Reforms of Pension System in Lithuania

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Abstract. Lithuania, like other Central European countries, undergoes a deep reform of the old age security system. The reform takes place in a controversial cognitive environment. The controversy is between methodological individualism and methodological holism as peculiar worldviews. The two world outlooks provide different reform perceptions and scenarios.

Key words: methodological individualism, methodological holism, public pension funds, private pension funds, mixed pension system

Introduction

Otto von Bismarck's initiative to begin with public pension system was in fact the beginning of what is today called welfare state. This endeavour had a multidimensional, intended and unintended, impact on the development of Western societies. Welfare state was a humanistic, softening political stresses (political tensions softening), economically prudent invention. It created conditions for more secure, more humane life, for appeasement between classes and for the evolutionary rather than revolutionary development of Western societies, for emergence of adequately educated and trained labour, to mention only a few dimensions.

Today the Bismarckian model is under heavy attack. Welfare state is criticised for being a heavy burden for public finance and for tax payers, for its corruptness, wastefulness, bureaucratism and other sins. This criticism comes mainly from neoclassical, neoconservative quarters, from adherents of methodological individualism. Having in mind the ideological and political power of these circles in the past two decades, it is no surprise that such an attitude influenced substantially not only public debate, but also the decision making process in many countries. Lithuania was among them.

The other part of the public and political discourse, which to a different extent upholds the holistic approach towards economy, admits that the contemporary welfare state has certain weaknesses and shortcomings, but they argue for reforms, but not for abolition of the welfare state.

Thus, discussion on the issue of pension reforms is part of wider disagreements on what economy is, how to make it more effective, and what the future of the whole public sector is, will be or should be. Those who assume that economy is synonymous to market naturally want to make public sector part of economy through marketization and privatisation. Others, who come mostly from the quarters of institutionalism, keynesism, social economy and who insist of the enrichment on economic science and economic thinking with the concepts of public goods and social capital are ready to discuss the means of economisation and rationalization of the public sector (among them privatisation), but they don't see marketisation as a panacea from all deficiencies of the welfare state. Therefore, when they discuss pension reforms they don't easily recant all Bismarckian argumentation.

Part of these people have in mind Wagner's law, another German invention of the late 19th century. It says that with the development of market economy the ratio of state expenditure to national product grows. In other words, German economist Adolf Wagner discloses the tendency of public economy growth. Wagner's law held for more than a century. Did it cease to hold in the 21st century? To our knowledge, the question remains open and requires a thorough scientific (theoretical and empiric) investigation.

Privatisation of pension system: pros and cons

Though there are stark differences between the opposing sides, the majority of specialists in the field agree on at least the following:

- the pay-as-you-go (PAYG) system faces major difficulties connected with the ageing of population. The ratio between retirees and labour or dependency rate is worsening (it is not the case with most oriental and Latin America's societies) and financial strains in the system are growing;
- PAYG is vulnerable to the political and administrative risk. With deterioration of political situation and insufficient efficiency of public administration the danger to the pension security increases;
- private pension funds could contribute to the development of financial markets. Accumulated contributions of participants of the pension fund would be used to purchase securities (shares and bounds) what would mean creation of additional demand in the financial markets and, finally, more investments;
- the connection between recent earnings and future pensions in PAYG systems often is not evident;

On most of other issues the two competing camps disagree. Adherents of methodological individualism insist that:

- publicly run pension funds are condemned for inefficiency, waist and unsustainability;
- an individual should avoid a pension system based on social solidarity or collectivism. An individual should take responsibility for his own old age security. He should accumulate part of his earnings on his individual account of the private pension funds. It would mean the liberation from the will of politicians and the whim of bureaucrats;
- the PAYG system is in its essence regressive, i.e. poor people are losers in this scheme, because they "start work

earlier in their lives and have a shorter life expectancy than do the better-off" (8, p. 6). This argument means that those earning more in the PAYG system are winners;

- a private pension system gives pensioners clearly defined property rights to their benefits. Here exists the possibility to make withdrawals from their individual accounts, to leave money to their heirs if they die before they fulfil their life expectancy, or use the savings to buy indexed annuities from an insurance company. Public pension schemes do not provide such rights;
- privatisation of public pension funds would mean the end of class division between capitalists and workers, creation of the society of worker–capitalists. It would be a major step towards social harmony in the society in case it adopts the policy of privatisation of the whole social security system (7, p. 6).

We have to admit that we presented here quite a radical version of the individualistic approach towards pension reforms. There are milder, less extreme positions which do not totally deny the rationale for the existence of public pension funds. Nevertheless, even proponents of these less extreme views are instinctively suspicious of everything what is public and are ready to tolerate public pension funds as an unavoidable, but (hopefully) temporary evil.

The other camp is more propublic or, in other words, more holistic. In its extreme forms, take as an example Soviet ideology, holism is antiprivate, antimarket. It over-emphasises programming (planning) and does not like spontaneity, etc. In its more balanced, moderate version holism admits private initiative, market with its invisible hand and spontaneity, but insists on the importance of public interest, of public goods, of social capital. Proponents of this economic approach tend to disagree on some fundamental issues with individualists. They hold that also the private and not exceptionally the public sector is liable to waist, corruption and inefficiency. The recent experiences with such giants of private business as Enron, Worldcom, Parmalat are the most exemplary cases to prove this. These examples show that managers of any firm, be it a producer of milk products or an auditing company, can cheat its shareholders and employees. Why should pensioners be an exception? On the other hand, it demonstrates that investment in securities is a risky undertaking which could lead to losses for pension funds and, finally, for retirees.

In their opinion, in reality, not in theoretical schemes, private pension funds cannot function properly without government participation: governments initiate privatisation (partial or total) of public pension systems, they have the obligation to supervise and regulate the activities of private pension funds. Without such a supervision and regulation the risk of abuses increases. State takes responsibility for those not involved in private pension funds, in providing minimal social guarantees for them. Finally, governments in the case of a failure of private funds should be ready to bail them out.

Governments that make decisions to privatise the pension system and that supervise and regulate private pension funds are inevitably blamed for their failures. Even in a hypothetical case of government's non-involvement policy into the pension sector, it would be blamed for such a non-involvement, for not defending retirees. Therefore in any case, having in mind that pensioners form a sizeable part of electorate, the state would be forced to provide bailout.[1]

All this means that in practice a purely private pension system cannot exist, that the reality of old age protection (security) is mixed – private and public economy. It is the case even for Chile, often presented as a country with a fully privatised pension system.

It would be imprudent to claim that one of the elements of this mixed system is effective and rational and the others are wasteful and irrational. In fact, such a mistake is done by some proponents of full privatisation of the pension system. To them, state involvement is undesirable for the sake of effectiveness. But if such involvement is, as was shown, unavoidable at least in the form of supervision regulation and bailouts, then the antinomy in the reasoning of individualistic approach is evident. In P. Orszag's and J. Stiglitz's words, "it is difficult to know why a government that is inefficient and corrupt in administering a public benefit system would be efficient and honest in regulating a private one" (5, p. 32).

The only solution for the antinomy is to admit that both market and public regimes have their virtues and weaknesses, that both are liable to failures, and that the best way to improve the efficiency of a pension system is to use the strengths of both market and public regimes. Theoretically, the options in this respect are plentiful.

Towards a mixed pension system: Lithuania's case

From the soviet past Lithuania inherited a purely public pension system, which was based on a pay-as-you-go and defined principles of benefits. After regaining Independence in the middle of 90s the contributory character of payments to the system was strengthened (made more explicit). At that time the social security fund "Sodra" was separated from the national budget as well. In 1999, the legislation allowing to create private pension funds was adopted. The idea was to attract people who would like to accumulate additional money for future pensions on individual accounts on voluntary basis. The existing social insurance system "Sodra" was left fully intact. But due to a low level of income of the majority of the population, to big uncertainties connected with this plan, the strained situation in the financial system after bank crises in 1995 and economic crises in Russia with their negative impact on Lithuania's economy, no practical steps were made in creating voluntary private pension funds.

At that time the campaign for mandatory private pension funds gathered the pace. With increasing strength the interest groups, business and media, with a subtle but tangible support of the World Bank, advocated for the compulsory privatisation of 20% of old age security contributions and their redistribution in favour of private pension funds. Lithuania had to follow Poland and Hungary in their pension system reforms. But the very coercive character of the process, dubious results of the reforms in neighbouring countries, the huge financial costs of the reform (up to 2% GDP yearly) gave birth to a strong intellectual and political opposition to the plans.[2] That opposition forced the above mentioned forces to change their

[1] More about the consequences of the increasing influence of the older electorate see (2).

[2] Author of this article together with some other Lithuanian specialists (R. Lazutka, A. Guogis) was among those in opposition (3).

strategy and to abandon the idea of mandatory private pension funds.

From mid 2003 a new law concerning private pension funds was approved. This law allowed to create voluntary private pension funds which could be joined by future pensioners who would like to switch (redirect) part of their social insurance contributions into these private funds. In fact it meant partial privatisation of the public pension system, because part of the financial flows which belonged to the public sector were redirected towards the private sector. As a result, "Sodra" loses part of its revenues.

Government committed itself to compensate this loss from the national budget. Until then the "Sodra's" budget, and the national budget as we said, had been separated; after the reform old age insurance became dependent on the national budget.

After a very active advertising campaign more than 400 thousand employees (about 30% of labour) joined the newly established private funds. They were promised more generous pensions while paying the same amount of contributions (this time combined – to public and private funds). From the point of view of conventional wisdom, increased benefits in relation to the same level of contributions seemed a gain for volunteers. At that time the financial and political stability in the country increased substantially and economic expectations in the society improved. These and some other factors explained why such a big percentage of employees joined a non-mandatory pension system.

Mass media and private interest groups claimed that private pension funds would increase national savings, lessen the risks characteristic of public funds, provide future pensioners with higher returns.

Part of economists have serious doubts concerning well advertised advantages of private pension funds. For instance, P. Orszag, J. Stiglitz openly speak about ten myths present in discussions of old age security[3]. The purpose and format of their paper do not allow to go through all argumentation, therefore we will apply and extend only the argumentation most relevant to the Lithuanian situation.

Some analysts assert that a traditional pension system is risky and unsustainable. The growing rate of dependency, political and administrative factors are the most frequently used arguments in proving this postulate. Sometimes in heated political debates "Sodra" is even called a financial pyramid.

Addressing this issue, we should compare the principal scheme of "Sodra" and the reformed pension system which combines both public pay-as-you-go and private fully funded elements.

"Sodra", being a public system, is based on social security contributions. Its revenues, except cases of surpluses, are practically immediately distributed to recipients (beneficiaries). Figure 1 below demonstrates this regime of social insurance.

In this figure we can see that "Sodra" in its pure form, when it is not borrowing in cases of

[3] They name 10 myths which are as follows: 1. individual accounts raise national savings; 2. rates of return are higher under individual accounts; 3. declining rates of return on pay-as-you-go systems reflect their fundamental weakness; 4. investment of public trust funds in equities has no macroeconomic effects; 5. labour market incentives are better under individual accounts; 6. defined benefit plans necessarily provide more of incentive for early retirement; 7. under individual accounts market competition ensures lower administrative costs; 8. individual account system is better than a corrupt public system; 9. bailout practice is worse under public defined benefit plans; 10. investment made by public funds is usually squandered and mismanaged. (5, p. 2)

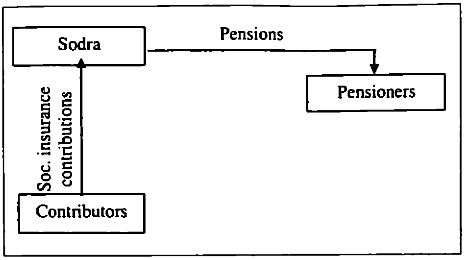

Fig. 1

deficits and when it is not investing its assets accumulated in the periods of surplus revenues, is a simple regime with only two channels of financial flows. Of course, it is not free of risks which are mentioned above. But the very simplicity of the system shows its, at least relative, stability and sustainability. The main risk here comes from the declining portion of contributors and the growing numbers of beneficiaries in the ageing society.

The scheme for "Sodra" would be more complex in a difficult or prosperous time. In times when revenues are lower than expenditures, this public social security fund would have two choices: to ask for government's financial support or to borrow from the private sector. The times of surpluses offer the possibility to invest into financial assets (government bonds or equities).

Lithuania's pension system became much more complex with the introduction of the private pillar into it. The existing system is demonstrated in Figure 2, which shows the flows of money:

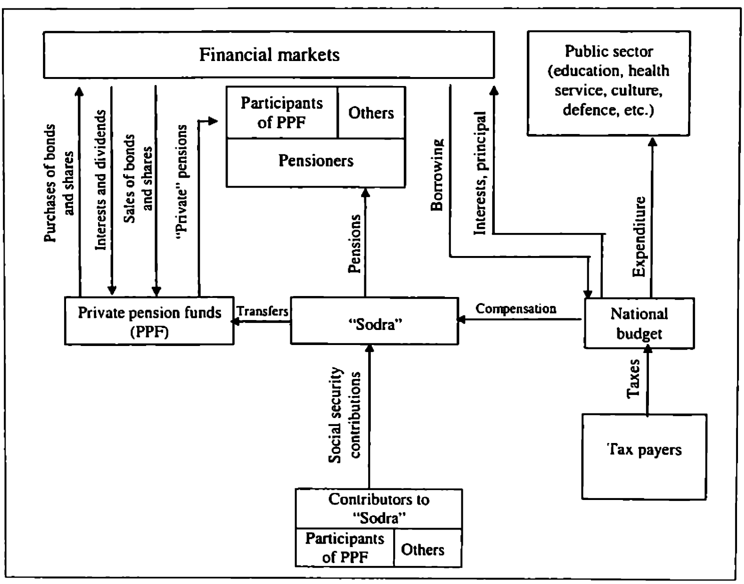

Fig. 2

Though in Figure 2 some details of the new social security regime are omitted (for instance banks which execute bank operations and certain surveillance and control functions), it presents the overall picture of the structure of interdependencies.

There are much more interdependencies in this new system in comparison with the previous "Sodra's" practices. If previously "Sodra" was to a great extent independent of the national budget and of financial markets, the new system is firmly tied to these two spheres of economy. Now the sustainability of the pension system depends not only on the ability of working population to pay contributions, on the goodwill and efficiency of politicians and civil servants, but also on the state of public finance at large and on the situation in financial markets. Even from the technical point of view the bigger number of interconnections means a higher uncertainty and accordingly a higher risk[4].

For example, the viability of the new, mixed pension system depends substantially on the ability of the national budget to compensate "Sodra" for loss caused by redirection of part of social security contributions to individual accounts of the private pension funds. It is not a trivial problem, especially in the moments of strained public finance when other spheres of public sector, such as health service, police science, etc., are underfinanced. Therefore an additional burden to national budget when the very tax revenues are small in absolute terms (underdeveloped economy means small budget) as well as in relative terms (about 30% of GDP), and if with time compensations from the national budget to "Sodra" are going to increase substantially in the future, the perspective of multiple risk may get more and more real. These multiple risks could get the form of increased taxes, or even a poorer than now financing of the public sector, or stagnating "state" pensions.

In the long run another danger looms: the ageing population would mean not only the shrinking numbers in labour force and accordingly the numbers of contributors to pension funds (public and private), but *ceteris paribus* contraction of the tax base as well. It is astonishing enough how this fact is overlooked by many economists. Predicting the risks to public pension funds caused by the changing demographic situation we should be aware of the risks of unsustainability caused by this factor to other spheres of economic life, first of all to public finance and the public sector at large. The decreasing number of tax payers will take the heavier burden of the developing public sector[5]. Part of this burden are compensations to the public pension system for loss made by

[4] Supporters of the idea of partial privatisation of the public pension system in Lithuania name only one risk factor and assert that it could be minimised. Vice-President of Lithuanian Free Market Institute G.Steponavičienė argues: "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." (8, p. 2). Admitting that this risk is real, we disagree that is the only risk. It is obvious from Figure 2 presented above. In fact, every flow of money, equity or government bonds depicted in the figure implies a certain level of risk.

[5] The majority in economic profession do not know or neglect the so-called A. Wagner's law, which states that in parallel with development of market economy the public sector grows as well. If it is the case, the growth and sophistication of the public sector would mean increasing costs of its support. Growing costs of the rapidly developing public sector, combined with the dwindling percentage of tax payers are serious problems for the ageing society. It is unlikely that it could be settled in the framework of the existing economic paradigm.

partial privatisation of its financial flows (or simpler – revenues).

Another set of risks comes from financial markets. Though investments made by private pension funds into the state bonds are quite safe, the purchase of equities implies the risk arising from fluctuations of financial markets, the perspective of bankruptcies of firms, etc. And though the diversification of investment portfolios is an effective measure of reducing the risk, participants of private pension funds have no guarantees that the tumbling prices of security won't dramatically lessen their future benefits.

Add the possible corruption and inefficiency of managers of private pension funds and/ or inability of government to regulate and monitor their activities, and we would have a more or less full picture of the main sources of risks which threaten the new pension systems.

All in all the economic effects of partial privatisation are in the best case doubtful. Then the question of the real motives for the reforms arises. Some economists maintain that "the move from PAYG to a fully funded system is politically rather than economically motivated. It is a function of importance attached implicitly to individual choice and risk-taking to the transparency of individual contributions and entitlements, and to state withdrawal from the economy." (2, p. 126)

Fairness

The official purpose of the pension reform in our country is to strengthen old age security guarantees, to enhance saving and investment, to develop capital markets. G. Steponavičienė presents the intentions of the reform as follows: "The pension reform in Lithuania is designed to achieve two major goals: to create a financially viable pension system and to create opportunities for a 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". (8, p. 2)

These declared objectives seem fair and rational. But the implementation of the goals proclaimed is fundamentally problematic. From the analysis presented above it follows that the viability, sustainability of the reformed pension system should not be taken for granted. Turbulences in financial markets or/and public finance could lead to diminishing returns of the system. That means that in case of bad scenarios pensions could be smaller rather than bigger for participants of private pension funds, because they – but not the private pension funds – will have to take all responsibility for loses caused by economic, political, ecological, social, military and other factors. In our view, it is unfair to place most of responsibilities on the individual who has the least control over the events influencing the size of his future pension. It is an unfair distribution of responsibilities and risks among the individual, pension fund and state[6]. At the same

[6] In this context, the idea of worker-capitalist society emerging with the creation of private pension funds does not seem very realistic. A participant of the private pension fund has very little control over his money invested into private pension funds. In most cases pension funds will cover their costs and will profit, while the return of an individual participant could be shrinking. Therefore his position is worse than, say, shareholder's, and calling him part of capitalist class smacks of artificiality.

time it is unrealistic. Though private funds could avoid part of risks putting the burden of possible losses on the individual's or state's shoulders, it is highly unlikely that due to the political pressures – which should by idea be absent in a privatised pension system – the state would be able stay aside.

As was already mentioned, one of the arguments against the pay-as-you-go system is its unfairness to poor, its *regressive* character. Critics assert that mortality rates among poor are higher and therefore those richer, living longer, get a bigger amount of pension benefits than poor participants of public pension schemes. Not all agree with such postulate. For example, E. Steurle and J. Bakija argue that at least in the US, even accounting for differential mortality rates, lifetime of return for lower income workers is higher than for high income workers. (9, p. 115–126). Speaking in more general terms, P. Orszag and J. Stiglitz says that "defined benefit systems are usually progressive and therefore provide a form of lifetime earnings insurance. If lifetime earnings are lower than expected, the replacement rate is higher than expected..." (5, p. 19) In other words, in most cases and aspects being *progressive* the public pay-as-you-go system redistributes funds in favour of poor at the expense of rich, contrary to claims of J. Pinnera and others.

How things look like *in the private* pension funds, where participants accumulate for their future pension on their individual accounts? At least in terms of the cost of administration and accounting this system is regressive; *e.g.*, future returns for worse-off in the system will be lower than for people with higher incomes. In the UK, 35–40 percent of the value of individual accounts are consumed by various fees and costs. Some of these costs are fixed, they do not depend on the size of the account. That means that these costs comprise a bigger proportion of smaller than big accounts, what in fact means regressiveness of the scheme, at least in this sense.

This system is not fair in terms of relations between generations, either. To say the truth, the pay-as-you-go system means redistribution of wealth between the generations: the working generation supports retired people. This redistribution through generations is not even. At its inception the system is very generous for the first wave of beneficiaries. They do not contribute to the system, but get pension benefits.

If the system would operate forever, in its mature form when all pensioners are former contributors to the scheme the rates of return would be more or less equitable to all ensuing generations. However, in case of abolition (total or partial) of the public pension system, the last generation would be a biggest looser. "It would pay contributions but receive little or no benefits", say R. Beattie and W.McGillivray (1, p. 13). The working generation living in the time of partial (like in Lithuania) or total (like in Chile) abolishment of the pay-as-you-go system has to carry a double burden of supporting (through contributions and taxes) the older generation and of accumulating for its own pensions. In Lithuania, we have just this period of time when working population has to carry an increased burden of the pension system. Though the rates of contributions to the "Sodra" are the same, in fact the economically active population has to additionally support the system through the national budget when the state compensates "Sodra" for the privatised part of its revenues.

Paradoxically enough, part of these contributors and tax payers, not being part of private pension schemes, wouldn't expect any benefits from them. Even more, there is a real risk that due to financial pressures caused *inter alia* by failures of private pension funds, the old age security of this intervening generation would be in jeopardy. The bigger contributions and taxes could turn into smaller benefits. They won't get private pensions, to which they contributed indirectly paying taxes, and they could lose part of they public pension[7]. This paradox of "double burden – double loss" is strengthened by the *paradox of ignorance:* those who carry the heaviest burden and face the biggest risk are not aware of the problem.

And here we turn to the main aspect of the fairness of the process. The pension reform would be more equitable if the very discussion on the subject would be open, transparent, non-biased, less ideologically driven. In such a discussion advantages and weaknesses of both public pay-as-you-go and private fully funded systems would be analysed and the best "mixture" of them would be proposed to the public. In the atmosphere of democratic openness and scientific prudence the relevant political, social, intergenerational consensus between generatious and social classes could be reached.

Until now, unfortunately, the process of pension system reforms has been marked by one-sided argumentation, by the lack of pluralism and real publicity. To use the term introduced by P. Pierson (6), the obfuscation strategy was applied. Less information and more propaganda gives a better result for power centres interested in privatisation of the public pension system. The very unfairness of the discourse gives rise to the suspicion that the real goals of pension reforms are different from those proclaimed.

If neither state, which collects contributions, nor private pension funds accept clear obligations concerning the size (level) of the future pensions and all risks are formally put on the shoulders of the individual, it is difficult to maintain that it is the system of social protection which insures future retirees from the loss of earnings. Eurostat in fact stated this refusing to recognize the private pension funds as part of Lithuanian social care (4, p. 1).

Conclusions

The issue of pension system reforms is only part of the wider debate about the role of state and market, about the interdependence between public and private interests, about the combination of solidarity and competition, the role of public goods and private goods. Unfortunately, economists rarely agree on these matters. Most of disagreements come from the gnoseological, paradigmatic differences. It is very difficult or even impossible to reconcile the attitudes, conceptions, programs and projects if they are created in the framework of different – individualistic or holistic – approaches. This applies to the programs of privatisation of public pension systems. Pros and cons of these programs are largely determined by these paradigmatic differences.

[7] Discussing fairness of one or another combination between public or private pension schemes, one shouldn't forget those who are neither contributors to "Sodra" nor participants to the private funds, i. e. unemployed, disabled people who have some old age guarantees. Regrettably enough these issues fall usually into oblivion though the risk for that part of the population of a least relative deterioration of the situation with partial privatisation of "Sodra", in our view, increases.

Another major factor of the process is the influence of different power centres. When power centres interested in privatisation of public pension system (because it gives access to important part of financial flows) are powerful enough to substantially influence other power centres – political parties, civil servants, trade unions – and the general public, the process begins. Only time will show whether the declared goals and the real intensions of these power centres coincide.

But even today there are serious grounds to state that privatisation of public funds leads to at least several disadvantages:

- additional strains to public finance what could press for more state borrowing, for poorer financing of education, culture, health service etc., or for higher taxes;
- an unfair burden to recent generations of employees in the form of additional public expenditure for old age security with the quite real prospects of smaller future pensions;
- diminishing opportunities to raise "state" pensions for today's and future retirees from "Sodra", because part of its resources are privatised and the possibilities of a proper compensation from the national budget are and will be limited;
- quite real prospects of mounting pressures on the political authorities by increasing old age electorate in ageing societies to make favourable decisions concerning old age, especially in cases when the pension system encounters serious difficulties. To pretend that the very privatisation of the public pension fund would eliminate or decrease such a political risk is a kind of wishful thinking.

Sooner or later with growing awareness of the whole network of interdependencies between the pension system and constantly changing economy at large will compel to review those overly individualistic pension policy assumptions which today to some people seem axiomatic, unshakable and universal.

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PENSIJŲ SISTEMOS REFORMOS LIETUVOJE

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Santrauka

Straipsnyje nagrinėjama pensijų sistemos reformavimo problematika. Dabartinė valstybinė apibrėžtų išmokų principais besiremianti „Sodros" sistema susiduria su tam tikrais sunkumais. Didžiausia grėsmė sistemos tvarkymui yra blogėjantis dirbančiųjų ir pensininkų santykis. Individualistinės krypties ekonomistų manymu, išeitis iš padėties yra „Sodros" iš pradžių bent dalinis privatizavimas. Tačiau, kaip parodo autorius, dalies „Sodros" lėšų privatizavimas kelia daug klausimų. Svarbiausi iš jų: 1) ar naujoji „mišri" sistema yra tvaresnė ir kelia mažiau rizikos; 2) ar ji teisingesnė; 3) ar ji iš tiesų leidžia išspręsti saugios senatvės problemą.

Kadangi visuomenės senėjimas kelia problemų visai ekonomikai, viso viešojo sektoriaus finansavimui, izoliuotas pensijų sistemos ateities klausimo sprendimas ir ypač remiantis individualistine paradigma vargu ar galimas.

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