



# Pre-reform service record in the Latvian pension system contributes to old-age poverty in Latvia

ESPN Flash Report 2016/68

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OCTOBER 2016

*One of the roots of the poverty risk for the age group 65+ lies in the mechanism for translating the pre-reform service record into the Notional Defined Contribution pensions' scheme enacted after the 1995 pension reform. The formula of initial capital used in pension calculation results in unfair and polarised benefits, with large share of very small old-age pensions. No attempts to fundamentally reform the existing mechanism have been made so far, but parametric changes took place in the past and are urgently needed now as well.*

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## Description

The at-risk-of-poverty rate for people aged 65+ in Latvia is growing catastrophically: 27.6% in 2014 and 34.6% in 2015 (EU28 in 2014: 13.8%). In the age group 75+ it has grown even faster: 31.6% in 2014 and 40.6% in 2015 (EU-28 in 2014: 15.2%). There is a growing realisation in society that one of the reasons for poverty among the elderly is connected with the existing mechanism used for translating the pre-reform service record into post-reform pension benefits. All transition countries faced this problem, and solutions vary significantly.

The Latvian pension system has undergone a very radical reform in 1995 (a new Law on State Pensions is in force since 01/01/1996), when the former flat-rate pension scheme with benefits depending only on the length of service years was replaced with notional defined contribution (NDC) earnings-related scheme, which follows the model of funded pensions' schemes: social insurance contributions are registered on individual notional accounts, the accrued notional capital is annually updated (valorised) in accordance with the national wage-bill growth, and when retiring the notional capital is turned into annuity by dividing the total accrued sum by the life expectancy value at retirement age. The NDC formula was applied to the whole working population. Therefore a mechanism was needed for incorporating the pre-reform service period into the NDC formula – i.e. the

Soviet times when no social insurance contributions did exist at all, and the early 1990s.

The legislator introduced the so called "initial capital" for this purpose. Its amount is based on two variables: 1) the length of employment up until 31/12/1995; and 2) the average earnings during the period 01/01/1996-31/12/1999 (reference period). Non-productive periods when the person did not get any earnings have the same weight as productive ones: the total amount of all earnings is divided by 48 months. To calculate the initial capital, the individual's average earnings in the reference period are extrapolated to his/her whole pre-reform working career.

This theoretically-derived initial capital is then incorporated into the person's notional capital.

The share of the initial capital in the total notional capital was close to 100% in the first post-reform years, and still remains very high: the average service record of those retired in 2015 was 36.4 years, and more than a half of the record related to the pre-reform years, in particular, the Soviet years when the employment was mandatory for everybody and unemployment was practically inexistent. The initial capital will be a part of the pension formula in Latvia until the last person with pre-reform working experience applies for a pension – ca. in 2044, but it will gradually lose its relative importance.

The years taken as the reference period (1996-1999) were quite hard for the Latvian economy and many individuals suffered from low earnings, long-term unemployment without benefits, grey under-the-table salaries, being unaware of the importance of this period for the amount of their future pension. Eventually, the very first post-reform years have demonstrated that the formula was generating a growing number of very small pensions, and the initial law has been supplemented with two amendments:

1) If the average insured earnings in the reference period were lower than the average countrywide insured earnings (or the person had no earning in the reference period), this countrywide average is used instead provided that these persons have accumulated at least a 30 year-long service record. If a person's service record is shorter than 30 years, another benchmark is applied: the average insured earnings in the reference period uprated by valorisation indices is compared to 40% of the average countrywide insured earnings in the year prior to the year preceding the calendar year of retirement (i.e. in 2016 the benchmark year is 2014). Should the benchmark figure be higher, then it is used for calculating the initial capital instead of the person's average.

2) In 2006, supplements for each pre-reform year of service amounting to €1 per year were introduced. Initially, they were granted only to persons with low pensions, but starting from 2009 they were extended to all pensioners. Since 2012 these supplements have been phased out: those who retired before 2012 are still receiving the

supplements, but later pensioners are not.

## Outlook & Commentary

The formula used for translating the pre-reform service record into post-reform benefit is the cause of many unfair distortions. The remuneration for the major part of the working career of the majority of the current pensioners is conditional on factors they could hardly influence: lack of legal jobs during the four years of high unemployment, abundance of jobs in the grey economy and year of taking the retirement.

The principle of a 30-year threshold (being a minimum vesting period for using the countrywide average instead of the individual average insured earnings when the latter is lower than the former) leads to situations when persons with very similar records with only one year difference (29 years vs 30 years) can vary by as much as 100%.

Therefore, we would first recommend that the 30-year requirement should be lifted and the average countrywide should be always used instead of the individual average insured earnings where the latter is lower. There are not many persons with short service record due to mandatory employment in the USSR, but they are an especially vulnerable group.

We would then also suggest stopping the phasing out of supplements; supplements should also be allocated to pensions granted after 2011. The Latvian Pensioners Federation, in addition to attributing the supplements to all pensioners irrespective of the year of retirement, is proposing to increase the amount of the

supplements by 50-100%. The Minister of Welfare declined both the increase of the supplements and their attribution to all pensioners in his letter to the Federation, but the Parliamentary Commission is still considering the proposal.

These measures would not be too costly for the state budget because the total pre-reform record of all Latvian pensioners is decreasing due to natural population decline.

Other solutions like a review of the pension formula or the introduction of a basic pension seem the least possible and probable now.

### Further reading

Law on State Pensions

[http://likumi.lv/wwwraksti/VVC\\_TULK\\_OJUMI/LRTA/LIKUMI/ON\\_STATE\\_PENSIONS.DOC](http://likumi.lv/wwwraksti/VVC_TULK_OJUMI/LRTA/LIKUMI/ON_STATE_PENSIONS.DOC)

Latvijas Pensionāru Federācija (Latvian Pensioners Federation), home page

<http://www.pensionari.lv/index.html>

Rajevska, O. (2014). Adequacy of pensions in the Baltic region. Regional Review: Research Papers, Vol. 10, p.41-51.

[http://du.lv/wpcontent/uploads/2016/01/Regionalais\\_zinojums\\_10.pdf](http://du.lv/wpcontent/uploads/2016/01/Regionalais_zinojums_10.pdf)

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