On-going discussions about the financing of the statutory funded pension in Lithuania

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In Lithuania, various stakeholders are discussing the financing of the statutory funded private pension scheme. The current system, under which a percentage of social insurance contributions is redirected to the private funds, is considered problematic with regard to the fairness and sustainability of the pension system. The government has promised to resolve the problem.

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Description

In Lithuania, the second pillar pension scheme is a statutory funded system, privately managed by financial institutions. Unlike other Central and Eastern European countries, participation is voluntary for all age groups. Initially, from its introduction in 2004, the scheme was financed only from social insurance contributions.

In 2014, it was decided to finance the scheme from three sources: mandatory social insurance contributions, extra voluntary contributions from the participants' own pocket and state subsidies. So, there are now two modalities of participation.

First, anyone who was a member of the funded scheme before 2014 is allowed to continue to transfer 2% of his/her contribution from the "pay-as-you-go" (PAYG) system to a funded scheme without modification (the so-called 2% mode).

Second, anyone is entitled, besides social insurance contributions, to pay an extra 2% from his/her own wage as well as to receive a subsidy from the state budget equal to 2% of the average wage in the country (the so-called 2%+2%+2% mode).

Participation is still voluntary, but those who have joined the scheme since 1 January 2014 may only participate according to the 2%+2%+2% mode.

About 90% of all employees insured for a public PAYG pension have signed up to the statutory funded scheme. One third of these contracts are inactive because the people are not working or have emigrated. More than one third are subject to the 2% mode and the same number to the 2%+2%+2% mode. At the end of the day, 80% of annual contributions come from public sources (PAYG pension scheme transfers and the State Budget) and 20% come from private contributions from the participants.

Pensioners' organisations have been asking the Government to stop financing private pension funds from social insurance contributions. Some politicians and experts support this demand (Jakeliūnas 2017, Lazutka 2017). The main ruling party, the Lithuanian Farmers and Green Union, has promised to reconsider the financing of the private scheme. The Prime Minister, the Minister of Social Security and Labour, and the Chairman of the Parliament's Budget and Finance Committee (S. Jakeliūnas) have repeatedly supported the idea. The Association of Private Pension Fund Managers criticises any proposal involving reform of the financing of private funds. The Government, despite its promise a year ago, has not yet made any decision.

Outlook & commentary

The increased number of entrants to the second pillar pension scheme increases transfers from the PAYG scheme to the second pillar pension scheme and reduces the capacity of the PAYG scheme to pay adequate pensions. The report of the National Audit Office shows a decreasing replacement rate of the PAYG scheme from the current 35% to 20% in 2050. Even now (latest Eurostat figures, referring to 2016), 40.3% of retired persons are at risk of poverty or social exclusion.

Because of social insurance contributions transferred to the funded scheme, PAYG pension benefits for the funded scheme participants will be reduced, while the majority of the second pillar scheme participants cannot accumulate adequate assets as the contribution rates are low (they vary from 2% to 6%). The forecast of the Ministry of Social Security and Labour shows a replacement rate of funded pensions in 2050 of only around 12%. According to the Chair of the Parliament's Budget and Finances Committee, fewer than 1% of retired participants now receive the annuities. Others receive only a lump sum payment at the point of retirement because their assets are too low to buy annuities.

We consider that the source of the challenges facing the current pension system is inadequate financing of the PAYG and second pillar schemes. In 2015, Lithuania allocated half as many resources to old age social security pensions as the EU28 average: 5.4% as opposed to 9.8% of GDP, according to Eurostat.

It is necessary to financially strengthen both schemes and to stop financing the second pillar scheme from the contributions to the PAYG scheme. On the other hand, financing of the funded scheme could be strengthened via an increase in private contributions from employees and employers.

Further reading

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