INTRODUCTION

In 1991, Latvia inherited its pension system from the Soviet Union, including its low statutory retirement age (55 for women, 60 for men), high income replacement rates (50 percent to 100 percent of previous monthly income), and pension expenditures financed directly from the state budget. Because this system was deemed unsustainable and not properly equipped to face existing and increasing socioeconomic and demographic challenges (such as increasing life expectancy and decreasing fertility rates), and decreasing state budget revenues, the Latvian pension system required fast and fundamental changes. As a response to these challenges, since 1995 the Latvian government has undertaken a systematic reform of its pension system, replacing the classic pay-as-you-go (PAYG) public pension pillar with individual defined-contribution plans. The main goals of the reform were to

- Reallocate and distribute risks and related costs among participants;
- Establish a stable and sustainable personal taxation system with the introduction of a fixed social contribution rate of 33.09 percent; and
- Introduce a new state social insurance program and its attendant legal framework.

In 2001, a new three-pillar model was established.

The purpose of this chapter is to provide a brief historical and economic review of the operation and performance of Latvia’s reformed three-pillar pension system, with a particular focus on funded pension schemes. The chapter also provides an analysis of the latest successes and implications of the system.

DESCRIPTION OF THE PENSION SYSTEM

A Multipillar System

Using the experience of the Swedish pension reform as a basis, the Latvian pension system underwent a structural reform between 1995 and 2001. In 2001, the
reform was complete and a new three-pillar pension system became operational. This new system was set up to deal flexibly with a number of growing demographic challenges, for example, increasing life expectancy, migration, changes in labor and capital markets, and changes in the age structure of the population more generally. Figure 18.1 shows the projected sharp long-term decrease in Latvia’s working-age population resulting from these demographic trends. Simultaneously, the changes in the age structure of Latvia’s population are projected to lead to a significant increase in the old-age dependency ratio (that is, the number of people ages 65 and older as a proportion of the number of people ages 16 to 64): from 30 percent today to 75 percent in 2060.

A First Pillar Based on Notional Defined Contributions

Latvia was among the first countries in central and eastern Europe to address all of these challenges by introducing a multipillar pension system, and it was the first country in the world to introduce a first-pillar PAYG (“solidarity”) pension system involving notional defined contributions (NDCs). In 1996, Latvia was one of the first countries to make a complete transition to NDCs for the entire working population. From a regulatory perspective, the reform included the gradual introduction of a statutory uniform retirement age of 62 years (applicable beginning in 2003 for men and 2008 for women), which since Soviet times had been 58 for men and 55 for women. From a financial perspective, the reform established a total contribution rate of 20 percent, shared between the first pillar...
based on notional defined contributions and the second pillar based on funded defined contributions (FDC). The original split of 18 and 2 percent between these two pillars was scheduled to change to 10 and 10 percent by 2010.

However, the 18 percent contribution rate allocated to the NDC did not suffice to finance old-age pension spending during the reform’s transition period. The total state social insurance contribution rate of 35.09 percent (33.09 percent before 2011) covers the transition to the new regime and finances current social insurance spending including old-age pensions; disability pensions; and unemployment, sickness, and parental benefits. The reform promised stability in the face of demographic and economic fluctuations, and it took into account the broad range of possible economic and demographic scenarios present in Latvia’s European Union (EU) accession process. The conversion to the NDC system in 1996 also raised a number of transition issues that had to be resolved; some of them had to be revisited in the period immediately following the initial reform legislation. The most important issue concerned the manner in which rights acquired under the old regime would be valued in the new, NDC regime and how to introduce the system in an economic environment characterized by structural upheaval, given that the country was just beginning to transform from a command to a market economy.

The main purpose of the new system was to establish personal pension accounts for each qualifying individual in both the notional defined-contribution and funded defined-contribution schemes. The reform also addressed allocation of the administrative and custody rights for the management of these pension accounts to the State Social Insurance Agency (SSIA) and of the assets of funded defined-contribution schemes (second tier) to licensed private pension fund managers. Initially, management of financial accounts was exclusively delegated to the State Treasury (October 2007), but during the transitional period (by 2008), the Treasury terminated these operations and the funded pension assets were completely transferred to private pension management funds according to each member’s selection or were equally distributed among the private pension funds.

Although the first pillar covered all workers, joining the second pillar was mandatory only for workers born after 1971. People born between 1953 and 1971 could join voluntarily while workers born before 1953 were not allowed to participate in the FDC pillar. By December 31, 2012, 12 years after the inception of the second pillar, the average age of participants was 39 years (for mandatory participants, 30.4 years, for voluntary affiliates, 51 years). As seen in Figure 18.2, the largest share of second-pillar pension participants was in the 25–40-year-old age group.

**Contributions to the First and Second Pillars**

The personal NDC accounts are financed through compulsory social contribution payments, which are directly levied on workers’ reported wages. Based on growth forecasts and expected wage growth before and after Latvia’s accession to the EU, the total social contribution rate was reduced from its previous level of...
38 percent to 33.09 percent. To allocate social and economic responsibility properly between the state budget and private individuals, 20 percentage points of the total 33.09 percent was allocated to finance the first and second pillars of the reformed pension system.

Ultimately, to reduce the future fiscal burden resulting from population aging and the rapid decrease of fertility rates in the 1990s, the 20 percent contribution was split differently between the first and second pillars in the years following reform (see Table 18.1).

The initial pension model calculations—which accounted for the aging of Latvia’s population, migration rates, and the level and volatility of returns on funded assets—concluded that the optimal division of contributions between the first and second pillars would be 14 percentage points and 6 percentage points, respectively. After initiation of the second pillar in 2001, management rights for

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**Table 18.1**

<table>
<thead>
<tr>
<th>Year</th>
<th>First Pillar</th>
<th>Second Pillar</th>
</tr>
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<tbody>
<tr>
<td>2001–06</td>
<td>18</td>
<td>2</td>
</tr>
<tr>
<td>2007</td>
<td>16</td>
<td>4</td>
</tr>
<tr>
<td>2008</td>
<td>12</td>
<td>8</td>
</tr>
<tr>
<td>2009</td>
<td>18</td>
<td>2</td>
</tr>
<tr>
<td>2010–12</td>
<td>18</td>
<td>2</td>
</tr>
<tr>
<td>2013</td>
<td>16</td>
<td>4</td>
</tr>
<tr>
<td>2016¹</td>
<td>14</td>
<td>6</td>
</tr>
</tbody>
</table>

¹Future plans of the government of Latvia.*

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the assets were legally and exclusively allocated to the State Treasury. However, after private pension funds also received the right to operate in this market, the State Treasury’s administration rights were legally terminated and, in October 2007, completely transferred to private pension management funds, which, in a majority of cases, were subsidiaries of large financial institutions. Subsequently, the private pension funds lobbied for the second-pillar contributions to be increased to 10 percent. However, according to the Ministry of Welfare’s projections, no further increases are planned for the contribution rate toward the second pillar—that is, the 6 percentage point share will remain unchanged for the long-term sustainability purposes of the first pillar.

To maintain the NDC pension accounts’ present real value as well as to adjust future pension payments to recover the transition costs during 1996–99 for members with job service before 1996, the collected contributions in the first-pillar NDC accounts are indexed annually by the average wage growth index. However, the system reduces accumulated pension capital if the index is negative. The applied index rates are used as chain indices for NDC capital increases by annually indexing the accumulated capital retrospectively by the rates in Table 18.2.

Contributions allocated to the second pillar (see Table 18.1) are transferred to personal FDC accounts at private pension fund managers selected by individuals and are invested. Accordingly, the growth or reduction of value of the pension capital in the second pillar depends directly on the performance of the selected pension plan as well as the investment strategy and structure of its financial instruments (deposits, bonds, equities, and the like).

Achieving Adequate Income Replacement Rates

An important indicator of the success of the system from the contributors’ perspective was the achievement of higher net replacement rates. In July 2005, the Latvian government set the goal of achieving replacement rates equal to 40–60 percent of previous employment income by participation in both the mandatory first and second pillars. Assuming average wage growth of 2 percent and average second pillar net returns of 4 percent, the contribution rate split of 14 percent to the first pillar and 6 percent to the second pillar to apply beginning in 2016 would yield a 60 percent net replacement rate after 45 years of service. The latest government decision to increase the statutory pension age from 62 to 65 years by 2025, with most people being in the reformed system by that time, is consistent with these assumptions. An additional, voluntary contribution of 10 percent to third-pillar schemes would bring the net replacement rate to 100 percent after 40 years of service—assuming average wage growth of 3 percent.

### TABLE 18.2

<table>
<thead>
<tr>
<th>Average Wage Growth Index Rates</th>
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</table>

and net returns in the second and third pillars of 6 percent. If the previous assumptions are used (40 years of service with 2 percent wage growth and 4 percent net returns) the replacement rate would be 83 percent. This illustrates the importance of contributing to voluntary third-pillar schemes to increase expected net replacement rates. Also, it is crucial to enhance long-term, low-risk investment initiatives for second- and third-pillar schemes so that they earn sustainable returns of 4 percent to 6 percent.

**FINANCIAL PERFORMANCE OF THE REFORMED PENSION SYSTEM**

Total assets in the second pillar have grown steadily as a result of a continuous increase in the number of participants (275,000 at end-2001, a year after the system was launched; 790,000 at the beginning of 2006; and 1,194,000 at end-2012). At end-2012, the value of second-pillar assets was 1,027 million Latvia lats—equivalent to 12 percent of Latvia’s 2011 GDP. Because of the successful launch of the second pillar, the rapid growth of new participants and their contributions, and favorable rules for pension plan managers with respect to guaranteed flat administration fees directly linked to collected contributions, fund managers were greatly interested in obtaining management licenses from regulators. By the end of 2011, there were nine licensed private pension funds in Latvia. Private pension funds succeeded in incorporating into funded pension legislation a ceiling of 2 percent for administrative fees out of collected contributions into the pension plans; in 2011, average administrative fees were 1.5 percent. These fees are collected by pension funds regardless of reported losses or profits of managed pension assets.

Regulations have been strictly binding with respect to allowed proportions of financial instruments and geographical segmentation. The second pillar’s investment structure as of December 31, 2012, is shown in Figure 18.3.

Figure 18.3 shows that regulatory limits on investment types as well as limits on foreign exchange exposure (10 percent of a single currency) created the current situation in which nearly half of pension assets are invested in Latvia. Because of underdeveloped financial markets, these assets are invested heavily in term deposits and government bonds. So-called conservative plans are not allowed to invest in equity markets, and their yields depend directly on domestic monetary and fiscal policies. So-called active plans are allowed to invest up to 50 percent in equity markets, with a limit of up to 5 percent invested in any particular asset. Because of these limitations, the majority of assets are allocated to relatively low-yielding, short-term government bonds and term deposits with a maturity of one to three years. As a result of insufficient investment opportunities, Latvian investment funds yielded returns of between 1 and 2 percent, which was below wage growth, depressing expected income replacement rates in the long term. More recently, investment returns either have been lower or slightly higher than consumer price inflation (in 2012, the average yield in FDC accounts...
was 4.14 percent). The history of return rates on funded pension assets is provided in Figure 18.4.

In 2009, after the start of the global financial crisis—which resulted in a rapid decrease of contribution revenues after a drastic increase in unemployment and salary cuts—the Latvian government had to make the unpopular decision to

**Figure 18.3** Allocation of Latvia’s Funded Defined- Contribution Net Assets by Geography and Financial Instrument

![Pie Chart](chart.png)


**Figure 18.4** Returns on Funded Defined-Contribution Pension Assets *(Percent yield)*

![Line Graph](graph.png)

significantly reduce the second-pillar contribution rate from 8 percent to 2 percent. The 6 percentage point difference was redirected to the financing of current pension expenditures in the first pillar. A minimum amount of second-pillar contributions were retained to be put toward the aforementioned demographic challenges. In addition, to compensate for the unemployment rate, in 2011 the government increased the total state social contribution rate to 35.09 percent, which is paid by employees and employers to the state. As can be seen in Table 18.1, the share of contributions to the second pension pillar was raised to 4 percent in 2013 and is scheduled to be 6 percent (the previously mentioned optimal rate) in 2016.

In 2013, from a public expenditure perspective, first-pillar expenditures exceed contributions. However, following the decision in 2012 to increase the retirement age to 65 by 2025, and based on growth expectations, the Ministry of Welfare projected that first-pillar contributions will exceed expenditures, leading to a surplus. This surplus is available to the general government budget to accrue in a special-purpose social budget to meet future long-term demographic challenges (see Figure 18.5).

Also, assuming that the first-pillar surplus will continue to increase and that the share of contributions to the second pillar will increase to 6 percent and remain at that level, it is expected that collected contributions in NDC accounts as a share of GDP will drop from 7.0 percent to 6.4 percent by 2050.

Initial Success of the Reformed Pension System

Latvia’s three-pillar pension system has been in place for almost 10 years and has experienced outstanding successes and failures. The system’s launch had a positive
impact on participation rates that resulted in a steady increase in contributions. The early successes of second-pillar implementation in all three Baltic countries was mainly due to the following:

- Governments ran public communication campaigns about the social and economic necessity of reforming the legacy system and about why people should be involved and contribute to the new system, ensuring that the number of people joining the second pillar increased rapidly and that participation remained surprisingly high (see Figure 18.6).

- The introduction of the second pillar coincided with a period when the returns on financial investments in global markets were high, and it was assumed that this trend would continue for many years, ensuring high returns both before and after Estonia, Latvia, and Lithuania entered the EU.

- The number of people joining the system increased as a result of the entry into the labor force of population cohorts born during the 1970s and 1980s, a period of high birth rates in the former Soviet Union.

- Contribution revenues grew rapidly between 2005 and 2008 on the back of rapid economic growth in all three Baltic economies. Contributions continued to increase partly because of wage growth and partly because second-pillar contribution rates went from 2 percent to 8 percent. Even in the years following the financial crisis of 2009–10, when wages were cut significantly, contributions continued to increase, which mostly occurred because of the compulsory entry of new participants into the system (Figure 18.7).

**Figure 18.6** Number of Participants in the Second Pillar

![Graph showing the number of participants in the second pillar from 2002 to 2012.](source: Financial and Capital Markets Commission (www.fktk.lv).)
The first challenges to payouts and the reliability of the system occurred about 10 years after the reform began, attracting attention from the public and causing negative attitudes about the system. If the initial reasons for the former PAYG system’s unsustainability, and for the introduction of NDC and FDC accounts, were low fertility rates, increases in longevity, and the migration of the working-age population, after the global financial crisis (which severely affected the Baltic economies), the reasons for unsustainability became the permanently high unemployment rates in all Baltic countries, the unacceptably high flat-rate administrative fees charged by pension plan administrators, and the regulatory restrictions against investing pension assets in long-term real economy projects.

In 2009 and 2010, the government’s main argument for the drastic reallocation of contributions from the second pillar to the first was the need to retain the sustainability of the social insurance budgets and to meet ongoing pension payment obligations. In addition, the Latvian government, under an IMF-supported program, executed a 10 percent nominal cut to current pensions in 2009. However, this cut was retrospectively reversed by a verdict of the constitutional court. Following this reversal, payments from the social budget had to be made; as a result, beginning January 1, 2011, the total social contribution rate increased by an additional 2 percentage points, to 35.09 percent.

NDC accounts continued to accrue higher notional pension capital, which continued to increase the government’s notional liabilities toward current contributors. However, these notional long-term liabilities had never been recognized from a public finance perspective (as in other types of unfunded pensions).
Delivering Targeted Income Replacement Rates

At end-2009, nearly 90 percent of total funded assets were concentrated in pension plans managed by financial corporations, helped by rapid growth in contributions. The government’s decision in 2009 to cut the contribution rate to the second pillar to 2 percent was influenced by public debate and pressure from the finance industry; hence, the more difficult option of terminating the second pillar entirely was cast aside. Still, the change was highly unsatisfactory to the industry, which argued that the decision would have a negative impact on the future pension incomes of the system’s current FDC account holders.

Learning from the Financial Crisis

During 2008 and 2009, major pension plans at SwedBank, SEB, and Citadele, which managed the largest amounts of second-pillar funded assets, reported significant decreases in returns on the net value of pension plans, ranging from −5 percent to −25 percent (see Figure 18.4). The decreases in returns, as well as the reduction in contributions to FDC accounts, were mostly explained and publicly presented as a result of the financial crisis. Nevertheless, other less widely publicized reasons also contributed to these outcomes:

- Fund managers promoted high-risk pension plans based on historical returns without adequately explaining the risks involved.
- Public and administrative support was lacking for reallocating pension assets into less volatile financial instruments in a timely manner during the global financial crisis and subsequent reinvestment activities before capital markets recovered.
- Local capital market opportunities were limited and regulatory restrictions were in place on the investment of second-pillar assets into local equities and derivatives through national stock exchanges or risk capital funds, as well as into direct infrastructure or energy development projects, which could have provided higher and more sustainable long-term returns.
- Legal measures that would limit or even eliminate pension plans’ administrative fees if negative returns were reported were not in place.
- Political decisions on the role of the social insurance system were influenced by private sector lobbying between 2004 and 2006, resulting in incoherent changes to the overall pension system. Moreover, the accrued social insurance budget surplus, the original purpose of which was to close the social insurance deficit between 2009 and 2012, was spent during that period.

REFORMS AND REFORM OPTIONS

Ease Investment Restrictions and Encourage Domestic Investment

After the global financial crisis, Latvia, along with the other Baltic countries, was one of the first European countries to restructure its public finances. From the
slump in GDP during those years, the economies of these three countries recovered and returned to a positive GDP growth trend (in 2011, 8.3 percent in Estonia; 5.5 percent in Latvia; and 5.9 percent in Lithuania). Larger EU economies were stagnating, with the result that EURIBOR rates continued to fall: the 12-month rate decreased from 4.711 percent in 2007 to 0.631 percent in September 2012.

As a response, the government should revisit investment restrictions and facilitate long-term investment initiatives in the national economy. These initiatives could include allowing funded second-pillar pension assets as well as third-pillar assets to be invested in real economy sectors, leading to a sustainable increase of economic capacity and value of investments, and increases in productivity, competitiveness, and guaranteed long-term returns. Such investments could include

- Infrastructure projects;
- Renewable energy and natural resources; and
- Risk and venture capital.

**Deal with the Issue of Interrupted Employment Records**

Long-term unemployment and interrupted careers have become more common in Latvia. Both have negative effects on future pension benefits because interrupted employment also reduces the accumulation of capital (notional or actual) in the first and second pillars. Historically, the main arguments for pension system reform and introduction of a funded second pillar were low fertility rates and the general aging of the population, but after the global financial crisis, high unemployment rates—peaking at 18.7 percent in 2010—and the stagnation of EU economies jeopardized the long-term sustainability of Latvia’s pension system.

To reduce the poverty risks of people who had lost jobs during the global economic crisis, the Latvian government established numerous social support programs and transferred the social support expenditure burden from the state budget to municipalities’ local budgets. Existing legislation provides legal framework for municipalities to finance and execute generous social support programs to support unemployed people and low-income households. The system of social support and benefits allows people to live sustainable lives, reducing their motivation to seek full-time jobs and integrate back into the labor market. This obstacle further damages Latvia’s pension system because it no longer collects sufficient contributions to cover the current expenditures of the first pillar nor does it allocate sufficient contributions to FDC accounts to provide reasonable replacement rates. Furthermore, it has implications for future income equality. Instead of continuing on this course, the government, in cooperation with municipalities, should invest financial resources into partnership programs with private investors for long-term employment initiatives that would help train these people for work with new technologies and integrate them back into the real, unsubsidized labor market.
Reduce Management Fees

Although the median level of total administrative fees in funded systems around the world ranged from 0.16 percent to 0.70 percent of total assets under management in 2011 (Rudolph, 2012), rates were significantly higher in Latvia, varying from 1.5 percent to 1.75 percent. The SSIA also charged each second-pillar participant an additional 0.76 percent on second-pillar assets to cover its administrative costs.

To diminish pension plans’ oligopoly incentives and to increase competition among pension plan managers, current management fees should be replaced by flat rates on contributions collected with performance-based fees on yields earned. Performance-based fees could be supplemented by capped fees, not exceeding 0.5 percent of contributions, to cover portfolio and account management costs.

Improve Financial Literacy

Financial literacy in the population can be closely linked to pension planning. A simple methodology is used in a number of countries to discover the population’s level of financial literacy. This methodology shows that only half of Americans ages 50 and older are able to answer simple questions about inflation and other basic financial concepts, and that only one-third have ever tried to develop a personal savings plan (Lusardi and Mitchell, 2009). Within this one-third, only two-thirds are able to properly manage and supervise their developed investment plans. The researchers prove that people who display high financial literacy are able to develop a pension plan and adhere to it better that those who do not. These findings are strengthened by research conducted in Germany (Bucher-Koenen and Lusardi, 2011) that confirms the positive impact of financial knowledge on pension planning using a similar but more complex methodology. Another stream of research finds that deliberate financial education has a larger positive effect on participation and savings rates than merely publishing information about existing savings and pension programs (Bernheim and Garrett, 1996). Unfortunately, Latvia’s financial literacy is still a largely unexplored topic; however, some indirect evidence shows that, on the whole, Latvians severely lack knowledge of available pension options and the ability to assess them to make an educated choice.

Latvia’s second-pillar pension system is administered by the SSIA. The only instrument of communication with citizens is the website providing information about available pension funds and pension plans, and their historical and latest returns (updated daily). These sites also allow users to download their individual pension statements. However, real-life evidence shows that the majority of Latvians are still ignorant about their pension options. The attitude of second-pillar participants toward the future wealth that had accumulated in their state-funded pension schemes shows that the majority do not believe that the government will be able to provide them with an adequate pension and that only today’s earnings matter. The 25–45-year-old age group in 2011 would be the first generation
whose pensions would mostly depend on second- and third-pillar savings; therefore, providing these individuals with sufficient information about investment opportunities and related risks is crucial. Because Latvian pension funds’ assets were severely hit by the global financial crisis, people started paying more attention to their investment behavior; however, without more active state support, via information campaigns, it will be much more difficult to ensure the adequacy of retirement income.

Ultimately, the pension reforms initiated in Latvia during the past decade were relatively successful and helped the country address its demographic issues. But experience from other countries indicates that without a sufficient level of financial literacy, people tend to over-rely on the government and do not consider long-term financial saving to be a means of ensuring retirement income. Moreover, the population exhibits significant differences in general attitudes toward money and financial information as well as in their willingness to plan for retirement. Therefore, future pension reforms should increase the general level of financial literacy and familiarity with, as well as attitude toward, the pension system and the importance of future personal long-term retirement savings.

**CONCLUSION**

In response to growing demographic risks from low fertility, increasing life expectancy, and emigration of the working-age population, and the shortening of the employment service period, Latvia successfully introduced its new pension system, which established good preconditions for mitigating these risks.

The financial crisis indicated that the new Latvian pension system was not properly designed to protect funded assets against real economic risks such as long-term unemployment and low rates of return.

Regardless of high participation rates in second-pillar pension schemes when they were introduced (attributable to positive government campaigns and high returns in global capital markets), people’s reliance on the new system significantly dropped after the global financial crisis. The financial crisis led to the decision to decrease second-pillar contribution rates and to divert those contributions toward addressing current fiscal deficits. The rapid decrease of the value of funded pension assets caused by double-digit negative returns on investment also played a part in citizens’ reactions to the pension scheme.

Legislative restrictions and insufficient international diversification of second-pillar funded assets caused Latvia—in comparison with Lithuania and Estonia—to be the most conservative and least competitive of pension systems. Its severely restricted geographical allocation of funded pension assets outside of its national economy and its investment of these assets in the national economy in mostly low-risk investment instruments such as term deposits and government bonds are leading to its very low returns. This chapter argues that the government has to revisit legislation on investment restrictions and encourage long-term investment in the national economy. The prospects and consequences of such investment...
policies would ensure long-term, low-risk, sustainable market returns of 4–6 percent on contributions in the second and third pillars. These investment policies would lead to the retention of local capital to be primarily invested into the national economy thus increasing national yield. It would also have a multiplier effect by generating new jobs to resolve long-lasting, double-digit unemployment rates; developing supporting industries; and enhancing tax collection for the state and for special social budgets (first pillar). At the same time, to protect such returns it is also important to develop a legal framework and reasonable financial instruments—such as project bonds issued by the government and supervised special purpose vehicles—to guarantee adequate yields within the life cycle of the project as well as return of principal at the maturity of the bond.

REFERENCES


