Vitas Vasiliauskas: Lithuania's pension system - how to ensure socially just and sustainable pensions?

Welcome remarks by Mr Vitas Vasiliauskas, Governor of the Bank of Lithuania, at the Economics conference of the Bank of Lithuania, Vilnius, 17 September 2018.

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Dear colleagues, like-minded guests and potential opponents,

Thank you for joining us at the second economics conference of the Bank of Lithuania. We are delighted to have you here.

When we decided to organise these annual conferences, we set ourselves an ambitious goal: what we seek is not only original insights and interesting discussions (although I make no secret of the fact that we are hoping for these, too), but also tangible results. It would not surprise me, then, if new and even unexpected ideas emerged from our sessions. At the same time, we aim to assess experiences tested in real-life conditions. In short, we seek concrete conclusions and proposals for resolving pressing economic problems.

It is this urgent need that dictates our choice of topics. Accordingly, last year's conference focused on the issues of income inequality. Following a thorough discussion and analysis, we concluded that inequality of income and, consequently, of opportunities, stems largely from our tax and pension systems. We agreed that these systems required an immediate and radical overhaul. Thus, today's topic – the Lithuanian pension system – is a natural continuation of that important discussion.

Since the ice has at last been broken, however, we can approach this crucial issue from a new angle. The Government has undertaken to reform the pension system which, sooner or later, in one way or another, will affect everything and everyone: everyday life as well as national public finances and macroeconomic stability. Such an all-encompassing topic warrants particular attention from public institutions, the public and the media. The Bank of Lithuania took an active part – and will be actively involved in the future – in expert discussions, commensurate with how it perceives its institutional duty.

In short, the situation can be summarised as follows: a step in the right direction has been made. However, only a step.

The work is far from complete since, first, it is important not only to design solutions but also to implement them qualitatively.

And, second, it is already clear that even if we faultlessly follow through with what has been initiated, some elements of the Lithuanian pension system will still need to be improved. In particular, what I have in mind is the need to increase transparency of the first pillar and to strengthen people's confidence in it. These issues will become increasingly important in the future. They will have to be addressed – and the sooner, the better.

Thus, today, I suggest that we set our gaze slightly beyond the visible horizon. In other words, I propose that in today's discussions, we consider the future of our pension system from the perspective of several decades rather than simply several years.

Let's take a moment, however, to notice our starting position: the status quo of the Lithuanian pension system and its envisaged developments. Let's briefly review the Bank of Lithuania's assessment and several key proposals which might help us take further steps in the direction outlined by the reform.

Colleagues,

We face two major problems: poor benefits now and the prospect of even poorer pensions in the future.

About the present. The average old-age pension is close to the poverty line. Speaking about residents receiving only a Sodra pension, the average replacement rate, that is, the ratio between pre-retirement labour income and pension, is only about 35 per cent, whereas the EU average comes close to 50 per cent. Approximately one in four senior citizens in Lithuania is exposed to the risk of poverty – according to the European Commission, once again we are ranked in the bottom three of EU countries. We find ourselves in this – third lowest – position quite often, and we are even starting to come to terms with it. However, there is another important indicator – the ratio between pension expenditure per pensioner and GDP per capita. Regrettably, this indicator ranks us in an even lower position.

About the future. The International Monetary Fund estimates that, with no reform of the system undertaken, the average replacement rate for residents who do not independently save for retirement would further decrease and reach only 20 per cent over the coming decades. This means that, in the absence of change, in a couple of decades pensions – calculated at the present monetary value – will be almost one-quarter smaller than they are now.

Nowadays, there are a number of reasons for poor old-age benefits. One of them is a low level of redistribution through the state budget. Last year, the amount of tax revenue in Lithuania was below 30 per cent of GDP, while the EU average was almost 40 per cent. By comparison, had we collected the amount of tax revenue at least equivalent to the EU average, our budgetary inflows would have been about 2 billion euros higher. Is this a lot or a little? That is almost as much as the amount of total pension expenditure that year.

The level of redistribution (and thus budget availability) is primarily an issue of the equity and efficiency of tax policy. Nevertheless, even if the most effective changes in taxation were implemented, they would not be enough on their own in the longer term. This is because alongside redistribution problems we have another adverse factor, namely, a highly complicated demographic situation. This leads to a worsening ratio between working-age and retirement-age population, which implies a heavier burden on public finances.

Against this background, it has become crucial to create the right conditions and incentives for income-generating residents to start accumulating their own financial reserves for old age. To the best of our knowledge, however, so far about 800 thousand persons – more than half of the working population – rely only on minimum accumulation or refrain from acummulating altogether. I do not want to sound too dramatic, but… this situation cannot be called anything other than a ticking time bomb.

Our honourable speakers will shortly present a broader picture – the practices of other countries and regions. We are likely to see that our challenges are not unique: most advanced economies have faced, or are currently facing, similar problems. And although they all have specific national characteristics and thus each seeks the most suitable solutions in its national context, all highly regarded models share certain features. First of all, one finds a focus on long-term sustainability. Second, one notes transparency and, consequently, a high level of confidence among the population. These features contribute to the achievement of the core objective, namely, to ensure more even consumption, that is, level of income, throughout the human life cycle.

The pension systems of our close neighbours, the Nordic countries, are considered among the best-rated in the world and are characterised by all of these features. I am therefore pleased that we will soon have the opportunity to hear professor Edward Palmer’s presentation on the Swedish experience in reforming their pension system and shifting towards a notional defined contribution-based model.

Colleagues,

When analysing the good practices of foreign countries, we note that, in addition to the aforementioned similarities, they have one more thing in common: none of the pension systems in which people today have confidence was created in a single sweep. Quite to the contrary, they were developed through protracted processes that called for consistency and patience.

The Lithuanian pension system, too, has for some time been on the path of review and transformation, on a greater or smaller scale. And even though one might argue about the meaning of certain “reconstructions”, and in particular their consistency and completeness, I believe that the recent decisions may create the conditions for favourable change.

First, the system gains more integrity. Having changed the structure of contributions to second-pillar pension funds (ceasing transfers of state social insurance contributions), there is no reason for an artificial confrontation between the first and second pillars.

The second advantage is the likelihood of more people enrolling in second-pillar pension funds. This would mean that more people would be better prepared for loss of labour income in the future. At the national level, this would contribute to the sustainability of the pension system and help mitigate the future demographic shock that awaits us.

The third point of particular importance for us is safer and more efficient saving. The Bank of Lithuania has found that, at present, almost two-thirds of persons participating in the second pillar save in funds with a risk profile inappropriate for their age. This inadequacy is a major obstacle to the efficient use of all opportunities that financial markets have to offer, preventing the accumulation of the maximum possible reserve for the future, with an optimum level of risk assumed. The decision to introduce so-called life-cycle pension funds in Lithuania is, therefore, truly welcome. This would help end the practice of “one size fits all” (which really does not fit anybody), and the investment risk of the assets accumulated correlate with the certain stage in the accumulator’s life, i.e. his specific age.

Finally, the maintenance cost of the system. Centralised administration of annuities in Sodra, a non-profit institution, would reduce their cost. On the other hand, limiting the maximum allowed deductions by private pension funds would help residents to accumulate more for old age.

Will the proposed changes be enough to ensure the long-term sustainability of the Lithuanian pension system and to better tailor it to the needs of the population?

Certainly yes. And, at the same time, certainly no. If these ideas are put into practice as envisaged, our reformed model may very well become both more attractive and more robust than the present system. However, if we seek to align with international leaders, we must take care not to get stuck with what has been designed so far.

Having said that, I hasten to assure everyone that we believe stability to be the greatest virtue of the pension system. Still, the Lithuanian pension system will require three further improvements.

The first one should ensure a closer and definitely more obvious connection between contributions and benefits. This is an essential condition both for achieving pension-system fairness and for strengthening incentives for residents to pay contributions.

The second aim is greater transparency. Having strengthened the connection between contributions and benefits, the first pension pillar should shift towards a model based on individual accounts (notional defined contribution model) – like the one currently in operation in Sweden, Norway, Poland and other European countries.

Such a system, ideally operating in real time, would clearly show the correlation between one’s social insurance contributions and the level of his or her future pension. A virtual individual account would demonstrate that unaccounted income reduces the accumulative pension in the first pillar, thus encouraging the payment of contributions.

The third direction concerns information and education. Clear communication on the old-age saving system is one of the most reliable means for managing risks of short-sighted choices. And – let's face it – there is such a threat if, after the entry into force of the approved changes of the pension system, people decide to opt for slightly higher income today, rather than in the future.

Currently, these are the three missing pieces of the puzzle of the Lithuanian pension system.

Colleagues,

I do not wish to be a prophet of doom, but the risks facing the Lithuanian pension system are very real. Unless we accomplish urgent work, we will soon face them – if not just round the corner, then around another couple of turns.

In order to create a truly sustainable – and I insist sustainable in the **long** run – pension system in which Lithuanians will have trust, we must strive for consensus, consistency and determination for further steps. Today, we have the opportunity to talk about these issues boldly, openly and in good faith.

I wish you all fruitful discussions and valuable insights, which may contribute to future policy decisions.

Thank you.