

## ASSESSMENT OF LATVIAN PENSION SYSTEM IN THE CONTEXT OF EUROPEAN PILLAR OF SOCIAL RIGHTS

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**Abstract.** Latvian pension system is considered to be one of the most sustainable, but it should be mentioned that financial sustainability may be achieved in different ways and sometimes the aspects of sustainability are estimated without considering system's ability to provide equity, equality and adequacy of retirement provision.

The European Pillar of Social Rights has been proclaimed in 2017. According to this statement delivering on the principles and rights defined under the Pillar is the joint responsibility of the EU institutions, member states, social partners and other stakeholders. The 3rd chapter devoted to social protection and inclusion establishes the key approaches to determining the minimum income, old age income and pensions. In particular, everyone lacking sufficient resources has the right to adequate minimum income benefits ensuring a life in dignity at all stages of life, and effective access to enabling goods and services; workers and the self-employed in retirement have the right to a pension commensurate to their contributions and ensuring an adequate income; everyone in old age has the right to resources that ensure living in dignity.

The aim of the paper is to estimate actual compliance of Latvian pension system with the requirements of the European Pillar of Social Rights.

The main findings show that the European Pillar of Social Rights creates completely new challenges to Latvian pension system, e.g. an ability to stay financially sustainable and comply with the principles of adequate income provision and ensuring living in dignity. Therefore more extensive and complex options of system's improvement should be proposed and assessed.

**Keywords:** *pension system, European Pillar of Social Rights.*

**JEL code:** H55

### Introduction

The European Pillar of Social Rights has been proclaimed by the European Parliament, the Council and the European Commission at the Social Summit for Fair Jobs and Growth in Gothenburg on 17 November 2017. In general it has stated new and more effective delivery of rights for citizens. One of its 3 categories has been dedicated to social protection and inclusion and obviously has determined new standards and challenges for European systems of social protection. Taking into consideration growing demographic pressure, thus, the increasing needs of older population, the 15<sup>th</sup> paragraph approves the rights for old age income and pension: "workers and the self-employed in retirement have the right to a pension commensurate to their contributions and ensuring an adequate income. Women and men shall have equal opportunities to acquire pension rights. Everyone in old age has the right to resources that ensure living in dignity" (European Commission, 2017).

According to 2016 Allianz Pension Sustainability Index Latvian pension system is addressed as one of the most sustainable amongst 54 countries (Allianz, 2016); however, sustainability statement is based mostly on the aspects of financial sustainability, which constantly exists under the impact of huge amount of different risks. We assume that system's non-compliance with the requirements of the European Pillar of Social Rights may create additional risks for the sustainability of Latvian pension system in future; thereby, it is necessary to assess pension system's capability to provide:

- 1) resources that ensure living in dignity and
- 2) a pension commensurate to contributions and ensuring an adequate income.

### Literature review

#### *The Concept of Dignity*

Scientific literature shows significant historical evolution of the concept of dignity already since Roman times. Despite its relative significance in the development of ideas, dignity began to enter legal, and particularly constitutional and international legal, discourse in any particularly sustained way in the first half of the 20<sup>th</sup> century. At the same time dignity still remains one of the most disputable terms amongst researchers.

Implementation of dignity in international and regional human rights texts derives from the use of dignity in the Universal Declaration of Human Rights. Dignity is mentioned there in different context; however, the context of social security also exists. Article 22, on the right to social security, provides: "everyone, as a member of society, has the right to social security and is entitled to realization, through national effort and international co-operation and in accordance with the organization and resources of each State, of the economic, social and cultural rights indispensable for his

dignity and the free development of his personality’. Article 23(3), set in the context of right to work, provides that ‘everyone who works has the right to just and favourable remuneration ensuring for himself and his family an existence worthy of human dignity, and supplemented, if necessary, by other means of social protection’ (United Nations, 1948). From our point of view dignity here is achieved as a result of certain activities, i.e. social protection or working.

Human dignity is also considered as a foundational concept of the global human rights regime, “the ‘ultimate value’ that gives coherence to human rights” (Hasson, 2003). The Vienna Declaration of the 1993 World Human Rights Conference claims “all human rights derive from the dignity and worth inherent in the human person” (United Nations, 1993). The 1966 International Human Rights Covenants declare “these rights derive from the inherent dignity of the human person” (United Nations, 1966) Mentioned documents and others, such as the European Pillar of Social Rights, are unclear as to the exact definition of human dignity and how it gives rise to or grounds human rights (Henkin, 1992; Beylveled & Brownsword, 1998)

The authors agree with J.Donnelly and other authors considering that it is not possible to find an explicit definition of the expression “dignity of the human person” in international instruments or in national law (Donnelly, 2009; McCrudden, 2008; Meyer, 2002). No one jurisdiction has a coherent judicially interpreted conception of dignity across the range of rights, and no coherent conception of dignity emerges transnationally. It is clear that the idea of dignity has become a central organizing principle in the idea of universal human rights, although with interesting differences between jurisdictions, and that there are several different strands of metaphysical and philosophical thinking feeding these differences.(McCrudden, 2008)

Human rights thus are based on but not reducible or equivalent to human dignity. Human rights are one particular mechanism – a particular set of practices – for realizing a certain class of conceptions of human dignity (Donnelly, 2009). At present leading comprehensive doctrines across the globe participate in a two-level overlapping consensus, on the idea that the social and political implications of one’s deepest beliefs are appropriately summarized in the idea of human dignity and that internationally recognized human rights provide a detailed specification of certain basic prerequisites of human dignity in contemporary circumstances and essential practices for realizing those that underlying conception of human dignity (Donnelly, 2009; McCrudden, 2008). Human rights, in other words, are both a roadmap and a set of practices for constructing a life of dignity in the conditions of the contemporary world. Rather than providing substantive meaning, a significant use of dignity is institutional: providing a language in which judges can appear to justify how they deal with issues such as the weight of rights, the domestication and contextualization of rights, and the generation of new or more extensive rights (McCrudden, 2008), therefore it is possible to predict future, judicial popularity of dignity in human rights adjudication.

#### *Adequate Income Dimensions*

Adequacy of pensions is one of the latest trends of scientific research. It is one of the main aspects of sustainability policy makers and scientists are concerned about. In some cases financial sustainability is achieved via the amount of retirement benefits and such scenario is not acceptable anymore as far as sustainability becomes jeopardized by political and social risks. In other words, society starts to disrupt the implementation of pension rules.

There does not seem to be a broad consensus in policymaking circles and academic literature on what constitutes the best measure of pension adequacy. While various indicators have been developed and used, no single measure appears to offer a clear indication of the extent to which reforms will impact on the achievement of pension system goals. That is why some studies pretend to define the term of adequacy or assess a limited range of adequacy indicators (Rajevska, 2016; EuropeanCommission & Committee, 2018; Saunders & Wong, 2011; Chybalski & Marcinkiewicz, 2016). Another direction of research tries to formulate the systemic approach to measuring pension adequacy (Grech, 2013; Alonso-Garcia, et al., 2018; Alonso-Fernandez, et al., 2018 and its contribution to the efficiency of pension system in general (Chybalski, 2016).

The Organization for Economic Cooperation and Development (OECD) considers an adequate pension system to be one that “replaces a worker’s earnings at a level which enables him or her to maintain a standard of living in retirement comparable to that enjoyed in working life—even though retirement income often do not just replace earnings”. (OECD, 2013)

According to Chybalski and Marcinkiewicz (2016) pension system adequacy should be perceived as a multidimensional category consisting of the following three dimensions:

- Dimension I: Protecting against poverty
- Dimension II: Consumption smoothing
- Dimension III: Differences in adequacy between the genders.

In the framework of estimating protection against poverty the at-risk-of-poverty rate for pensioners is considered as one of the most representative indicators. It characterizes the group of people whose main activity status is 'retired' and it expresses the share of pensioners with an equalized disposable income below the at-risk-of-poverty threshold. This indicator is the main measure of monetary poverty included in the EU list of indicators, it is a relative one - net income less than 60% of national median (European Commission, 2011).

Concerning consumption smoothing, usually there are two essential measures based on income: the replacement rate, which is the most commonly used in studies discussing pension adequacy, as well as the relative median income ratio for the population aged 65+ . The replacement rate is defined in a number of ways, by applying different numerators and denominators, nevertheless, it is always some kind of relationship between income in the retirement period and income in the period of economic activity. According to the methodology applied by Eurostat, the aggregated replacement ratio is defined as the ratio of the median individual gross pensions of the 65–74 age category relative to median individual gross earnings of the 50–59 age category, excluding other social benefits (European Commission, 2020). This indicator is usually criticized as far as it takes into account gross income, but social insurance contributions paid by pensioners are usually much lower than by working people.

Eurostat also provides methodology for measuring the last dimension of pension system adequacy, i.e. income disproportions between the genders. Absolute differences between the values of relevant indicators are calculated separately for men and women (European Commission, 2020). These are:

- Gender differences in the at-risk-of-poverty rate of elderly people 65+;
- Gender differences in the aggregate replacement ratio;
- Gender differences in the relative median income ratio of elderly people 65+.

## **1. Latvian Pension System Compliance Assessment**

### **1.1. "Living in dignity" estimation**

As many other countries around the Globe, Latvia proclaims dignity in the Constitution of the Republic of Latvia (Satversme). This document does not provide precise definition of dignity. The term is included in the chapter, determining fundamental human rights. From the formulation of the chapter, i.e. "The State shall protect human honour and dignity" (Constitutional Assembly, 1922), it is not possible to specify, if dignity is the foundation of human rights in Latvia or one of them. Taking into consideration, that dignity statement is included in the list of traditional human rights together with the right to social security in old age, human health protection and guarantee of basic level of medical assistance for everyone, the right to education etc., dignity in Latvia is supposed to be one of the fundamental human rights. Latvian legislation usually determines financial thresholds for the rights, which maintain some minimum core. In other words, it is possible to specify what amount of financing must be provided for ensuring basic education or health protection, however, financial bottom line for dignity or 'living in dignity' does not exist. Latvian legislation doesn't provide a particular explanation in what way living in dignity is achieved, but the authors assume that it might be a result of the implementation of traditional human rights such as the right to social security in old age, health protection and other.

The Ombudsman of the Republic of Latvia (the main independent person, which keeps trace of compliance with the law by Governmental and municipal institutions) constantly receives claims of Latvian citizens being sure, that the amount of old age provision does not provide living in dignity. Only in 2019 the Ombudsman seven times informed Latvian Government about the non-compliance of social benefits (including retirement benefits) with the idea of dignity, equity and equality and twice submitted claims to the Constitutional Court of the Republic of Latvia (Ombudsman of the Republic of Latvia, 2020). The analysis of these reports shows, that the Ombudsmen and the Constitutional Court interpret dignity as a result of realizing the fundamental human rights.

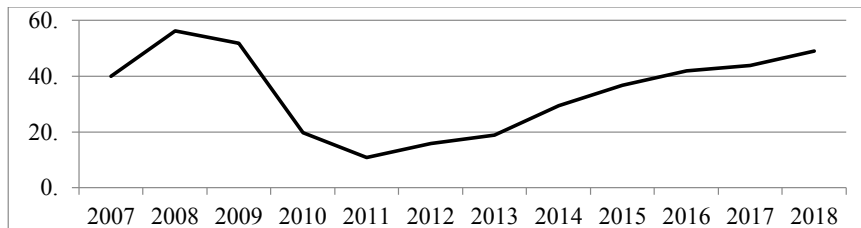
The authors conclude, that it is impossible to assess if Latvian pension system and benefits provided provide an opportunity to live in dignity without estimating the adequacy of realizing other human rights regarding retirees. However, pension provision is an essential element of social protection in old age, thus provision of adequate pension benefits is one of the steps in achieving living in dignity.

### **1.2. Adequacy of retirement benefits**

Assessment of indicators according to the three-dimensional approach does not demonstrate positive performance of Latvian pension system. Data shows, that in 2018 the at-risk-of-poverty rate for pensioners in Latvia is the second highest in the EU (European Commission, 2020).

Fig.1. demonstrates historic development of the at-risk-of-poverty rate for pensioners in Latvia. Since 2011 the rate is constantly increasing, that is to say, Latvian pension system itself does not provide an opportunity to avoid the risk of poverty for the majority of retirees. Gender differences

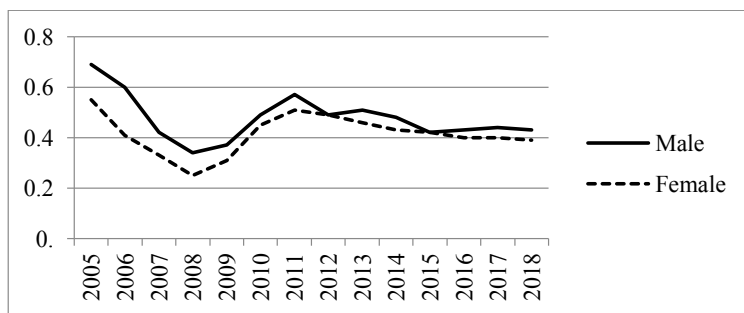
in replacement ratio lead to much higher the at-risk-of poverty rate for female. For example, in 2018 female indicator was 53,9 and male indicator 43,5.



Source: European Commission, 2020

Fig. 1. At-risk-of-poverty rate for pensioners in Latvia 2007-2018, %

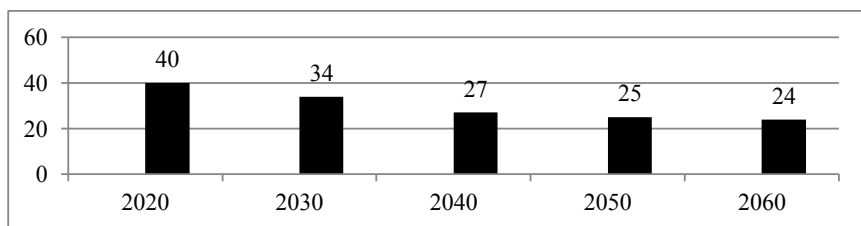
As for the second dimension of adequacy- replacement ratio- the results of assessment are almost similar to the previous comparison: in 2018 aggregate replacement ratio for pensions in Latvia is the third lowest in the EU and its development trend shows constant negative dynamics since 2011 (see Figure 2). Figure 2 also shows non-compliance with the 3<sup>rd</sup> dimension of pension adequacy. According to the methodology of the European Commission the aggregate replacement ratio is gross median individual pension income of the population aged 65–74 relative to gross median individual earnings from work of the population aged 50–59, excluding other social benefits.



Source: European Commission, 2020

Fig. 2. Aggregate replacement ratio for pensions by sex in Latvia 2018

Obvious question here is the dynamics of replacement ratio in future. Worth mentioning, that different projections of future replacement ratio show different dynamics. For example, the forecast of the Bank of Latvia, carried out in 2019 (see Figure 3), demonstrates twice lower replacement ratio in 2060 (Tkačevs & Kalniņš, 2019). It is necessary to mention, that this replacement ratio takes into consideration the amount of average gross pension benefits provided by 2 mandatory levels of Latvian pension system and average gross salary, not median indicators.



Source: Tkačevs & Kalniņš, 2019

Fig. 3. Replacement ratio forecast for pensions in Latvia 2020- 2060, %

Other projections also show the decrease in replacement ratio but more moderate. Net theoretical replacement ratio projection of the European Commission shows 10% drop down for Latvia in 2016- 2056 based on the assumption of male worker at the standard pensionable age after an uninterrupted 40-year career on a standard employment contract, for longer working career the projected decrease is 6%, (European Commission, 2018). Due to differences in assessment methodology the differences in replacement ratio appear.

The approach of the Bank of Latvia is not common in assessing the replacement ratio, but the authors suppose it to be rather valuable. This approach discovers the main risk, which may jeopardize the sustainability of the system and create barriers in attaining its goal of providing equity, equality and finally living in dignity. Table 1 shows the development of average and median salaries and wages in Latvia.

Table 1

**Average gross and median monthly salaries and wages in Latvia in 2011-2019, euro**

Indicator	2011	2012	2013	2014	2015	2016	2017	2018	2019
Average monthly wages and salaries	660	685	716	765	818	859	926	1004	1076
Median wages and salaries	NA	NA	NA	NA	NA	NA	707	774	832
Median as % of average	NA	NA	NA	NA	NA	NA	76,3	77,1	77,3

Source: Central Statistical Bureau of Latvia, 2020

Unfortunately, median income is supposed to be an experimental statistics in Latvia, that's why data prior to 2017 is not available. Median gross salaries and wages in Latvia are more than 20% lower, than average. Such distinction at present reflects income stratification and demonstrates, that half of Latvian taxpayers contributes to pension capital accumulation from relatively small income. As far as the pension system provides benefits commensurate to contributions, insufficient contributions lead to inadequate benefits.

Latest assessment and projection of Latvian NDC scheme show rather positive development prospects, claiming the theoretical pre-tax replacement ratio of 47% and after-tax ratio of 65% (European Commission, 2015; Palmer & Stabina, 2019)

In 2019 the population aged 50–59 has higher concentration of 41,3% in the interval of 700-1000 euro monthly salary and wages. The population aged 40-49 mostly (41,8%) concentrates in the interval of 1000-1500 euro and has higher concentration in income intervals above 1500 euro. Also the population aged 20-49 concentrates more in the interval of 1000-1500 euro. At the same time the population aged 50-59 has higher concentration in the intervals below 700 euro (Central Statistical Bureau of Latvia, 2020). It is possible to assume, that the median income of population aged 50-59 is very close to the median income of the whole population - 832 euro- or even lower. Consequently, even relatively high 60% replacement ratio assessed according to the methodology of the European Commission at present locates a person directly at the at the risk of poverty line. In other words, the pension system is not responsible for low pension provision, low salaries and wages are the basis for inadequacy. It is worth to mention, that the second tier of Latvian pension system- mandatory funded scheme- at present is not able to increase pension benefits substantially. The main reason is the same: low salaries, thus, low contributions lead to insignificant amount of accumulated capital. Moreover, the efficiency of private fund managers is also a very disputable topic in Latvia (Bule & Leitāne, 2017).

Inadequate pension benefits create the best motivation to continue working after achieving the retirement age- the goal pension reformers fight for. Pension recipients are ready to work for low salaries, which younger workers can't accept. The authors consider this phenomenon as one of the main driving factors of severe emigration, which in turn, is supposed to be one of the main risks of pension system's financial sustainability.

## 2. Social sustainability as an additional risk for financial sustainability

Latvian pension system is financially stable, but its sustainability is achieved mostly by supporting low level of retirement benefits, this seems to be financially fair: low salaries- low pension insurance contributions- low pensions. In 2018 the authors have carried out a representative survey with the aim to figure out the main aspects of people's attitude towards Latvian pension system. 66% of respondents agreed with the statement, that their opinion on pensions is shaped by the experience of their parents and grandparents, thus, negative experience creates negative attitude. 86,5% claimed, that current level of poverty amongst pensioners eliminates motivation to undertake pension insurance contributions (Bule, Leitane, & Rozite, 2018).

Retirees usually are the most active voters in Latvia. Current ratio of population over the working age is already 23%, but the amount of pensioners is close to 30% (Central Statistical Bureau of Latvia, 2020). Political impact of this group is very significant. Taking into consideration demographic trends, it is possible to assume, that in future this impact will become even stronger and under this pressure policymakers will have to change the norms of the system as it already happens. There are few examples of such activities changing the context of financial sustainability. One of the latest is the correction of capital indexing procedures. Previously pension capital (not retirement benefits) has been indexed according

to the development of total amount of all taxable salaries, in case of decrease the index has been negative. The retirees appealed against this norm and the Constitutional court agreed with the objection, that's why indexation doesn't reduce pension capital anymore, even if general taxable income is falling, so to say, indexation creates liabilities not covered by working population.

Most of retirees are not satisfied with the amount of pension benefits. As it has been mentioned previously, the amount is commensurate to contributions, but pension recipients don't agree, that it is adequate and fair as far as benefits are compared with an average salary. Table 2 indicates, that the absolute majority of retirees are the recipients of benefits much lower than median and average salary, therefore, EU-SILC 2018 shows extremely low level of satisfaction with financial position amongst pensioners (Central Statistical Bureau of Latvia, 2020). It is not surprising, that this group of voters creates enormous political pressure and Latvian pension system doesn't have immunity against it.

Table 2

**Number of pension recipients by average size of pension granted in 2019, persons**

≤ 100.00	18 037
100.01-150.00	19 389
150.01-200.00	7 686
200.01-250.00	16 132
250.01-300.00	70 937
300.01-400.00	185 456
400.01-500.00	64 824
500.01-1000.00	58 245
>1000.01	9 773

Source: Central Statistical Bureau of Latvia, 2020

Assessing the financial situation and the opinion of retirees, the younger population forms negative attitude towards the pension system in general (Bule & Leitāne, 2017). As a consequence the following problems emerge:

- 1) the absence of confidence in the long-term sustainability of the pension system and therefore
- 2) low pension insurance contributions and traditionally high tax avoidance (1/3 of socially insured contribute from the minimum salary), thus low savings and small pensions.

### Conclusions

The European Pillar of Social Rights together with demographic and economic changes obviously will create new challenges for Latvian pension system. At present the system does not comply with the requirement of the European Pillar of Social Rights, furthermore, its financial stability and sustainability are under the risk of negative social impact.

Being well-designed, financially smart and fair, the system suffers from local population's severe critics, hatred and defiance. The authors assume, that without parametric corrections and financing model's reestimation Latvian pension system alone will hardly be able to guarantee living in dignity and adequate income for all if income stratification and demographic and social risks will continue to develop in the same way like at present. Latvian policymakers should not rely only on raising the retirement age and must consider an opportunity of parametric corrections, like other Baltic states do. It is also necessary to improve protection of the system itself against social risk via:

- 1) reassessing the system of healthcare and social assurance;
- 2) increasing the level of financial literacy and motivation to avoid shadow economy activities;
- 3) developing real welfare growth and decreasing income stratification.

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