need for continuous reforms stabilizes the political situation. Second, the new system largely insulates retirement provisions from political interference. Politicians are unable to affect the level of benefits for political reasons. Holzmann notes that new system sensitizes workers to financial issues and enterprise performance, reducing the dichotomy between capital and labor. This, too, encourages improvements in labor productivity and higher economic growth.

Barr (2000) counters with two reasons effective government is critical for the success of three-pillar pension system. First, he notes that fiscal imprudence on the part of a government may accelerate inflation, which in turn would reduce the real return to (or even decapitalize) pension funds. Second, funds may be vulnerable to lack of regulatory capacity in financial markets, e.g. for reasons of consumer protection.

In the Baltics, politics have often dictated the indexing of pension benefits, so indexing has not tracked inflation, or even been predictable. Moreover, disputes over pension reform cut deeply across political lines. Final decisions about the new system are difficult because certain interest groups inevitably benefit at the expense of other interest groups.

3.2 Problems related to three-pillar system

We now examine the main problems facing pension reform in the Baltics. Leading the list is how to finance the transition from a PAYG system to a funded pension system. As current members of the labor force are already expected to pay the benefits of current pensioners, how can they also contribute funds for themselves? The disadvantage of adopting a three-pillar system is that moving to it imperils the very purpose of the pension system, i.e. old-age security for workers. Analysts also doubt the capacity of the institutions in transition economies to make a completely new system work properly.

3.2.1 Transition costs

Even if, as Holzmann claims, the situation in labor and financial markets ease or eliminate the double burden on the transition generation, dealing with transition costs remains the most intractable challenge of pension reform. Financing options include raising pension contributions, cutting pension benefits or other public expenditures, or increasing public debt. Transition economies have the additional option of dedicating revenues from the privatization sales state assets to covering transition costs.

The amount of financing required depends on the how the second pillar is proportioned. The larger the payroll contribution and the more employees participating in second pillar accounts, the greater the deficit in the first-pillar PAYG system. Thus, the objectives of pension reform and the economic and institutional constraints determine the optimal size of the second pillar. Some estimates put the lower limit for the payroll contribution rate at 4-6 %. Below that, moving to the new system becomes too inefficient. On the other side, financing costs limit the maximum size of the second pillar. Estimates of the upper limit are in the range of 7-10 % of payroll (Lindeman et al. 2000).

Simulations by Hviding and Mérette (1998) suggest taxation to be the most favorable way of financing a new pension system, but also note cutting benefits as an option to financing the transition phase. Their basic argument is that when transition costs are financed by debt, reform becomes counterproductive due to low investment rates and high debt-service payments. The main advantage of debt financing, they note, is that it makes it possible to spread transition costs over several generations.

The optimal financing strategy depends on the country's external balance situation. A country with a strong current account surplus can choose the politically attractive option of extensive debt financing and distribute the transition costs over many generations (Schimmelpfennig 2000). On the other hand, a country with high external debt must rely on taxation, and thus, there is only one generation available to pay the transition costs.

Every country reforming its pension system must identify the most suitable way of financing the transition costs. Chile committed to its reform during a period when the government budget was running a surplus of 5 % of GDP. Recent estimates show there are still fiscal pressures, even 20 years after reforms. Sweden seeks to finance its transition costs with a

trust fund in which it has accumulated SEK 750 billion, or 40 % of GDP. Most of the assets in the fund represent real investments, but there are also government bonds. General tax revenues will finance redemption of these bonds. Among transition countries, Hungary plans to rely on debt financing during the first year but after that it tries to keep its budget unchanged by finding measures to offset the contribution loss. Kazakhstan has decided to rely on debt financing, while Poland hopes to finance its reforms through privatization sales (Cangiano et al. 1998).

According to preliminary calculations, pension reforms in Baltic countries will cost about 1 % of GDP during the first year. The transition period will take 3-8 years and after that the pension scheme should be balanced. Baltic countries have yet to decide how they will finance the transition costs. They plan to finance the costs partly by borrowing and possibly use money from privatization sales. Unfortunately, the Baltics are all quite vulnerable to external shocks due to their openness and large current account deficits. So far, these current account deficits have been offset by large foreign investment flows, often in connection with privatization projects. In Estonia and Latvia, privatization is almost complete, so FDI flows could diminish. On the other hand, the Baltics have quite modest levels of external debt. Lithuania, with the worst position, has foreign debt amounting to about 25 % of GDP. Given that Maastricht treaty only expects EU accession candidates to have external debt of less than 60 % of GDP, the Baltics still have plenty of breathing room. The payroll tax in Baltic countries is already high, so there is no enthusiasm for further increases. On the other hand, cutting benefits is unrealistic given the current modest level of pension benefits.

3.2.2 Higher risks to pensioners

Traditional PAYG systems normally exert a balancing effect on the economy during a recession by paying out guaranteed pension benefits. If a FF system fails during a recession, it could amplify the shock to the economy by reducing pensioner incomes. Structural changes in the economy and market turmoil can also reduce rates of return. These risks must be borne by imperfectly informed individuals (Barr 2000). Other risks include demographic changes that influence asset prices and unexpected inflation that damages the value of pension funds (Hemming 1998, Heller 1998). Management risk can also arise through incompetence of operators in the financial sector or involved in supervision (Barr 2000). Indeed, one of the big advantages of PAYG systems is that risks are shared among pensioners, contributors, taxpayers, and future taxpayers.

The risks faced by pension systems can be particularly high in small economies like the Baltics. The financial sector is still tiny and undeveloped and there are real risks associated with the adequacy of government regulation and supervision of the pension funds, competition among funds, and transparency of fund operations to investors. Of these, focus on the skills of the state supervisory authority is the most critical. Here sophisticated management is needed, because success depends on a government's ability to walk the fine line of providing comprehensive supervision without imposing overly restrictive rules (e.g. on the composition of investment portfolios) that may disturb the markets (Heller 1998). Moreover, an undeveloped financial sector can decrease the rate of return by lowering the productivity of investments. In Estonia, the capitalization of the Tallinn Stock Exchange at the end of 2000 was less than USD 1.8 billion, or 36 % of GDP. The market capitalization of the Riga Stock Exchange amounted only to USD 0.6 billion (8 % of GDP) and the Lithuanian National Stock Exchange was worth USD 1.6 billion (14 % of GDP). Clearly, the three-pillar pension

system would face considerable difficulties with strong restrictions on investing abroad. All the Baltics have already completed their preliminary talks on the chapter on free movement of capital in their EU membership negotiations, so the restrictions on investing pension funds abroad are unlikely.

3.2.3 High administrative costs and preconditions to success

Launching a new pension system needs to be complemented with development of institutions and preparation of a legal context for the reforms. The development of privately managed pillars assumes at least rudimentary capital markets and an adequate regulatory framework to limit investment risk. The funded system also has marketing and administrative costs that may lower its efficiency.

Vittas (2000) identifies three preconditions to successful implementation of pension reform. First, the authorities must be strongly committed to maintaining macroeconomic stability. Particularly, they must be willing to maintain low inflation; neither the financial sector nor institutional investors can function efficiently in environments with high, volatile inflation. Broad fiscal balance is also important as a key to a low inflation. Second, there must exist a core of sound, efficient institutions. Third, there must be effective regulation and supervision.

The Baltics have all demonstrated a commitment to macroeconomic stability. Inflation is low and public deficits continue to decrease. The main worrying point is the effect of ongoing current account deficits on external balance. They have also made progress toward fulfilling the last two demands. Baltic countries have sold their biggest banks to foreign enterprises, which has helped to develop strong, efficient banking sectors. In Lithuania, the development of the banking sector has proceeded slower, but there are already many international actors involved in the banking sector. Notably, the Baltics have made great strides in developing financial supervision and legislation related to the supervision in anticipation of EU membership. However, the institutions are still relatively weak and suffer from a lack of capable personnel.

A Summary of the Pros and Cons of Funded Pension Systems

| Pros | Cons |
|---|---|
| <ul style="list-style-type: none"> - Robustness in the face of demographic change - Closer links between contributions and benefits reduce labor market distortions - Higher saving rates and capital accumulation - Acceleration of financial market development - Greater transparency and reduced political risks | <ul style="list-style-type: none"> - Dealing with transition costs - High investment risks for pensioners - High administrative costs and preconditions to success |

4 Reforms to date

The first attempts to introduce a national pension system in Baltic countries occurred in 1991-1992. These attempts were unsuccessful due to the unstable economic and political environment. The parliaments in Estonia and Latvia adopted new pension laws in 1993 and Lithuania introduced new pension legislation in 1995. All three countries started the reform by

scaling back their PAYG systems. The aim was to cut public expenditure of pension system by raising the retirement age, revising the indexing system and tightening the eligibility for early retirement and disability pensions. The countries also sought to establish a closer link between lifetime contributions and benefits. This was expected to increase the share of employee contributions, discourage working in the informal sector, and improve tax compliance.

Latvia committed to a three-pillar pension system in 1995. While all Baltic countries now have legislation in force for the third pillar, voluntary pension funds have yet to attract much interest. Latvia has passed a law on the second pillar. The Estonian and Lithuanian parliaments are expected to adopt similar laws in the near future. Although all three countries are developing three-pillar pension systems, their models differ significantly.

4.1 First-pillar reforms

In **Estonia** the retirement age has been revised upward each year since the beginning of 1994 so that a retirement age of 63 years will be reached in 2006 for men and in 2010 for women. The New Social Tax Act in 1999 introduced the possibility of early retirement at a reduced pension. In **Latvia**, the 1995 pension legislation foresaw an increase in retirement age for women from 55 to 60. After Russia's financial crisis in August 1998, the Latvian government decided to gradually increase the retirement age to 62 years for both women and men. Early retirement at 80 % of full pension is allowed only to persons with at least 30 years of service. In **Lithuania**, the aim is to attain a retirement age of 62 years for women and 62.5 years for men in 2009 (Schiff et al. 2000). The retirement age will likely increase to around 65 years eventually to ensure financial stability of the pension system.

The countries have also changed their indexing provisions to guarantee affordability of the pension system. In **Estonia**, pension increases have often been politically motivated – and not entirely predictable. To bring certainty to the process, the Estonian parliament passed a state pension insurance bill in December 2000. The act foresees indexing of pensions every April according to the consumer price index and the social tax paid by a person before reaching pension age. The new indexing system enters into force in 2002. In **Latvia**, pensions are indexed to the consumer price index and wage index. During the accumulation period, contributions in the account will be indexed so that liabilities do not grow more rapidly than revenues. Pensions will also be adjusted for life expectancy and demographic changes. The law eliminates special pension increases to pensioners who reach the age of 80. In **Lithuania**, pensions are indexed to a weighted average of minimum level of standard of living and average wage in the economy (Schiff et al. 2000).

Estonia introduced the first pillar of its new pension system at the beginning of 1999. The new system consists of three components: a National Pension Rate determined each year by parliament, a length-of-service component, and a level-of-contributions component. The national pension is granted to a person who has reached retirement age. Long service is highly appreciated in the system and guarantees a high-level pension for a worker even with low-level contributions. The implementation of new principles made it necessary to register all social tax payments in individual accounts. **Latvia** introduced its new pension system in 1995, which strengthened the link between lifetime contributions and pension benefits. Under the new system, the monitoring of each workers social tax payments has been improved; workers have individual accounts into which they make payments. Every year workers receive statements of their contributions and accumulated savings. This may increase personal

motivation to make contributions. According to the new formula, the earlier one retires, the less money he receives as a pension. There are some groups of people whose pension, according to this system, would be very small. For them there still exist a minimum guaranteed pension of 30 lats per month to every worker that reaches the age of 65. **Lithuania** reviewed its pension system in 1994. As a result, the pension benefits in Lithuania are counted as a function of years of service and earnings. The basic pension is determined according to years of service so that workers having at least 30 years of service receive the full basic pension and those with less than 15 years are ineligible for the basic pension. The supplementary pension is formed according to a worker's lifetime earnings and contributions (Schiff et al. 2000).

The benefits for working pensioners have also been cut. In Latvia, a working pensioner with monthly pension above 60 lats will receive 60 lats. In Lithuania, it was decided in May 2001 that working pensioners earning less than a minimum monthly salary get their pension in full. Working pensioners earning more receive only the base monthly pension.

The experience with pension reform in the Baltics has been mixed. Some reform influences will be far-reaching. Increases in retirement age and tightening of eligibility for benefits has strengthened the finances of the pension fund in all three countries. For example, the Estonian Social Insurance Fund (SIF) remained financially sound until mid-1998 and did not allow pension expenditures to get out of hand. However, the financial position of the Estonian pension fund has recently become more precarious. First, in mid-1998, it lost almost 20 % of its surpluses due to the closure of two banks. Second, a deteriorating social tax revenue performance due to the slowdown in the economy in combination with the 24 % increase in average pensions that became effective in 1999 has resulted in sizable deficit for the SIF. Also in Latvia, the financial situation worsened when benefits were substantially raised as a political appeasement. In Lithuania, the weak economic development due to Russian crises in 1998 at the same time with increasing number of pensioners led to deficits in the social insurance funds. In 1999, the deficit was 1 % of GDP. Despite the increase in the payroll tax, the deficit was estimated at 0.4 % in 2000.

4.2 Reform of the second and third pillars

In **Estonia**, the third pillar of voluntary schemes was established in August 1998. That year, the country's largest bank, Hansabank, announced the first private pension fund in Estonia. Payments made to voluntary life insurance pension contracts are made by employees and the contributions to the funds are exempt from income tax.

After intense political debate, the Estonian government submitted to parliament in April 2001 a draft of its second pillar pension reform. If the government approves the second pillar scheme, it would be introduced on July 1, 2002. Under the draft pension bill, entering the new system is optional for anyone currently working. It will become compulsory for those coming entering the workforce after January 2002. According to the draft, employees would pay the 2 % tax currently contributed to the state scheme, while employers would be expected to pay in an additional 4 %. The Ministry of Finance estimates that financing the second pillar will create a budget deficit of 0.9 % GDP in 2002, 0.5 % in 2003, and 0.1 % in 2004. In the longer term, the budgetary situation will ease. Estonian parliament will decide later this year, how pension reform and related transition costs will be financed. The authorities do not consider extensive debt financing a viable option, but accumulated proceeds from past privatization sales and the proceeds from future privatization sales could be made available. The Estonian authorities do not regard pension reform as a tool for promoting a domestic capital market.

They are opposed to forcing people to invest only in government debt instruments or other domestic instruments. Allowing investments to go outside Estonia, the risks to pensioners would be diversified and returns would be less dependent on the economic situation in Estonia.

Latvia has been the Baltic leader in pension reform. Its third pillar has been working since 1998, although these private pension funds are still unpopular with employers. In Latvia, both employers and individuals can make contributions to the funds. Employee contributions to the third pillar are tax deductible and the tax on earnings is deferred. At the end of last year, three open pension funds were licensed. The lion's share of private pension funds went into the closed fund of Lattekom, which provides pension insurance for its 4,500 employees (Zilite 2000). Accumulated additional pension capital stood at LVL 4.7 million at the end of June 2000.³

The Latvian parliament adopted a law on its second pillar in February 2000 and it has been working since July 1. Contributions to the second pillar by employers and employees under 30 years old are mandatory, while contributions by those between the age of 30 and 49 are optional (De Castello Branco, 1998). Second-pillar contribution rates at the beginning of reform are set low to limit transition costs. The contributions then rise from 2 % of income in 2001-2006 to 4 % in 2007, 8 % in 2008, 9 % in 2009 and 10 % from 2010 onwards. Contributions to the first pillar will be reduced accordingly. The authorities have projected pension fund assets in 2020 to be 20 % of GDP (Lindeman et al. 2000). To reduce administrative costs, the State Social Insurance Agency (SSIA) will operate the pension fund during the initial 18 months (Fox & Palmer 1999). SSIA will likely invest the funds primarily in state securities and time deposits with banks. Starting from 2003, the management of the funds will be entrusted to private companies. More detailed regulations about the investments is still to be done. The pillar will be supervised by the national supervisory agency from 2003.

The **Lithuanian** parliament approved a law that provides the legal basis for establishing a system of supplementary voluntary pension schemes in 1999. Again, the third pillar has not tempted investors to date. The government is planning tax incentives to encourage voluntary contributions by both employees and employers.

In Lithuania, disagreements over funding prevented progress of a bill to establish compulsory private pension funds. The tabling of the bill occurred in June before the collapse of the New Policy government. The new government has promised to push ahead with the reform. Lithuania's second-pillar law should be approved by parliament during current year. Under the bill pending, the law would come into force from the start 2002 and the first transfers would be made at the beginning of 2003. The bill suggests that 5 % of the current tax paid to social welfare and pension fund SoDra be transferred to compulsory cumulative funds. Participation would be obligatory for those under 40 years old and voluntary for those between 40 and 50. According to preliminary calculations, in 2003 about 870,000 persons or 75 % of employed persons would become participants in the second pillar. The objective is that each person participating in the second pillar would be free to choose a pension fund operating in the country. State supervision of pension funds will be arranged and carried out by Securities Commission. Securities Commission Officials will distribute licenses to each fund and make the necessary restrictions to the investment targets. The Ministry of Finance has calculated that the transition will cost some LTL 500 million (USD 125 million) a year or 1.0 % of GDP. It expects a balanced budget by 2011. The government has planned to finance 50 % of the transition costs with the accumulated privatization proceeds held in the national Reserve Stabilization Fund. The remaining costs would be financed by debt. The World Bank has promised to provide financial and technical support to Lithuania. Lithuanian officials are

not worried about the financing. They expect most funds will be invested in Lithuanian government securities. They also believe that the reform will speed up the development of the financial sector and increase the savings rate, and by doing so, accelerate economic growth. The aim is to keep the first pillar at its current level during the transition. The second pillar will then gradually bring in extra benefits. The aim of the reform in Lithuania is to increase the average replacement rate from the present 40 % to 50 % in 2023.

Conclusions

Pension reform was inevitable in the Baltics. The problems with the pay-as-you-go system inherited from the Soviet Union appeared along with worsening demographic conditions, rising contribution rates, and extensive tax avoidance. All three Baltic countries decided to adopt a three-pillar model. The model can be realized in many ways in accordance with the particular needs and circumstances of the country. So far, only Latvia has actually finalized the details of its second pillar. The Estonian and Lithuanian parliaments are expected to adopt second-pillar legislation in coming months. Latvia still has many open questions concerning its second pillar, particularly transition rules. Indeed, no Baltic country has yet adequately addressed the question of financing of transition costs. Current preliminary calculations of transition costs rely on optimistic expectations on the rate of return generated on mandatory second-pillar savings. This may be a mistake, given that pension reforms elsewhere (e.g. Chile and Sweden) cost much more than Baltic planners currently assume. In any case, any financing plan will have to be clear enough to assure that the new system does not severely harm the interests of new pensioners in the short run.

Estonia and Lithuania have yet to determine such issues as pillar sizes, risk protection for pensioners, administration of the funded system, regulations on investments in the second pillar, and tax treatment of pension contributions. These decisions will essentially determine the characters of their pension systems and their influence on the economy. The choice in Estonia and Lithuania is between a large reform with more employees participating the system (and thus a larger financial deficit), and light reform with a smaller second pillar and more modest fiscal deficit. If the Estonian and Lithuanian parliaments approve currently proposed drafts of reform, both countries will be committed to more extensive reforms than Latvia. The reforms would mean higher contribution rates and more employed participating in the second pillar. This will cause a larger financial deficit, but may also make the second pillar more efficient. Considering the worsening demographic situation, the adequacy of the Latvian reform also needs to be addressed. In all three countries the size of the pension benefits must be determined along with the level of redistribution of benefits among pensioners. An open question is what guarantees the governments will give to the pensioner in the event his pension fund goes bankrupt. All these decisions concerning the pension reform have political ramifications. Indeed, political changes could even threaten the continuity of the pension reform process.

Baltic citizens should remember that developing their financial sectors or raising their savings rate are not goals of reform in themselves, but means to guaranteeing sufficient income for pensioners. It would be unfair to ask pensioners to carry all the risks by restricting them to investing only into their small economies in order to develop their country's tiny financial sector or to accelerate economic growth by increasing capital formation. Baltic countries are small, open economies where economic fluctuations are unavoidable. In this environment, a solid pension system could even help smooth these fluctuations. For pension

reform to be successful, it requires a comprehensive reform package covering all areas of macroeconomic and microeconomic policy. In particular, these countries need to have a working financial supervision agency, solid macroeconomic formation, well-developed institutions, and tight fiscal policy so that the economy benefits from pension reform. It is easier for any pension system to work in a healthy environment.

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Notes

¹ <http://europa.eu.int/comm/eurostat>.

² In 1999, the gross domestic savings rate in EU countries varied between 16 % of GDP in Greece and 28 % of GDP in Finland. (<http://www.worldbank.org/data/databytopic/databytopic.html>).

³ Latvian Insurance Supervision Inspectorate, <http://www.vaui.gov.lv>.

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