Baltic Old-Age Pension Reform: Looking for the Common Trends.

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Among large set of social reforms, old-age pension reform can be regarded as one of the most important. Organisation and management of pension systems is a burning issue all around the world. There are many reasons for that. Let us mention ageing of the population in industrial countries, world economic crisis and efficiency problems of the welfare state. Central and Eastern Europe countries face even additional complications due their communist past and speedy process of transition.

Baltic States are very often regarded as one socio-political and economic entity, which presumably will follow the same path toward liberal democracy. Baltic people themselves prefer to stress national identity and diversity in development of Estonia, Latvia and Lithuania. Today, in the very end of 1990-s, when all three Baltic states have gained almost 10-year experience in reforming pension systems, we can put the question - Who is right? Are there more common or unique features in emerging pension schemes? What are the reasons for that? Are we able today to evaluate economic efficiency and social equity of each pension system? These are the main issues of the present paper.

First of all we have to learn the social environment, where pension reforms take place. Generally speaking, we can distinguish implicit and explicit factors exposing their impact on the content and implementation of reforms.

Implicit factors include labour market situation, dependency ratio, and ageing of population, privatisation activities, and integration into EU.

Explicit factors refer to the legislative process, political party’s composition, administrative structures, and public attitudes toward state welfare provision.

Although Baltic states do not belong to the developed industrial countries, their demographic development is very similar to this part of world. During transition period some negative trends became even sharper. First of all, extremely low birth rate must be pointed out. Only Lithuania had the positive natural increase
rate until 1994. Today population is decreasing in all three countries, Estonia having the most dramatic drop in births. In the end of 1990-s births formed in Estonia only a quarter of those in the beginning of decade. As for pay-as-you-go pension insurance this trend will have very serious and long lasting consequences.

The other key factor for pension systems is dependency ratio. This statistical measure has currently both demographic and political aspects. Communist countries had usually very high employment rate without any gender disparity. Situation in post-communist Baltic States is quite opposite to that - share of occupational active population is constantly declining. Amongst unemployed one can see significant portion on people, who are not looking for the job. In 1989 labour force (population between 15-69 years of age) formed in Estonia 77% of total population, in 1996 the same figure was only 68% and. Lithuania, who had already in earlier times lower employment rate, experienced in 1996. The employment rate 58,1%. In 1991-1994. The share of economically active population decreased in Estonia in Latvia 6,2%, in Estonia 4,5% and in Lithuania 1,1%. Comparing men and women’s dependency ratio we can see increase in both terms, but women’s labour force participation rate is decreasing faster. This gender difference was stronger in early years of market reforms.

Gender disparities gain even more importance when speaking about ageing of population. Although women tend to live longer in any industrial country, in Baltic States this contrast is especially sharp. Women’s mean life expectancy is about 10 years higher as men’s figure and there is practically no difference between three countries. Once again we can notice that during transition period this divergence became more intense. The increasing share of people over 59 years in Baltic countries (currently around 20% of population) will according to some social prognoses mean 1,5 taxpayer per 1 pensioner in the near future. Because of lower pension age and higher life expectancy, women compose majority of old age social security recipients.

This situation urged social policy makers to rethink appropriate pension age for their country. According to pension reforms eligibility age will step-by-step rise 5 or 6 years for women and 0 or to 2 years for men. The most radical changes will occur

1 Sotsiaaltrendid. Eesti Statistikaamet, 1998, Lk. 35.
in Estonia, where starting from year 2003 the universal retirement age of 63 will be in force. In the other end we have Latvia, who lifted women’s pension age from 55 years to 56. As we can see from data above, demographic situation in Latvia is the worst amongst neighbour countries, what will probably cause additional tensions in funding old age pension schemes?

In general terms all three Baltic States tend to follow similar demographic and labour market patterns. By closer look one can notice, that in Lithuania negative features like decrease of labour force participation rate and decline of birth rate are not so deep as in Estonia and Latvia. This is because of less importance of Soviet migration in Lithuania and probably also due to the significance of Catholic Church in the country.

Privatisation is the main keyword for economic reforms in Central and Eastern Europe. Although private enterprises play significant role almost in all post-communist economies, their share in GDP and in policy-making process is different. Estonia had during the 1990-s right-wing cabinets, which kept a strong faith into open market and minimal state. As a result of such policy, wages and salaries grew faster as pensions did. So, in 1993 average old-age benefit formed 35% of average net salary, what is remarkable lower as in Nordic countries. Beginning from middle of 1990-s ratio between average salary and old-age benefit starts to diminish and consists in 1996 45,7%. This tendency can be at least partly explained by changes in government composition. After Estonian parliament elections in 1995 there have been moderate right-centrist parties in ruling coalition, who won elections thanks to support of elderly electorate. Comparison of relevant figures with two other Baltic States confirms correlation between liberal economic policy on the one hand and between salaries and social benefits on the other. The ratio between amount of average salary and average old age pension is lowest in Lithuania, which is known as the most leftist in Baltic. The approximate ratio is there 45%, less for higher salaries and more for lower salaries.

Political orientations did affect not economic production and income level only, but also welfare sector, including social security provision. As a direct consequence of these trends, establishing of private pension funds is going on both in

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legal and entrepreneurial sense. Law on Private Pension Funds was passed in Latvia in 1997 and in Estonia a year later. At the same time status of compulsory occupational schemes remains still vague. This demonstrates clearly different power of political pressure groups - Insurance firms can make the legislature work for their interests, whereas labour unions remain deprived.

Main actors in policy making are in parliamentary democracies however political parties. Keeping this in mind, one can compare how often pension reform issue was debated in national parliaments. We cannot say, that during the 1990-s it was out of agenda in any Baltic State. At the same time, frequency and weight of relevant debates is different. Lithuania accomplished their pension insurance acts first (1994), Latvia being the second (1995-98). Estonian parliament passed main laws in 1998, but some of them will enter into force step-by-step a couple of years later. We believe that ideological composition of parliaments is the factor that matters here.

Social security reforms have not been amongst the first priority in transition period. By referring to C.Offe (1996) one can agree, that only some ad hoc measures were taken to soften social costs of transformation. Until mid of 1990-s pensions were paid according to the former soviet principles, although formally new legal acts have been approved. This kind of ignorance holds also true for academic or political discussions concerning aims and long-term prospective of pension reform. Let us mention some of the key problems, pointed out by World Bank research (1994) and having great importance for countries in transition. A pension system should

1. reduce hidden costs, which may hinder economic growth (decline of employment, decrease of real wage, bad investments, high administrative costs)
2. be based on strategic planning to meet economic and demographic changes
3. Be transparent and protected from political manipulations.5

It seems to be too hard task to fulfil all three criteria in the framework of one main pension system. PAYG-system promotes social solidarity, is insensible to the inflation and has low administrative cost. Funded system at the same time encourages financial savings and investments, is insensible to the population crisis, and supports honest taxpayer behaviour. Consequently, the best solution is to unite positive features of

both system and construct some mixed pension scheme. Let us investigate how Baltic countries deal with this problem.

Pay-as-you-go is mentioned in relevant laws of all three countries as the main principle of old-age benefit system. This is not surprising, because almost all countries around the world, with very few exceptions (Chile for example) run PAYG systems. By closer look one can distinguish certain differences between Estonian, Latvian and Lithuanian systems.

Lithuanian pension system was established from January 1995 after a package of relevant laws, passed by parliament in 1994, enter into force. Old-age pension consists of two parts: a flat rate basic pension and earnings-related supplementary part. Calculation of the supplementary part takes into account insurance period and wage of the insured person. It is worth to mention, that Lithuania takes into account also wages, paid before pension reform (i.e. up to 1994), whereas Estonia decided in new Law on State Pension Insurance to ignore them as not objective and reliable enough. According to the current Estonian Law on State Living Allowances the former earnings of the beneficiary have also no relevance to his/her pension.

Latvia introduced his new pension system in 1995 and therefore calculation of benefits makes difference between insurance periods before 1995 and after. In the former period pension consisted from basic pension (30% of average salary) and supplementary part. For supplementary part length of service was multiplied by 10% of average salary. Current pension formula does not have a flat rate part, instead of this a value of personal pension capital (contributions on personal account + annuities) is taken into account. So, in case of Latvia we can follow a clear line toward continental earnings-related pension policy, whereas for Lithuania the Scandinavian model of solidarity seems to be more sympathetic.

Estonia had the longest break between the first provisional Act on State Living Allowances (1993) and laws, completing the pension reform. The latter have been passed by parliament in summer 1998 and will enter into force during the 4-year period. Consequently, today pension payments are made according to the formula set up in Act on State Living allowances. It has some common features with the Lithuanian practice. State Pension consists also from two parts: from flat-rate social pension and supplementary part, which calculates length of employment. As said above, former salary of the pensioner has no relevance. After 1 January 2000, when
the Act on State Pension Insurance will enter into force, the formula will be changed toward more classical insurance. Pension shall consist from three parts: annually adjusted by parliament basic part, calculated share of length of employment and share of personal insurance contributions. Calculation procedures are carried out according to the norms, set up annually by Government. As financial base for these calculations stand real and expected contributions into Social Fund. Hence here is no direct relation to the average salary like it is in Latvia.

All features and criteria discussed above hold for the state compulsory insurance, commonly known as the first pillar. Very often one can hear that Baltic pension systems will be built up as 3-pillar systems. What is the situation in this direction? The vaguest seems the prospective of occupational and private schemes in Lithuania. There is neither relevant law in parliament or in force. In Latvia the first Private Pension fund was established in 1994, but did still not operate in 1997. Law on Private Pension Funds was passed in 1997 and is effective from 1998. Some Latvian policy makers believe that the early introduction of private funds must be reconsidered or even postponed to give for state schemes time to grow. Estonia passed relevant law in summer 1998, it is already in force, but Estonia meets the same problems as neighbouring countries - low incomes and little possibilities for savings, also lack of public legitimacy of insurance funds.

Concerning the second pillar, Latvia is in the advanced position. According to the Concept of Pension Reform in Latvia, the introduction of the compulsory funded pension scheme was planned in 1998. The scheme will be compulsory for all wage earners and voluntary for self-employed persons. Until this point Estonia follows the same path. But further we must speak about different approaches. In Latvia personal contributions will be paid in private pension funds, which will be strictly controlled by state. Everyone has the right to choose his fund. The state will be responsible for the collection of contributions and the calculation of the payment of pensions, but the funds will be responsible for the efficient investments. In Estonia, the second pillar is foreseen as run under public or semi-public administration.

When the system is designed in general terms, the next issue arises: **How to secure sufficient funds** for payment of benefits? Thus we shall study principles of social contributions in three Baltic States.

The new tax policy was set up right after restoring of state independence. Unlike previous issues, here one can notice similar approach to the social tax in Latvia and Lithuania, whereas Estonia took during 1990-s different way. In the latter contributions to the Social Insurance Fund were paid by employer only as a payroll tax (20% of gross salary to the Pension Fund and 13% to the Sick Fund). There was no individual social insurance accounts. This caused practice of so called “envelope salaries”, where the real wage paid to employees was much higher as that declared to the tax administration. To overcome this problem and to force people to earn more, a new Law on Social tax was passed by Estonian parliament and it is in force from 1.January 1999. According to the law employer has to pay social tax from personal salary of every employee, not from the gross salary of enterprise or organisation. Latvia introduced the principle of personal insurance accounts already earlier in 1996 by running a relevant database on employers. Due to the insufficient co-operation between relevant institutions, the completeness of database is hard to estimate. It is said, the level of real tax contributions is about 10% less as it shall be.7

The formula of divided contribution responsibility was debated in Estonia, but does not currently have any legal outcome. Latvia and Lithuania are using principle of shared contributions already from 1992. Main tax burden is placed on employer (37% for Latvia and 30% for Lithuania), whereas employee pays 1% of his/her salary as social tax. Lithuania is not considering changing the existing division, but for Latvia such distribution of contribution rate is already history. In 1.Jan.1998. The Law on State Compulsory Social Insurance entered into force, which marked a tendency toward stronger responsibility of employee. During transition period Jan.1998-Dec.2001 the rate of compulsory contributions shall be 37%, from which the employer shall pay 28% and 9% the employee. From 2002 the amount of contribution is reduced to 33% of contribution base, this rate will be distributed into equal parts between employer and employee. These changes were at least partly urged by first experience in implementation of pension reform in Latvia. As one can see above, the social tax burden was heaviest in Latvia. As it often happens, the result of high duties
was not the expected one and lack of funds remains a significant problem in pension policy.

Regarding allocation of pension funds and role of government revenues, one can see unanimity amongst three countries. Social security contributions are kept in special funds, which are separated from the state budget. A small amount of transfers from the latter is used to pay special or additional state allowances for certain categories of pensioners. As Estonian experience shows, practice of separated budgets is approving oneself. This system is more flexible and allows react quickly to the growth of wages. As a result, old-age pensions are raising faster as child allowances, paid from the state budget.

Every issue in welfare policy meets the question of efficiency and equity equilibrium. For societies in transition it is used to be a sensitive topic. On the one hand we need to secure economic growth, on the other hand, we cannot do this on the expense of social peace. Let us look in this point on two equity issues. Firstly, adjustment of payments and secondly, computing of former, so called rouble-wages.

Elderly people form significant portion of electorate, therefore problem of adjustment of pension benefits is often a play-card in electoral campaigns. Estonia is the only Baltic country where an automatically system of adjustment does not exist. The rise of pensions depends on growth of social insurance contributions into social Insurance Fund and is in competence of Estonian parliament, who has to amend Act on State Living Allowances. According to the legal data this was made 8 times in period 1993-1998, approximately twice per year.

In Latvia and Lithuania the system of periodical adjustment exists. The former country undertakes moderate indexation, the latter stronger. In Lithuania basic part is adjusted according to the price index by special Government decree, and the supplementary part is adjusted according to the average wage automatically by decision of the Social Insurance Fund. As for Latvia pensions are calculated according to the changes in amount of average salary in the country.

We lack economic data to assess financial warranty of adjustment policy. As shows the case of Estonia, to make pensions grow no automatic adjustment is needed. On the other hand, the latter system gives for old-age people more security guarantees that their wellbeing shall not be subject to political bargain.

7 Ibid. p.38.
The question of dealing with former earnings and pensions paid on bases of Soviet time records has very similar background in the sense of public opinion. Majority of the older people believes, that all periods of service and all earnings (including period before monetary reform) have to be counted for the pension benefits. These political parties, who represent mainly interests of old-age citizens (as for example Estonian Party of Pensioners and Families), stand on the same position. It goes without saying that unanimity of public opinion has little role to play, when composition of executive and legislative bodies between Baltic countries is different. Departing from the right-wing liberal ideologies Estonia implemented policy of “no returns and no references”. It means, that neither Soviet period or transition period will be taken into account for further pension payments. According to the Law on State Pension Insurance, insurance period will be counted starting from 1.Jan.1999. In the other end we have Lithuania, leaving Latvia in the middle. Latvia tried to compute in 1990-1993 also former wages, but because of financial constraints gave this principle up. Lithuania remains the only country, which counts also wages, earned in Soviet roubles. Because wages by Soviet regime have been a matter of political ideology they did not reflect qualifications of employee nor his real contributions. For example unskilled workers in industry earned much more as qualified persons in health and educational sector. Wages in agriculture were also extremely low. Therefore it is hard to agree completely with the thesis, that by taking rouble-wages into account government will promote social equity.

Comparing Baltic pension systems in general we can recognise similar pattern of reforms in Estonia and Latvia. Lithuania has chosen more moderate policy, which regards government as the main regulator and provider of social security in old age. Lithuania is also the only one, who does not enforce establishment in near future funded pension schemes. These facts illustrate a considerable connection between implicit and explicit factors of social security reform.

These connections have many different aspects. Obviously not all of them did came out yet. But already today we can predict some, which were not taken into account and therefore will rise problems by policy implementation. As a common issue the problem of tax administration could be mentioned. Personal social insurance accounts, which will be introduced in all countries, is not the only and ultimate remedy as shows the practice of Latvia.
All Baltic countries are applying for EU membership. Estonia, who has made greatest success on this way, has to meet hard challenge - to harmonise its liberal social security ideology with the European social-democratic one. Results of latest parliamentary elections in leading EU countries can shift European social policy even more to the left. For Baltic States it could mean decrease of disparities between Estonia and Latvia on the one hand, and Lithuania on the other.

By joining European community Baltic countries have to consider adoption of their pension policies to the European labour market trends. High unemployment rate makes EU countries to promote older people to leave labour market earlier, providing for them special pension schemes. In Belgium, France and Germany majority of pre-pensioners is not in paid employment. In Baltic one can see an opposite policy. Legal norms make it difficult and financially unreasonable to leave employment earlier as on fixed pension age. This situation can be explained by low unemployment rate until 1998, and also with some sort of naïve views, that long service\(^8\) is economically efficient. One can expect that policy makers have to reconsider the issue of eligibility for old-age social insurance quite soon.

Conclusion of comparative analyses of Baltic pension systems by EU issue is not an occasion. Social dimension of European integration will be the most powerful factor, shaping in near future the development of social insurance policy in the candidate states.

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\(^8\) minimum length of service for full pension is 30 year in Lithuania