

TAXATION OF PENSIONS IN THE BALTIC STATES

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Abstract. Pension systems of the three Baltic States have very much in common. These commonalities are induced by their common past, similar socio-economic environment and common prevailing development trends. However, some certain elements of pension system design vary significantly among the countries. Quite interesting variations can be found in the taxation-related aspects: sources of financing pension budgets (taxes and social insurance contributions), tax incentives for stimulating personal voluntary pension savings, tax rates for statutory and voluntary pensions in payment.

The author has studied the national pension legislation (laws, Cabinet regulations), academic literature and statistical data sources. The research is limited to old-age pension benefits, not covering disability and survivors' pensions. The effective tax rates on pensions are highest in Latvia and lowest in Lithuania, both for mandatory and voluntary pensions, following the same pattern as labour taxation in the region.

Key words: Baltic States, pensions, income tax, tax incentives, fiscal welfare.

JEL code: H55, H71, H75

Introduction

The research objects of this study are pension systems of Estonia, Latvia and Lithuania, and, more narrowly, those elements of these systems that relate to the fiscal welfare dimension. They are a very beneficial object for comparative studies, since the three Baltic States have very much in common, making it even interesting to find differences and discrepancies.

Pension reforms in the region started in the mid of the 1990s and now all three countries have modern three pillar pension systems.

The vast academic literature dedicated to pension reforms in Estonia, Latvia and Lithuania, or – in a broader context – in the post-communist Central and Eastern European countries (e.g. Tavits, 2003; Aidukaite, 2003, 2006, 2009 and 2011; Rajevska, 2015) is focusing mainly on the transformation paths of social security systems, discussions on welfare state concept etc.

The approach of this paper is close to the research performed by Lithuanian scholars (Skackauskiene, 2013; Skackauskiene & Tuncikiene, 2014) for labour income taxation in the Baltic States: a consolidated review of existing regulatory standards, rates and principles.

The material in this paper is a synthesis of information from numerous sources:

1. ASISP (Analytical Support on the Socio-Economic Impact of Social Protection Reforms) annual national reports on pensions, health and long-term care for Estonia, Latvia and Lithuania written by country experts: Andres Võrk, Lauri Leppik and Gerli Paat-Ahi (Estonia). Inara Bite and Ruta Zilvere (Latvia) and Teodoras Medaiskis and Danguole Jankauskiene (Lithuania).

2. Information from the specialised web-sites:

- www.pensionikeskus.ee (held by the Central Depository of Estonia);
- www.manapensija.lv (held by the Central Depository of Latvia);
- www.pensijusistema.lt (held by the Ministry of Social Security and Labour of Lithuania);
- www.vsaa.lv (held by the State Social Insurance Agency of Latvia);
- www.sodra.lt (held by the State Social Insurance Fund Board of Lithuania);
- www.socmin.lt (web-site of the Ministry of Social Security and Labour of Lithuania).

3. Laws

- State Pension Insurance Act (Estonia), RT I 2001, 100, 648;
- Social Tax Act (Estonia), RT I 2000, 102, 675;
- Income Tax Act, RT I 1999, 101, 903.

- Funded Pensions Act (Estonia), RT I 2004, 37, 252;
- Law on State Pensions (Latvia), adopted on 02/11/1995;
- Law on State Social Insurance (Latvia), adopted on 01/10/1997;
- Law on State Funded Pensions (Latvia), adopted on 17/02/2000;
- Law on Personal Income Tax (Latvia), adopted on 11/05/1993;
- Law on State Social Pension Insurance Pensions (Lithuania), I-549, adopted on 18/07/1994;
- State Social Insurance Law (Lithuania), I-1336, adopted on 21/05/1991;
- Republic of Lithuania Law on Personal Income Tax, NIX-1007, adopted on 02/07/2002.

4. Statistical data are obtained from online databases of national statistical bodies: Statistics Estonia (www.stat.ee), Central Statistical Bureau of Latvia (Centrālā statistikas parvalde, CSP, <http://www.csb.gov.lv>) and Statistics Lithuania (Lietuvos statistikos departamentas, <http://www.stat.gov.lt>).

The research is limited to old-age pension benefits, not covering disability and survivors' pensions. The effective tax rates on pensions are highest in Latvia and lowest in Lithuania, both for mandatory and voluntary pensions, following the same pattern as labour taxation in the region.

Research results and discussion

1. Overall design of old-age pension systems in the Baltic States

Estonia, Latvia and Lithuania entered their new eras of independence with identical old-age security systems, inherited from the Soviet period. They also faced very similar transition-related challenges. The processes of radical economic and political reforms were accompanied by reforming the old soviet social security system. Some reforms have been commenced already in 1990 in all three Baltic States, starting from introducing of social insurance contributions

(social tax) and financial separation of the social insurance system from other budgetary expenditures. The second wave of pension reforms in the second half of the 1990s was very much influenced by the World Bank seminal report "Averting the Old-Age Crisis: Policies to Protect the Old and Promote Growth" (World Bank, 1994). The paper has introduced the concept of three-pillar pension system and actively propagated the substantial shift to privatization of mandatory pensions. By the beginning of this century, the structure of pension systems in all three countries included:

- Pillar I: a state-managed compulsory pension scheme, operating on the pay-as-you-go principle, financed by social insurance contributions ('pension tax'), and offering earnings-related benefits;
- Pillar II: a privately-managed, compulsory, and fully-funded pension scheme, financed by social insurance contributions;
- Pillar III: privately managed voluntary pension schemes, in the form of pension funds or insurance policies offered by insurance companies.

Pillars I were created by reforming the existing state pension schemes, while pillars II and pillars III were introduced as completely new schemes. The purpose of this paper does not involve any thorough analysis of the elements of the Baltic pension systems and pension benefit computation procedures, those interested may refer to the author's other recent publications (Rajevska 2014, 2015).

2. Funding of pension budgets

Pensions are financed from social budgets replenished by social insurance contributions made by insured persons and their employers (in Estonia the term "social tax" is used). For some categories (e.g. self-employed, unemployed persons, those on sick-leave or maternity or child-care leave, working pensioners etc., the

contributions are made in accordance with special rules). In Latvia, the so-called 'pension supplements' – one euro per one pre-reform year of service record that were assigned to those

retired before 2012 - are financed from the general state budget.

Generic rates for persons participating / not participating in mandatory funded pillar (pillar II) are given in the below two tables.

Table 1

Rates of social tax (social insurance contributions) for persons NOT participating in pillar II (generic case) in the Baltic States, as in December 2015

	Social insurance contributions (% of gross earnings)			
	paid by		total	of them to pensions
	insured person	employer		
Estonia	-	33	33	20
Latvia	10.5	23.59	34.09	20
Lithuania	9	30.8	39.8	26.3

Source: author's compilation from national social insurance agencies data

The highest rate of social insurance contributions is observed in Lithuania but at the same time this country has the lowest income tax on employees' salaries, so the total tax burden

on wages is the heaviest in Latvia. The division of contributions between employees and employers is the least beneficial to Latvian employees as well.

Table 2

Rates of social tax (social insurance contributions) for persons participating in pillar II (generic case) in the Baltic States, as in December 2015

	Social insurance contributions (% of gross earnings)					
	paid by		total	of them to pensions		
	insured person	employer		total	1st pillar	2nd pillar
Estonia	2	33	35	22	16	6
Latvia	10.5	23.59	34.09	20	15	5
Lithuania	10	30.8	40.8	27.6	24.6	3

Source: author's compilation from national social insurance agencies data

As it can be seen from the above tables, in Estonia and Lithuania, pillar II participants make additional contributions, making their net earnings lower compared to those not participating in pillar II. Until quite recently, Estonia was the only country in Central and Eastern Europe to increase the total contribution rate when introducing pillar II, using both the so-called "top-up" and "carve-out" methods simultaneously (Leppik & Vork, 2006). Lithuania followed suit starting from 2014. Besides that, in Lithuania, the state makes extra payments to pillar II pension fund from general budget (financed by other taxes), i.e. pillar II in that

country is financed by three sources: person's mandatory social insurance contributions, additional personal contributions made by workers (like in Estonia), and state subsidies to pension funds from the state budget (the amount of state subsidy is the same for all covered by the scheme, irrespective of the actual personal wage, it is calculated from the average wage in the country, in 2015 it was EUR 6.61 per month per person), (A similar scheme can be found also in Estonia but there it relates only to a very specific case: the so-called 'parental pension'. The state makes additional contributions from the general budget to II pillar II pension funds for one parent (either a mother

or a father). The amount of the contribution is set 4% of the countrywide average insured wage (in 2015 – EUR 31.71), this is the amount that the state transfers to pension funds for one parent. Such additional contribution is paid from the date of childbirth until the child becomes three years old, regardless of the fact whether the parent has returned to work or not.). However, those Lithuanian pillar II participants who joined the system before 2013 were allowed to continue participation in pillar II under old rules (that were similar to Latvian scheme), i.e. with no additional personal contributions and with no state subsidy, and this option was chosen by 64.5% (684 thou.) of pension funds participants. One third (33.2%) of pre-reform pillar II participants (352.5 thou.) have joined new scheme: increased personal contribution in return for additional state subsidy (*Figures from State Social Insurance Fund Board of the Republic of Lithuania (SoDra) statistical data website <http://atvira.sodra.lt/en-eur/index.html> (retrieved on 20/12/2015).*

Estonian and Lithuanian legislators, in contrast to their Latvian counterparts, allowed some degree of flexibility to pillar II participants, offering more than one scenario to the participants.

3. Taxation of pensions in payment – pillar I and pillar II

In Estonia, all mandatory pensions paid from pillar I and pillar II are taxed by income tax (in 2015 – 20%, the same rate remains in force in 2016) but there is an additional tax allowance for pensions. The tax-free income for pensioners in 2014 was EUR 374 per month (consisting of general tax exempt income EUR 1,728 per year, plus additional tax exempt for the state pension – EUR 2,520 per year). If the payments start in the middle of the year, the additional tax exemption calculated for the pension payments is also made for the months preceding the beginning of the payments. The tax exempt levels are regularly revised, thus, in 2016 the monthly tax-free

income for pensioners was raised by EUR 395 per month.

Average pension levels are below this threshold: in Quarter 3 of 2015 (the latest available data at the time of writing this paper), the average Estonian old-age pension was equal to EUR 370.90, so the effective tax rate on pensions is very low.

In Latvia, state pensions (i.e. payments from pillar I and pillar II) are subject to income tax – 23% (rate for 2015 and 2016). The tax-free income for pensioners is also higher than for those in working age and amounts to EUR 235 per month (EUR 2,820 per year). Pensions, assigned before 1996 (i.e. in accordance with the former Law on State Pensions) are not taxed irrespective of the amount.

In contrast to Estonia, the majority of Latvian pensions lie above this line – in Quarter 3 of 2015, the Latvian average old-age pension was equal to EUR 273.00 (net), which means that the effective tax rate on pensions is significantly higher.

In Lithuania, no income tax is levied on pension benefits paid from statutory pillar I and pillar II schemes (meanwhile, the average old-age pension in Quarter 3 of 2015 was equal to EUR 246.90).

4. Taxation of pensions in payment – pillar III

Taxation of voluntary pillar III pensions is also different in the three study countries.

In Estonia, pillar III pension benefits are taxed at 0%, 10% or 20% rates depending on the duration of the participation in the scheme, age of retirement and way of taking out the benefit.

There is no age restriction on the time of finishing the accumulation phase and commencing the pay-out phase: a person can receive payments from the voluntary funded pension whenever s/he wishes. However, a full income tax rate of 20% is applicable for all sums withdrawn from the insurance contract or pension

fund before the person becomes 55 years old, unless the person has become fully and permanently incapable of work. In such case, tax incentives are applicable: 10% income tax is charged on the payments from pension fund and no income tax at all is charged on lifetime payments from an insurance company (annuity) paid monthly or quarterly.

After the person has become 55 years old, the payments are taxed with 20% income tax if less than 5 years have passed since the conclusion of the contract or first acquisition of redeemable units. In the case that more than 5 years have passed, single and fixed-term payments are taxed with 10% income tax, while lifetime payments from an insurance company (annuity) are not taxed with income tax.

In Latvia, the benefits can be received from pillar III pension plans only after the person becomes 55 years old (unless s/he is granted with the first degree of disability). The payments are taxed with income tax at 10% rate.

In Lithuania, the rules are similar to Estonian ones: pension benefits paid from pillar III voluntary funds can be received at any age and are levied with 15% income tax but become tax-free if a person:

- holds savings in a pillar III pension fund for at least 5 years and reaches the age of 55 at the time of payment of the benefit (and the pension savings agreement was concluded before 31 December 2012); or
- holds savings in a pillar III pension fund for at least 5 years and reaches the age which is five years earlier than the threshold for the old-age pension at the time of payment of the benefit (if the pension savings agreement was concluded after 1 January 2013).

5. Tax incentives for voluntary pension savings

Voluntary funded pension schemes function almost uniformly in all three countries. National pension legislations are designed to motivate

people to save in pillar III, what differs are the rates and bases for return of income tax on the contributions paid to private pension funds.

In Estonia, for contributions of up to EUR 6,000 or 15% of gross earnings income tax (20%) is returned.

In Latvia, for contributions of up to 10% of gross earnings income tax (23%) is returned. But if a person accumulates pension savings by making contributions both to a pillar III pension plan and to a lifetime insurance cover, s/he may double the base for income tax return: up to 10% for contributions to a pension fund plus up to another 10% for contributions to an insurance company.

In Lithuania, for contributions of up to 25% of gross earnings income tax (15%) is returned.

Although the overall approach is absolutely similar, the figures vary between countries, Lithuania offering the most generous incentive for voluntary accumulations.

Conclusions, proposals, recommendations

- 1) Pension systems of the Baltic States have a lot in common, including the general structure and functional role of the three pillars, overall approach to financing pension budgets and taxation mechanisms.
- 2) Pension budgets in all three Baltic States are financed from social insurance contributions ("social tax"), the highest rate being observed in Lithuania and the lowest in Estonia. In Estonia and Lithuania, pillar II participants pay additional contributions, making their net earnings lower compared to those not participating in pillar II.
- 3) In some specific cases, pensions are partially financed also from the general state budget in all three Baltic States.
- 4) Lithuania is the only Baltic country, where statutory pensions are not subject to any tax. Both in Estonia and Latvia, pillar I and pillar II old-age pensions are subject to income tax (20% in Estonia and 23% in Latvia).

Pensioners are granted with higher tax exemptions than persons in working age.

5) Tax exempt threshold in Estonia is higher than the average pension level, i.e. the majority of pensions are not taxed. Meanwhile in Latvia, tax exempt line is below the average pension.

6) The most elaborated regulation of taxation of pillar III pensions can be found in Estonia, the least flexible rates are observed in Latvia.

7) All three countries offer similar mechanisms of tax incentives for accumulating individual voluntary pension

savings in pillar III pension funds or insurance companies, providing income tax returns for pension contributions.

8) All things considered, the pension-related effective tax rates are the highest in Latvia. They should be revisited in order to learn lessons from Estonian and Lithuanian examples.

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