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Lithuania social briefing:

Lithuania's pension system amidst challenges and opportunities

Linas Eriksonas

China-CEE Institute

Kiadó: Kína-KKE Intézet Nonprofit Kft.
Szerkesztésért felelős személy: Chen Xin
Kiadásért felelős személy: Huang Ping

1052 Budapest Petőfi Sándor utca 11.
+36 1 5858 690
office@china-cee.eu
china-cee.eu

Lithuania's pension system amidst challenges and opportunities

The increasing inflationary pressures on the economy mounting due to the COVID-induced public expenditures and the low-interest rates have put the most vulnerable members of society, especially the pensioners, in dire straits. The need to raise the pensions have become a must for the government as it approaches the end of the first year in office. In July, facing the repeated calls by the pensioners' associations and heeding to the recommendations of the EC and OECD experts, the government announced a new pension reform that it expects would allow increasing the level of the basic pensions as the economy grows.

Below is a brief overview of the current situation that the country faces as it tries to address relative poverty among the senior citizens of society in a rapidly ageing society - navigating between demographic challenges and the opportunities for a more market-driven approach to ensure a more satisfactory livelihood for pensioners. It considers the means and policy measures that aim to create more value out of social security.

Lithuania's society has undergone a tremendous demographic change during the last two decades. Since the access to the European Union, which opened the labour market to the Lithuanian nationals, almost a third of the working population left the country. During the last two decades, the population has plummeted from 3,5 million inhabitants to the old-time low of 2,8 million, and the numbers are further on the decrease. During the period 1990 – 2020, the labour market lost one million inhabitants who emigrated for work or because of other socio-economic reasons, while only 372 thousand immigrants came to the country to replace them.

One can argue that at the time, mass emigration has decreased the level of long-term unemployment and even brought some indirect benefits as experienced, for example, through a burgeoning remittance economy. In 2010, at the height of emigration, the personal remittances reached their peak and amounted to 4,52 per cent of GDP. However, the medium and long-term impact of out-migration on the economy was negative. The economic migrants and their families have constituted the most productive parts of Lithuanian society, people in their 20s and 30s. Their loss to communities added additional pressure on the demographic balance and, in turn, on the pension system. The country lacks enough workforce to earn adequate pensions required for the retirees, who constitute about 35 per cent of the population.

Hence, the retirement age increase for a long time became the only viable, if not a very sustainable, solution. In the early 1990s, Lithuania inherited a Soviet-style pension system characterised by generous early retirement provisions, privileges for certain occupational groups, and a weak link between contributions and benefits. When the reform process began in 1995, the retirement age was gradually increased to 62.5 years for men and 60 years for women (reached in 2006).

In 2011 the parliament agreed to prolong the pension age from 60 years for women and 62 years for both men and women to 65 years in 2026 to be raised by four months annually for women and by two months – for men. Accordingly, the pension age in 2021 for women was set at 63 years and four months and for men – 64 years and two months. The main argument for extending the pension age was the need to decrease the number of pensioners amidst the rapidly dwindling working force due to out-migration and mortality due to the worsening public health. The politicians further argued that Lithuania has to increase the pension age to be compatible with the advanced EU Member States, where the pension age on average was about 65 years.

However, after soon it became apparent that prolonging the retirement wage alone would not suffice to ensure decent livelihoods for senior citizens. The savings for pensions have started to be seen as investment vehicles that could create additional economic value, catering to the needs of the financial sector and the citizens concerned with their future pensions in the uncertain times. A three-pillar pension system created in 2004 has slowly taken off during the time of the booming economy before the financial crisis of 2008-2009. The system has survived the crisis and, following an additional reform in 2019, created additional possibilities for pension funds to participate in the financial markets.

The first pillar consists of state social insurance, where the employers and the employees pay contributions to Sodra (The State Social Insurance Fund Board under the Ministry of Social Security and Labour) from paid wages. A person becomes entitled to an old-age pension when one has accumulated the required number of working years. The minimum period of pensionable service in Lithuania is 15 years, and the minimum is 32 years (in 2021), but it will reach 35 years in 2027. To accumulate years of pensionable service, one must contribute at least 12 minimum monthly salaries per year.

In 2021 the basic salary in Lithuania has amounted to 440 EUR but to qualify for this minimum pension, one needs to meet the minimum number of years spent in employment. Yet, the number of working years required for obtaining a basic pension has constantly been increasing. To put into perspective, in 1994 the minimum number of years was only 25, in 2021 – 32 and, as society rapidly ages on, in 2027, the minimum number of working years is due to reach 35.

The second pillar is called pension accumulation, where part of the contributions to pension funds are paid from the state budget but the employee also contributes to the accumulation. Since 2019, the second pillar of pensions in Lithuania has been reformed as follows. An employee contributes 3 per cent of the so-called salary "on paper" (a gross salary), with a state incentive of 1.5 per cent of the country's average wage in the previous year. Contrary to most other CEE countries, Lithuania's second pillar is not mandatory. It is made up of individual accounts, but employees are free to choose whether to join or not. Acceptance of second pillar pensions has been strong and participation has increased rapidly. The second pillar funds have grown to 5 billion euros with the main size of the funds (1,2 billions) invested in the funds of the age group 40-46 years.

During the last few years Lithuania’s pension funds have performed remarkably well. In 2020 the annual yield of Lithuania’s pension funds (4,9 per cent) was listed among the top 10 performing OECD countries, according to the pension funds. During the first-half of this year the Lithuanian pension funds have doubled on their performance with an average yield of 11,4 per cent for January-June, while within the funds for the age group 33-39 reached a record-high yield of 14,13 per cent. The second quarter witnessed the yield of 4,7 per cent.

The third pillar of pension saving is entirely private, where the working person pays the amount and frequency of contributions one wants to make after concluding a contract with the pension company. The third pillar is still underdeveloped and consists of voluntary pension funds or life insurance products. Only 200 million euros have been invested in these funds. The average return on investment for the first half of the year in 2021 was 8,2 per cent.

However, the pension funds cater to the future generation of the pensioners, while the current one faces the difficulty of meeting the ends due to rising inflation that affects the price level of products and services. Thus, the government decided to increase the basic pension level by abandoning the principle, according to which the basic pension depended on the number of years spent in employment. Instead, a new principle is being adopted. According to the planned provisions, the pensions would depend on the contributions paid while in employment. On 26 August, Minister of Social Security and Labour Monika Navickienė announced by the end of 2022, a new way of defining the amount of the basic pension could reduce poverty by 25 per cent.

The increase of pensions and the pension model that the government plans to present to the Parliament during the autumn session are not the only measures the government is taking to improve the quality of life for the elderly. There is already a single person's allowance, which will reach its first recipients in November. From January, this benefit will increase and will reach almost half a million people. The aim is to achieve by 2024 that the pension (including the basic pension and the one in the second-pillar pension funds) could amount to about 50 per cent of the average salary in the country. To compare, the EU average is 60 per cent.

However, achieving this goal can become an increasingly fleeting target as society continues to age due to the negative demographic trends that have little prospect to revert unless the migration policy opens the borders to the organized immigration of skilled workforce. At the beginning of the year, the European Commission published the Green Paper on Aging, which outlines the principles for the respective directive to be adopted in few years. The document specifically mentioned that "to keep the national old-age dependency ratio constant in 2040 relative to 2020", projections suggest that a number of the EU Member States would have to extend working life. The EC has singled out Lithuania (along with Luxembourg), where working life would have to be extended to the envisioned maximum, that is 72 years, while, for example, Malta, Hungary and Sweden would have to extend working life to 68 years. However, their working life until 72 years might not be feasible as the existing average age for men in Lithuania is shorter than the envisioned working age by half a year. Hence, the pension system planners need to consider whether there will be time for pensioners to enjoy their pensions, and start creating the pre-conditions for the longer lives for citizens.

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