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Pensions and National Social Insurance System

Justas Karčiauskas

China-CEE Institute

Kiadó: Kína-KKE Intézet Nonprofit Kft.

Szerkesztésért felelős személy: Ju Weiwei

Kiadásért felelős személy: Feng Zhongping

1052 Budapest Petőfi Sándor utca 11.

+36 1 5858 690

office@china-cee.eu

china-cee.eu

Pensions and National Social Insurance System

Summary

As the Ministry of Social Security and Labour has announced how much pensions and other social insurance benefits will increase next year, this article briefly introduced Lithuania's pensions and social insurance system. The State Social Insurance Fund (SODRA) is the agency managing the pensions and social insurance system. It appears that there are some considerable risks and uncertainties with financing the pensions system. Shrinking Lithuania's population and the decreasing number of people who work and pay national social insurance contributions as well as the system without investments in pensions funds are among the main factors that make financing problems even more challenging.

Introduction

In September the Ministry of Social Security and Labour (SADM) has announced the pensions and other social insurance benefits will be increasing next year. The article looks into the sources and expenses of SODRA's budget and discusses why financing Lithuania's national social insurance system will be an increasing problem for years to come. Widely discussed solutions to this financing problem are also outlined.

Financing of the pension and social insurance system

The finances of the pensions system in Lithuania is managed by the State Social Insurance Fund (SODRA). SODRA has its own budget. All employed and self-employed people in Lithuania need to pay national social insurance contributions, which is based their salaries. In return, people get socially insured, that means they get payments from SODRA in case they get ill, go on maternity or paternity leave. The insured people also get unemployment benefits and, perhaps most importantly, they get monthly pension payments once they reach the retirement age.

In 2023, the planned income of SODRA is 6.65 billion Euros. [1] The main source of SODRA's income is the national social insurance contributions, paid by working and insured individuals. For the last three years the budget of SODRA had a surplus which means that its income exceeded the expenses. However, after taking a closer look into SODRA's finances, it seems that there may be serious challenges in sustaining and financing the pension and social insurance system as it is.

The first problem is the structure of SODRA's income and expenditure. SODRA is essentially collecting national insurance contributions money from currently working people who are part of social insurance system. Instead of investing its revenues in some pension fund, SODRA is forced to immediately redistribute this money to current pensioners and other social benefit receivers, for example, the unemployed, or those on maternity leave, and so on. It is because during times when SODRA's revenues exceed expenses, SODRA has not been able to accumulate any sizable money surplus which could be invested. That means that SODRA is not able to create any value and grow its assets by itself but mainly relies on new social insurance contributions.

This leads to another problem which is demographics situation in Lithuania. For most years of independent Lithuania, its population has been shrinking with an exception of last year and this year, mainly due to huge immigration from war-torn Ukraine. If this downward trend of population decrease continues and society keeps aging, that means that SODRA's income from new social insurance contributions will decrease and its expenses for pensions and other social insurance benefits will increase because there will be an increasing proportion of old people in a society.

The challenges of financing the pensions and social insurance system are already revealed by the fact that almost 40 per cent, or almost 2.7 billion Euros, of this year's planned income of SODRA's budget is financed by the national budget, i.e. paid by the state. That means that SODRA and the social insurance system is already unable to finance itself and requires funding from the state. Moreover, this need of financing from the state will be increasingly desperate because the structural problems and challenges of financing the system are set to get bigger.

[1] LIETUVOS RESPUBLIKOS SEIMAS: Seimas pritarė 2023 m. „Sodros“ biudžetui, at: https://www.lrs.lt/sip/portal.show?p_r=35435&p_k=1&p_t=282960

Pensioners situation

As of 2023, pension age, or retirement age, in Lithuania is 64 years 6 months for males and 64 years for females. Pension age has been gradually increased for both males and females, and by the year 2026, pension age for both males and females will be increased to 65 years. [2]

According to Lithuania's State Social Insurance Fund (SODRA), the proportion of pension-receiving citizens who still work full time is steadily growing. While in 2010 it was 9 per cent of pension-receiving citizens officially worked full time, in 2022 this proportion grew to 12 per cent. Working pension-receiving individuals already comprise more than 5 per cent of all working population in Lithuania. In 2022 the average monthly pension for males was 574 Euros and for females was 481 Euros, while pension amount working people is higher – 597 Euros for males and 542 Euros for females, respectively.[3] In September, the Ministry of Social Security and Labour has calculated and announced how much pensions will increase next year. According to the minister, next year the average old-age pension will grow by approximately 66 euros and reach 605 euros, and for those with the necessary length of service, it will grow by 70 euros to 644 euros. [4]

Because of demographics-related problems, namely, decrease in births and aging society, it will become an increasingly bigger burden for Lithuania's economy to support pensioners. In order to make financing of pension system a bit more sustainable in the short and medium term, the pension age of both males and females has been increased and will reach 65 years by 2026. However, this measure alone will not be enough. Today, in 2023, the ratio between one pensioner and one working and social insurance contributions paying person is 1,4. [5] As the number of pensioners and their proportion of total population is set to grow, this ratio will keep decreasing. This means each pensioner, on average, will be supported by less amount of working and social insurance contributions paying people.

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[2] SODRA: Old-age pension age table, at: https://www.sodra.lt/lt/senatves-pensijos-amziaus-lentele?lang=en

[3] SODRA: More and more people who have reached retirement age continue to work, at: https://www.sodra.lt/lt/naujienos/vis-daugiau-pensinio-amziaus-sulaukusiu-zmoniu-toliau-dirba?lang=en

[4] DELFI: Apskaičiavo, kiek kitąmet didės pensijos: turint būtinąjį stažą, pridės 70 eurų, at: https://www.delfi.lt/verslas/mano-eurai/apskaiciavo-kiek-kitamet-dides-pensijos-turint-butinaji-staza-prides-70-euru-94658627

[5] SODRA: More and more people who have reached retirement age continue to work, at: https://www.sodra.lt/lt/naujienos/vis-daugiau-pensinio-amziaus-sulaukusiu-zmoniu-toliau-dirba?lang=en

Ways to address the situation

There are a number of ways to address the challenges of sustainability of Lithuania's pensions and social insurance system.

The first solution is to increase the amount of people who work and pay national social insurance contributions. The question then becomes how to achieve this? Allowing greater immigration of working-age foreigners would bring benefits almost immediately but is a politically sensitive issue. Encouraging giving more births and boosting population in this way is a very slow process with results which are far from guaranteed, and any benefits in terms of increased payments of social contributions would only come in 20 or 30 years.

Another solution which would make social insurance system more sustainable is to encourage current working people to contribute more money which could be invested in pension funds and grow in value. This idea was one of the drivers of the pension reform in 2003.

The 2003 pension reform and pension funds

The reform of the pension system that started in Lithuania in 2003 provides for three sources of accumulation of funds for future pensions - the so-called pension tiers. There are three tiers of the pension system:

- Pension tier I - state pension. The state ("Sodra") pension will be paid from the taxes paid by future employees to "Sodra".
- Tier II pension funds. Part of the "Sodra" taxes collected by the state, which are accumulated in a person's personal pension fund account, is invested.
- Tier III pension funds. The person himself invests, but the state encourages it because it applies personal income tax relief. It is earned not only from investment, but also from the benefit.[6]

In other words, the 2003 pension reform encouraged creation of private pension funds. In Lithuania, Pension funds are actually mutual funds, for which the law establishes special conditions and additional restrictions, and which are focused on the funds accumulated by the population for old age. For example, the second-tier pension fund is special in that it

[6] WIKIPEDIA: Pensija, at: https://lt.wikipedia.org/wiki/Pensija

accumulates part of the taxes a particular person currently pays to Sodra, while the person himself has to invest his own money in the third-tier pension fund. By encouraging citizens' voluntary savings in the third-tier pension fund, the state provides tax relief - the personal income tax paid is returned from the invested amount. The purpose of the three levels of pension is that the sum of the income received from all three sources in old age constitutes a large part of the income received by a person until then. It is considered that the pension should be about 70-80 percent of the previous salary, for that, that a person should not change his life habits, in other words, that he should not start saving a lot. [7]

Although the rules of how much you can invest in Tier II pension funds and the conditions of cashing in those contributions have been changing, it can be said that the reform was a success. As of 2022, more than 1,4 million Lithuanians invested more than 5,6 billion Euros into different pension funds. [8]

Conclusion

Although SODRA has been running a surplus budget for a few years in a row, it is apparent that Lithuania's pensions and national social insurance system is hardly sustainable. The Pension Reform of 2003 has created a model that allows and encourages investment in pension funds. It remains to be seen whether these extra contributions, chosen and controlled by individuals themselves, will help to turn around the whole system.

[7] Ibid.

[8] LUMINOR BANKAS: 5 svarbiausi pensijų sistemos Lietuvoje įvykiai: nuo išmokų pagal profesiją iki savarankiško finansų valdymo, at: https://www.luminor.lt/lt/naujienos/5-svarbiausi-pensiju-sistemos-lietuvoje-ivykiai