THE ADEQUACY OF THE LATVIAN PENSION SYSTEM IN THE FACE OF EUROPEANIZATION

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Abstract

The aim of the paper is research and analyses of the dimensions of pension adequacy in Latvia and the deficiencies of the current social protection and old-age pensions in the light of the various European social models and their origins. In order to reduce poverty and social exclusion, in all European social models it is essential for the governments to take active part and support the basic elements - pensions, health and long-term care, social protection of the poor and the disabled, and tax redistribution.

The task of each pension scheme is providing the contributor the possibility to maintain his/her standard of living also after retiring. By ensuring sufficient level of income replaceability, the risk of poverty among older people is minimized. Yet the comparatively new pension systems of the East- European countries, as well the pension system of Latvia, lack this ability.

The analyses of the author highlight the need to review the design of the Latvian pension system and to find the right balance between PAYG (Pay-As-You-Go) systems and fully funded systems. In comparison with other European countries, the replacement ratio in Latvia is one of the lowest within the EU 27 countries. Other important vice of the Latvian pension system, which especially influences the income of single pensioners, is the inability to inherit the accumulated capital within the state obligatory funded pension scheme.

Keywords: Social model, pension system, adequacy

Introduction:

Social security as a human right is a social and economic necessity, and the role of the social security system is combating poverty and providing economic security. The current task of the European Union governments is adapting their social security systems to the changing economic, political, demographic and social circumstances.

In the first part of the article the author identifies the basic values of the European social model. European social model is the background for the European welfare and includes democracy and individual rights, social protection and solidarity, free collective bargaining, market economy and equal opportunities for all. In order to reduce poverty and social exclusion, in all European social models it is essential for the governments to take active part and support the basic elements - pensions, health and long-term care, social protection of the poor and the disabled, and tax redistribution.

Pension systems and their diversity, their compliance with the needs of societies and resources of states, evolution and reforming of these systems have been widely studied by numerous experts from different countries and of different areas of expertise. Retirement – income systems are diverse and often involve a number of different programmes. Classifying pension systems and different retirement–income schemes is consequentially difficult. Furthermore, comparing these systems is certain to be controversial as every system has evolved from each country's particular economic, social, cultural, political and historical circumstances.

The aim of a pension scheme is ensuring income replaceability of the socially insured after reaching certain age. There are various types of pension schemes existing in the European countries - contributory or non-contributory, defined-benefit or defined-contribution, mandatory or voluntary, basic or supplementary, social insurance or occupational or personal, publicly or privately managed. The choice in favor of one or the other pension scheme is made according to the specific historical, social and economical circumstances of the concrete country.

In the paper, the author describes the functioning of the social security system of Latvia in case of retirement. The pension system of Latvia is comprised of three pillars – the state obligatory non-funded pension scheme, the state obligatory funded pension scheme and the private voluntary pension scheme. The task of a pension system is minimizing the risk of poverty among older people, but the comparatively new pension systems of the East-European countries, as well the pension system of Latvia, lack this ability. Even more, the analysis of the statistical data performed by the author of the paper show that the current pension system of Latvia merely covers the minimal costs of living.

European social model

European social model is the background for the European welfare and includes democracy and individual rights, social protection and solidarity, free collective bargaining, market economy and equal opportunities for all. The idea of European Social Model Jespen and Pascual (2005) implies the European endeavor to reach coexistence of economical growth and social cohesion and it marked demarcation from the American social model, considered a counter-example.

In addressing welfare state questions, Esping – Andersen (1990) proposed that “The theoretical intent was not really to arrive at an understanding of the welfare state, but rather to test the validity of contending theoretical models in political economy.” “Citizens obtain welfare from three basic sources: markets, family, and government.”

In 1990, Gøsta Esping-Andersen classified the states into three welfare state regimes: „liberal” regime (USA, Canada, Australia and the Great Britain), “conservative” regime (Austria, France, Germany and Italy) and “social democratic” regime –type ((Denmark, Finland and Sweden,). In 1996, Ferrera suggests the expansion of the Esping-Andersen typology by adding the Southern social model, which includes Italy (initially classifies as belonging to the conservative regimes), Spain, Portugal and Greece. This model is characterized by a high level of labour protection, generous social insurance system and a relatively inflexible job market.

Gosta Esping- Anderse typology of welfare state has been criticized and several authors have developed alternative typologies (Ferrera 1996; Bonoli 1997; Korpi and Palme 1998) and experts note that the categories of Esping-Andersen “are nearly as often criticized as they are used” and present-day researches should exercise this concept with a liberal share of caution. In addition to differences between these four aggregate models, other dissimilarities clearly exist among countries within each model. However for simplicity purposes, the following sections will overlook individual countries and rather compare the performance of these models in terms of selected social and economic policies.

According to Sapir, Andre (2006), globalization creates both threats and opportunities. In order to overcome the possible threats, European labour markets and social policies must be reformed. And here the concept of a single European social model is largely irrelevant. Among the four existing European social models, whereas each performs differently in terms of efficiency and equity, the Nordic and the Anglo-Saxon models are those that work efficiently. Yet only the Anglo-Saxon model succeeds in reaching both equity and efficiency. The other two models – the Continental and the Mediterranean models - must be reformed because they are inefficient and unsustainable. In order to reduce poverty and social exclusion, in all models it is essential for the governments to take active part and support the basic elements - pensions, health and long-term care, social protection of the poor and the disabled, and tax redistribution.

The Central and Easterner European countries (Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia and Hungary), the former socialist countries, belong to the 5^{th} European sub-model, and even though they have joined the European Union, this exclusion somehow continues. Due to the common past, they have similar institutional characteristics, and are at an early stage towards the European social policies.

In Europe, the policies of social protection and the policies of efficiency promotion do not evolve similarly – due to the ongoing Europeanization, economic policies have significantly changed while social protection policies have remained national.

Summary of the 21st century pension models

The 1999 treaty of Amsterdam marked an important step forward in European social protection and inclusion policies. The Treaty consolidated the mechanisms set in place by the Treaty of Maastricht and promoted a series of social policy priorities at Community level. Article 136 confirms for the first time that social policy is the joint responsibility of the European Community and its member states. During the Lisbon Summit in March 2000 Member States and the Commission decided to assess progress towards the common objectives on social protection and inclusion within the Open Method of Coordination (OMC). As a new Member State, Latvia will also have to participate in the OMC in the field of pensions.

Pension systems and their diversity, their compliance with the needs of societies and resources of states, evolution and reforming of these systems have been widely studied by numerous experts from different countries and of different areas of expertise. These are political and social scientists, economists and financial analysts.

As the OECD (2011) notes, “retirement – income systems are diverse and often involve a number of different programmes. Classifying pension systems and different retirement–income schemes is consequentially difficult”. Furthermore, comparing these systems is certain to be controversial as every system has evolved from each country’s particular economic, social, cultural, political and historical circumstances. There is no perfect system that can be applied universally around the world.

To look back at the history of pension system reforms, in the 1994, the World Bank published the path-breaking publication “Averting the Old Age Crisis”, stressing the need to reform pension systems around the world because of the looming ageing of population in developed countries. The paper introduced the concept of multi-pillar pension system:

- a mandated, unfunded, and publicly managed defined benefit system;
- a mandated, funded, and privately managed defined-contribution scheme, and
- voluntary retirement savings.

In the reforms implemented in the second half of the 90s with the active participation of the Bank throughout the world, these concepts had first priority.

The authors: Holzmann and Hinz in 2005 to include two additional pillars:

- a basic (zero) pillar to deal more explicitly with the poverty objective and
- a nonfinancial (fourth) pillar to include the broader context of social policy, such as family support, access to health care, and housing.

David Natali (2008, 2011) has analyzed multi-pillar pension system. The scientist notes, “Different instruments usually coexist within a single pension system. In fact the latter consists of different programmes or schemes, each with its own rules of access, financing, benefit calculation and administration. The complex system of programmes providing protection for the elderly represents the institutional design of pensions. This gives information about the role of different institutional spheres: state, market, civil society and social partners (pension mix)."

Although after reforms the national systems of European countries have blended, still there are significant differences among specific groups of countries. Table 2 summarizes what we call the 21st century pension models.

Table 2. Summary of the 21st century pension models

	1st Generation Multi-pillar	2nd Generation Multi-pillar	1st Generation Social Insurance	2nd Generation Social Insurance
Public schemes' Goal	Basic protection (poverty prevention)	Salary savings (some adequacy)	Salary savings (some adequacy)	Salary savings (some adequacy)
Private schemes' Coverage	Mandatory or quasi-mandatory	Mandatory	Voluntary	Quasi-Mandatory
Earnings – related schemes	(mainly) Private	Public / Private	(mainly) Public	(mainly) Public
Countries	UK, NL, IRL, DK	PL, SK, HU, EE, LT, **LV**	DE, FRA, ITA, SPA	SWE, FIN

Source: Natali, (2008)

The first group which includes UK, Denmark, Ireland and the Netherlands is called the first generation of multi-pillar systems. Here, the system has proved stable and earnings-related schemes are mainly private.

The Central-Eastern European countries belong to the second generation of multi-pillar systems. Although the significance of supplementary schemes (through mandatory coverage) has been augmenting there, the provision of future earnings-related benefits still is expected to be based on both public and non public programmes, while voluntary pension funds have not become that influential.

The third group includes the Continental and Southern European countries, i.e. Germany, France, Belgium, Spain, etc. This is the first generation of social insurance system, which is now undergoing reforms, as a result of which the social welfare after retirement shall be ensured by combination of public and non public programmes.

Nordic countries belong to the second generation of social insurance systems. The role of earnings-related public pensions has been decreasing here, while the role of the supplementary, on the other hand,- increasing and now are more influential than in the first generation of social insurance countries.

Common objectives for pensions

EU Member States (EUROPEAN ECONOMY, Koopman, et al.2010) are committed to providing adequate and sustainable pensions by ensuring:

(1) ***adequate*** retirement incomes for all and access to pensions which allow people to maintain, to a reasonable degree, their living standard after retirement, in the spirit of solidarity and fairness between and within generations;

(2) the financial ***sustainability*** of public and private pension schemes, bearing in mind pressures on public finances and the ageing of populations, and in the context of the three-pronged strategy for tackling the budgetary implications of ageing, notably by: supporting longer working lives and active ageing; by balancing contributions and benefits in an appropriate and socially fair manner; and by promoting the affordability and the security of funded and private schemes;

(3) that pension systems are ***transparent***, ***well adapted*** to the needs and aspirations of women and men and the requirements of modern societies, demographic ageing and structural change; that people receive the information they need to plan their retirement and that reforms are conducted on the basis of the broadest possible consensus.

Pension adequacy is defined and measured along the two dimensions of income replacement and poverty protection. To achieve adequacy, pensions also need to be sustainable, safe and adapted to changing circumstances as reflected in the three European pension objectives of adequacy, sustainability and modernisation (or adaptability).

Holzmann and Hinz (2005) have concluded that a pension system should be such "that provides benefits to the full breadth of the population that are sufficient to prevent old-age poverty on a country-specific absolute level, in addition to providing a reliable means to smooth lifetime consumption for the vast majority of the population." In order to reach this aim, poverty of pensioners must be eliminated and the whole system must be patterned so that one can get adequate income over the lifecycle.

Borella and E. Fornero (2009) have proposed that it is important to create an appropriate and fair link between contributions and benefits, since adequacy of income in old age is the fundamental goal of a pension model. Statutory public pensions have to "incorporate some mistrust of the individual's planning capacity, far-sightedness, intertemporal consistency and consequently rules and/or incentives so as to substitute for/encourage individual's planning capacity."

The aim of each pension scheme is providing the contributor the possibility to maintain his/her standard of living also after retiring.

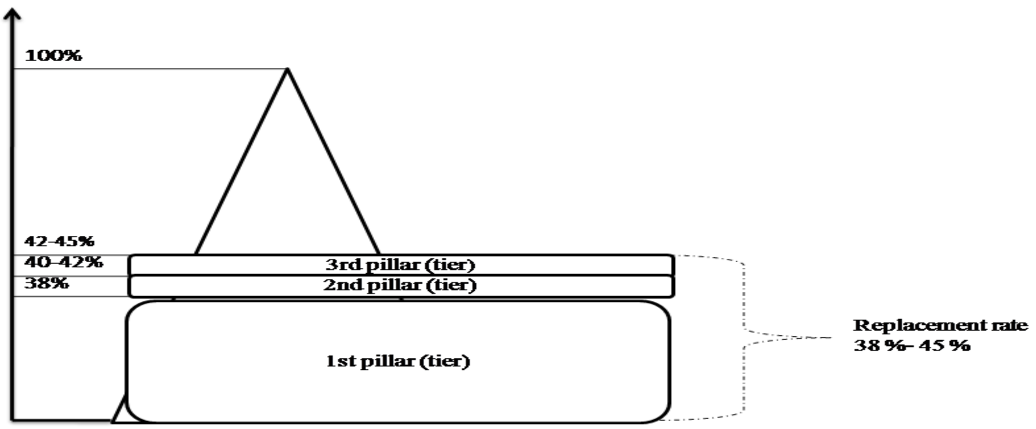
Trends in adequacy of retirement income

Often a one-dimensional measurement is used to describe the replacement rate. On the contrary, this rate may be based on all income of pensioners, including earnings from work. Borella and Fornero (2009) have applied this concept, showing the broadly-defined replacement rates, including not only pension benefits, but also other income of pensioners.

As to measuring pension adequacy, Zaidi (2010), Mintz (2009), Holzmann and Ufuk (2009) have the same approach. Hurd and Rohwedder (2008) have expanded the concept of adequacy by viewing it in terms of individual welfare and denying the role of replacement rate, i.e. using absolute or relative values. Instead, they use wealth to measure welfare, thus referring merely to the owned resources and one's spending habits.

For characterizing adequacy, the author shall use one of the dimensions utilized for adequacy evaluation – the replacement rate. Replacement rate is a case study based calculations that show the level of pension income in the first year after retirement as a percentage of individual earnings at the moment of take-up of pensions. State pensions and occupational pensions together form the largest component (European Commission, 2012a; OECD, 2011; OECD, 2012). Overall, public pensions account for around 60% of incomes of over-65s. There are differences between Member States; for example, in France and Hungary, public transfers account for about 85% of incomes (OECD, 2011).

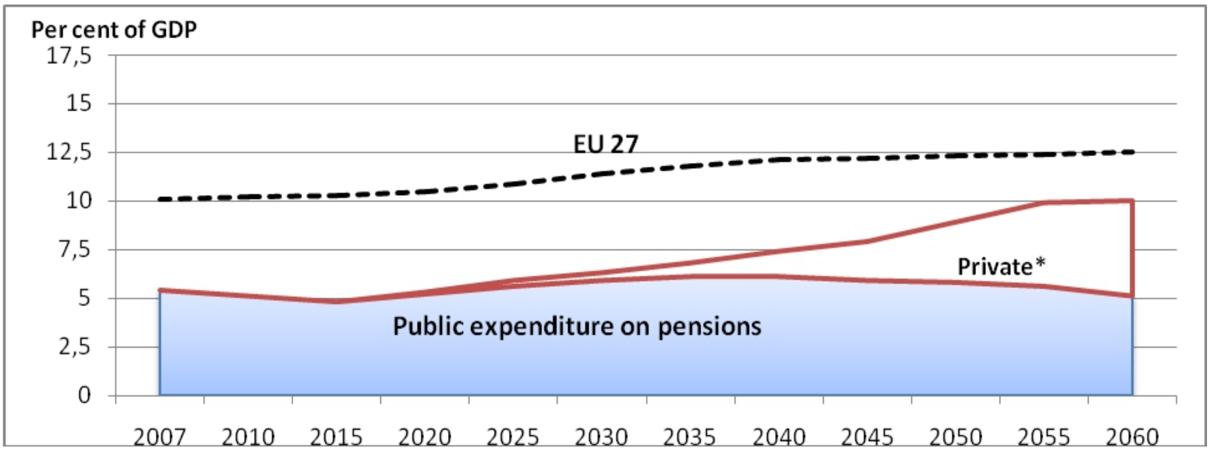
Figure 1. Replacement rate of pension in 2012



Source: authors' survey and calculations.

Figure 1 shows that in Latvia, the 1st pillar covers 84.5 % of replacement rate and shows that replacement rate in Latvia (Pukis and Dundure 2012), including all three levels, reaches only 42-45%. The crisis has highlighted the need to review the design of the Latvian pension system and the need for the right balance between PAYG (Pay-As-You-Go) systems and fully funded systems. Comparing the situation of Latvia with other European countries, one can conclude that replacement ratio is one of the lowest within the EU 27 countries (Zaidi 2010). The long-term impact of the reforms on the finances of pension systems is illustrated in Figure 2. The chart shows the aggregate flows of money from projections that used 2007 as their base year and were published by the European Commission (2009a). In each case, the blue shaded area shows the percentage of GDP expected to be paid in public pensions up to the forecast horizon of 2060. The white shaded area shows the total benefit payments expected from mandatory private pension schemes. For reference, the black line shows the unweighted (simple) average of expenditure for all 27 EU member states.

Figure 2.Total value of benefits from public and mandatory private pensions before reform reversals: EU countries and Latvia



** Benefit payments from mandatory private pension plans*

Source: OECD pension Outlook 2012.

Pensions constitute by far the main source of income of older Europeans, who represent a large and growing share of the EU population. Around 24% of Europeans are pensioners, in Latvia, according to the data of the Latvian Central Statistical Bureau as on the 1st of January, 2013, there are 483 595 old-age pensioners in Latvia (average 24 %). Almost 2/3 of these are women. As the task of a pension system is ensuring sufficient level of income replaceability, it has to minimize the risk of poverty among older people. Yet the comparatively new pension systems of the East- European countries, as well the pension system of Latvia, lack the ability to avert the risk of poverty for elderly people. In accordance with data in 2011 Year (Table 1), in the EU on average the expenditure of governments of the Member States for social protection is 29.4% from GDP, while Latvian government for this purpose directs only 15%, which is the second lowest indicator among the Member States. The 2011 threshold for the risk of poverty calculated by Eurostat in Latvia was 147 Latvian lats (or 209 euros) a month per person.

Table 1. Expenses for social protection as GDP (percentage)

GDP	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
Latvia	12.2	11	12.31	16.9	17.8	15.0
EU (27)	27.4	26.2	26.4	29.6	29.4	29.4

Sources: Eurostat; Central Statistical Bureau of Latvia.

Table 2 shows that in 2012, 4923 pensioners in Latvia were receiving the old-age pension under 50 Latvian lats (71 euros), but the number of recipients of the old-age pension from 50.01 to 150 Latvian lats (213 euros) is 102 220 thousand pensioners. They are the risk group for poverty. The state social security benefit, to which the minimum amount of old-age pension is linked, is 45 Latvian lats (64 euros) per month, and this amount has remained constant since 1 January 2006. It is based neither on economic indicators, nor estimates of the necessary means to ensure the needs of an individual, and is obviously much less than the estimated threshold for the risk of poverty.

Table 2. The division of pensioners according to the average size of the allocated pension

Pension size (in lats)	**Number of old-age pensioners**					
	2007	**2008**	**2009**	**2010**	**2011**	**2012**
30.01-40.00	6	54	110	122	274	3 452
40.01-50.00	65	42	95	152	231	1 471
50.01-60.00	7 702	132	574	1 026	1 599	3 956
60.01-70.00	5 012	511	665	1 093	2 921	1 636
70.01-80.00	20 726	896	2 332	4 912	9 619	6 992
80.01-90.00	60 265	1 952	2 421	4 231	5 483	2 108
90.01-100.00	88 456	7 066	6 556	8 311	8 272	5 078
100.01-150.00	250 246	165 674	94 156	87 332	84 024	82 450
150.01-200.00	20 386	243 358	281 038	271 967	261 758	256 734
200.01-400.00	12 505	42 607	78 740	87 563	96 065	104 041
> 400.01	1 796	2 889	6 643	9157	11 499	14 163

Source: Central Statistical Bureau of Latvia.

Filip Chybalski (2012) has defined three dimensions of adequacy: income, poverty, and differentiation of pensioners' material situation by gender. „Minimisation of poverty risk among pensioners is one of the goals of the pension system in terms of its adequacy." The scientist emphasizes that "it is a goal which necessitates redistribution (mostly intragenerational but also intergenerational) within the pension system. The need to achieve this goal is obvious and does not require further explanation". The third dimension has been defined by the European Commission: "Modernisation of Pension System, namely: Meet the Aspirations for Greater Equality of Women and Men, including in material terms or with regard to the standard of living."

Women are more likely to reach old age than men. According to the data of the Latvian Central Statistical Bureau, the life expectancy for both newborns and people above working age has increased. In 2010, the life expectancy for newborns was 73,8 years, whereas for men it was 68,8 years but for women – 78,4 years. After turning 65, the life expectancy for men was 13,2 years and for women - 18,1 years. Obviously, it is projected that this increase will continue (Dundure 2012).

Table 3. At risk of poverty by ages and gender (%)

Years	**2008**		**2009**		**2010**		**2011**	
	Males	**Females**	**Males**	**Females**	**Males**	**Females**	**Males**	**Females**
60+	37,2	46,3	15,7	21,7	9,8	11,3	12,1	16,7
65+	40,6	50,7	12,9	21,6	6,1	10,2	8,6	16,6
75+	49,8	56,1	10,4	22,3	3,3	10,4	5,1	14,9

Source: Central Statistical Bureau of Latvia

Older women tend to be poorer than men, as illustrated by Table 3. Risk of poverty for females is higher in all age groups above 60 years of age. In the group above 65 years, the risk of poverty is higher by 38 %, but in the group above 75 years, - even by three times (see Table 3).

Jasna A. Petrovic (2013), FERPA Women's Committee President analysed poverty rate among older women and men. Her main findings are: "The poverty rate among older women is higher than for older men, especially in Member States where the predominant pension schemes relate benefits closely to lifetime earnings and contributions."

The survey of Dundure (2012) in her paper "Older people and the labour market" shows that equal opportunities in employment for elderly people are at a disadvantage and discrimination on the grounds of age as the most widespread form of discrimination in Latvia. Women consider that most often employers discriminate them against their gender.

Another reason why in Latvia single pensioners, mainly women, are at a high risk of poverty is the inability to inherit the capital accumulated in the 2nd pension pillar. According to the applicable legislation, the fund units (shares) of mandatory funded pensions, the same as the benefits, cannot be inherited. When the contributor dies, the accumulated funds are moved to the first pillar and subsumed in the overall budget of social insurance for old age.

Due to a recent legislative change in 29 April 2012, this situation can be evaded by buying an annuity (joint insurance contracts with fixed duration of guaranty can be inherited), but it doesn't solve the problem, because buying annuity is a complicated and expensive process.

Conclusion:

In Europe, the policies of social protection and efficiency promotion do not evolve similarly – due to the ongoing Europeanization, economic policies have significantly changed while social protection policies have remained national.

It is important to ensure adequate old-age income by promoting individual rights to pension and facilitating equal access to mandatory state-regulated pensions whether or not supplementary pensions are developed.

Latvia must re-balance the overall pension portfolio between public (the first pillar) and private funded schemes by promoting state-regulated pensions in particular for the most vulnerable, i.e. secure adequacy of old-age income by reducing its dependence on risks linked to financial market fluctuations. The Member States, as well as Latvia, should guarantee a minimum income for older people equivalent to at least the poverty threshold of 60 percent of national median equivalised household income, as a way to promote their social inclusion and autonomy.

Other important vice of the Latvian pension system that especially influences the income of single pensioners is the inability to inherit the accumulated capital within the state obligatory funded pension scheme.

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