THE FINANCIAL ILLITERACY OF LATVIANS UNDERMINES THEIR WELL-BEING IN OLD AGE

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Abstract
An extremely individualized NDC + FDC pension system in Latvia assumes the individuals' overall responsibility for the amount of their future pension, both in pillar I and II. Meanwhile, specific tax regimes — for the self-employed, for seasonal workers, for workers of the so-called microenterprises — with low social contributions have gained popularity, and the share of the shadow economy is large, eventually leading to the situation when more than a third of all taxpayers pay social contributions from the base lower than the statutory minimum wage. In many cases they do it without realizing that their future pensions will also be minimal. For the pillar II, this is aggravated by the fact that more than three-fourths of the participants do not control the profitability of their savings in pension plans. Although Latvian legislation allows changing pension plan and fund manager, more than 90% do not use this opportunity, and almost half of those who use it have done so under the influence of advertising, rather than rational thinking. The pillar II share in public old-age pension benefits in the course of time will constitute an increasingly significant part. In Latvia, all persons born after June 1971 are mandatory participants of pillar II pension funds, as well as the majority of those who were given the opportunity to join them voluntarily. Having shifted responsibility for their future pensions entirely to workers, the state and fund managers could take a more serious part in their financial education.

Keywords: financial literacy, insured wage, mandatory funded pensions, NDC. JEL codes: H55, H75, J32.

1. Introduction
Pension reforms in the second half of 1990s in Eastern Europe to a large extent were inspired by the World Bank path-breaking publication "Averting the Old Age Crisis" (The World Bank 1994), that introduced the concept of multi-pillar pension system and actively propagated the substantial shift to privatisation of mandatory pensions. It was anticipated that this shift would bring along higher rate of return under individual accounts and better labour market incentives. Mandatory funded pillars (II pillars in the World Bank terminology) based on financial defined contribution principle (FDC) have been introduced in many countries, including Latvia (since 2001).
The scholars had warned, however, that “individual funded accounts leave the individual facing most of the risk, in particular from differences in pension fund performance” (Barr 2002, p. 31) and that the majority of individuals are not fully aware of the risks, as they “can be myopic and/or imperfectly informed, giving a justification for compulsion” (Barr 2006, p. 65).

In the case of Latvia, individual pension accumulation accounts exist not only in the funded pillars, but also in the pay-as-you-go public pension pillar that is built as a notional defined contribution (NDC) scheme. Lack of any flat rate component in pension formula, where the benefit is depending fully and completely on contributions, deprives the lower-income groups of population (who at the same time are less informed and less educated groups) of the traditional safety net mechanisms of conventional pension systems.

A knowledge-based welfare state presupposes participation of enlightened individuals in social security schemes, including public and private pensions. Such individuals should be able to make informed decisions with long-range planning horizon. Although the average level of financial literacy among Latvians is relatively high (Rajevska and Stavausis 2015), their knowledge of the national pension system and long-term investment planning is not sufficient.

2. Retirement planning in Latvia

2.1. Pillar I (pay-as-you-go) – Notional Defined Contribution

The very concept of NDC, which imitates the FDC, roots in individualized accounts, where each participant accumulates their own notional pension capital. The role of annual interest rate is played by vaporization coefficients, calculated as the annual increase of the total insured wage in the country; and at the moment of taking the retiring, the accumulated capital is annuitized by dividing by the average remaining life expectancy. The insured wage is different from the “normal” salary (gross or net), since the first accounts also for sick leaves, unemployment benefits, maternity benefits, from which social contributions are made as well. And, which is even more important, for some categories of employed – the self-employed, patent workers, seasonal workers, employees of the small companies with special tax regimes (the so called “micro-enterprises”) – their insured wage can only be only a small fraction of their work income.

As a result, pension benefit depends on many factors, the most part of which are beyond control of a prospective pensioner, and if there is more than 5-10 years left to retirement, one can hardly make an accurate estimation of its size on their own.

Senior economist at the Swedish National Social Insurance Agency (the country where the NDC model had been elaborated), Annika Sundén pointed out that “individuals often have limited financial knowledge and know little about the characteristics of their public and occupational pension plans or how much to expect in retirement benefits. This could mean that many workers reach retirement with inadequate resources and as a consequence will need to postpone retirement or lower consumption in retirement.” (Sunden 2006, p. 325). The formulae used
in defined benefit schemes are, normally, quite straightforward, making it easy for a worker to estimate the expected benefit and to compare the replacement rate with the advice provided by financial planners about how much of preretirement earnings should be replaced to maintain living standards in retirement. Even when more complicated formulae are applied, it is easy for pension administrators to calculate replacement rates and communicate this information to beneficiaries. Sundén stresses, that, in defined-contribution schemes (both funded and notional), benefits are not defined but depend on contributions and it is difficult to express the expected benefit in terms of a replacement rate. It is also difficult to estimate benefits because they vary with the rate of return.

Yet when the state does its best to translate the formulae into “understandable” figures, the people seem not to be fully aware of their meaning. She instances a Swedish experience with so-called “orange envelopes” – annual account statements sent out to all participants of public NDC and FDC schemes starting from 1998, since the new pension system had been implemented. These statements include information on the account balance; pension credits earned during the year, and the indexation of the account balance – that is, the rate of return. The orange envelope also includes account information on the Premium Pension (pillar II – funded defined contribution scheme). In addition to providing information about expected (projections for three different retirement ages – early, normal and deferred retirement), the orange envelope summarizes how the reformed pension system works and promotes the main message that lifetime earnings determine benefits. In 2003, only about 10 percent of respondents looked at all of the information in the envelope and less than half of all participants look at the benefit projection. The level of complexity of the schemes implies that the costs associated with understanding the pension scheme could appear greater than the benefits, even if information is available. Moreover, “retirement is seen as something unpleasant and a cause for worry, which means that thinking and planning for retirement, can also involve psychological costs”. However, six years later she identified sufficient progress in Swedish respondents’ knowledge and understanding and attributes it to persistent educational campaign (Sunden 2013). Information and education leading to improved financial literacy clearly is important, but perhaps equally important is to design pension plans that make it easy for participants to make decisions.”

Before 2009, State Social Insurance Agency (SSIA) in Latvia was also annually sending out notices on the accumulated notional pension capital by post, albeit those notices did not include information on pillar II as well as any pension benefit projections. In crisis years, postal dissemination of the notices was abolished for the sake of austerity budget, and had never been resumed. Presently, the inhabitants of Latvia are offered such notices on request free of charge, but only electronically. Therefore, the person ordering a notice should have either electronic signature or internet-bank electronic identification. The procedure is not intuitive for rare internet users, and few prospective pensioners are regularly checking their notional accounts.
And even though, there is no full information in one notice sufficient to make an estimation of the size of future pension. An interested person should take a number of further steps. The website www.manapensija.lv ("my pension" in Latvian language) maintained by the Central Depository of Latvia, from the end of 2013 contains pension calculator\(^1\), which asks users to input data from three different sources into empty fields (having previously received these data via internet-bank and on the portal of electronic government services), and then makes a forecast based on very optimistic assumptions:
- that a person shall not have breaks in income until retirement;
- that a person shall not have a fall in the wage level until retirement;
- that inflation rate shall be 2\% per year, and salaries shall grow by 4.21\% per year;
- that notional capital shall grow by 3.53\% per year (that is, real growth by 1.53\% taking inflation into account);
- that financial capital in pillar II and III shall grow nominally by 5.06\% per year (i.e., 3.06\%, taking inflation into account).

The calculator does not contain an option to make estimations in case of taking early or postponed retirement.

Current experience does not justify these assumptions: for the period from 2003 to 2016, the average annual yield in [mandatory] pillar II pension plans was 3.95\% (and taking into account inflation in was even negative: -0.43\% per year), the average nominal annual yield in [voluntary] pillar III pension plans in the period from 2011 to 2016 was 3.35\% (the real one – 2.06\%) (Better Finance 2017).

The historical rates demonstrated by pillar I (NDC) looks better: the average annual “yield” in notional capital from 2003 to 2016 was 10.6\% (inflation-adjusted average rate – 6.54\%), which is much higher than the figures projected for the future. However, such high rates were possible mainly due to the favourable demographic situation for capital valorisation indices: large generations born in the 1980s were coming to the labour market, while less numerous generations of war and post-war years were leaving it; and on top of this their retirement was slowed down constantly by gradual increase of the retirement age. Now the situation is turning upside down – not so many children were born in the 1990s and 2000s, and the retirement age of a large generation of baby-boomers is approaching.

Nevertheless, even such a highly optimistic calculator returns projections of the total pension (pillar I + pillar II) amounting to 45-48\% of the (last) salary. More realistic calculations predict replacement rate at the rate of 35\% of the last salary from the two mandatory pillars (Kreicbergs 2017).

The current aggregate replacement ratio in Latvia is the second lowest in the EU: 0.42 as opposed to 0.58 EU-28 (figures for 2016) (Eurostat), and is expected to decrease further.

The survey conducted by the author earlier showed that the majority of the inhabitants of Latvia have a poor idea of the pension replacement rate and are

\(^1\) http://www.manapensija.lv/en/pension-system/calculator/
unaware of how much would they have to earn in order for the desired pension amount to become reality. Most of the respondents supposed that their pension would be equal to 60-65% of their net salary. This view is widespread among population irrespective of region, gender, educational level (Rajevska et al. 2014, p. 38).

This is common that the expected replacement rate exceeds the actual one estimated by mathematical calculations. Thus, a recent study in the Netherlands (van Duijn et al. 2013) demonstrated that the largest discrepancies were found for younger cohorts and for individuals with less education and working experience, and the mismatch is mostly related to poor institutional knowledge. Inflated expectations are characteristic also to Italians (Botazzi et al. 2006) and Estonians (Mattson 2014).

2.2. Insured wage – differences among employment and tax regimes

Another problem, associated with the Latvian NDC system, is the use of the „insured wage” amount, and not on the gross or net wage. For persons under a regular taxation regime (regardless of employment contract) the insured wage is equal to the gross wage, whereas it is significantly lower for the self-employed, patent workers and seasonal agricultural workers. In the long run, therefore, these special tax regimes dramatically undermine both the current and the future social security of those involved, as the amounts of old-age pension primarily depend on the paid contributions (which are, in turn, assessed on the base of the insured wage).

In 2017, the total rate of social insurance contributions for standard workers was 34.09% of the gross wage (which, in their case, is also the insured wage). The largest part of contribution income is directed to pension insurance; in 2017, this represented 24.54% of gross wages, with the remaining 9.55% divided among five other social insurance areas.

The self-employed may freely select the fraction of income from economic activity from which they make social or make no mandatory social contributions at all if they prove that their income was lower than the minimum. Honoraria and royalties were not subject to social contributions until 2018. The insured wage of the employees of microenterprises could be several times lower that their net income from work, etc.

Since the self-employed, and natural persons paying patent fees pay social insurance contributions only on a fraction of their wage/income, their accumulated pension capital is meagre, which will result in very small pensions in due course. However, this will not affect individuals soon, since those retiring over the next 3-5 years, as a rule, will have sufficient rights acquired before the current system was introduced.

The director of the Direct Taxes Department of the Ministry of Finance has revealed that in 2016 31.22% of social insurance contributors were making payments from a base below the minimum wage: these were part-time workers with monthly wages below the statutory minimum, patent workers, and most micro-enterprise employees. The majority of the self-employed prefer to make
contributions at the lowest possible level, which is the statutory minimum wage. This situation threatens the sustainability of the social security budget. The level of contributions paid by micro-enterprise employees was so low at that time that they would need to work three times longer than regular taxpayers to accumulate the notional pension capital sufficient for just the minimum statutory pension (Kalāne 2016).

Many of these people are not fully aware of the dramatic consequences of such type of tax avoidance for their future old age well-being, while in some cases it is a coerced choice under the pressure of the employer. The regulation of social insurance contributions base for the non-standard employment types and special tax regimes started to be revised in the last two years in order to strengthen the financial security of those groups, but still they are much more vulnerable to old-age poverty.

2.3. Pillar II (funded) – Private Pension Funds (Defined Contribution)

The population knowledge about functioning of pillar II is very far from an adequate one, as well. Participation in pillar II pension funds is mandatory for certain age groups: in 2018, all who are younger than 48 years are mandatory participants and almost all residents of working age above 48 are voluntary participants of one of the 23 private pension plans offered by 8 fund managers; voluntary participation cannot be terminated as there is no possibility to opt out of the scheme.

It is anticipated that individuals would take their own responsibility and choose:
- investment strategy: conservative, balanced, active or aggressive – depending on the permitted proportion of shares in the portfolio;
- pension plan manager – there is a possibility to change the fund manager for another once per year and to change the investment strategy (“pension plan”) within one fund twice per year;
- the ways of withdrawal the pension upon reaching the retirement age: buying a life insurance policy or adding the accumulated capital to pillar I pension.

It is also anticipated, that the choices made by the participants would be rational and based on their deliberate analysis of the market and after careful consideration. However, the previous international research has demonstrated that such assumptions are patently false (Brown 2014).

In Latvian practice, likewise, those assumptions prove unsounded: for instance, those who join the system for the first time are automatically allocated in a random manner to one of the conservative pension plans (i.e. those not having shares in their portfolios), which is the least effective way of building up pension savings in the start of working life. Despite of recommendations based on successful experience of other countries (Stavausis 2015), life-cycle investment strategies are not allowed by Latvian legislation.

Although change of the pension plan is not complicated in Latvia and no redemption fee is charged, more than 90% do not use this opportunity, and almost half of those who use it have done so under the influence of advertising, rather than rational thinking (SKDS 2015).
In spring 2016, SIA “Aptauju Centrs”, commissioned by the Advanced Social and Political Research Institute of the University of Latvia, conducted the public opinion poll “Mastery of Life and Information Literacy” for the country Human Development Report (Holma 2017). The author of this paper has specifically studied the answers of the respondents to the question whether they control the profitability of their pillar II pension savings – this question was a part of the “financial literacy” sub-group of questions (Rajevska 2018 [forthcoming]). The survey revealed, that 76.8% of those respondents who claim to have participated in pillar II pension funds do not control the profitability of their pension plans, and only 32.2% of those who control do it annually. The very breakdown of the answers demonstrates lack of financial literacy: 31.8% of the respondents aged 65+ have chosen the answers “I do not control” or “I control annually”, although the only valid answer for this age group would be “I do not have a 2nd pillar pension account” (because they were not even allowed to join pillar II). On the other hand, there are respondents of younger age groups (below 44 years), who are working and who have chosen the answer “I do not have a 2nd pillar pension account”, while they are enrolled in pillar II pension schemes automatically. The analysis shows no difference in answers of Latvians and non-Latvians, men and women, having and not-having minor children. There are statistically significant differences between the answers of respondents from different regions, of different educational level, age, working in public or private sector, etc. The respondents’ answers also correlate with their self-reported locus of control and ability to critically assess the information found and to compare information sources.

An international research (Lusardi and Mitchell 2011) has shown that persons with higher levels of education – who, as a rule, have higher incomes and therefore make larger contributions to pension funds, – are better informed in financial matters and are less vulnerable to risks of choosing an inappropriate investment strategy. Less educated persons, whose incomes are lower, are more exposed to the risk of making a wrong investment choice. In this context, funded pillars are rendering a disservice to lifetime poor, causing further distortion in income distribution in old age.

3. Conclusion

Pension system in Latvia imposes responsibility for the future pension on individuals, both in PAYG and funded pension pillars. Low interest demonstrated by the population to the performance of state funded pension plans demotivates fund managers from competition and undermines the future adequacy of funded pension component.

Meanwhile, the complexity of pension formula in the public NDC scheme, existence of socially precarious tax regimes, and insufficient information not allowing individuals to make grounded estimations of the size of their future pensions lead to further loss of workers’ trust in the national pension system, preserving the background for tax avoidance.
Improving financial literacy in the field of pensions is needed to enable people make informed choice of financial services for their future wellbeing.

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