I Overview

In recent years, the issue of pension reform has been high on the agenda of many countries. To a large extent, this reflects common concerns regarding demographic trends of declining birthrates and increasing life expectancies that have shed serious doubt on the sustainability of current pension systems. Most countries have attempted to shore up their pay-as-you-go (PAYG) systems through some combination of reduced lifetime benefits and higher social taxes.

For some countries—including the Baltics—the search for solutions to the long-run problems facing pension funds has led to consideration of more fundamental reforms, in particular, a move toward the "three-pillar" pension system initially adopted by Chile in the early 1980s and promoted by the World Bank. Under such a scheme, the first pillar, aimed at providing a pension on a pay-as-you-go basis, is essentially a scaled-down version of the existing mandatory pension scheme. The second pillar aims to supplement this pension through a mandatory fully funded (defined contribution) plan, financed by a diversion of a portion of the payroll tax. The third pillar is designed to stimulate voluntary retirement savings, including through various tax advantages, and with public involvement limited to oversight and regulation.

A number of potential advantages have been ascribed to this type of pension scheme, including increased retirement income and national savings, and enhanced efficiency of capital and labor markets. However, a move to a fully funded scheme also imposes important costs, in particular on the current generation and the budget. The net effect on the welfare of present and future generations is therefore difficult to assess and in any case depends crucially on the specifics of the reform. The introduction of a mandatory fully funded (FF) scheme does not, however, in and of itself solve the problems associated with aging societies. Whether such a reform would be more effective in this regard than a policy aimed at shoring up the long-term finances of the PAYG system depends on several factors, including the extent to which the FF pension can increase national savings and output.

The Baltic countries have been in the forefront of transition economies in their pursuit of pension reform. They have taken important steps to shore up the long-run financial health of their existing pension funds and made preparations for the implementation of a three-pillar scheme. A review of their efforts to date provides an opportunity to assess possible benefits and pitfalls of pension reform, in particular for other transition economies. Further, as the Baltic countries are still in the process of reform and, in fact, have yet to make a number of crucial decisions regarding the ultimate design of their new pension systems, this is an opportune time to revisit the objectives of the reform and examine in detail the trade-offs among these goals that will inevitably be faced as the Baltics move forward.

Upon regaining their independence, the Baltics inherited the pension system of the Soviet Union. Section II examines this inherited pension scheme and initial attempts to reform its shortcomings, which included very low retirement age, complex benefit rules, and lax eligibility requirements. These flaws in pension design became dramatically apparent early in the transition as rapid inflation combined with a decline in economic activity limited the adequacy of pension benefits and brought into doubt the sustainability of the pension systems. While differing in important details, initial efforts to shore up the long-term finances of the Baltic pension systems have relied on reducing or slowing the growth of benefits, raising retirement ages or otherwise tightening eligibility for benefits, and establishing closer links between individual contributions and benefits in order to reduce labor market distortions and enhance collection of payroll taxes.

While the reforms did, to a significant degree, achieve the objective of putting the finances of the pension funds on a sounder footing, they have proved politically difficult to sustain. Ad hoc benefit increases, as well as continued difficulties in collecting payroll taxes, have tended to erode early gains. These difficulties, combined with the recognition that demographic trends in the Baltics are unfavorable, led to the view that more fundamental reforms

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would be required to ensure a sustainable pension system with adequate income for retirees.

In the mid-1990s, all three countries began to plan their eventual move to a three-pillar system. While all three countries have passed legislation to put in place voluntary private pension plans—the third pillar—and Latvia and Estonia are likely to implement their fully funded second pillar in 2001–2002, fundamental questions about the design of this fully funded scheme remain open. Section III outlines the progress made in the Baltics to date in this second stage of pension reform, examines the potential benefits and costs of this reform, and discusses the main considerations for each of a number of design decisions that will be made in the next several years.

The introduction of a fully funded pension scheme can have important macroeconomic effects. In Section IV, the potential implications for pension reform on savings and the savings-investment balance are analyzed, and it is shown that the impact depends very much on how that reform is financed. In particular, under the assumption that individuals are neither fully forward-looking nor completely myopic, a tax-financed move from a pay-as-you-go pension system toward a fully funded plan would tend to increase aggregate savings, while a debt-financed reform would reduce aggregate savings.

Given the potentially important macroeconomic impact of pension reforms, economic policy design should carefully consider their implications. Section IV argues that a pension reform should be evaluated in terms of whether it improves the long-run sustainability of the public finances, and so should be interpreted in the context of an intertemporal budget constraint, incorporating both the PAYG and FF schemes. At the same time, the financing of pension reform must also be consistent with prudent macroeconomic and debt management policy over the shorter term.

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