

Will enhancement of non-contributory elements in Latvia improve the adequacy of pensions?

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In May 2021, following the Constitutional Court ruling on the inadequacy of minimum pensions in Latvia, the Welfare Ministry proposed the introduction of a (flat-rate) basic pension. This was intended to replace the current minimum pension subsidy and pension supplements. A year later, the approach has changed radically: the ministry no longer envisages a basic pension, but is reintroducing supplements based on years of service, making them a permanent and increasingly important part of the pension formula, keeping the acquisition of pension rights closely linked to the person's work history. This move may increase income inequality in older age groups, and its specific impact on the adequacy of minimum pensions is debatable.

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Description

The Latvian statutory pension system comprises two schemes (pillars), both financed from social contributions: the pay-as-you-go notional defined contribution (NDC) scheme and the funded defined contribution (FDC) scheme. The amount of the pension therefore depends solely on the contributions paid by an individual. If the calculated pension is lower than the statutory minimum (SM), a redistributive mechanism is activated: the shortfall in the minimum amount is supplemented by a state budget subsidy. Furthermore, there used to be one non-contributory element in the pension formula: the pension supplement (PS). This was introduced in 2006 and phased out in 2012: people who retired before 2012 still receive the PS, but later pensioners do not. The PS is based on the years of service before 1996 (i.e. before the introduction of the NDC scheme) and is indexed annually; in July 2022, it varies between €1.16 and €1.74 (depending on the year of retirement) per month per service year.

The SM depends on the length of the service record (the longer the service, the higher its level) and there are no rules requiring it to be indexed in line with inflation, wage growth or anything else. It remained unchanged from 2006 to 2019, ranging from €70 (for those with a 15-year record) to €109 (more than 40 years' record). In 2020, it was increased by 25% (to become €88-€136 respectively). Over the same period 2006-2020, the average pension grew by 227% and the average wage by 166%.

In December 2019, the Supreme Court (the highest court in the three-tiered Latvian court system) filed a Constitutional Court case claiming that the existing minimum pension regulation violated the individual's right to social security in a democratic socially responsible state. In 2020, the Constitutional Court in a number of its judgements ruled that the whole regulation of the minimum income and social assistance thresholds in the country was not compliant with the Constitution, and mandated the government to increase the minimums and peg them to a sound socio-economic indicator.

From January 2021, the SM was raised to €150-€220 per month. Later, in September 2021, the government adopted the Plan for Improving the Minimum Income Support System for 2022-2024. According to the Plan, the SM will be pegged to the median equivalised income. In addition, the Plan requires the Welfare Ministry to draft a concept note by the end of the year, setting out how the pension system should be reformed in a way which retains the close link between contributions and benefits. The ministry's draft concept note was published only in May 2022, and there is still a way to go before it is approved by the Cabinet of Ministers. The published document is very different from what was announced last year by the Ministry officials in the media: they had spoken of the introduction of a flat-rate basic pension, paid to all pensioners on top of the "earned" insurance pension, set at 20-25% of the median income and replacing the minimum pension subsidies and PS. As this was considered too costly for the budget, the final version is more sophisticated and reintroduces per-service-year supplements instead of abolishing them: 1) from 2023: these supplements would

also be granted to those who retired after 2012 (this would affect almost one third of pensioners); 2) from 2024: the PS amount would be linked to the median income, and 3) from 2029: the PS would also be granted for the years after 1996. This would make the PS a permanent and increasingly important part of the pension benefit, while acquisition of pension rights would still be closely linked to a person's work history.

The rationale for adding a non-contributory component (either in the form of the initial flat rate or the PS) has been paradoxically explained by the declining level of proportionality between contributions and benefits. As soon as the SM is pegged to the median income, its growth will keep pace with the growth in wages. Meanwhile, the indexation formula means that pensions paid will grow more slowly than wages, as inflation and wage increases are only partially compensated. So, with every year the SM will be closer to the average pension, and the share of pensioners on a minimum pension will increase. For instance, the SM for a person with a 38-year record amounted to 49% of the average pension in the first quarter of 2022, but is projected to reach 56% of the average in 2024. At the bottom of the scale, the level of the pension would become less dependent on contributions, and the length of service would gain more importance.

The difference between the calculated pension and the SM is subsidised from the state budget. The draft concept note contrasts the terms "earned pension" and "accrued pension", and argues that it would be unfair for the budget to pay more to people who have not "earned" their pensions and less to hard-workers. The reasoning is that this will cause discontent among those who have paid higher contributions but find themselves among the recipients of the same minimum pension, which in turn will discourage the population from paying social contributions and

undermine the sustainability of the whole scheme.



Outlook and commentary

Unequal treatment of pensioners who retired in different years has been the target of criticism in Latvia; resumption of the PS for those who retired after 2011 has repeatedly been debated but never approved in the parliament. In this sense, the approval of the new concept may be considered as a long-awaited restoration of justice. However, it is questionable whether such a reform will improve the adequacy of minimum pensions significantly, as the targeted benchmarks are pretty uninspiring: for a person with a 40-year record only 40% of the median income is guaranteed and, what's more, with a 2-year lag. Thus, most of those earning an income below the at-risk-of-poverty threshold will remain at risk under the new rules. The impression given is that the Ministry sees minimum pension beneficiaries as "free-riders" not deserving of decent benefits.

Moreover, it is difficult to accurately assess the impact of the reform on income inequality in the older age group. The lowest income decile may benefit the least from this innovation. At present, only the insurance pension is taken into account for determining entitlement to the minimum pension: if it is short of the SM, it is brought up to this level by a state subsidy, and the PS is added to the SM amount. In the proposed scheme, the PS is included in the calculated pension and only then is it compared to the SM. Thus, higher income groups would receive their PS on top of the current pensions, but the lowest income group would receive them instead of their present SM subsidies, fully or partially. Therefore, both the absolute and the relative increase in pensions among the most needy may be smaller than in wealthier groups. Income inequality in the 65+ age group in Latvia has been one of the

highest in the EU for many years, and the planned reform may cause it to increase still further. The draft concept note focuses solely on budgetary expenditure and lacks any assessment of the impact of the proposed measures on at-risk-of-poverty-or-social-exclusion (AROPE) levels, the S80/S20 ratio, the gender pension gap, or other established indicators of pension adequacy.

The concept was discussed behind the scenes, and was posted for the general public on the government's legislative initiatives portal for only two weeks in May 2022, without any announcement on the ministry website or any news portals. An open letter from the Welfare Minister to the Federation of Pensioners, informing them that the draft had been published for discussion by all comers, was only received by the Federation when the deadline for the discussion had already passed. However, the final version of the concept may be substantially different from the current one, as in June 2022 the draft was criticised by several official bodies. The Ministry of Finance, then, does not support pegging of the PS to the median income, and has also asked for specifications on the sources of the additional funding needed for the reform; the Ministry of Justice has asked for justification of the time frame for the implementation of the proposed measures; the Cross-Sectoral Coordination Centre has called for more detailed calculations of the fiscal impact, and the Employers' Confederation disagrees with the conceptual assumptions of the document.

Further reading

Konceptuālais ziņojums (2022). [Par pensiju sistēmas pilnveidošanu](#) [Concept note on "Improving the pension system"].

Rajevska, F. and Rajevska, O. (2016). 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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