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Pension System in Changing Economic Environment: Case of Latvia

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Abstract

European and other world countries are facing changes in their population age structure. This leads to conclude that intensifying ageing of population is a global phenomenon. Latvia has introduced a new three-level pension system aimed to reduce the effect of demographic risks and demonstrating the country's intention to provide viable public and private combination in old-age provision. The demographic estimates of European Commission show that by 2060 in Latvian population number elderly people aged 65 and over will almost double. The potential impact of demographic change on the age structure and the size of population is dramatic and still the main problem that cast the doubt on the ability of state mandatory non-funded pension scheme to provide a full-fledged social security. Personal financial planning, personal investments in Private voluntary pension schemes are important. The objective of research is to investigate whether the existing Pension system in Latvia is working effectively under changing economic environment to reach the goal of providing appropriate pension level for the retired persons. It analyzes the role of Private voluntary pension schemes, the current demographical situation with a flow of emigration and impact of new tax incentives for employees. The research evaluates efficiency of Private voluntary pension schemes and Latvian pension managers in providing appropriate pension level to future retirees in actual financial markets situation. Necessary action scenarios to provide wholesome standard of living in the future are analysed.

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1. Introduction

Today's global economic development trends require a change of views on the sustainability of pension systems and the prospect of their future development directions. Rapid changes are taking part in the economy and these changes will have an impact on the demographical structure of the population. Due to technological progress life expectancy will increase and changes the relationship between the number of employees and the number of recipients of old age pension will occur. Better health care will cause even deeper demographic crisis. Productivity in the sector of «real economy» will raise and that will cause economic structural changes and changes in labour demand.

The aim of the reform of Pension System was to restructure the existing pension system according the present social-economic system in Latvia. The previous pension system did not meet the needs of market economy and, consequently, it was not able to function in the new situation. A complete rework of the pension system was carried out in 1995 in cooperation with the World Bank. Three pension levels have been introduced in the country.

The objective of research is to investigate whether the existing Pension system in Latvia is working effectively under changing economic environment to reach the goal of providing a full fledged social security for the retired persons. The authors analyse the role of Private voluntary pension schemes taking into consideration the current demographical situation with a flow of emigration as well as the impact of macroeconomic situation.

Qualitative methods are used for theoretical comparison and analysis of pension systems. Interviews with experts and personal observations are used to reveal the problems in the current pension system of Latvia. Quantitative research methods: statistical data analysis, forecasting and other financial calculations are used.

2. Define Pension System

Creating a social security system, it is essential to meet the present generation's social and economic needs without compromising future generations. Without such an approach sustainable development of society cannot take place and quality of life would not increase. A serious challenge is the aging population, which is of increasing concern. The major question is whether the society will be able to provide dignified existence and active social life at the retirement age. Currently pension systems are a subject of a lively debate among professionals and society.

The previous pension system in Latvia did not meet the needs of market economy and consequently, it was not able to function in the new situation. According to previous system reform the size of the pension did not depend on the amount of payment made, thus, the amount of the pension depended on average salary and the length of service. Such situation did not stimulate the workers to follow tax payments because the pension was ensured even in such cases when tax payments were made according minimal wage set by the legislation of the country. So risks of pension system sustainability in the future were present. The major task was to set up a financially sustainable system to reduce the risks of rapidly aging population. (Mavlutova & Titova, 2014)

Origin of the name *pension* derives from mediaeval England term *pension* (payment), which in its turn derives from *pensio*, *pension*, *pensus*, *pendere* (consideration, to consider, payment, to pay) in Latin.

The following definition of the term *pension* is found in Great Britain Concise Encyclopaedia: a pension is a regular payment to a person retired from work in case of disablement due to age, physical disability or expiration of fixed term service (Britannica Concise Encyclopaedia, 2006). The payment period usually continues till the end of natural life of the retiree, or sometimes the payments are extended and assigned to the widows/widowers of retirees after their death.

Oxford dictionary (2012) explains the term “pension” as a regular payment made to the retired persons (or older) or to the physically handicapped persons, or to the widows.

Statistical bureau of European Communities defines the term “pension” as periodical payments with the aim to maintain receiver's income after retirement ceasing paid employment at the normal pension age or to back the income of elderly people.(European Parliament's Employment and Social Affairs, 2010)

Organization for Economic Cooperation and Development (2003) defines pension as payments made to the participants of the pension fund (or to the dependent person) after retirement age.

The following definition of old age pension was suggested in Latvia: the old age pension is constant and regular income of society members approaching the age determined within laws and regulations, which provides them with

social funding of full value in long term in accordance with the length of service and social insurance payments made during in advance (Volskis, 2011).

Evaluating above mentioned explanations the authors believe that pension is a periodical payment with the aim to maintain income after retirement or to the incapable of working persons at the age and physical state determined within laws and regulations.

There are three main objectives lying at the basis of old age pension system:

- The principle of solidarity;
- The principle of justice;
- The voluntariness principle.

The old-age pension shall be calculated on the basis of the following formula:

$$P = \frac{K}{G} \quad (1)$$

where,

P – annual pension, the twelfth part of which is the monthly pension;

K – the insured person's pension capital, which is formed by the amount of insurance contributions registered in such person's account and the annual capital gains. The pension capital is dependent upon the insurance contribution wage index. The updating of the pension capital and the procedures for the calculation of the insurance contribution wage index shall be determined by the Government. Pension capital to which the insurance contribution wage index has been applied, taking into account the insured person's choice in requesting an old age pension, shall be supplemented with: The funded pension capital that has accrued in accordance to the Law on State Funded Pension;

G – the time period (in years) in respect of which from the year of granting the old-age pension, the payments of the old-age pension are planned. The registration of the person's pension individual pension capital is carried out since 1996.

Globally there are four main drivers of pension reforms:

1. Aging - increasing life expectancy and declining birth rates.
2. Availability - ensure those who are unable to invest in and maintain a sufficient level and for several decades after retirement
3. Substitutability - standard of living comparable to the well-being of working.
4. Labour force participation - must pay interest, so as not to tend to retire earlier and avoid the payment of pensions.

3. The Features of Current Latvian Pension System

The existing pension system is organized so that the residents can participate in securing their own old age. The core principal of the pension system is the following: the higher social insurance instalments are deposited at the present moment, the higher pension will be received in future.

The aim of the state implemented Pension Reform is to create a financially stable and efficient pension scheme that is based on individual social security contributions which in turn will ensure such amount of pension that depends on the contributions made over the previous period, as well that will facilitate the increase of social security contribution growth.

The reform envisages the introduction of three-level pension system, thus improving financial position of old age people and risk division between the state (future tax payers) and person's savings in compulsory and voluntary pension scheme.

Two different kinds of financing pension system should be mentioned:

- Defined Benefit (DB) – pension system which guarantees pension payments of definite volume not taking into account mandatory or voluntary paid social insurance contribution
- Defined Contribution (DC) - pension system at the basis of which lies pension contribution directly dependent on the paid social insurance mandatory or voluntary contribution into personal pension accounts.

The principles of the above mentioned two pension systems (DB and DC) were transposed into pension system of Latvia. Basing on the justice principle, pension contributions in Latvia are directly dependent not only on social insurance mandatory and voluntary contribution, but also on the length of service and on the profitability level of the chosen funded pension plan. Alongside with the mandatory social insurance contribution every person has the possibility to enlarge his/her personal pension fund paying voluntary contribution into private pension funds.

Pension Level 1 was introduced in 1996, it includes generation and gender equal treatment principles. According to the European Pay –as- you-go System (PAYG) it is the type of pension which is subjected to huge demographical risks. PAYG envisages that the current retirees are being paid from the contributions of today's working population. It is believed that such a system reduces the savings amount, because the working population is not interested to make additional savings (Bode, 2003).

The major drawback of this system is its changeable ratio between the working population and the retirees. As the number of working people decreases and the number of retirees increases, the tax revenue might not be sufficient in order to pay pensions. According to the research data carried out by Deutsche Bank and AEGON Global pensions' research, the envisaged reforms were meant to reduce this risk. Such reforms were carried out in the United States and Western Europe, further they were introduced in Central Europe, as well as in Eastern Europe (Life in European Union, 2012). The reforms are being introduced also in Asian countries.

According to the existing legislation in Latvia, a definite pre-pension and pension age has been determined in order to receive pension due to the age. Rising the pension age has been one of the implemented tools to reduce the problem of aging. Starting from January 2014, by then the existing pension age 62 years, and adding 3 months per year and, thus, by January 2025 the pension age will be 65 years. So, starting from January 2025 a person will receive old age pension if his/her insurance standing is at least 20 years. (Law On State Pension, 1996) . The Law on State Pension also describes definite cases where the person has the right to receive old age pension prematurely; it is possible 2 years in advance of the legal pension age.

Pension Level 3, that is, private voluntary pension scheme was introduced in 1998. Pension Level 3 envisages a free choice for every individual to set up additional accruals for their pension by making contributions into Private Pension Funds. (Law On Private Pension Funds, 1998)

Pension Level 2 was introduced in 2001. Since that period a part of social security contributions that have been made, are being invested in financial markets and pension accruals are being made in each Pension Level 2 personal account.

Taking into account the above information, the major success of pension system reform in Latvia is creating Pension Level 2, which is compulsory to the majority of population; it also helps to reduce the effect of demographic risk on pension. However, this pension level is being subjected to many other risks, which the population of Latvia must take into account when deciding the appropriate Pension Fund. (Law On State Pension, 1996)

In accordance with The Law On State Funded Pension (2001) each individual has the right to choose how to organize the payment of his funded pension capital. The need for Pension Reform was the result of a steadily increasing aging population, instead of keeping the current retirement age. Life expectancy has been gradually increasing. As a result, every year we see the growth in costs for pensions from social security budget.

The task of the developed pension system is to increase the compensation level under the condition that the person takes part in all three Pension Levels at the same time. Additional accruals to their pensions are formed in Pension Level 2 from their personal savings registered in pension capital which in turn is being invested in stocks, bonds and other securities, as well as bank deposits. Investment is being carried out by an intermediary- licensed wealth manager. Thus, pension capital accrues much faster than inflation and the average salary in the country. (State Social Insurance Agency, 2015). Nowadays Pension Level 2 participants can choose their own wealth manager either state or private and to change investments plans twice a year.

From 2009 to 2013, the pension contributions were transferred to Pension Level 1 in the amount of 18%, contributions made to Level 2 were of just 2 %. At present, Pension Level 1 will receive 15% of social contributions, Level 2 of 5%. Such an allocation change made in 2009 was not conducive to confidence in the pension system (State pension special budget, 2015).

Initially the aim of Pension Level 2 was not only to increase pension capital, ensuring full value pensions in future, but it was meant to facilitate the development of national economy. There are seven private pension funds in

Latvia now, which offer 27 different pension plans individual can invest into.

The investment has been done according two strategies:

- Active pension plans – the strategy of investing entities. Great part of assets is invested into shares and other securities. Those pension plans were chosen by 54.52% of representatives;
- Integrated pension plans envisage to invest assets into secure state, local authority and commercial associations securities and term deposits. of credit institutions, which ensure stability of income, chosen by 45.48% of individuals.

In 2015 contributions of pension plan representatives reached 12.7 mln EUR. Average private pension capital yield of one individual rose by 6% or by 67 EUR and it has reached 1262 EUR. The average age of the individuals was 46 years. (The Association of Commercial Banks of Latvia, 2015)

Currently the money is invested in short term deposit savings where its profitability is much lower than inflation, so money loses its value. Bonds accumulate money for the state budget which goes to consumption but not into state investments in the long term. Part of the money is being invested into shares or other securities. Generally profitability of private pension plans is quite attractive (see Table 1)

Table 1. Yields of Level 2 private pension plans (%). *Source:* The Association of Commercial Banks of Latvia, 2015

Plans	1 year	3 years	5 years	10years
Balanced pension plans	4.91%	5.32%	4.40%	4.19%
Active pension plans	6.62%	7.33%	4.97%	3.40%
All pension plans average profitability	5.33%	6.00%	4.83%	4.04%

The growing importance of participation in Pension Level 3 schemes is the main reason why the authors chose to analyse Pension level 3 funds in Latvia. The money that the individual regularly pays into the fund is being invested in various financial instruments depending on the chosen investment strategy. The aim of private funds is not only to save the money for the retirement but also to gain additional value. State grants various tax incentives for both companies that employee contributions are made in favour of Pension Level 3 funds and individuals who are themselves engaged in such contributions. Pension Level 3 contributions into the pension fund, which does not exceed 10 % of gross salary, are not subject to income tax.

Private pension scheme aims at participants with the private pension funds to accumulate and invest in their own- and for them voluntarily made cash contributions, thus providing additional pension capital. Pension plan members can participate in the pension plan, both directly and through their employers.

From the age of 55 of its members may get all the accumulated capital, or to continue membership and receive funds in instalments. Accumulated capital is private property, regardless of who paid contributions, and it is subject to the law of succession. Currently here are two types of Pension Level 3 private funds in Latvia:

- closed-end pension funds, which are intended only for employees and which has been established by the same company (employees' involvement is an initiative of the employer);
- open pension funds in which a member may become any person, either directly or through his employer and which consists of specially licensed bank or a life insurance company.

There are six Pension Level 3 funds currently operating in Latvia: five open (subsidiaries of Latvian banks) and one closed pension fund. In total Pension Level 3 pension funds offer 14 pension plans.

Table 2. Net assets and number of participants in Latvian Private pension funds. *Source:* Financial and Capital Market Commission, 2015

Date	Net Assets, in thousands EUR	Number of participants
31.12.2009	94536	189499
31.12.2010	111928	191307
31.12.2011	119474	198575
31.12.2012	142423	207523
31.12.2013	235693	220646
31.12.2014	280784	236084
30.06.2015	305855	244452

Pension Level 3 private pension plans had accumulated more than 300 mln EUR in 2015, since the end of 2009 figure has tripled. Number of participants in private pension plans gradually increases (see Table 2)

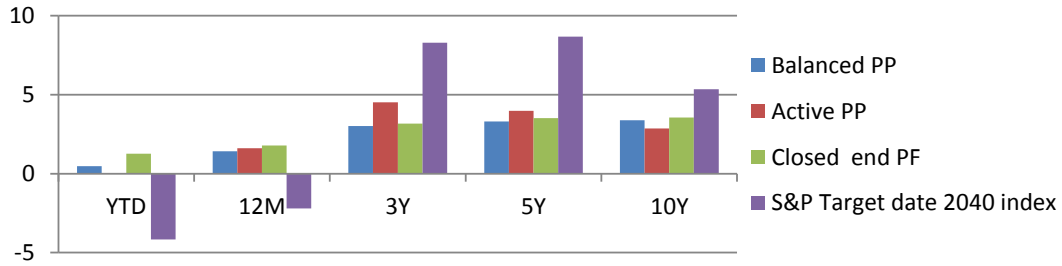


Fig.1. Pension Level 3 funds yields (%) . Source: compiled by the authors

As shown in Figure 1, Pension Level 3 funds have been able to provide a stable long-term capital gains to its investors, providing up to 3.5% per annual yield on the investment after deduction of commissions for the ten-year period.

Although looking at the Latvian pension fund managers submission, the authors conclude that Latvian pension fund managers investment strategy can be seen as conservative - 88% of the investment portfolio consists of investments in debt securities and investment funds, 10% of the portfolio is a deposit with commercial banks (see Figure 2). Those investment strategies provide lower investment volatility, but the long-term performance is far below global market averages.

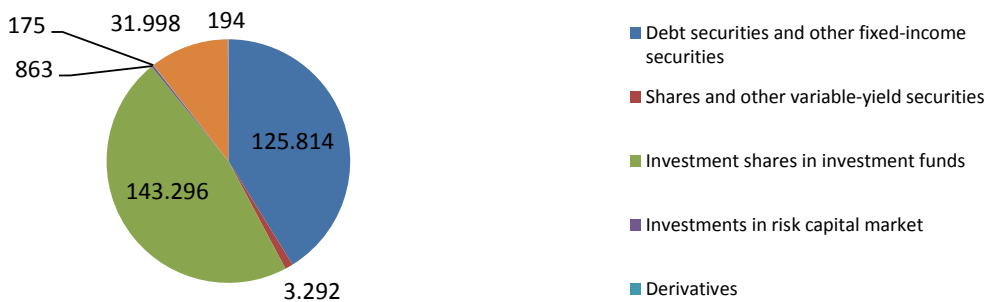


Fig.2. Level 3 Pension Plan Net assets on 30.06.2015 (in thousands EUR). Source: Financial and Capital Market Commission, 2015

The amount of money accumulated in pension funds rapidly grows and investment options problems are becoming more acute. Therefore, Latvia has no other option but to build a competitive financial market, that is attractive to pension funds managers, unless it wants to make this significantly increasing, capital guaranteed maximum stay in the country. Ban on investing in other countries is not possible, because it would violate fundamental principles of free movement of capital within the EU market. Some financial instruments in Latvia are quite attractive to local pension fund managers however the range is very limited. Latvian financial market can be seen as quite small and illiquid.

Unfortunately, the local capital market development requires political will, which is still missing. Politicians averse to abandon or at least to reduce the state share in large enterprises, as averse to make important decisions that could look favourably to the financial sector. The authors look at these attempts as willingness to make cosmetic improvements in the situation, which does not solve the problem in long term.

4. The Economic Environment of Latvian Pension System

An increase in the retirement age, reduction of substitutability and increase in social taxes (or other payments such as pension funds) can be observed around the world.

The problems that Latvia is facing today and will face over the future ten or twenty years such as migration, low birth rate, aging of society and the changes in national economy and economy in general, as a result of the crisis, leads to the fact that the burden on the social security budget will keep growing.

Economists claim that such a ratio, in which there are so few employees and so many dependants, especially pensioners, cannot sustain for a long term. Latvia, like the whole EU, undergoes significant demographic changes and this process influences structural changes in the number of the inhabitants. There will be slower economic growth in Latvia as a result of internal and external factors.

Latvian economic situation was improving during the last 5 years, as it's shown by main development indicators (see Table 3). Given the global economic trends, the weak economic growth in the EU, the recession in emerging markets, the Latvian economic growth slowed down in the last 2 years. But rather optimistic economic growth rates do not reflect the situation in the area of pensions and the authors conclude that the quality of life for older people will decrease in the light of future demographic trends. That is why everybody should start thinking about his pension already now.

Table 3. Economic development key indicators in Latvia, 2011- 2015 *Source: Economic development of Latvia, 2014*

	2011	2012	2013	2014	2015f
(Growth, in comparison with the previous year, %)					
Gross domestic product	5.0	4.8	4.2	2.3	2.0
Private consumption	2.9	3.0	6.2	2.6	2.4
Public consumption	3.1	0.4	2.8	3.1	1.8
Formation of total equity capital	24.2	14.5	-5.2	0.1	-3.0
Exports	12.0	9.8	1.5	1.7	0.7
Imports	22.0	5.4	0.3	0.3	-0.8
Consumer prices	4.4	2.3	0.0	0.6	0.5
(% of GDP, unless indicated otherwise)					
General government sector balance	-3.4	-0.8	-0.9	-1.4	-1.0
General government debt	42.7	40.9	38.2	40.0	35.0
Changes in the number of employed	1.3	1.6	2.1	-1.1	0.2
Unemployment rate	16.2	15.0	11.9	10.9	9.8

Since the previous population census carried out in 2000, the number of population has decreased and in 2015 it constituted 1986096 inhabitants. The decrease of population has been due to natural population movement (the death rate increased the birth rate), as well as because of international migration.

The negative changes of structure and number of the inhabitants are explained by the low birth rate and comparatively high death rate on 1000 inhabitants of Latvia. During the last seven years the situation has not improved and every year negative natural increase is created and that means that the death rate is higher than the birth rate.

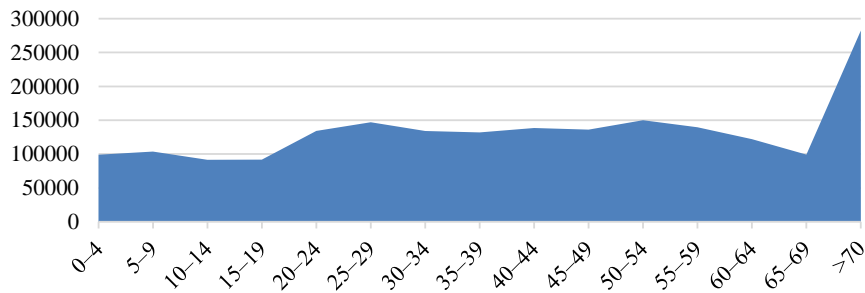


Fig.3. The age structure of the inhabitants in Latvia (2014) Source: CSB, 2015

When studying the age structure of the inhabitants in Latvia in 2014 (see Figure 3), the authors have come to the conclusion that the number of children up to age 15 is considerably lower than the number of the people who have reached the employment age in Latvia. This means that the demographic situation in Latvia over the last years is worsening and thus, the demographic load is increasing.

The generation that in 5- 10 years could be economically active citizens and become tax payers is very small in number. Demographers of Latvia point out the unwillingness of the government or their inability to tackle the problem. Latvia has a favourable geographical location, so it will not stay empty, that is why the flow of immigrants could be the only way out of the situation for the future pensioners. It is obvious that the government is not capable of solving this problem.

State grants various tax incentives for both companies that employee contributions are made in favour of the third pillar pension funds and individuals who are themselves engaged in such contributions. Pension Level 3 contributions into the pension fund, which does not exceed 10 % of gross salary, are not subject to income tax.

Now the government of Latvia is highlighting that everyone needs to start thinking about their pension themselves. It is done during disadvantaged time, because in a period of boom, when everyone had high incomes, no one spoke about that. Today when the situation with the government budget is negative, they start thinking about that. People do not understand and think that it is not fair to give a lot of their income to pensioners now and at the same time they need to save money for themselves.

Although most of leading Baltic bank experts admits that the habit to save for future is more developed in Lithuania and Estonia. Lithuanian people traditionally are regarded as saving nation. 39% of the inhabitants make investments for their future. But Estonian people have greater possibility to save because the level of income is higher than in other Baltic countries. 27% of the respondents are saving for the old age, but in Latvia – only 18%. That means that the ostrich policy is used or people rely on different alternatives which might give additional income to their pensions – continuing work after reaching the retirement age or relying on children or other relatives' support. But it cannot guarantee adequate income level in retirement.

The average monthly old-age pension in Latvia was 259 EUR in 2013, which, in comparison to the average pension benefit in 2009 had been raised by 26,7 EUR (10%), and it constituted 278,65 EUR in 2014. The distribution of all pension benefit almost had not been changed for the period from 2009-2012 due to the fact that pensions have not been indexed. The inhabitants with the length of service less than 10 years, have been insured with the state social security allowance. The state social security allowance is guaranteed 64.03 EUR.

There is tendency across almost all European Union countries that benefit ratio which shows the ratio between the average gross public pension benefit and the average gross salary will decrease. (Eichhorst et al., 2011) It is especially important for Latvia, which has already the lowest benefit ratio from all the countries and is predicted to become even smaller. These ratio tendencies show that in future the supplementary pension, for example, private pension funds will become even more important in order to keep the high life quality.

According to the current pension system and due to the demographic situation, the working people of today will receive lower pensions. The problem remains because the current demographic situation means that the number of retirees will grow, but the number of working people and taxpayers will continue to reduce. The pension system in

Latvia has been formed in accordance with the principles of classical finance pyramid. It works well when number of new participants grows, that is, the number of taxpayers increases and the country experiences a significant economic growth.

Pension reforms are needed in every country in order to reduce the risks, however, they are carried out taking into account different conditions and limitations which are affected by demographic situations. Germany and Southern Europe, namely Italy, Portugal and Spain are affected by the most severe demographic problems. As to the UK and France, this problem does not have such an impact on the population due to higher birth rate (Borsch-Supan et al, 2005). In case of Latvia, the demographic situation is extremely important. Not only the ratio between birth rate and death rate is negative, as it was mentioned above, but also the so called “envelope salaries”, unemployment and migration to other countries influence pension system as the revenue from taxes reduce, thus making less contributions to the pension fund. As a result, the state is forced to raise taxes, which slows down the economic development.

Financial literacy and personal planning is the subject which has not gained large popularity in Latvia. Sociological research carried out by Financial and Capital Market Commission in cooperation with investigation centre SKDS on finance literacy of inhabitants in Latvia proved the participation level of the inhabitants in using financial services. According to FCMC chief Kristaps Zakulis (2014), the knowledge and activities related to various financial questions also have been clarified.

The pensioners who retired during the last two years and who had received the so-called “envelope” salary confess that they have felt a significant decrease of their income. If we compare the pre-pension income to the pension volume, then, the average drop in income constitutes 52%. That means that these retired persons should live on small income, accordingly, every fifth inhabitant of Latvia supports financially elderly relatives by allocating 138 EUR monthly. If the illegal economy does not decrease, not forming long-term savings of a proper volume and the population still going older, then, in future, state budget might significantly experience certain pressure on it. (Sauka & Putnins, 2015).

5. Conclusion

The level of Latvian industrial efficiency significantly falls behind the average efficiency level in EU. Current low absorption of innovation reduces the possibility to achieve rapid improvement of macroeconomic situation. Innovation process must be related to creating comparative advantage, particularly within markets identified as perspective for Latvia. The current model of economic development is given the low added value. Economic development of Latvia must be geared to high value-added and science and knowledge-based economic model.

In order to reduce impact of increasing labour costs on competitiveness of Latvian manufacturers, it is necessary to improve competitiveness of tax system.. Reduction of tax burden on business and employment must be achieved.

In order to reduce the negative impact of demographic changes on production modernization, it is necessary to encourage development of professional education and system of lifelong education, by ensuring accordance between labour supply and demand, through putting emphasis on improvement of employee skills and increasing professional mobility; to introduce relevant life-long learning system for elderly people in Latvia.

It is necessary to consider seriously migration issues (immigration and emigration) policy, so that it contributes to a qualified workforce and enhances economical growth. Government should develop a broad Latvian citizen return migration program, including the integration in the labour market and training and social inclusion measures.

It is significant to reduce shadow economy by supporting honest entrepreneurs and creating favourable conditions for conversion to official economy, and to continue transformation of State Revenue Service into institution helping entrepreneurs.

It is necessary to increase gradually the contributions into the Pension Level 2. Pension Level 2 savings should be invested in more profitable financial instruments in Latvia and other countries.

Latvian government should encourage Latvian securities market development in order to achieve the Latvian population pension saving investment in the Latvian economy. This could be achieved by raising capital (equity and borrowed) of state owned enterprises through the local securities market. It's small size and lack of choice for investors are the main reasons for the underdeveloped securities market.

The government in collaboration with Financial and Capital Market Commission should provide information

campaign about benefits, opportunities of investments and the Pension Level 3 future role. The social tax should be decreased gradually by motivating people to apply for the Pension Level 3. The accumulation system should be introduced when working people make contributions into private pension funds and receive pension later from these savings.

To open closed pension funds for employees of state structures and companies with a state capital in order to promote this activity.

As regards gradual growth of pension age, it is necessary to facilitate the system and availability of health care. It enables the pensioners to take care of their health and to be able to work effectively. It includes the necessity to have mandatory state funded health checks every year.

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