(IN)EFFECTIVENESS OF THE LATVIAN PENSION SYSTEM IN ADDRESSING THE PROBLEM OF POVERTY AMONG THE ELDERLY

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Abstract
Against the EU background, Latvia demonstrates extremely high rates of the at-risk-of-poverty or social exclusion among the population in older age groups 65+ and 75+, as well as the highest levels of income inequality (S80/S20) among the elderly. The country is consistently among the bottom three performers in respect of these indicators, lagging behind its neighbours in the Baltic Sea region. The authors demonstrate what specific elements of Latvian pension system make it an inappropriate instrument in poverty alleviation. In the absence of redistribution mechanisms in mandatory NDC and FDC pension pillars accompanied by relatively high tax burden on pensions, the only systemic element aimed at alleviation of poverty in the old age is the statutory minimum pension, which is not equal to the task. Delay with the introduction of the minimal income level (proclaimed in 2014) and termination of subsistence minimum calculation since 2014 have also contributed to the deterioration of the situation of the receivers of small amount pensions. Since fundamental changes in mandatory pension pillars (I and II) are hardly practicable, the solution may be found in development of the so called pillar 0 (social assistance) and pillar IV (housing programs, healthcare programs, other formal and informal forms of financial and non-financial support to the elderly), which are also drastically underdeveloped in Latvia.

Keywords: basic protection, NDC, poverty alleviation, public pension.
JEL codes: H55, H75, I32.

1. Introduction
Along with many other countries that undertook fundamental pension reforms in 1990s, Latvia went through an essential reform of its old-age pension system in 1995 by introducing the notional defined contribution scheme, later complemented by mandatory and voluntary private pension funds. It was anticipated that the modern multipillar system would strengthen the social security of the elderly and bring decent pension benefits to the population.
reality, after twenty years of the reform being effective, the pensioners in Latvia are among the poorest in the EU.

2. Poverty among the elderly in Latvia

Elderly age in itself places a person at risk of social exclusion (fewer social contacts, deteriorating health, rigidity of thinking, ageism and other prejudices from society, etc.). Similarly, poverty itself makes an individual exposed to this risk, reducing their ability to acquire the goods and services necessary for active social life. The combination of these two factors – poverty and old age – aggravates this risk.

The EU countries assess their progress in the field of social inclusion using Eurostat statistical instruments. The main tool is the aggregate indicator “People at risk-of-poverty-or social exclusion” (AROPE) (Eurostat 2014) – measured in thousands persons or in percentage (as a share of the total number of inhabitants). AROPE rates are calculated both for the total population of a country, and for separate age groups. The rates for older age-groups in Latvia and the average EU rates are reflected on Figure 1.

![Graph showing AROPE rates in Latvia and EU for different age groups from 2008 to 2016](image)

**Fig. 1.** People in the older age groups at risk of poverty or social exclusion in Latvia and EU in 2008-2017, in %
Source: Eurostat.

It should be noted that in the vast majority of EU countries – in 21 out of 28 (i.e. ¾) – the proportion of people exposed to the risk of poverty or social exclusion (AROPE) in the age group 65+ is lower than for the population under the age of 65. The average difference in the ratios is minus 6.5 percentage points: 24.7% in the younger age groups compared to 18.2% among those above 64
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(2016). As a rule, the elderly have a stable income in the form of old-age pension, no dependent minors, accumulated some savings and have no mortgages. Only in seven countries the picture is reversed: persons in the age group 65+ are more exposed to the risk of poverty or social exclusion. These are the three Baltic countries (Latvia, Lithuania and Estonia), the European "anti-champion" in the sphere of poverty – Bulgaria, two more countries of Eastern Europe – the former Yugoslav republics of Croatia and Slovenia, and Malta. Of these countries, the biggest gap between groups below and above 65 years is in observed Estonia (20.9 percentage points) and Latvia (18.2 percentage points), while the smallest in Slovenia (1.8 pp).

The relative median income ratio (65+) is the second lowest in the EU (trailing only Estonia, again): 0.63 compared to 0.93 in EU-28 (2016). The highest historical rates were observed in 2011-2012 (0.86 and 0.80 respectively), which was not the sign of fast improvement of pensioners’ wellbeing, but of rapid deterioration of working population incomes. Thus, although the average European indicator showed stable growth by 0.01-0.02 per year, in Latvia in the last decade we see an increase from 0.64 to 0.86 from 2007 to 2011, and then roll back to 0.63 by 2016.

Likewise, as was shown on the Figure 1 above, the share of pensioners exposed to the risk of poverty was also decreasing in 2010-2011. However, the Figure 2, where the poverty threshold (set at the 60% of the median disposable income) is juxtaposed with the average pension level in respective period clearly reveals the nature of the “improvement”.

![Graph showing average old-age pension amount and poverty threshold in Latvia](image)

**Fig. 2.** Dynamics of the average old-age pension amount and poverty threshold in Latvia in 2007-2016

Source: Eurostat, Central Statistical Bureau of Latvia.

Considering the two components of AROPE indicator for the elderly: rate of severe material deprivation and at-risk-of-poverty rate (AROP), the following
inferences can be made – material deprivation is decreasing much more successfully than relative poverty risk. While the number of the elderly experiencing severe material deprivation has decreased by 78 thousand from 2007 to 2016, the number of relatively poor seniors with incomes lower than 60% of the median has risen by 11 thousand conversely. This is definitely due to the fact that the very threshold has grown almost twice during the decade: from €168 to €318 per m (rapid growth before the crisis followed by with a sharp dip and then by recovery), whereas the average pension was increasing slower albeit constantly.

Should we attribute the incidence of poverty among the elderly only to the deficiencies in the Latvian pension system? In our opinion, predominantly yes. In 2017, the other social transfers (except for the pensions) helped to reduce the poverty among the elderly by 3.1 percentage points – from 43.0% to 39.9%; in 2016 – by 3.2 percentage points, in 2015 – by 2.8 percentage points. As a matter of fact, the Latvian system of social transfers is among the least effective ones in the EU – see Figure 3 below, which shows the effectiveness of social policies in all age groups in total.

![Fig. 3. Impact of social transfers (other than pensions) on poverty reduction in Latvia and EU in 2007-2016, in %](image)

Source: Eurostat.

The underdevelopment of the social protection system is a repetitious subject of the country specific recommendations (CSR) that Latvia receives annually from the EC via Country Reports. Social assistance system is one of the policy areas where the wordings of Commission’s recommendations are repetitious and the reforms are stalled.

Year on year since 2012 the CSR wording remains almost unchanged: “Tackle high rates of poverty and social exclusion by reforming the social assistance system to make it more efficient, while better protecting the poor” (2012), “Tackle high rates of poverty by reforming social assistance for better coverage, by

The Commission’s assessments are absolutely precise, because Latvia has announced some measures but did nothing for their implementation. Therefore in the year 2017 Country Report the EC draws the attention of the authorities in Latvia to the necessity of making actual steps: “Implementation of the recommendations has slowed down in the recent years. Over 2012-2014, Latvia made ‘some’ progress with the overall implementation of the country-specific recommendations, due to reforms initiated under the financial assistance programme, post-programme surveillance and the euro adoption process. More recently, as the economic situation has normalised and external pressure has decreased, the urgency of policy measures has abated, leading to a slowdown in the reform process to ‘limited’ in recent years” (EC 2017, p. 10).

While the coverage of the mandatory old-age pension system is very wide (close to 100%) and in the near absence of other social transfers (as shown above), the key role in the poverty incidence among the old age groups is played by the pension system itself, which is unable to deliver decent standard of living to its participants. Although some of the old-age pensioners are still working and receiving wages in addition to their pensions and some are receiving their pensions from more than one state, nevertheless, to the majority of Latvian old-age pensioners public pensions are their only source of income (except for the financial support from their family members).

3. General description of Latvian pension system

The old-age pension system consists of a state administered mandatory notional defined contribution (NDC) scheme, a mandatory statutory funded scheme (FDC) and voluntary personal pensions. Pillar I is a pay-as-you-go NDC scheme. The amount of the individual pension from pillar I is determined by lifetime contributions paid into the scheme thus accumulating the individual’s notional pension capital. For years of service prior to 1996, notional capital is calculated on the basis of the wage history in 1996-1999 (for those who had low wages in 1996-1999 but have at least 30-year insurance record, the basis is the country’s average insured wage in the reference period).

To calculate the individual amount of annuity at retirement, the aggregate individual pension capital is divided by the gender-neutral average life expectancy at the age when the pension is claimed (G-factor). In this manner Latvian pension formula automatically links the amount of the assigned pensions to changes in life expectancy. That means that persons of the same age and with the same amount
of accumulated pension capital who retired later receive lower monthly pensions. The notional pension capital is annually valorised based on the national wage bill growth, meaning it is affected by the size of the labour force, i.e. fewer working people mean lower valorisation. Pension entitlements are thus affected by demographic changes twice: through valorisation of pension rights during accrual and through benefit calculation upon claiming a pension.

The pensionable age in the mandatory pension system is set to increase from 62 to 65 by 2025 by 3 months every year (starting from 2014). The minimum insurance period to qualify for an old-age pension is set at 15 years and from 2025 it will be raised to 20 years. Early retirement is possible 2 years before statutory pensionable age provided the applicant has minimum 30-years’ insurance record. During early retirement (i.e. before reaching the statutory pensionable age) the pension is paid at the level of 50% of the calculated pension amount. According to the data of State Social Insurance Agency, each fifth newly granted old-age pension is an early one; this option is especially popular among women: 21.3% in 2015 and in 2016, compared to 16.1%-16.6% of early pensions among men.

Pensioners, except early retirees, may combine receiving the full pension and income from work that also gives entitlement to periodic recalculation of pension benefit based on additional contributions. Many Latvian pensioners are using this opportunity: 33.6% of all old-age pensioners below 70 y.o. are still working — 36.0% of men and 32.0% of women. In the age group 70-74 the share of working pensioners is more than twice lower — 14.6%, and at the age 75+ continue to work only 4.6% of pensioners (SSIA 2017).

Pillar II is a statutory funded defined contribution scheme, launched in 2001. Pillar II is mandatory only for those born after 01/07/1971. The vast majority of all those born between 01/07/1951 and 30/06/1971 who had right to join the pillar voluntarily have exercised this right. On October 30, 2017, there were 1.272 mln members of the state funded pension scheme and the total worth of assets was ca €3.200 billion. At the same time, a significant part of the members are inactive, i.e. have not made a single payment into the scheme throughout a year: in 2016 inactive members made 22.2% (2015 – 21.8%, 2014 – 20.4%) (SSIA 2016). Since 2009, the proportion of active participants has not exceeded 80%, but before the 2008 economic crisis it was at 87-89%. The large proportion of non-active participants is due to the fact that a large part of Latvia’s population has emigrated abroad and makes no new contributions any longer. The benefit is accrued by transferring part of the social insurance contributions to one of 9 mandated asset managers offering 23 pension plans of three various risk profiles: active, balanced and conservative. At the time of retirement the accumulated capital can be converted into an annuity either by adding it to the first-pillar notional capital or by purchasing a life pension insurance policy.

Pillar III is voluntary, any person and employers can make contributions to a private pension fund: 6 funds offer 18 pension plans. In June 2017, pillar III covered 28.5% of economically active population and predominantly financed from own contributions, with less than 20% of all contributions made by employers and the assets made €410 mln (7.8 times less than pillar II assets). The
share of inactive members is higher than in mandatory funds: 29.5% made no contributions in 2016 (30.3% in 2015, 33.5% in 2014) (Financial Capital and Market Commission). 16% of all assets belong to one pension plan covering just 4.6% of participants: this is the only closed pension fund in Latvia, whose participants are employees of the three state-owned shareholding companies, and contributions are made by the employers, therefore it can be considered as a sort of occupational pension.
The majority of today pensioners are receiving their pensions from pillar I only.

4. A ‘bug’ or a ‘feature’?

We have already studied the reasons why the share of small amount pensions is so substantial in Latvia (Rajevska and Rajevska 2018), and have demonstrated that in the near absence of redistribution mechanisms in mandatory pension pillars accompanied by high tax burden on pensions, the only systemic element aimed at alleviation of poverty in the old age is the statutory minimum pension, which is not equal to the task, being set at disconcertingly low level: €70 - €109 per month (depending on the length of the insurance record). This is the lowest minimum pension level in the EU. The other reasons include the unfair conversion of pre-reform employment record into pension formula, as well as the pronounced income inequality in the working age which is not counterbalanced by any kind of non-contributory (basic) pension component.

But why is the situation exactly what it is? All the above answers provide only „technical” sort of reasoning, pointing to specific features of the design of the pension system is Latvia. But does the today outcome complain with the designers’ vision of pension system? In our opinion, the answer is positive. The right-wing parties that form the Cabinet in the last 25 years continuously, do not consider pension system as an instrument of combatting poverty. Political elites in Latvia share the individualistic type explanations of poverty, characteristic to liberal and neo-liberal paradigm: the major cause of the poverty is seen in bad behaviour, laziness, lack of will power, lack of thrift nad proper money management and poor moral of the needy individuals (van Oorschott 2000).

Let us consider the definitions of pension system objectives in the political documents of the EU:
The White Paper on Pensions formulates in the following way: “the basic purpose of pension systems is to deliver adequate retirement incomes and to allow older people to enjoy decent living standards and economic independence” (EC 2012, p. 4).
The newly proclaimed European Pillar of Social Rights also contains a special paragraph on the subject: “15. Old age income and pensions. A) Workers and the self-employed in retirement have the right to a pension commensurate to their contribution and ensuring an adequate income. Women and men shall have equal opportunities to acquire pension rights. B) Everyone in old age has the right to resources that ensure living in dignity.”

Similar approach can be found also in the documents of the OECD (OECD 2017), in the articles and books published by the World Bank (Holzmann 2000;
Holzmann et al. 2008; Holzmann 2012), IMF (Shang 2014), ILO (2014), in the works of Barr and Diamond (Barr 2002; Barr and Diamond 2006; Barr and Diamond 2008; Barr and 2014), Ebbinghaus (2011), and others.

The Latvian Law on Pensions does not enunciate the purpose of the pension system as though considering it as something self-evident. However, the way of understanding the role of old-age pensions by the policy-makers can be derived from the words and deeds of the governmental bodies and officials.

Illustrate, the Latvian Ministry of Welfare, sees the objectives of the pension system in the “provision of long-term financial sustainability” (in the first instance) and in the “adequate replacement rate in accordance with individual contributions” (Alliks 2016; Ministry of Welfare of the LR 2016). Thus, the sustainability of the instrument is supposed to be the main purpose of its existence, as if a pension system has its own inherent value beyond its societal role. Yet “NDC systems [are] in principle automatically sustainable with respect to population aging because the expected changes in the demographic and macroeconomic environment will automatically lower benefits” (Borsch-Supan 2014, p. 146).

Further on, the term “adequate” is applied not to the amount of pension benefit, but to the replacement rate. However, according to the dictionary definition “adequate” means “sufficient for a specific need or requirement”, and a rate itself cannot be adequate or inadequate, when it is not juxtaposed to some real measurand. Until we see changes in the thinking of politicians, Latvia’s pension system will continue to be ineffective in combating poverty.

The masterminds of Latvian pension reform in 1990s, the World Bank pension expert team leaders, have reassessed their then vision of the policy approach to pension system reform, pointing out the necessity to refocus on basic protection for the vulnerable elderly and more realistic views about the capacity of funded schemes to manage risks and about the achievable rates of return (Holzmann 2014, p. 87). While the basic objectives of pension systems – poverty alleviation and consumption smoothing – have remained unchanged, the focus of attention between the two has re-shifted or at least broadened. “The move towards a tighter contribution-benefit link that has characterized many recent reforms of earning-related schemes has limited the capability to redistribute income towards low-income groups within the schemes” (Holzmann 2014, p. 89).

5. Conclusion

Dangerously high rates of the population of Latvia aged 65+ at risk of AROPE – very high on the European background and consistently higher than in neighboring Lithuania and Estonia – are largely explained by the design of the pension system in our country that does not provide for virtually any redistribution mechanisms from the rich to the poor. Thus, the existing risks of poverty and social exclusion, which the individual is exposed to during the working period, are not compensated in old age, but are preserved and aggravated. Low

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1 https://www.merriam-webster.com/dictionary/adequate

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replacement rates lead to a risk group of those who before retirement were relatively well-off: unlike the absolute majority of European countries, where the risk of poverty and material deprivation in old age is less than before retirement, in Latvia, retirement is associated with a significant increase of these risks.
The share of pensioners exposed to the risk of poverty and social exclusion is constantly high and growing. Statutory minimum pensions and old-age social security allowances are very low and not tied to wage levels.
Since fundamental changes in mandatory pension pillars (I and II) are hardly practicable, the solution may be found in development of the social assistance programs, as well as housing programs, healthcare programs, other formal and informal forms of financial and non-financial support to the elderly, which are also drastically underdeveloped in Latvia. However, the improvement of social safety nets is retarding, despite of persistent reprimands from the European Commission in the Country Reports.
Until we see changes in the thinking of politicians, Latvia's pension system will continue to be ineffective in combating poverty.

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