ECONOMIC ISSUES OF PENSION REFORM

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Abstract

The transformation period towards market economy is inevitably referred to the new approach of solutions to different kinds of socio-economic issues. One of the latter is a pension reform. Having chosen the proper solution to those problems is certainly one of the major questions.

The version of Lithuanian pension reform is clearly expressed as a trend of the reduction of the liability and rising of responsibility of the future pensioners. The realization of this option confronts with a series of economic and social problems.

Analyzing the economic issues of pension reform there must be identified three major problems. The first concerns the “disadvantaged generation” of pensioners. The second is a risk problem related to the savings funds choice, their profitability, investment opportunities. Third, the evaluation of the various storage options and risk factors.

The economic problems can not be dissociated from the social standard change.

Keywords: pension reform, economic problems, social insurance, savings funds, risk.

Introduction

Pension reform in Lithuania focus on the gradual shift from social insurance to the growing mobilization on the part of the pension from the pensioner's money. The reform takes place in crisis situations, the low economic level, the complex demographic situation conditions. Revealing a number of economic problems, the solution has a significant influence on the reform process.

The aim of the research - to consider issues related to the realization of the development of pension reform: the state social insurance pension system, the place of pensions, savings, and their forms of risk issues, as well as the realization of the problems related to social issues

The problematics of this research is not a new topic. There are a number of studies which examine the individual aspects of the problem (Lazutka *et al*., 2002). However, this article summarizes the development of pension reform related problems. Theoretical generalizations of these problems represents a further specific study.

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Pension reform is related diametrically opposite approach to the retirement fund formation, from the state social insurance pension transition to the accrued pension. Due to this fact, the different age groups of people find themselves in different situations. If young people can and have the opportunity to gather the required old-age benefits of retirement fund, this group of older people do not have such opportunities. This "disadvantaged generation" - the pre-retired and retired people. They rightly expect that the state must provide them well-earned pension, depending on the acquired experience and the resulting earnings. This problem is connected with the tempo of reform and size of the pension.

Second, the risk of a problem related to the savings funds choice, their profitability and investment opportunities. This problem is particularly exacerbated in the current financial crisis. The potential of distrust of the savings funds may seriously affect the progress of pension reform.

Third, the success of pension reform depends on the chosen method of saving. Fund in savings funds, bank accounts and the like - is so called the working money in the economy. Completely different situation with money which is being saved “in socks“ – it means being kept away from the circulation of money.

Research methods: Article considers the theory and practice of the conduct of the reform and related problems, the research also includes literature review, case analysis.

The content of the pension reform

Old-age security system mainly consists of the three-tier (Srinivas *et al*., 2000):

The first step - the base, includes all, or at least all hired persons of the working population. This is a public or social security pension, guaranteed by the state. Of course it is not created, but only in accumulated by the State, but the state (with few exceptions) is a reliable guarantor.

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The second stage - occupational pension schemes. They are provided by employers, their associations, trade unions. Participation in these is often a collective, under the employment contract act.

The third step - voluntary, individual insurance, which people take care of themselves.

This is based on the population criterion, each step includes the different amount of population. The first includes the most (often all or at least the major part of employees), the second different occupational groups of workers, and the third - only those individuals who insure themselves, voluntarily.

An analysis of pension-making models (Barr, 1998; Behrendt, 2000; Dubinas, 1992; Makinen, 1999, Palacios and Whitehouse, 1998) allows to distinguish the two diametrically opposite (private and public social security) and many intermediate variations. The specific choice of model is being affected not only by economic criteria but also by the social identity of the person and State responsibility of the priorities. These criteria also make an influence on Lithuania's pension reform. Established principles of the pension reform were being strongly influenced by the practice formed over a long period of time. This practice claims the people‘s fate to the country, and not taking responsibility for themselves. Mentioned principles were also influenced by the difficult financial situation which prevented the guarantee of pension notable size.

Launched in 1995, the content and the process of the pension system reform was examined in more detail in our article (Sakalas and Leščinskienė, 2006) and conference reports (Sakalas and Leščinskienė, 2004 and 2006), so this paper does not deal it in more detail. We can only note the main points:

- Focus on the pension reform to a gradual transition from the state social insurance to private insurance;
- The first stages of the reform change: the methodology for calculating the pension, the newly appointed pension rates which are often declining (the Pension Act, 1994);
- Established a direct dependence between paid contributions and benefits to obtain the desired size in the future;
- Initiated in 1999 the Pension Funds Act [8] introduced the possibility of additional private pension insurance;
- Financial crisis has slowed the tempo of the reform.

The review of pension reform (Sakalas and Leščinskienė, 2006) suggests that the pension reform process faced with a series of problems. This paper does not analyse the slowing down of the reform of the pension relating to the financial crisis (freezing of the pension growth, stabilization of a private accumulation, etc.).. However, there are a number of economic problems, whose resolution would make clearer the pension reform process and the interference which influences the process.

Economic issues of pension reform

This article examines a number of the economic issues of the pension reform, whose resolution would allow a clearer understanding of both the setup options of the reform, as well as related obstacles. The examining of these issues is based on the following main points:

- The main aim of this reform is to minimize the state social insurance and transfer responsibility on the shoulders of future pensioners;
- The main objective is realized by reducing the compulsory state insurance contributions and increasing the private insurance contributions;
- The reform process aims to ensure social justice, the augmentation of pension amount for pensioners in all groups regardless of the legal retirement date;
- The principle of social justice does not mean that the recent level of pensions will remain unchanged. Perspective tendency would require to draw level to the EU countries in living standards, of course, regarding to the assessment of the economic development pace.

„The disadvantaged generation“ of pensioners

In this category we assign the part of pensioners and workers, which could not / can not use the accrual of pension benefits of the reform. Deserved criticism of the state pension system, however, need to remember that the maximum amount of pension used to guarantee, as compared to the working population, a relatively high standard of living of pensioners.

1991 the Republic of Lithuania State Social Insurance Act entered into force, consolidating the social insurance, finance and management, a distinction between the social security budget from the state budget, appeared the constant social security budget deficit, which affected the amount of payable pension. Lazutka

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R. (1995 and 2007) notes that the 1991-1993 year, the pension depreciated by almost four times. In this situation, the need for increased social benefits, the pension system did not meet the real economic situation, thus the increasing state social insurance fund budget deficit required to take the radical pension system reform, which was launched in 1995. Current economic situation (high unemployment, economic recession, income inequality, informal economy, companies bankruptcies, privatization, the gross domestic product, the purchasing power of savings) and the social effects (aging, birth rates decline, the number of dependents increase) highly influenced the state budget and state social insurance fund the budget deficit and the depreciation of the pension. 1995-01-01 The Republic of Lithuania Law on Social Insurance Pensions came into force [7], which substantially changed the situation. The reform was intended to link the contributions to the payments respectively by differentiating this proportion. Pensions were converted applying the rule based on decreasement prevention, pention indexation mechanism linked to the basic pension and restricted income (the rates approved by the Government), the retirement age had been started extending, established mandatory pension seniority of 30 years.

It result in a low old-age pension amount, a significant amount of social insurance fund budget deficit, despite the relatively high social security contributions paid by employers.

There were also formed a group of present pensioners and future pensioners, which is fully dependent on the size of pensions paid by the State, as they do not have access to the accumulation of pension funds increase opportunities. In 2001 the first Pension savings fund project has ensured that persons up to 40 years are obliged to participate in the pension program and those of age 50 – in accumulation pension system does not participate, it has also provided the voluntary participation of other persons. While in October 2002 there was set a voluntary participation in cumulative funds of all persons, this has not changed the situation. So the group called *disadvantaged generation* formed(the people whose retirement after the age of 1995-01-01 and which is not appropriate to collect the funds of private pension funds), which must meet the State indexed pension. Second, they have equal rights to focus on the pension increase, which is being expected by the young workforce today.

These problems are not simple at the theoretical level:

– a long-term change in the amount of the pension, the assessment of demographic and economic change needs to be predicted;
– a break-even point, when the basic pension will have to be earned by the workforce, needs to be provided so the problem of the *disadvantaged generation* will become irrelevant.

Based on these projections there can be formed an amount of the employed state social insurance contributions, which would cover not only personal, but also the *disadvantaged generation*‘s needs.

Risk problem of pension fund

The accumulation of pension fund activity aims not to maintain the money entrusted to them, because this can be done by "protecting the money in a stocking". It aims at the significant increasement of the storage of the funds entrusted, while keeping sight at their security aspects. The main risk - the funds will be lost or diminished, for reasons beyond the control of the fund participants.

The main place where the risk of pension funds appears is investment. The optimum variant would be to allow for professional investment managers to invest freely, without restrictions, to ensure maximum return on investment, as well as competition so the participants of the pension funds could choose their investment strategy, risk profile and return on investment. Such an investment mode, where the manager decides where to invest the accumulated funds and the authorities of the rules does not impose any restriction is called the "reasonable man rule" (prudent man rule) (Morkūnienė, 1999). Investing on the basis of "reasonable man rule" is prevalent mainly in Anglo-Saxon countries, which have accumulated many years of investment experience and in those countries where is an investment tradition. Continental European countries, as a rule, usually impose some restrictions to the pension fund investments. In setting these requirements it is normaly going away from the particular internal and external conditions that determine their level of risk.

Inside risk is associated with the loss of opportunity for the pension fund's fault. In most cases, it is determined by an insufficient Fund staff competence, the low level of fund administration, and the like. There can be named such types of internal risks:

1. Quality of administration.

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1.1. Maladministration, i.e. improperly kept financial records, inadequate pension fund management, the inappropriate responsibility. Very often, inappropriate investments are determined by the other activities not related to the pension fund purposes. Outstanding legal and administrative framework. It is often ambiguous, incomplete. It is necessary to conduct the annual independent audit. It is necessary to ensure the independence of the depositary to the pension fund and its management company. Internal decision-making control. Ability to hire a management company, which, in turn, could be required for suitable action, as well as the management requirements. Civil liability of managers.
1.2. High fund management costs of the participant, who develops for improper annuities fund management, funds being lost due to banks, financial intermediaries, depository office.

2. *The human factor influence.*

2.1. The human factor is related to the lack of staff competence, their low level of responsibility. Financial markets ussually lack of specialists and those working are in the lack of theoretical knowledge and practical experience.
2.2. Discrimination of participants of pension funds taking other participants into account.

3. *Influence of the internal legal regulation.*

3.1. Restrictions on the participants to leave the fund, discrimination of the participants of small pension funds.
3.2. Misuse of assets evaluation, possibility to transfer responsibility for the management company employed.
3.3. Improperly conducted the reorganization and liquidation of pension funds. Certain principles, but not the detailed arrangements to be implemented as a reorganization, liquidation or other reorganization procedure must be established by law. State supervision should be informed. Possible reorganization of project approval. Compulsory liquidation or bankruptcy case, state oversight should have a greater role, as may be necessary to protect the interests of the participants.
3.4. Participants in the unfavorable conditions of participation changes. The participant should have the right to freely exit the fund if there are changes of pension rules.

Outside risk is associated with possible loss of funds due to reasons independant from the pension fund. This shift in the classical approach has economic, legal and social environments.

1. Economic environment is being shaped by the number participants of pension fund activities. Pension funds as well as other financial institutions' activities and the environment is affected by other activities related to their players. Pension funds activity is being affected by:

1.1. Banking system. Pension funds depository can only be banks, so the pension funds‘ accumulated funds may be lost as a result of the insolvency of banks, inadequate execution of its functions. To minimize this risk, only a financially sound commercial banks should be entitled to the pension fund depositaries. The legislation must ensure the financial responsibility for damage and loss of salary to pension funds if the bank - a depository improperly carried out its functions.
1.2. Securities market intermediaries (brokerage firms and commercial banks). Given that the funds accumulated in pension funds invested in securities through the securities market intermediaries (only they have the right to act on a stock exchange), it is necessary to properly regulate the separation of pension fund assets from the estate agents in order to avoid the loss of property on the latter's fault.
1.3. Pension funds. They now lack of mutual competition. There is no fundamental difference between them.

The examination of the external economic environment, requires to draw attention to the recent very significant factor affecting - the *global financial crisis*. It is an example of the impact of factors which cross different countries, and even go out of EU frames.

No less important are internal economic factors, which determine the level of unemployment, living standarts, education level, and contributions to retirement funds rate.

2. Legal environment is shaped by the Pension Funds Act [8], which forms the operational content of the interaction between the different supervisory authorities, the procedures for their implementation mechanism. However, the application of practices enabled the clarification of a number of areas for improvement.

The Law Article 6, paragraph 1 names the **restrictive norms of the risk of pension fund**: capital adequacy, liquidity, the maximum open position in foreign currency. However it is questionable, whether the commercial banks by the standards of the transfer of pension funds have purposeful activity regulation.

Pension funds face the challenge of accumulated fund participant age income, by investing the contributions in securities. Unlike commercial banks, pension funds can provide a sufficiently clear view when and how to learn, pension funds are not re-loaned but invested, so there is no reason to identify the liquidity and capital adequacy, the maximum open position in foreign currency ratio, even when investment in Lithuania market would be more risky. Pension fund investment security and liquidity of the Act provides for an investment portfolio diversification requirement. These standards are not similar to operating insurance companies. This does not reduce the security of pension funds, but would reduce the influence of controling authorities, to allow pension funds greater flexibility to pursue its activities, non-freezing funding, and pension funds, participants will be able to accumulate more wealth in old age.

Pension Funds Act 35, paragraph 3 provides the possibility of the Securities Commission **to limit pension fund investments** in commercial banks' deposits and securities. Pursuant to this provision, the Securities Commission has adopted a resolution "On the pension scheme assets investment restrictions“, which provide for maximum rates of investment in securities, depending on their type, issuer and investment geography.

Subjective choice of restrictions does not increase the size of pension fund investment security, but reduces the opportunities for pension funds to invest in safe securities, regardless of their type, issuer, or investment strategy. To increase the investment security is sufficient of a diversified investment portfolio requirement, therefore, additional restrictions should be abandoned.

To avoid over-concentration and affecting corporate governance, it is appropriate to determine the 10% limitation for the acquisition of one company securities. Limitations of risk is usually a requirement to invest in liquid, or the international rating agency of the rating companies issued securities. Conflicts of interest are being addressed in the asset transfer prohibition on transactions between related persons. It is important to mark the international diversification of investments. This is particularly important for small countries such as Lithuania, where it is important to assess the two factors - pension funds accumulated funds to promote local economic growth and investment yield, and increase of security. Depending on the internal and external conditions both variants are possible potential market for foreign investment promotion and also restriction.

Investment regulation also depends on the accumulation (or self-binding) method. Given that compulsory collection of individual case is forced to join the pension fund, the government usually applies certain restrictions on investment. Desire to regulate the investment is determined also by the fact that the Government has guaranteed a minimum level of benefits. Therefore, limits are being set to ensure diversification of investment instruments in accordance with the type, the one purchased by the issuer's securities.

Practice shows that the investment regulation is more efficient when there are maximum limits („no more than“) rather than the minimum („at least“). Lack of the minimum of restrictions is that the composition of the investment portfolio depends mainly on the State set limits, without freedom of choice for investment managers and pension fund participants. On the other hand, setting of minimum limits reduces the possibility of competing in the investment strategy, which affects the return on investment, while at the same time, and pension fund participants.

32 Art. Paragraph 2 provides that each program, the pension fund has **a commitment to pay a specified amount of annual yields.** This requirement obliges the funds, because the discharge potential is not known in advance, and thus increases the fund's operating risk. In addition, such a requirement is a declarative one, whereas the pension fund may be also set at zero yields. This requirement provokes a high standard injections diversification and yield forecasting.

Legislation provides the opportunity to establish a pension fund that guarantees a specific pension fund yields, but at present none of the pension funds operating in Lithuania do not guarantee a fixed yield, and does not guarantee the size of a future pension (annuity). According to the Securities Commission report on the activities of the 2008 31 December Lithuania had 9 III pillar pension funds, which were managed by the 5 management companies. III pillar pension funds had the number of participants about 21.5 thousand. [9]. It is doubtful whether the accumulation of pension system, which is financed by social insurance premiums, would increase the pension amount.

Implementation of the above mentioned proposals would submit more favorable conditions for the pension funds to act as the market changes, to promote "internal" efficiency of the issuers, to reduce the influence of authorities, pension funds would allow participants to accumulate more wealth in old age.

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3. ***Social environment*** determines the risk which is associated with the attitude of the participants of pension funds in terms of the ongoing pension reform, the trust and the economic environment. It must be recognized that the social environment can not be seen as very favorable. This leads to:

- Certain approach to the state institutions and increased pension reliability;
- The economic situation of instability, financial crisis, banking crisis decreases the confidence of private entities, which implement the pension reform;
- The rough legislative framework of pension reform, rapid correction also decreases the confidence in the pension reform;
- Lack of the responsibility of younger generation for its future level. This phenomenon is characteristic not only to Lithuania, but also to the younger generation of developed countries. Recently received funds are spent to meet the needs of today hopeing that future issues will be resolved at a later date, usually in anticipation of government aid to their decision.

One of the pension fund safe activities is ensured by strengthening of public relations, publicity and transparency of information. This is primarily related to the requirement to cover objectively the expected pension funds investment results, as well as the other information set by rules that the pension fund participants could properly select the most effective option. In particular, it is indeed important to ensure the investment results of the calculation methodology, so the results are comparable. Pension funds, only having detailed information about the acquisition of securities or other assets, could properly invest the accumulated funds. Therefore, the information must be well-timed.

Diversity of the accumulation potential

Pension ensures the subsistence level, which can be realized in various ways. Some of them are not actively promoted, but at high risk of pension funds or low efficiency, can not be excluded. Each way of savings at a different level combines the private and the public interest.

The private interest is expressed by the maximum possible monetary gains - money-saving efficiency and security - the lowest risk. Choice here is often the result of individual personality, penchant for risk.

Public interest is expressed as well as the safety of money - the lowest risk, because the money is safe, although not directly the State takes the responsibility. This is being showed also by today's global financial crisis, an example where virtually all the world‘s governments has assumed additional responsibilities to reduce the effects of the crisis, implicitly acknowledging their guilt. A second major interest - the involvement of those collected funds in the country's economy, but it also depends on the pool level of security assurance.

There can be such storage methods:

- Participation in the II, III step saving, or the additional retirement with varying degrees of risk;
- Purchase of shares or bonds;
- Life cumulative or investment insurance;
- Keeping money in banks;
- Storage of money "in a stocking";
- Illegal financial activities.

1. II, III stages and additional pension savings. Everyone who has chosen to accept stage II of the pension contract, refuses a part of the pensions paid by the State. All other social security guarantees remain. The decision to participate in the II pillar pension funds is very significant, prior to its adoption it is necessary to evaluate a number of factors, since the cases of the return only in the state social insurance pension remain uncertain.

Third pillar pension funds - the funds in which it is possible to accumulate money in addition to old-age pension. Third pillar pension funds operate in the same principle as an additional pension insurance. There are provided different risk and return of investment options:

- Conservative investment - low risk and low expected profitability;
- Sustainable investment - the average risk and average expected profitability;
- Active investment - high risk and high expected profitability.

Additional pension - a service which aims to ensure a higher-income insured retirement. Middle and higher incomes receiving persons reserve their spare money for retirement as a single insurance premium

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form. Pension insurance is associated with long-term investment, so before the decision all the possible environmental changes must be very carefully considered.

The main problem in the context of this option, relatively low past profitability and vague accumulation models. Exploring the attractivity of this option these deficiencies need to be assessed.

2. Acquisition of shares or bonds. This savings model is being used by people of higher income. This is risky, profitable version which requires competence, particularly in the purchase of shares, what makes it being used by the limited circle of the population. A characteristic feature of this variation - insertion expediency: the awarding himself selects the direction of insertion, and thus promote one or another business.

Investment into debt securities - bonds is an attractive way. So the bond holder receives a fixed rate of interest and even in the company's bankruptcy case has priority over the shareholders receive the liquidation of the assets. In particular, there are possibilities to obtain high state guarantees purchasing securities.

Therefore, this storage option is quite an attractive one, and can compete with the first variant of the accumulation.

3. Savings and investment insurance. Cumulative life insurance - this is a traditional life insurance, when the periodic payment of premiums save some money and the amount of the guaranteed accumulation interest for the future.

Investment life insurance - the insurance service devoted to a maximum security benefits seeking and unafraid of the risk taking people when the share of insurance premiums invested to earn more than 3% per year. Investment life insurance differ from other types of life insurance in that part of contributions to investments, hoping to obtain more profit than the fixed rate. Therefore, it is this branch of life insurance worth insurance for persons interested in the investment, because the final accumulated sum of money will depend on how successful investing appears.

By its contents and the realization way this variant is close to the first version of saving. The advantage is that there is no long-term attachment to one of saving the species.

4. Accumulation of funds in banks. Banks are actively involved in the above mentioned storage options, so taking part in them, we demonstrate trust to the banks. Due to the financial crisis, the emergency decree adopted on deposits up to EUR 100000 hedges, should further increase confidence in banks. It can be argued, that the times of "Sekundes" bank has passed so the people can more readily hold the money in banks both in short-term and term deposits, and thus collect the money for an old age.

5. Money storage "in a stocking" is normal for older people. It is the storage method of small amounts of money. Life experience shaped the lack of trust to the state system syndrome that is often transmitted to children and grandchildren. This option is not acceptable to public view, because money kept "in a socking" is considered to be not in the welfare of the public money.

6. Illegal financial activities. This is unacceptable, culpable way of saving money, giving loans to the illegal business, and the like. This can be lucrative, but illegal activity so will not be discussed in this paper.

As one can see, there may be a variety of storage options. Often they are very close - applicable alternative to a retirement insurance. It can be argued that the pension should be based on the popularity of a series of adjustments. In our view, it is necessary to consider the following aspects of the problem:

- Reduce administrative costs. Until now, no Lithuanian act did not oblige insurance companies to make the contract administration charges are applied in public - thus increasing distrust of the system;
- Required explicit incorporation of the compensation calculation. Because they are virtually impossible for long period (increasing age of the population, inflation, the economic situation change, and so on.). There should be the minimum accumulation rate guarantee. The responsibility for the failures must not only be on the insurer, but also on the pension funds that are the organizers.
- The reduction of the insurance contracts of the tightening of the insurer. The insurer is subject to a penalty for non-payment fees, early termination of the contract etc. Open-mindedness in this area is necessary to increase the attractiveness factor;
- -Also the unpopular idea should be considered that the decline of SODRos contributions does not affect those who don‘t insure additional accrual insurance. Certainly, there should be other forms of collection of personal use assessed. One of the criteria for the application of this claim can be obtained by income level.

Only the resolution of these problems can increase the pension funds and the implementation of accrual, more attractive, effective functioning of pension funds system.

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Conclusions and suggestions

1. The market economy is changing many areas of decision methods. One such area is the formation of pension funds, and disbursement of benefits.
2. Present pension reform is characterized by the gradual abandonment of the state social insurance and the shift to private insurance. The aim is to make insured persons responsible for their own future.
3. Analysis of the evolution of the installation of pension reform showed that the success of reform depends on the internal and external conditions that affect the reform model and its application of the economic consequences.
4. The paper identified three main problems in the group, which were considered deeper.
   4.1. The beginning of the pension reform marks the refusal of previous pension and payment, of the principles of formation and the moving towards others, personal responsibility for their own future, principles. There is a persioners group, called *the disadvantaged generation* who can not benefit from the new reform opportunities, in addition to that, the new reform to those persons no longer pays attention. This forms a series of reform modeling problems that are associated with *the disadvantaged generation* of pension-level protection.
   4.2. Particularly acctual is the pension funds risk problem. Risk issues of particular importance to the newly undergone the market economy countries. It is even more difficult for the global environmental problems, the economic situation of instability, because of tradition, an imperfect adoption of pension reform legislation.
   4.3. Transformation of pension system reform is being considered in the aspect of liberalization, of the reliability and efficiency and also it is important that there are many other options for saving options. Their task - to harmonize private and public interests. In all cases, in particular, is to ensure a high standarts of living and, secondly, to raise money to the decision of the government programs.

Only the resolution of the issues raised in this paper may increase the pension fund accumulation and utilization efficiency and atracct more people interested in retirement accumulation.

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