European Commission

EUROPEAN SOCIAL POLICY NETWORK (ESPN)

Financing social protection

Latvia

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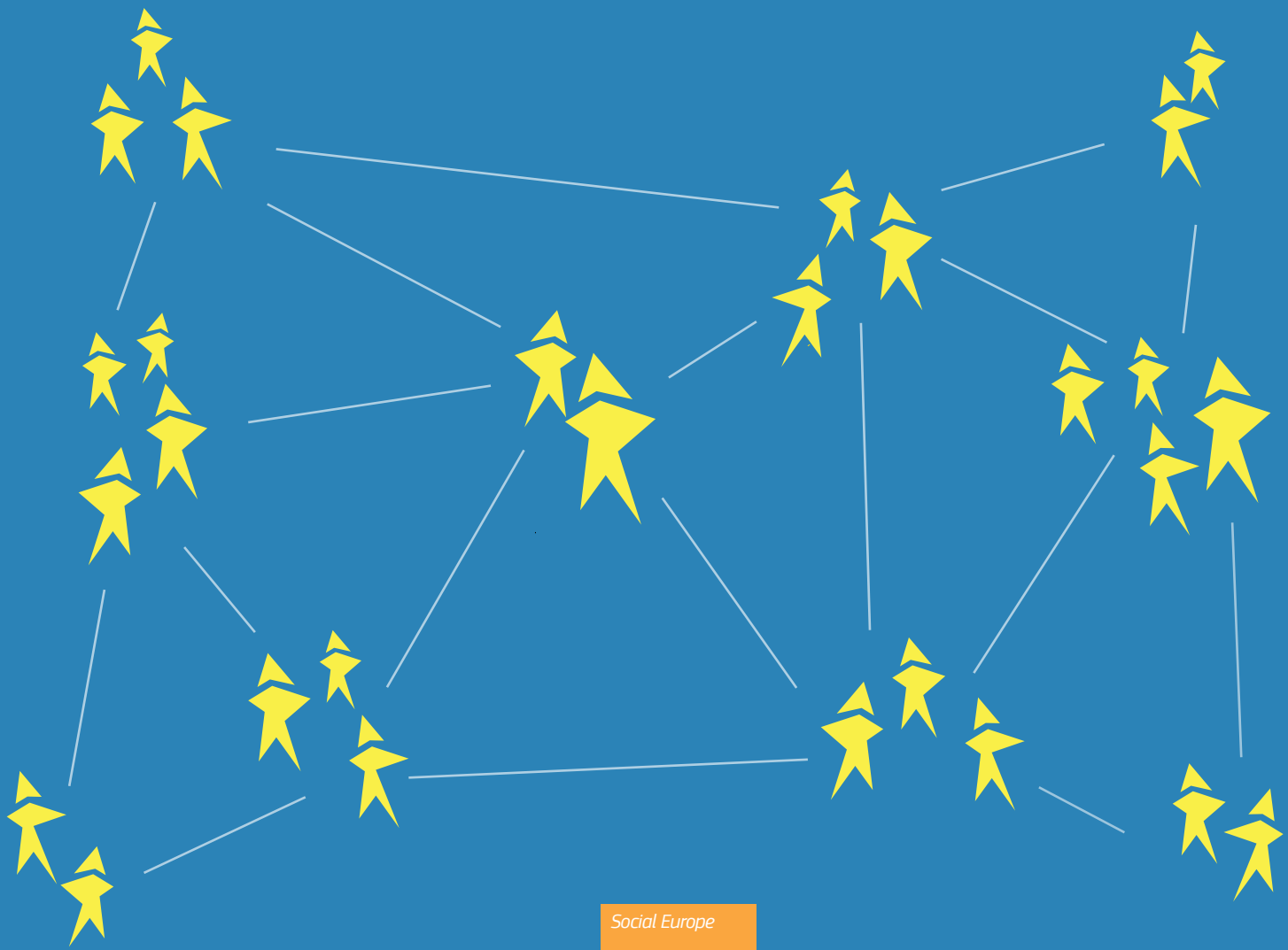

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European Social Policy Network (ESPN)

ESPN Thematic Report on Financing Social Protection

Latvia

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Directorate-General for Employment, Social Affairs and Inclusion

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The European Social Policy Network (ESPN) was established in July 2014 on the initiative of the European Commission to provide high-quality and timely independent information, advice, analysis and expertise on social policy issues in the European Union and neighbouring countries.

The ESPN brings together into a single network the work that used to be carried out by the European Network of Independent Experts on Social Inclusion, the Network for the Analytical Support on the Socio-Economic Impact of Social Protection Reforms (ASISP) and the MISSOC (Mutual Information Systems on Social Protection) secretariat.

The ESPN is managed by the Luxembourg Institute of Socio-Economic Research (LISER) and APPLICA, together with the European Social Observatory (OSE).

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Summary

During the period from 2005 to 2016, social protection expenditure in Latvia increased by 57% at constant prices, and from 12.2% of GDP in 2005 (EU-27: 26.0%) to 15.2% in 2016 (EU-28: 28.2%).

Expenditure on some functions – disability, unemployment, old age and family – grew fastest over the period. In 2016, the share of old-age benefits in total social protection spending was higher than the EU-28 average, at 47.8% (EU-28: 40.1%); while the share of sickness/health benefits was lower than the EU-28 average, at 25.0% (EU-28: 29.5%). Means-tested benefits are thinly represented in the Latvian social security system, and the thresholds used for their calculation are inadequately low. Austerity measures had a strong influence on social protection expenditure in the period from 2009 to 2014: sickness, unemployment, and parental benefits were capped; and from October 2009 until December 2012 the state co-financed the guaranteed minimum income and housing benefit with municipalities.

Financing for social protection in terms of purchasing power standard (PPS) per inhabitant was just 35% of the EU-28 average in 2016. Social contributions were the main source. The total rate of social contributions grew by 2 percentage points (p.p.) from 33.09% of the gross insured wage in 2005 to 35.09% in 2018. Employees pay less than one third of the sum, with the greater part paid by employers. More than 70% of all contributions are earmarked for the pension sub-budget. Contribution rates are already quite high and can hardly be increased, otherwise labour costs might become uncompetitive. In view of the shrinking working-age population, the increase in the average insured wage will offset the fall in the number of active contributors to a limited extent only. Therefore, a further increase in general government contributions seems unavoidable.

With the maturing of the state-funded pension scheme (pillar II), a growing number of pensioners are becoming dependent on private pension funds, so the share of private financing will grow accordingly.

The healthcare system in Latvia is chronically underfinanced. It also has a high ratio of out-of-pocket co-financing by patients. The lack of consistency in the reform of health financing is threatening the sustainability of the healthcare system. It may be worth considering reassigning 1 p.p. of social contributions from the pillar II pension to meet the needs of healthcare (at the same time putting further caps on pension fund management fees).

Policy trends were diverse and even contradictory, including: cost-saving; support for specific target groups; reallocating funds in financial flows; increasing the pension age; halving the maximum duration of sickness benefit (from 52 to 26 weeks); and reducing the early-retirement pension benefit from 80% to 50% of the calculated amount. A number of policy adjustments after the crisis were based on the lessons learned during the recession: the change in the split of contributions between the pension pillars I and II resulted in more funds being directed to the pay-as-you-go scheme, while the revision of the pension capital valorisation indices contributed to a more equitable calculation of the pension amount.

However, the sustainability of the social insurance budget has always been, and remains, a top priority for policy-makers in Latvia. The social insurance budget maintained a positive cash balance during 2005-2016. This was largely achieved at the cost of an inadequately low minimum level of benefits. However, the increase in child and family benefits significantly reduced child poverty.

Personal income tax (PIT) reform took place in Latvia in 2018. It introduced more elements of progressivity into the tax system. However, this reform, as well as the developments in family policy, benefited the middle of the income distribution, as well as the richest decile. The system of differentiated tax exemptions is very complicated and has caused a lot of misunderstanding among both taxpayers and accountants: its

simplification is needed. With the falling number of active contributors, the possible reintroduction of caps on benefits also emerges as an issue.

1 Current levels and past changes in financing social protection

Accession to the EU in 2004 accelerated economic growth in Latvia. In 2005, there were 1,131,215 socially insured persons (those for whom contributions were paid). In the two subsequent years, the number grew by 6%, to 1,202,399 persons in 2007. During the crisis, the number dropped sharply in 2009 (-7.92%) and in 2010 (-7.49%) and later stabilised at a lower level: 2015, 1,082,152; 2016, 1,085,152; and 2017, 1,084,930.

Population decline resulted from both long-term negative natural change (each year the death rate exceeded the birth rate) and, more importantly, from negative net migration. In total, Latvia lost 12% of its population due to emigration between 2004 and 2017, and the majority of emigrants were of active working age. The demographic situation affected all social policy sub-fields.

Between 2005 and the end of 2016 the total population fell by 13.3% (from 2,250,000 to 1,950,000); at the same time the working-age population fell by 15.2% (from 1,430,000 to 1,212,000), and the pension-age population fell by 10.1% (from 483,000 to 434,000). This meant that the share of the pension-age population increased, by 1 p.p. from 21.5% to 22.5%, despite successive increases in the statutory pension age (going from 62 years for men and 60.5 for women in 2005 to 63 for both sexes from 2017).

Changes in the financing of social protection over the study period were also rooted in the following factors.

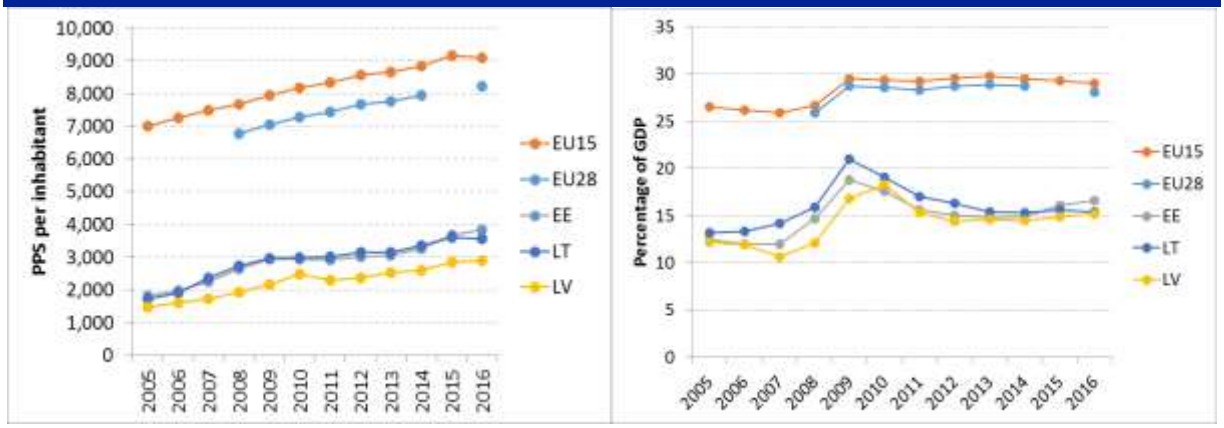
- Economic issues: fast economic growth at the beginning of the period, followed by an overheated economy and then a deep GDP fall in 2008-2010 – a lingering economic and financial crisis that was overcome only in 2013.
- Austerity policies: a whole package of austerity measures was introduced during the crisis years – including capping some benefits, tightening eligibility rules and suspending indexation. Most of those measures were cancelled at later stages, but some of them have remained in force until the present.
- Institutional changes: changes in social contributions, raising of the retirement age, amendments to the pension formula, increase in the number and amount of child and family benefits, introduction of special tax regimes, and PIT reform.

Despite the increase in social protection spending after 2005, Latvia remained among the EU laggards, spending dramatically less than the EU average and less than its Baltic neighbours both in terms of PPS per capita and in proportion to its GDP. Financing for social protection in terms of PPS per inhabitant was just 35% of the EU-28 average in 2016 (in the same year Latvia's GDP per capita in PPS was 64% of the EU-28 average). During the period, from 2005 to 2016, social protection spending (PPS per inhabitant) increased by 49.7% in Latvia, less than in Estonia (52.7%) and Lithuania (51.7%). No data are available for the EU-28 for 2005, but social protection spending by the older (EU-15) member states grew by 23.1% over the study period (see Fig. 1). Convergence is happening, but insufficiently quickly.

In terms of a percentage of GDP, public social protection spending in Latvia amounted to 12.2% of GDP in 2005 and reached 15.2% in 2016 (see Fig. 1). Thus, the total increase in 11 years was 3 p.p. (Estonia 4.1; Lithuania 2.2; EU-15 2.5).

After the beginning of the crisis, expenditure on social protection in Latvia as a percentage of GDP started to grow. Nonetheless, one must bear in mind that GDP fell in 2008 by 4.6%, in 2009 by 17.8% and in 2010 by 0.2%. Hence, in absolute numbers the increased spending was not that significant. The growth rate of social spending in Latvia as a percentage of GDP was the highest among the EU countries during the crisis (6.2 p.p.). This can be explained by the rapid drop in GDP, the low starting point and the short-term state co-financing of municipalities in providing social assistance (see Section 2.1.3).

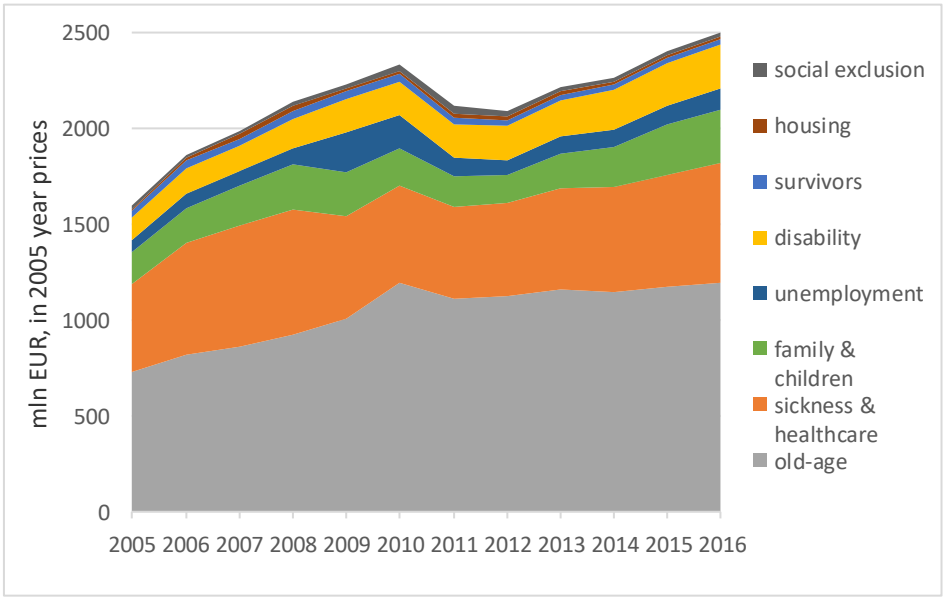
Figure 1. Social protection expenditure in Latvia, 2005-2016 (in PPS per inhabitant; as a percentage of GDP; and compared with EU-28, EU-15, Estonia and Lithuania)



Source: Spasova and Ward (2019), Annex ESSPROS (European System of integrated Social Protection Statistics) tables.

Looking at social protection spending in constant prices (base year 2005) (Fig. 2), total spending increased by 57%, from €1,596 million in 2005 to €2,499 million in 2016. The largest share belonged to old-age benefits, followed by sickness and healthcare benefits, with family and child benefits in third place.

Figure 2. Social protection expenditure by function in Latvia, 2005-2016



Source: Spasova and Ward (2019), Annex ESSPROS tables.

While total expenditure on social protection in the observed period increased by 57%, some individual areas grew faster: spending on disability benefits increased by 99%, on unemployment by 75%, and on both old-age and family/child benefits by 64%. Other areas demonstrated growth below the average: housing 45%; and sickness 37%. Social exclusion spending actually fell by 10%, and spending on survivors by 14%.

From 2011 to 2016 gross expenditure on social protection was around 14.4-15.2% of GDP, rising by 3 p.p. from 12.2% in 2005 (the lowest in the EU) to 15.2% in 2016 (the second lowest in the EU: the EU-28 average in that year was 28.1%).

1.1 Old age

Traditionally, the largest share of social expenditure in Latvia has been made up of old-age benefits. It was higher than the EU-28 average in the period examined: 45.6% in 2005 (EU-27: 38.7%) and 47.8% in 2016 (EU-28: 40.1%), with rather significant fluctuations in between. A substantial increase (64%) in old-age expenditure took place between 2005 and 2016 (at constant prices).

Table1. Social protection expenditure on old-age benefits: Latvia 2005-2016

	2005	2008	2010	2012	2014	2016
€ million in 2005 prices	728.28	920.24	1,196.55	1,122.47	1,147.12	1,194.38
As % of total social protection spending	45.6	43.0	51.3	53.6	50.6	47.8

Source: Spasova and Ward (2019), Annex ESSPROS tables.

Different kinds of regulatory changes took place in that period, as follows.

- Changes in the split of pension contributions between the pay-as-you-go and funded pillars (see Section 2) – more funds remained in the public social insurance scheme.
- A reduction in the pension benefit in the case of an early retirement, from 80% to 50% of the calculated amount, has been in force since 2009.
- Introduction of pension supplements for the pre-reform service years (i.e. before 1996) for all pensioners in 2009, and further changes in their regulation (see Box 2 in Section 2).
- Expansion of the service pension schemes in 2006-2010 (see Rajevska, 2017a).
- Gradual increase in the state retirement age, from 62 in 2013 to 65 in 2025 for both sexes.
- Amendment of the pension formula in 2015 (new rules for the valorisation index), which led to an upward revision of all pensions granted from 2010 to 2015. From 2016 to 2018, 147,600 pensions were revised (old-age, survivors' and service pensions). The review was carried out for those people who retired during the crisis, to ensure that they would not receive a lower pension than people who had the same length of service and had accumulated social contributions, and were of the same age, but who had retired in the years of economic growth. The monthly amount of old-age pensions increased on average by €33.87, varying from a few cents to hundreds of euros.

1.2 Healthcare and sickness

The funding allocated for healthcare in Latvia has been one of the lowest, if not the lowest, in Europe. It fluctuated from 3.3% of GDP in 2005 to 3.5% of GDP in 2012, and 3.07% in 2016. Latvia has a universal healthcare system. Healthcare benefits are predominantly in the form of a state-covered share of medical treatment costs or compensation for medicine costs. They are mainly financed from general taxes (some wealthier municipalities have their own healthcare benefits, most often means-tested ones).

Table 2. Social protection expenditure on sickness and health: Latvia 2005-2016

	2005	2008	2010	2012	2014	2016
€ million, in 2005 prices	455.45	654.14	501.91	486.18	547.97	624.86
As % of total social protection spending	28.5	30.6	21.5	23.2	24.2	25.0

Source: Spasova and Ward (2019), Annex ESSPROS tables.

The largest amount of spending on sickness and healthcare benefits, and their biggest share in total social protection spending, was in 2008; and the lowest points for both were during the recession (see Table 2).

In 2009, there were changes in the sick pay[1]/sickness benefit[2] payment regulation: the burden on employers was reduced, but at the same time the total duration of sickness benefit was capped at 26 consecutive weeks (or 52 weeks in a three-year period). Should the person not recover within this time, they moved from the sickness insurance scheme to the disability insurance scheme. With this measure, part of sickness expenditure moved to another function. Even more importantly, temporary caps on sickness benefits were in force from 2009 to 2014 as part of the austerity package. Benefits not exceeding €16.38 per day were paid in full, but sums above this threshold were only paid at 50%. When the caps were lifted, sickness benefit payments increased rapidly in 2015 and 2016 by tens of millions of euros each year.

The healthcare system in Latvia is chronically underfinanced. It also has a high ratio of out-of-pocket co-financing by patients. Private spending on healthcare remains very high. In 2017, only 57% of health spending was publicly funded (the EU average was 79%). Most of the remaining spending was paid for directly out of pocket by households (in 2013, 38.47%; 2014, 39.11%; 2015, 42.07%). Inconsistent attempts to introduce healthcare insurance as part of the social insurance system are still ongoing (see also Lace 2016, 2017). The accessibility (including affordability) of healthcare services is a topical policy issue in the country. The Healthcare Financing Law (2017) provided that the healthcare sector should receive funding equal to 4% of GDP as of 2020.

1.3 Family and child benefits

The share of social protection expenditure on families and children was around 11% before the recession, and after a significant drop in the period from 2010 to 2013 it returned to the same level in 2016. The share of family and child expenditure in total social protection spending in Latvia was larger than the EU-28 average, proving the high priority of family policy in Latvia. Family benefits are universal and not means-tested, while maternity, paternity and childcare benefits are contribution-based for the employed and universal for the unemployed. In nominal terms, expenditure on parental benefit and maternity and paternity benefits almost doubled between 2012 and 2016.

Table 3. Social protection expenditure on family and children: Latvia 2005-2016

	2005	2008	2010	2012	2014	2016
€ million, in 2005 prices	168.84	235.53	196.47	148.53	205.89	276.45
As % of total social protection spending	10.58	11.0	8.42	7.10	9.08	11.06

Source: Spasova and Ward (2019), Annex ESSPROS tables.

Family and child policy was included in the list of policy priorities in 2009 as a response to the long-lasting (since 1991) depopulation process. Parental benefit was added to the contributory schemes a year before, in 2008. It is possible to receive parental benefit in combination with childcare benefit. If a parental benefit recipient receives income from paid work, the benefit amount is cut by 70%.

[1] From day 2 to day 10 (before 2009 – to day 14) the person receives sick pay from the employer.

[2] From day 11 (before 2009 – from day 15) sick pay is replaced by sickness benefit, paid by the Social Insurance Agency.

The payment duration of childcare and parental benefits was extended from 12 to 18 months in 2010. The amount of childcare benefit was doubled in 2013 and from 1 January 2014 it was increased to €171 per month.

During the period of severe austerity measures, maternity, paternity and parental benefits were capped: in 2009-2012 the cap was set at €16.38 per day (and sums above this threshold were paid at 50%); in 2013-2014 the threshold was doubled to €32.76 per calendar day. As from 1 January 2015 the caps were abolished for all types of benefits.

In 2018, family benefits stimulating the birth of children were increased significantly, and in addition measures for supporting foster families and guardians received more financing.

1.4 Other spending areas

In terms of expenditure on other areas of social protection in the period examined, there was a steady increase in the share of spending on disability: its share of total spending rose by less than 2 p.p., but at 2005 prices it almost doubled (Table 4). For other spending areas, there were significant fluctuations during the recession.

Table 4. Social protection expenditure by function in constant prices (base 2005, in € million) and share of total social protection spending: Latvia 2005-2016

Function	2005	2008	2010	2012	2014	2016
Disability	114.09	157.79	176.61	178.04	207.02	226.53
%	7.15	7.23	7.57	8.51	9.13	9.07
Survivors	34.98	40.91	39.37	33.46	31.01	29.97
%	2.19	1.91	1.69	1.60	1.37	1.2
Unemployment	66.59	86.47	171.99	75.96	91.96	116.51
%	4.17	4.04	7.37	3.63	4.06	4.66
Housing	9.12	29.06	18.64	19.74	15.31	13.25
%	0.57	1.36	0.80	0.94	0.68	0.53
Soc. exclusion	18.69	19.11	31.29	28.72	20.07	16.83
%	1.17	0.89	1.34	1.37	0.89	0.67

Source: Spasova and Ward (2019), Annex ESSPROS tables.

The peak unemployment level (19% at the beginning of 2010) led to a dramatic increase in related spending, despite the capping of unemployment benefits during 2009-2014. The low level and short duration of unemployment benefits in Latvia contributed to the willingness of the unemployed to emigrate, which was the most important factor in the sharp decline in the number of insured persons.

Social exclusion and housing benefits are paid from municipal budgets. Developments in municipal social protection expenditure in Latvia from 2005 to 2017 can be divided into three periods: slight fluctuations from 2005 to 2007, followed by a leap, then a peak in 2010.

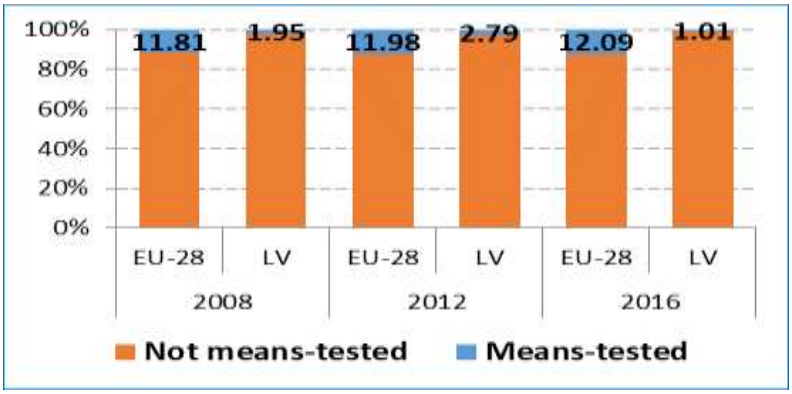
The government adopted the Social Security Network Strategy for the period from 1 October 2009 until 31 December 2012 along with the necessary funding. The state co-financed 50% of the guaranteed minimum income (GMI) and 20% of housing benefit in 2010-2012. The goal of the strategy was to elaborate emergency security measures, in order to lessen the negative social impact of the crisis. Co-financing by central government improved the availability of means-tested benefits (see Fig. 3).

Lower municipal spending on social assistance in absolute terms continued up to 2018, with the total in 2017 half that in 2012 (see Section 2). With the first signs of improvement in the economy, the government reduced the GMI amount to €49.80 for one household member per month. This was intended to motivate people to look for a

job. However, research performed by the World Bank in 2013 did not discover wide dependency on the GMI among the inhabitants of Latvia (World Bank, 2013). Funding for social exclusion benefits is extremely low in Latvia.

Means-tested benefits played a minor role in social protection in Latvia in the period examined. In Latvia they were just 1% of all benefit spending in 2016, compared with 12% in the EU-28 (see Fig. 3). These were mostly social exclusion benefits paid by municipal authorities, which have limited financial resources.

Figure 3. Proportion of means-tested and non-means-tested benefits in total social expenditure: Latvia and the EU 2008-2016



Source: Spasova and Ward (2019), Annex ESSPROS tables.

1.5 Gross vs net expenditure

The majority of social protection benefits are subject to PIT at the same rate as wages. Pensioners and those who have dependants have higher tax exemptions. For example, in 2015 the tax exemption for a person without a dependant was €75 per month; for each dependant it was increased by an additional €165 per month; and for a pensioner the tax exemption was €235 per month. Pensions are not subject to social contributions, but sickness and unemployment benefits are, as well as parental benefits.

Table 5. Effective combined taxation and social contribution rates on social protection benefits: Latvia 2007-2015, %

	2007	2008	2009	2010	2011	2012	2013	2014	2015
All benefits	1.95	2.03	2.50	2.99	2.79	3.12	3.35	3.23	3.39
Old age	1.25	1.28	1.85	3.60	3.33	3.83	4.22	4.41	4.57
Sickness/Healthcare	3.88	3.95	4.68	4.12	3.59	3.51	3.70	3.36	4.00
Unemployment	4.33	6.30	5.38	2.74	3.38	4.77	4.52	3.74	3.75
Disability	0.15	0.21	0.45	0.69	0.79	0.83	0.85	0.89	0.88
Survivors	0.08	0.13	0.21	0.34	0.39	0.39	0.49	0.53	0.61
Family/Children	0	0	0	0	0	0	0	0	0
Housing	0	0	0	0	0	0	0	0	0
Social exclusion n.e.c.	0	0	0	0	0	0	0	0	0

Source: Eurostat [spr_net_ben].

In Latvia, the effective taxation rate on social protection benefits (Table 5) was lower than the EU-28 average (7.8% in 2015). Between 2007 and 2015, the difference between net and gross expenditure as a share of GDP increased in Latvia from 0.2 p.p. to 0.5 p.p. (the main explanation was that average pension amounts grew faster than tax exemptions, so more and more benefits became subject to taxation).

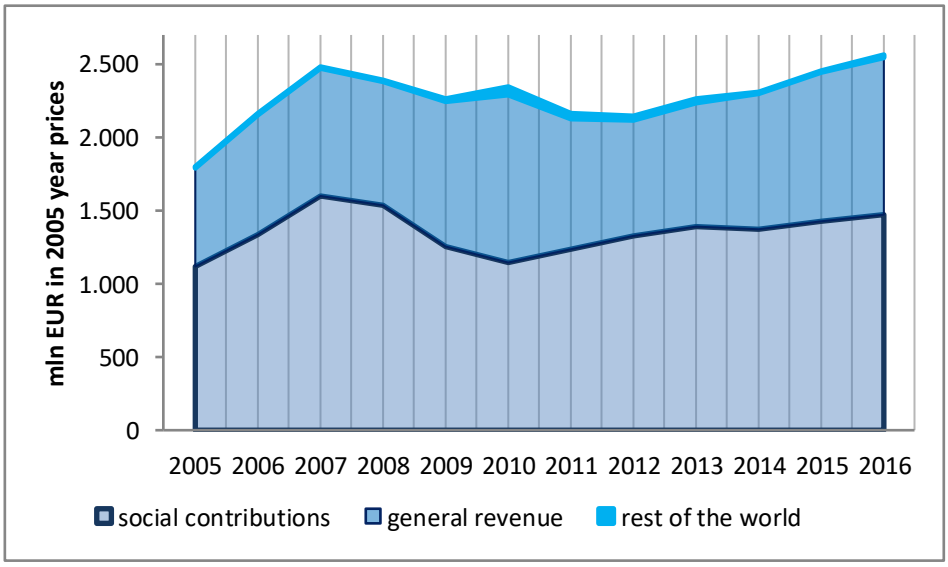
2 Current mix and past changes in the sources of financing for social protection

Social protection in Latvia is financed from the following sources (in the order of their importance).

- Social contributions paid for insured persons (by employers, employees and the self-employed, and in some cases by the state).
- Central government tax income (in the form of state subsidies and state social allowances).
- Local government tax income.
- Employers cover sick pay for the first 10 calendar days of illness or injury (mandatory), and buy private health insurance policies for their employees (voluntary). Regretfully, no statistics are [publicly] available on employers' expenditure of this type.

The next Figure (Fig. 4) illustrates the structure of social protection receipts by type: whether they come from social contributions, general revenue or from the 'rest of the world'. In 2005, social contributions made up 61.9% of all receipts, general revenue 37.5% and the 'rest of the world' 0.6%. In 2010, the share of social contributions fell to its minimum point throughout the observed period, 48.8%, while the two other components reached their peak values (general revenue 49.1%, and the 'rest of the world' 2.1%). Then social contributions resumed their growth and in 2016 they accounted for 57.3% of all receipts, general revenue 42.1% and the 'rest of the world' 0.5%.

Figure 4. Social protection receipts by type: Latvia 2005-2016



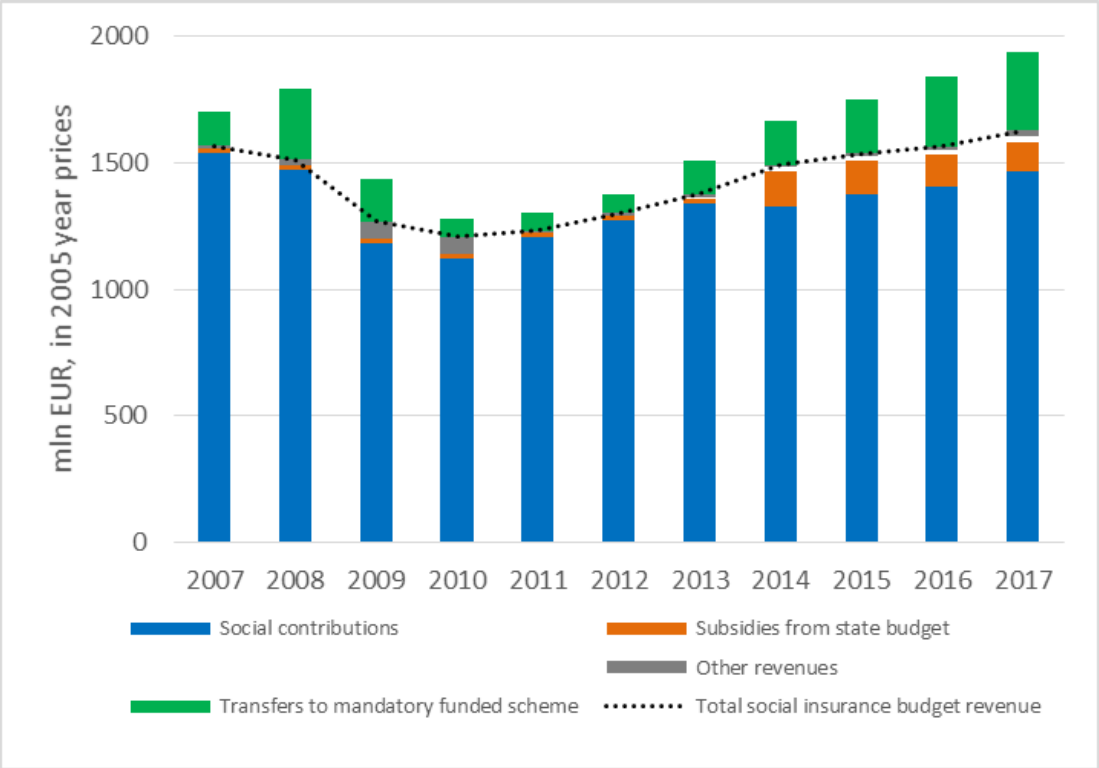
Source: Spasova and Ward (2019), Annex ESSPROS tables.

Average insured wages at the start of the period examined were very modest: €312.92 per month in 2005. The wages of socially insured persons increased very rapidly in 2006 – by 24.56%, followed by 33.08% in 2007 and by 20.52% in 2008, a period when the Latvian economy overheated and high inflation ruled. This resulted in growing social insurance revenues and in a growing share of social contributions in the overall financing of social protection, from 61.9% in 2005 to 64.4% in 2008. The global recession affected both the number of active participants in the social insurance system and their earnings. The sharp rise in wages and salaries was followed by a drastic reduction, by 10.44% in 2009 and by a further 4.07% in 2010. The first signs of resumed growth were already evident in 2011. However, even in 2014 the average monthly contribution of socially

insured persons was lower than the 2008 figure. The average contribution of socially insured persons exceeded the 2008 figure only in 2015.

Figure 5 demonstrates the changes in the social insurance budget revenues, including the increased share of state subsidies. Apart from contributions and subsidies, the social insurance budget receipts include transfers back from private pension funds (see Box 1), interest on deposits, dividends from capital, and recourse claims. The contributions transferred to mandatory pension funds are shown 'on top' of the social insurance revenue, as they are not included into the social insurance budget.

Figure 5. Revenues of the state social insurance budget: Latvia 2007-2017



Source: State Social Insurance Agency annual reports, authors' calculations.

2.1 Sources of financing

2.1.1 Social insurance contributions

Those who are socially insured are employees and self-employed persons. The state also covers contributions for persons taking care of a child under 1½ years and recipients of maternity benefit, as well as spouses of diplomats. Contributions by sickness and unemployment benefit recipients are made as transfers between the social insurance sub-budgets.

Table 6. Breakdown of social contributions by insurance types (% of gross insured wage), generic case: Latvia 2005-2017

	2005	2010	2011	2012	2013	2014	2015	2016	2017
Pensions	25.26	21.66	25.56	26.74	26.60	25.16	24.39	23.86	24.54
Sickness and maternity	2.77	2.47	2.27	2.28	2.28	2.46	2.79	3.05	3.49
Disability	3.17	3.18	3.02	3.16	3.37	3.21	3.14	3.11	2.30
Unemployment	1.80	3.81	2.56	1.50	1.48	1.63	2.10	2.08	1.90
Accidents at work/occupational disease	0.09	0.29	0.31	0.41	0.42	0.46	0.53	0.54	0.48
Parental	-	1.68	1.37	1.00	0.94	1.17	1.14	1.45	1.38
Total rate	**33.09**	**33.09**	**35.09**	**35.09**	**35.09**	**34.09**	**34.09**	**34.09**	**34.09**
Employer	24.09	24.09	24.09	24.09	24.09	23.59	23.59	23.59	23.59
Employee	9.00	9.00	11.00	11.00	11.00	10.50	10.50	10.50	10.50

Source: MISSOC.

The total rate of social contributions remained rather consistent: it increased from 33.09% in 2005-2009 to 35.09% in 2011-2014, then went down to 34.09% in 2015-2017 (it was 35.09% again in 2018). Employees pay less than one third of the sum, and the biggest share is paid by employers. Within this total rate, contributions are split between several insurance types. Table 6 shows the breakdown for a 'typical employee'. Some categories pay lower contributions: thus, working pensioners do not pay disability and unemployment insurance premiums, and have a lower rate for sickness and maternity premiums; working service pensioners and disability pensioners who have not yet reached the statutory pension age do pay disability contributions, but at a lower rate than a generic case. The self-employed are not covered against unemployment and accidents at work, as well as paying lower sickness and maternity premiums. Workers employed during a term of imprisonment do not pay contributions for accidents at work, sickness and maternity or parental insurance. There are some specific rates for foreign employees of foreign employers, and others.

Accordingly, the contributions collected are distributed across six different sub-budgets:

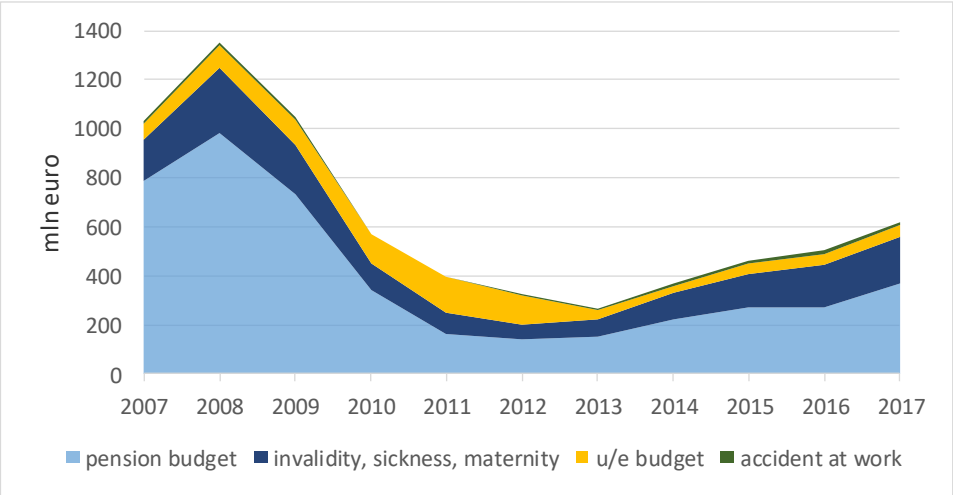
1) the pension budget;
2) the disability, sickness and maternity budget;
3) the unemployment budget;
4) the occupational disease budget;
5) the healthcare budget (since 2018); and
6) the administrative budget.

Each sub-budget has its own income and expenses, and the allocation of rates between the sub-budgets is revised annually based on their performance and planned expenses. The cash balances of the sub-budgets for 2007-2017 are shown in Figure 6.

The aggregation of spending areas within the sub-budgets differs from ESSPROS function groups: the pensions budget includes most service pensions and survivors' pensions; the disability, sickness and maternity budget incorporates three ESSPROS functions; and the occupational disease budget includes sickness benefits, reimbursements for healthcare, survivors' pensions and disability benefits. None of the budgets had negative cash reserves during the period 2007-2017 (see Fig. 6). Such a phenomenon can be explained by the large reserves accumulated during economic growth in 2005-2008. The sharp

temporary cut in transfers to funded pension accounts, from 8% to 2% in 2009-2012, also contributed to the health of the social insurance budget. Starting from 2014, state subsidies to the social insurance budget increased considerably as well (see Section 2.1.2).

Figure 6. Fiscal performance of the social insurance sub-budgets (cash balance at year end): Latvia 2007-2017



Source: State Social Insurance Agency reports (2008-2017), authors' calculations.

There is a cap on the personal income on which social contributions are paid. The Cabinet of Ministers revises the cap each year (Table 7).

Table 7. Cap on social contributions, € per annum: Latvia 2005-2019

2005	2006	2007	2008	2009-2013	2014	2015	2016	2017	2018	2019
28,315	29,453	33,864	42,117	-	46,400	48,600	48,600	52,400	55,000	62,800

Source: Cabinet Regulations (2004-2019).

In 2009-2013, the cap was temporary removed, as the social insurance budget reserves were quickly depleting and all possible sources for their replenishment were required. This, however, entailed increased obligations towards high earners in future, since the benefits are not capped.

There is no floor level for income subject to employee social contributions, whereas the self-employed pay contributions only if their income is higher than the statutory minimum wage (for more detailed information see Rajevska 2017b). Where the state pays the contributions for persons taking care of a child under 1½ years, the insured amount is €171 per month, and for recipients of maternity benefit €71.4 per month (2019). A very important problem is the large number of contributors making payments from a very low base; that is, only part of their earned income is reckoned for social insurance. Thus, in 2016-2017 almost one third of all social contributions were made from sums not exceeding the statutory minimum wage, due to the presence of socially precarious tax regimes for the self-employed and for the employees of micro-enterprises, allowing them to minimise taxes, but endangering their social security.

2.1.2 Central government budget

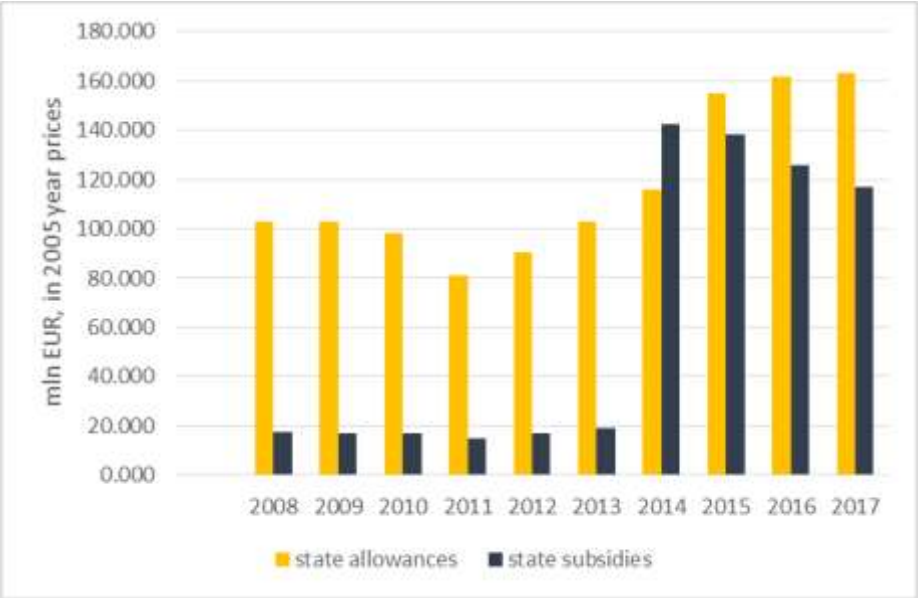
The second largest source of financing for social protection is the state general budget. It participates in several ways:

1) state subsidies to the social insurance schemes;
2) state social allowances and benefits;

3) financing of healthcare in the form of full or partial coverage of the costs of treatment, medicines, prostheses, etc.;
4) co-financing of social assistance benefits with municipal budgets (this was in place in 2009-2012).

The largest expenditure consists of state social allowances, followed by state subsidies to the social insurance system. Before 2014, the latter did not play a significant role (see Fig. 7), but starting from 2014 the financing of pension supplements (see Box 2 for details) was subsidised by the state.

Figure 7. Financing from the state budget – state social allowances and subsidies to the social insurance budget: Latvia 2008-2017



Source: State Social Insurance Agency annual reports, authors' calculations.

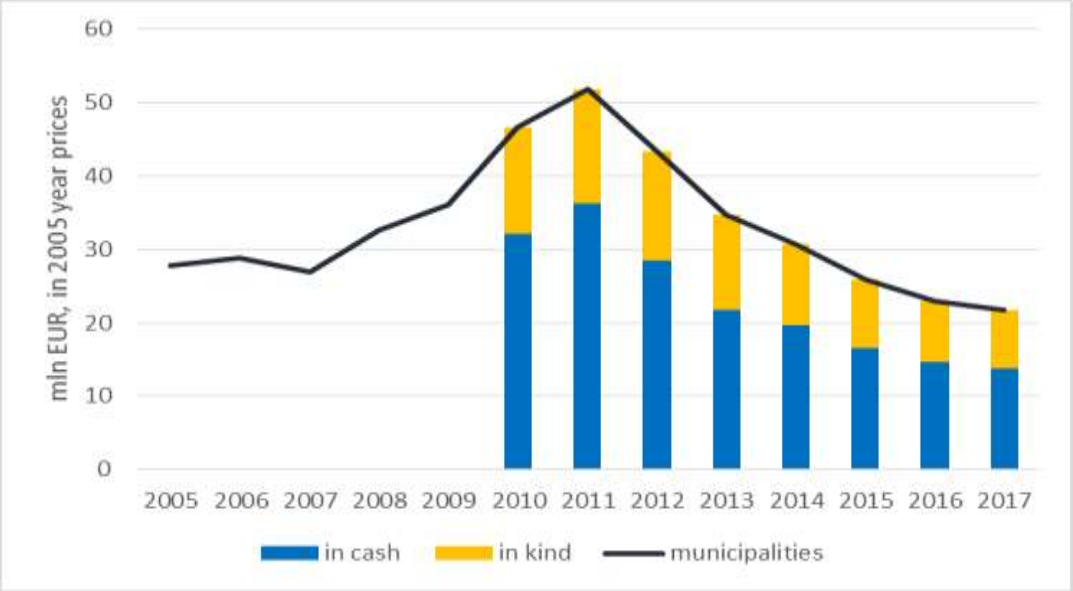
The general government budget pays universal flat-rate allowances: the family allowance, childcare allowance, childbirth allowance, and allowances to foster families and guardians (in total, family and child benefits account for more than half of all state allowances), as well as the state social security allowance (paid to disabled people and to elderly people who do not have a sufficient period of contributions for social insurance benefits) and some other kinds of allowances.

2.1.3 Local government budgets

Local governments are responsible for social assistance benefits and allowances: the GMI allowance, housing allowance, and allowances to orphans, foster families and persons in a critical situation. Some municipalities complement the mandatory schemes with their own benefits and allowances, both in cash and in kind, including for childbirth, healthcare, and transport costs. Many municipality-funded schemes are means-tested (in contrast to the lack of means-tested schemes at national level).

After 2011, the sums spent by local governments on social assistance benefits continually fell (see Fig. 8), due to the emigration of recipients and the improved economic situation, but also the unchanged means-testing thresholds. Despite rising prices and wages, the GMI remained inadequately low: €50-57 per month. At the same time, the 'poor household' threshold (giving eligibility for certain benefits and allowances) has remained unchanged – €128 per month per person – since 2009. Some wealthier municipalities (e.g. the capital city of Riga) set higher thresholds as a gesture of goodwill, but many local budgets do not have sufficient income to do so. Because of the low thresholds, fewer people qualify for the GMI and other social assistance, and as a result local governments' expenditure on such benefits falls.

Figure 8. Financing of social assistance benefits from local municipalities' budgets: Latvia 2005-2017



Source: Ministry of Welfare annual reports on social services and social assistance, authors' calculations.

2.1.4 'Rest of the world'

According to ESSPROS data, the amount of receipts from the 'rest of the world' was quite comparable to social assistance financing by local municipalities: the sums (in nominal terms) varied from €6.55 million (or 0.20% of all receipts) in 2008 to €69.06 million (2.12%) in 2010. Seemingly, these are different social programmes financed by the EU structural funds.

2.2 Financing of major spending functions

2.2.1 Financing old-age benefits

Old-age benefits in Latvia are not means-tested. Most old-age benefits are state pensions from the social insurance pay-as-you-go pillar (pillar I). A very small, but increasing, proportion are state-funded pensions (pillar II). The pillar II pension scheme is described in Box 1.

Box 1. Mandatory funded pension scheme in Latvia

Participation in the funded scheme is mandatory for those born in 1971 and later, and voluntary for those born between 1951 and 1970. Part of participants' social contributions is transferred from the state social insurance budget to privately managed pension funds. When participants reach retirement age, their accumulated pension capital is returned to the state social insurance pension budget. The capital either remains there (the typical case) or is further re-routed to a life insurance company. The number of cases of the latter is growing fast: in 2014, only 1.65% of retiring participants in the funded scheme bought annuities; but in 2015 it was 5.5%, in 2016 14.8%, and in 2017 21.8%. Those who opt to buy a life insurance policy receive two separate benefits from two different sources – one from the state and one from the life assurance company.

Table 8. Movement of capital between the pay-as-you-go and funded pension pillars, € million: Latvia 2005-2017

	Capital accumulations in the pillar II funds	Transferred from the state social insurance to the pillar II funds	Transferred from the pillar II funds back to the state social insurance	Transferred from the state social insurance to life insurance companies
2005	117.18	41.65	0.11	-
2006	181.10	58.81	0.21	-
2007	348.43	159.67	0.54	-
2008	659.81	378.27	0.96	-
2009	1,002.21	234.32	2.08	-
2010	1,179.00	93.76	2.86	-
2011	1,246.84	96.86	4.17	-
2012	1,460.99	107.41	5.25	-
2013	1,681.16	195.46	9.91	0.10
2014	2,009.00	254.00	20.36	1.10
2015	2,336.08	319.41	28.96	4.04
2016	2,763.99	412.96	38.40	9.84
2017	3,278.41	474.68	50.42	16.29

Source: State Social Insurance Agency annual reports.

In practical terms, pillar II pensions (either paid as life insurance or as part of the state pension benefit) are also financed from social contributions: it is simply that the contributions have spent some time in pension funds. The existing statistical data do not make it possible to compare the capital returned *from* the pension funds back to the social insurance agency budget with the amounts originally transferred *to* them: in some cases it may be less, since the funds have no obligation to ensure a positive investment return.

For those who do not have a sufficient insurance record, state social assistance pensions are paid, but the number of people concerned is very limited. ESSPROS data show that slightly less than 5% of all spending on old-age benefits consisted of benefits in kind in 2016, and their share was increasing (in 2005 they made up 2.5%, and in 2010 2.9%, of all benefits spending). These appear to be local government expenditure on items such as long-term care and compensation for transport costs.

The majority of pensions are financed from social insurance contributions, and more than 70% of all contributions are earmarked for the pension sub-budget. Pension contribution rates varied during the period examined (see Table 6 above).

A sharp increase in the share of central government revenue in the financing of pension expenditure in 2014 was caused by subsidising pension supplements (see Box 2) from the general tax budget. Since 2014, the size of this subsidy has been constantly reducing due to the natural fall in the number of supplement recipients (no supplements are granted to those who retired after 1 January 2012).

Apart from pension supplements, the general budget subsidises pensions to some specific categories of beneficiaries (such as Chernobyl liquidators, politically repressed persons under the Soviet regime, and certain lists of professions[3]). State social assistance pensions are financed directly from the general government budget.

[3] Many professions in Latvia are eligible for service pensions (see Rajevska 2017a). These are not contribution-based, but defined-benefit schemes. They are normally higher than old-age pensions and the age for taking them is significantly lower. When a service pensioner reaches the statutory old-age pension age, they cease to

Box 2. Pension supplement for pre-reform years of service

In 1996, the Latvian pension system underwent a fundamental reform, changing from almost a flat defined-benefit scheme to a notional defined-contribution (NDC) one. The so-called 'initial capital' was used to account for pension rights earned before the reform. However, the imperfections of this method soon became evident, and in order to improve the situation, an additional element in the pension formula – the pension supplement – was introduced in 2006. Initially, the supplement was granted only to people with low pensions, but starting from 2009 it was extended to all pensioners. Since 2012 these supplements have been phased out: those who retired before 2012 are still receiving the supplements, but those who became pensioners after that are not. In 2014, the financing of the supplements was shifted from the social insurance system to the general government account. The amount of the supplement for those who still receive it is the same (€1.00 per pre-reform year) as 12 years ago, with the exception of the oldest pensioners – from 1 July 2018 those who retired in 1996 and earlier get €1.50 for each pre-reform year.

Another controversial issue is the so-called solidarity tax that was introduced in 2016 on income above the social contribution caps (see Table 7). The rate of the solidarity tax was the same as the rate of social contributions (i.e. 34.09% in 2016 and 2017, and 35.09% in 2018), and the payment was split between the employer and the employee in the same way as for social contributions. The tax collected was directed to the state budget in 2016 and in 2017 (not earmarked). The solidarity tax was challenged in the Constitutional Court in 2017, and the Court recommended reviewing the existing order. As a result, in 2018 the tax collected was accounted for in a different way: 10.5 p.p. were treated as PIT; 10 p.p. were directed to taxpayers' personal savings in mandatory and voluntary funded pension schemes (pillars II and III); 1 p.p. was allocated to healthcare insurance; and the remaining 13.59 p.p. went to the 'common pool' of the pay-as-you-go pension pillar I (which does not have individual notional accounts, thus no extra pension liabilities towards taxpayers were incurred). Since January 2019 the rate of the solidarity tax has been reduced from 35.09% to 25.5%, and the tax is paid fully by employees. 10.5 p.p. are treated as PIT, 1 p.p. as health insurance, and 14 p.p. are allocated to individual accounts in the pay-as-you-go pension scheme (pillar I), the latter thereby increasing pension liabilities towards people in the public pension scheme. Thus, the 'solidarity' of this tax has remained only in its title. The solidarity tax was imposed in lieu of social contributions, and its aim was to maintain the same level of total labour taxes for high earners as for low and middle earners, at the same time not increasing obligations by the state social insurance system towards high earners. The present situation is a reversion to the previous one: high earners pay proportionally lower taxes, at the same time accumulating pension rights from the sums above the social contribution caps (see also Rajevska 2019).

2.2.2 Financing healthcare expenditure and sickness benefits

Healthcare and sickness benefits in Latvia are financed from different non-overlapping sources.

Sickness benefits are financed from social insurance contributions (from the sub-budget for disability, sickness and maternity, and, to a much lesser extent, the sub-budget for occupational diseases). All employees are insured against sickness/injury (the self-employed are not insured against occupational diseases and accidents at work). A comparison of the state social insurance reports (showing statistics on the sickness

be a service pensioner and become an old-age pensioner. Their old-age benefit is calculated according to the standard contribution-based scheme. When this calculated amount is lower than the service pension the person had before, the 'missing part' is subsidised by the central government budget (before 2016, the whole pension benefit, including the 'missing part', was financed from the social insurance budget).

benefits paid in cash) and ESSPROS data allows us to conclude that sickness benefits account for approximately 10-15% of aggregate expenditure, while the remaining 85-90% is spent on healthcare.

Healthcare is financed from general taxes. In 2017, the government decided to change the healthcare state funding scheme by introducing a healthcare insurance component. Thus, from January 2018 the state social insurance contribution rate was increased by 1 p.p. (0.5 p.p. paid by employers and 0.5 p.p. by employees). This increase was intended to better fund the healthcare system, and the contributions collected in 2018 were used to increase wages for doctors and nurses.

2.2.3 Financing family and child benefits

Family and child benefits are divided into two broad groups: contribution-based and non-contributory flat-rate benefits. Contribution-based benefits consist of maternity and paternity benefits and parental benefits financed from the state social insurance budget. Conversely, the childbirth allowance, family benefits, childcare benefits, foster family and guardians' benefits, as well as different supplements for caring for a disabled child, are flat-rate and financed from central government revenue. In addition, municipalities may have their own family and child benefits, both in cash and in kind. In 2016, less than 0.5% of all spending on family and child benefits was means-tested.

There was a drastic change in the split of financing sources between 2005 and 2008. In 2005 the split was 15.1% from social contributions and 84.9% from government revenue, whereas in 2008 the respective proportions were 53.3% and 46.7%. This can be attributed to the introduction of contribution-based parental benefits in 2008 and a rapid increase in the average insured wage, whereas non-contributory benefits were not revised. Later on, with the introduction of more generous benefits in the non-contributory schemes, the split between social contributions and general taxes stabilised at 35:65.

3 Strengths and weaknesses of the existing mix of financing options and potential future sources of financing – national debate on the topic

The strength of the Latvian model of financing social protection is its ability to maintain a positive balance even against the background of a very turbulent environment. The sustainability of the social insurance budget has always been, and remains, a top priority for policy-makers in Latvia. In the meantime, Latvia spent the lowest share of GDP (12.2%) on social protection in the EU in 2005, and the second lowest (15.2%) in 2016.

Social contributions play a leading role in the existing mix of financing for social protection in Latvia. The last decade demonstrated the increasing role of general government contributions, with central government subsidising the social insurance schemes and introducing new universal benefits. In view of the shrinking working-age population, higher average insured wages will offset the fall in the number of active contributors to a limited extent only. Social contribution rates are already quite high (35.09% in 2019) and can hardly be increased, otherwise labour costs might become uncompetitive. Therefore, a further increase in general government contributions seems unavoidable. With the maturing of the state-funded pension scheme, the share of private financing will grow, too. At present, the funded scheme is mainly accumulating resources and has not yet reached its 'saturation level': in 2016, inflows into the scheme were more than 10 times higher than outflows. The change in the proportion of contributions as between pillars I and II resulted in more funds being directed to the pay-as-you-go scheme. The revision of the pension capital valorisation indices contributed to a more equitable calculation of benefits.

The social insurance schemes (old-age, disability, sickness, unemployment, maternity/paternity and parental benefits) are based on the pay-as-you-go principle, with present contributors financing present recipients, at the same time as the benefit amount is closely linked to the contributions paid by a certain individual. Such a system creates proper work incentives, albeit requiring significant resources for its administration. The State Social Insurance Agency in Latvia has shown an excellent performance in dealing with the task cost-efficiently: in 2016, administration costs accounted for 1.44% of all social protection expenditure (EU-28: 2.67%).

Latvia's experience with the micro-enterprise tax regime (see Rajevska 2017b) demonstrated the pitfalls of an over-simplified approach to taxation, with a measure aimed at combating unemployment becoming a tax evasion trick at the cost of workers' social security. In recent years, due to amendments in the legislation, the number of micro-enterprises has fallen considerably and the damage mitigated to some extent.

Among the weaknesses of the social insurance schemes, the inadequately low minimum levels of the benefits should be mentioned, especially as concerns old-age pensions. Low-wage earners might have a disincentive to diligently pay contributions, seeing that even the average old-age pension is lower than the at-risk-of-poverty threshold (e.g. in 2016 the average monthly old-age pension was €280, while the at-risk-of-poverty threshold for a single person was €318.25). In such a situation, people often prefer to stay in the 'shadow zone', paying contributions only on a part of their actual income from work.

Also, with the declining number of active contributors, the question of reintroducing caps on benefits emerges. At a time when the minimum old-age pension level was set at €70 per month (and for people not having a sufficient insurance record only €64 per month), the highest state pension in Latvia in 2018 amounted to €19,300 per month (275 times higher!). This is an exceptional case, of course, and the second highest pension was 'only' €7,600 per month (approximately 100 times higher). The difference between the minimum and maximum pensions should be reduced, by an order of magnitude. We suggest that this might be achieved from both ends: first and foremost, by increasing the minimum, but also by setting a maximum.

The share of general government contributions in the financing of social protection in Latvia (42.1%) was slightly above the EU-28 average (40.4%) in 2016. The schemes financed from central government taxes on a non-contributory basis have different redistributive effects. Where they cover broad segments of the population (such as healthcare and family benefits), they redistribute from almost everyone to almost everyone. The increase in child and family benefits significantly reduced child poverty. The situation where social insurance schemes are subsidised by general government revenue (supplements to old-age and disability pensions, or to politically repressed persons from the Soviet past) is a sort of intermediate case. We suggest that in Latvia this kind of general government financing is better suited to social protection than the direct financing of universal flat-rate benefits. **Subsidies from the general budget might be used to solve the long-neglected problem of increasing the minimum pensions**: where the pension formula returns amounts below the minimum, the 'missing part' could be financed from subsidies (as in Poland).

A similar approach could be used to increase the adequacy of unemployment and disability benefits: rather than raising contribution rates (which would increase obligations towards all income groups, and the wealthiest would gain more in absolute numbers) or introducing new universal state-financed allowances (which would make the system overcomplicated), **decent minimum levels would be set for social insurance benefit amounts, partially subsidised from general tax revenue**.

On the other hand, **social protection schemes at the municipal level require more co-financing from the central budget**. Means-tested benefits are thinly represented in the Latvian social security system, and the thresholds used for their calculation are inadequately low. Means-testing requires administrative capacities not possessed by municipalities in Latvia, but nor do the latter have sufficient financing to drag the needy out of poverty.

The lack of consistency in the reform of health financing is threatening the sustainability of the healthcare system. Administrative structures for the management of financial flows have been reformed several times during the last 23 years.

PIT reform took place in Latvia in 2017 (new regulations have been in force since 2018). It introduced more elements of progressivity into the tax system. The standard PIT rate of 23% was reduced to 20% for incomes up to €1,667 per month, and a second tax rate of 23% was applied to incomes between €1,667 and €4,583 per month. Beyond this income, the upper PIT rate was set at 31.4%. However, the lowest-income households were not well targeted by this reform. EUROMOD[4] simulation analysis by Ivaškaitė-Tamošiūnė et al. (2018) showed that, whereas more than 90% of households benefit financially from the combined effect of the different reform components, only 40% of the poorest decile do, given that most of people in this category had no, or a very low, tax liability previously. The reform is of most benefit to the middle of the income distribution, but also benefits the richest decile. The system of a differentiated tax exemption, which was introduced with the tax reform in 2018, is very complicated and has caused a lot of misunderstanding among both taxpayers and accountants: its simplification is needed. This problem is already on the public agenda in 2019. **The solidarity tax should be earmarked for improving the situation of the neediest groups in society** (including through increasing the GMI and the minimum pension).

The other potential source of social protection financing can be found in the **partial reassignment of the funds directed to the pension pillar II**. The funds accumulated in privately managed pension funds (€3.7 billion as of February 2019) contribute almost nothing to the present well-being of the country. Meanwhile, the management fee of the fund managers is too high (1%) compared with the fee levels in western European

[4] An EU tax-benefit microsimulation model.

countries. At the same time, healthcare funding in Latvia is critically low. It may be worth considering reassigning 1 p.p. of social contributions from the pension pillar II to the needs of healthcare, at the same time putting further caps on pension fund management fees.

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