

DEVELOPMENT OF LATVIAN PENSION SYSTEM IN CHANGING ECONOMIC ENVIRONMENT

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Abstract

Latvia, like any European country, is facing challenges in pension system organization due to the population age structure. In the 1990s, during the reform of the social sector, Latvia introduced a three-level pension system aimed at reducing the effect of demographic risks and demonstrating the country's intention to provide a viable public and private combination in old-age provision. The potential impact of demographic change on the age structure and size of the population is dramatic and the main problem is the ability of pension schemes to provide retirement incomes which fully correspond with previous employment income without reducing quality of life. Thus, personal investments in retirement income schemes are also important.

The aim of this research is to investigate what the possible solutions are for developing the existing pension system in Latvia and incentives for personal investment to ensure provision of an appropriate retirement income level.

The paper addresses the efficiency of the Latvian private pension system. The current situation is described, the efficiency of private voluntary pension schemes is estimated taking into account the Latvian demographical situation with a flow of emigration, and the impact of existing tax incentives for employees is analysed.

Qualitative methods (statistical data analysis, forecasting and other financial calculations) are used for theoretical comparison and analysis of pension systems. Interviews with experts and personal observations are used to reveal the problems in the current pension system of Latvia.

Recommendations for possible incentives for development of private pension investments are made. Also, conclusions on possible development directions are drawn.

Keywords: pension system, private voluntary pension scheme, solidarity principle, full-fledged social security, taxation of pensions

Research paper

1. INTRODUCTION

Modern economic development trends require a change of views on the sustainability of pension systems and the prospect of their future development directions. Changes in the economic environment and the impact of the demographical structure of the population lead to changes in how pension systems function. Technological progress and an increase in quality of life also cause life expectancy to increase, and changes in the relationship between the number of employees and the number of recipients of old age pensions will occur. Productivity in the sector of the "real economy" will rise and that will cause economic structural changes and changes in labour demand. The Latvian pension system has always

been an object of research since it was established after the reform in the 1990s. Initially, the aim of the pension system reform was to restructure the existing pension system according to the present social-economic system in Latvia to meet the requirements of the market economy and, consequently, it was not able to function in the new situation. Three pension levels have been introduced in the country. In analysing the social security system some authors (Kozlovskis and Bistrova, 2015) concentrate on the first (state pension) and second (state-funded pension) levels. Others, such as Rajevska (2013), analyse comparative aspects of funded pension schemes. This paper addresses the efficiency of the Latvian pension system focusing on the third (voluntary private pension) system.

2. PENSION SYSTEM DEFINITION AND THE LATVIAN PENSION SYSTEM

In creating a social policy system, it is essential to meet the present generation's social and economic needs without compromising future generations. Without such an approach, sustainable development of society cannot take place and quality of life would decrease. The main assumptions for social policy are budgetary constraints (fiscal policy requirements), protection of taxpayer rights and interests (tax policy requirements) and social protection and poverty reduction requirements. A serious challenge is the aging population, which is of increasing concern. The main question is whether society will be able to provide a dignified existence and an active social life at retirement age. Currently pension systems are a subject of lively debate among professionals and society. The previous pension system in Latvia did not meet the needs of the market economy and consequently, it was not able to function in the market economy conditions and current demographic situation. According to previous system reform, the size of the pension did not depend on the amount of payment made; rather, the amount of the pension depended on average salary and length of service. Such a situation did not stimulate employees to make tax payments because the pension was ensured even in cases when tax payments were made according to the minimum wage set by the country's legislation. Thus, risks regarding pension system sustainability in the future were present. The main task was to set up a financially sustainable system to reduce the risks involved with a rapidly aging population. (Mavlutova & Titova, 2014)

The word *pension* derives from the mediaeval English term *pension* (payment), which in turn derives from *pensio*, *pension*, *pensus*, *pendere* (consideration, to consider, payment, to pay) in Latin. The following definition of the term *pension* is found in the Britannica Concise Encyclopaedia: "a pension is a regular payment to a person retired from work in case of disablement due to age, physical disability or expiration of fixed term service" (*Britannica Concise Encyclopaedia*, 2006). The payment period usually continues till the end of the natural life of the retiree, and sometimes the payments are extended and assigned to the widows/widowers of the retirees after their death. The Oxford Dictionary (2012) explains the term "pension" as a regular payment made to retired persons (or older) or to physically handicapped persons, or to widows. The Statistical Bureau of European Communities defines the term "pension" as periodical payments with the aim of maintaining the receiver's income after retirement when paid employment at the normal pension age ceases or to back the income of elderly people (European Parliament's Employment and Social Affairs, 2010). The Organization for Economic Cooperation and Development (2003) defines pensions as payments made to the participants of the pension fund (or to the dependent person) after retirement age.

The following definition of old-age pension was suggested in Latvia: an old-age pension is a constant and regular income for members of society approaching an age determined within laws and regulations which provides social funding of full value in the long term in accordance with the length of service and social insurance payments made in advance (Volskis, 2011). The authors agree with Holzmann et al. (2008) and Rajevska (2016) that a successful pension system is an equitable system, one that provides income redistribution from the lifetime rich to the lifetime poor consistent with societal preferences in a way that does not tax the rest of society external to the system, and one that provides the same benefit for the same contribution.

In evaluating the explanations above, the authors believe that a pension is a periodical benefit (payment) with the aim of maintaining income after retirement or ensuring that, at the age and physical state determined within laws and regulations, persons incapable of working receive the incomes necessary to maintain minimum living standards.

There are three main objectives lying at the basis of an old-age pension system:

- The principle of solidarity;
- The principle of justice;

- The voluntarily principle.

Globally there are four main drivers of pension reforms:

1. Aging – increasing life expectancy and declining birth rates.
2. Availability – providing for those who are unable to invest in and maintain a sufficient level, for several decades after retirement
3. Substitutability – standard of living comparable to the one maintained during working years.
4. Labour force participation – must pay interest, so as not to tend toward retiring earlier and avoiding payment of pensions.

The existing pension system is organized so that residents can participate in providing for their own old age. The core principal of the pension system is the following: the higher the social insurance instalments deposited at the present moment, the higher the pension received in the future.

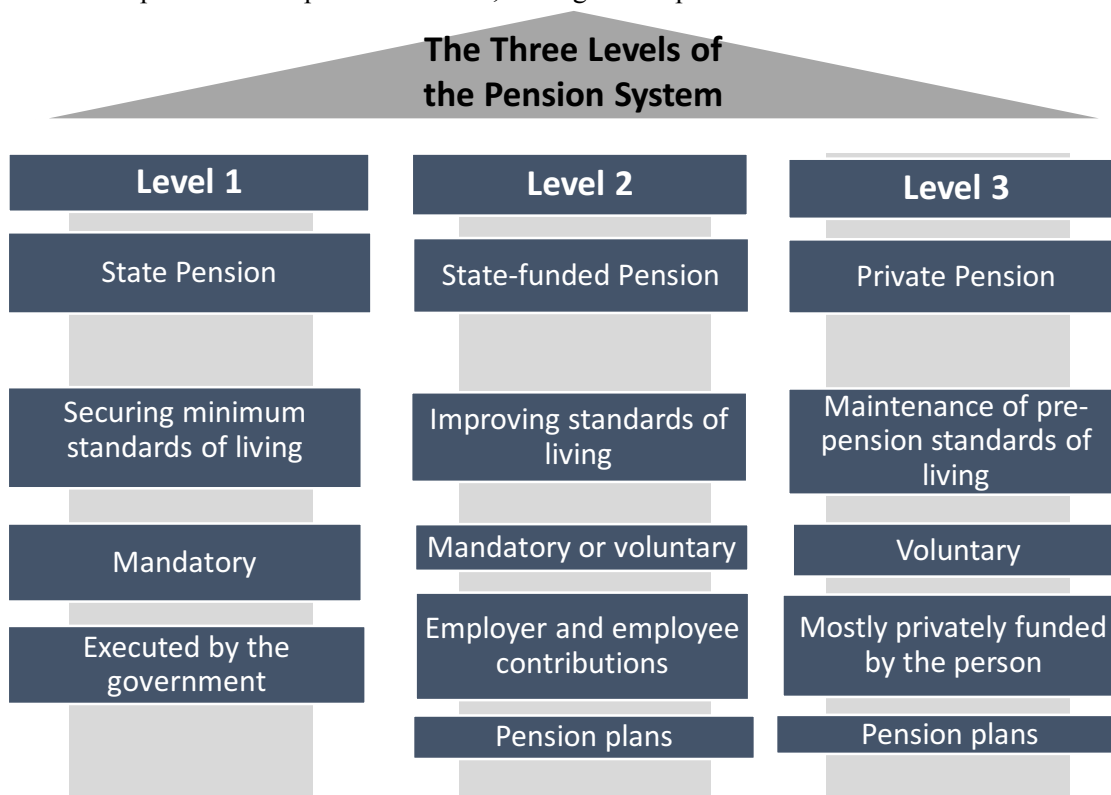


Figure 1. The Structure of the Latvian Pension System

Source: compiled by the authors

The aim of the state-implemented pension reform is to create a financially stable and efficient pension scheme that is based on individual social security contributions which in turn will ensure an amount of pension that depends on the contributions made over the previous period and that will facilitate social security contribution growth.

The reform envisages the introduction of a three-level pension system as shown in Figure 1, thus improving the financial position of elderly people and division of risk between the state (future taxpayers) and a person's savings in compulsory and voluntary pension schemes.

With regard to financing, two different kinds of pension system should be mentioned:

- Defined Benefit (DB) – a pension system which guarantees pension payments of a definite volume, not taking into account mandatory or voluntary social insurance contributions.
- Defined Contribution (DC) – a pension system at the basis of which lie pension contributions directly dependent on the mandatory or voluntary social insurance contributions paid into personal pension accounts.

The principles of these two pension systems (DB and DC) are implemented in the Latvian pension

system. Based on the justice principle, pension contributions in Latvia are directly dependent not only on mandatory and voluntary social insurance contributions, but also on the length of service and on the profitability level of the chosen funded pension plan. Alongside mandatory social insurance contributions, every person has the possibility to enlarge his/her personal pension fund by paying a voluntary contribution into private pension funds.

Pension Level 1 was introduced in 1996. It includes principles of equal treatment regardless of generation and gender. According to the European Pay-as-you-go System (PAYG), it is a type of pension which is subjected to huge demographical risks. PAYG envisages current retirees being paid from the contributions of today's working population. It is believed that such a system reduces the savings amount, because the working population is not interested in making additional savings (Bode, 2003).

The main drawback of this system is its changeable ratio between the working population and retirees. As the number of working people decreases and the number of retirees increases, the tax revenue might not be sufficient to pay pensions. According to research carried out by Deutsche Bank and AEGON Global, the envisaged reforms were meant to reduce this risk. Such reforms were carried out in the United States and Western Europe; further, they were introduced in Central Europe as well as Eastern Europe (Life in European Union, 2012). The reforms are being introduced in Asian countries as well.

According to the existing legislation in Latvia, a specific pre-pension and pension age has been determined in order to provide pensions based on age. Raising the pension age has been one of the tools implemented to reduce the problem of aging. As of January 2014, when the existing pension age was 62 years, 3 months have been added per year; thus, by January 2025 the pension age will be 65 years. So, starting from January 2025 a person will receive an old-age pension if his/her insurance standing is of at least 20 years. (Law On State Pension, 1996). The Law on the State Pension also describes specific cases where a person has the right to receive an old-age pension prematurely; it is possible 2 years in advance of the legal pension age.

Pension Level 3, that is, a private voluntary pension scheme, was introduced in 1998. Pension Level 3 envisages a free choice for every individual to set up additional accruals for their pension by making contributions into private pension funds. (Law On Private Pension Funds, 1998)

Pension Level 2 was introduced in 2001. Since that period, a part of social security contributions that have been made have been invested in financial markets and pension accruals have been made in each Pension Level 2 personal account.

Taking into account the information above, the main success of pension system reform in Latvia is creating Pension Level 2, which is compulsory for the majority of the population; it also helps to reduce the effect of demographic risk on pension. However, this pension level is subjected to many other risks, which the population of Latvia must take into account when deciding on the appropriate pension fund. (Law On State Pension, 1996)

In accordance with The Law on the State-funded Pension (2001), each individual has the right to choose how to organize the payment of his/her funded pension capital. The need for the pension reform was the result of a steadily increasing aging population, which has made it difficult to keep the current retirement age. Life expectancy has been increasing gradually. As a result, every year we see a growth in costs for pensions from the social security budget.

The task of the pension system is to increase the compensation level under the condition that the person takes part in all three pension levels at the same time. Additional *accruals* to their pensions are formed in Pension Level 2 from their personal savings registered in pension capital which in turn is invested in stocks, bonds and other securities as well as bank deposits. Investment is carried out by an intermediary – a licensed wealth manager. Thus, pension capital accrues much faster than inflation and the average salary in the country. (State Social Insurance Agency, 2015). Nowadays Pension Level 2 participants can choose their own wealth manager, either state or private, and change investment plans twice a year. The authors agree with Garon, J. D. (2016) and Diamond (1994) that publicly managed pension plans are subject to political risks. Even benevolent governments may be tempted to engage in excess redistribution among retirees using pension wealth. Because of this, some have argued that funding and privatizing public pensions could reduce political risks.

From 2009 to 2013, pension contributions were transferred to Pension Level 1 in the amount of 18%, while contributions made to Level 2 were just 2%. At present, Pension Level 1 will receive 14% of

social contributions, while Level 2 will receive 6%. Such an allocation change, made in 2009, was not conducive to confidence in the pension system (State pension special budget, 2016).

Initially the aim of Pension Level 2 was not only to increase pension capital, ensuring full-value pensions in the future, but to facilitate the development of the national economy. There are seven private pension funds in Latvia now, which offer 20 different pension plans an individual can invest in.

Investment has been carried out according to two strategies:

- Active pension plans – the strategy of investing entities. A large part of assets is invested into shares and other securities. Such pension plans were chosen by 54.52% of representatives;
- Integrated pension plans envisage the investment of assets into secure state, local authority and commercial association securities and term deposits of credit institutions, which ensures stability of income. Such pension plans were chosen by 45.48% of individuals.

In 2015 the contributions of pension plan representatives reached 12.7 mln EUR. The average private pension capital yield of one individual rose by 6% or by 67 EUR and has reached 1262 EUR. The average age of the individuals was 46 years. (The Association of Commercial Banks of Latvia, 2015)

Currently the money is invested in short-term deposit savings where its profitability is much lower than inflation, so the money loses its value. Bonds accumulate money for the state budget which goes to consumption but not into state investments in the long term. Part of the money is invested in shares or other securities. Generally, the profitability of private pension plans is quite attractive (see Table 1).

Table 1

Yields of Level 2 private pension plans (%)

Plans	1 year	3 years	5 years	10 years
Balanced pension plans	4.91%	5.32%	4.40%	4.19%
Active pension plans	6.62%	7.33%	4.97%	3.40%
Average profitability of all pension plans	5.33%	6.00%	4.83%	4.04%

Source: The Association of Commercial Banks of Latvia, 2015

The growing importance of participation in Pension Level 3 schemes is the main reason why the authors chose to analyse Pension Level 3 funds in Latvia. The money that the individual regularly pays into the fund is invested in various financial instruments depending on the chosen investment strategy. The aim of private funds is not only to save the money for retirement but also to gain additional value. The state grants various tax incentives for both companies where employee contributions are made in favour of Pension Level 3 funds and individuals who are themselves engaged in such contributions. Pension Level 3 contributions to the pension fund which do not exceed 10% of gross salary are not subject to income tax.

In private pension schemes participants with private pension funds accumulate and invest in their own voluntarily made cash contributions, thus providing additional pension capital. Pension plan members can participate in the pension plan both directly and through their employers.

From the age of 55, its members may receive the entire accumulated capital or continue membership and receive funds in instalments. Accumulated capital is private property, regardless of who paid the contributions, and is subject to the law of succession. Currently there are two types of Pension Level 3 private funds in Latvia:

- closed-end pension funds, which are intended only for employees and which have been established by their company (employees' involvement is the initiative of the employer);
- open pension funds, in which any person may become a member, either directly or through his/her employer, and which involve a specially licensed bank or a life insurance company.

There are six Pension Level 3 funds currently operating in Latvia: five open (subsidiaries of Latvian banks) and one closed pension fund. In total, Pension Level 3 pension funds offer 14 pension plans.

Table 2

Net assets and number of participants in Latvian private pension funds		
Date	Net assets, in thousands of EUR	Number of participants
31.12.2009	94536	189499
31.12.2010	111928	191307
31.12.2011	119474	198575
31.12.2012	142423	207523
31.12.2013	235693	220646
31.12.2014	280784	236084
31.12.2015	305855	330416

Source: Financial and Capital Market Commission, 2015

Pension Level 3 private pension plans had accumulated more than 300 mln EUR in 2015; since the end of 2009, the figure has tripled. The number of participants in private pension plans is gradually increasing (see Table 2).

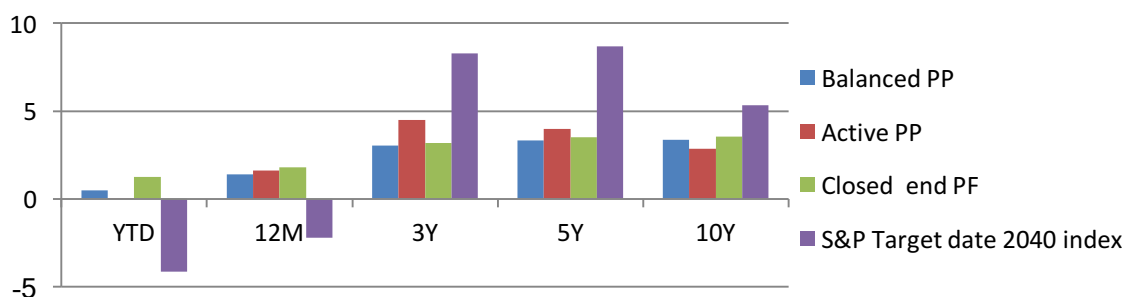


Figure 2. Pension Level 3 fund yields (%)

Source: compiled by the authors

As shown in Figure 2, Pension Level 3 funds have been able to provide stable long-term capital gains to their investors, providing up to a 3.5% annual yield on the investment after deduction of commissions for the ten-year period.

Through looking at the Latvian pension fund managers' submission, the authors conclude that Latvian pension fund managers' investment strategy can be seen as conservative – 88% of the investment portfolio consists of investments in debt securities and investment funds, and 10% of the portfolio is a deposit with commercial banks (see Figure 3). Those investment strategies provide lower investment volatility, but the long-term performance is far below global market averages.

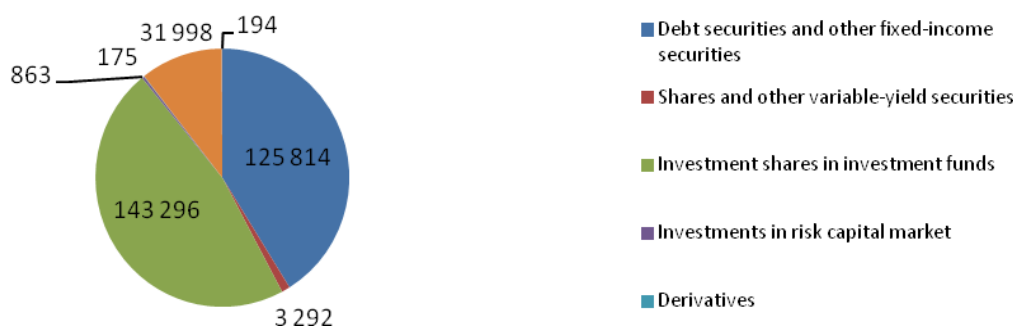


Figure 3. Level 3 Pension plan net assets on 30.06.2015 (in thousands of EUR).

Source: Financial and Capital Market Commission, 2015

The amount of money accumulated in pension funds is growing rapidly and investment option problems are becoming more acute. Therefore, Latvia has no other option but to build a competitive financial market that is attractive to pension fund managers, unless it wants to cause this significantly

increasing, capital guaranteed maximum to stay in the country. A ban on investing in other countries is not possible, because it would violate fundamental principles of free movement of capital within the EU market.

Some financial instruments in Latvia are quite attractive to local pension fund managers; however, the range is very limited. The Latvian financial market can be seen as quite small and illiquid.

Unfortunately, local capital market development requires political will, which is still missing. Politicians are averse to abandoning or at least to reducing the state share in large enterprises, just as they are averse to making important decisions that could reflect favourably on the financial sector. The authors look at these attempts as a willingness to make cosmetic improvements in the situation, which does not solve the problem in the long term.

3. POLICY AND ECONOMIC ENVIRONMENT OF THE PENSION SYSTEM

The OECD (2011) prepared an overview of tax treatment of pensions and pensioners. The key results are as follows: “The personal tax system plays an important role in old-age support. Pensioners often do not pay social security contributions. Personal income taxes are progressive and pension entitlements are usually lower than earnings before retirement, so the average tax rate on pension income is typically less than the tax rate on earned income. In addition, most income tax systems give preferential treatment either to pension incomes or to pensioners, by giving additional allowances or credits to older people.” Specifically, the following basic concepts (principles) of tax treatment for occupational schemes are currently used in the reference countries (Hughes, 2001):

- The EET principle (exempt contributions, exempt investment income and capital gains of the pension institution, taxed benefits) is used by the vast majority of EU member states, including Latvia, as well as the United States, Canada, Switzerland, Norway, and others;
- The ETT principle (exempt contributions, taxed investment income and capital gains of the pension institution, taxed benefits) is applied by three EU member states (Denmark, Italy, Sweden);
- The TTE principle (taxed contributions, taxed investment income and capital gains of the pension institution, exempt benefits) is used by New Zealand;
- The TET principle is applied in Iceland and Japan.

The authors agree with the conclusion of Vostatek, J. (2014) that different approaches to taxing public pensions and to social security contributions can be explained by differences in emphasis on various social models in different countries and by inconsistencies in the implementation of social and fiscal reforms. Increases in the retirement age, reductions of substitutability and increases in social taxes (or other payments, such as pension funds) can be observed around the world. It can be concluded that tax practice and theory is not uniform in its approach to the taxation of personal pensions. Modern tax policy has a tendency to stimulate significant retirement savings and ignore the fiscal costs associated with this. However, in a changing economic environment the EET principle seems to be insufficient for stimulating investments in private pension schemes. EU indirect tax policy also rejects taxation of personal pensions and other financial services by VAT on the basis of an alleged technical problem with the taxing of the margin.

Taxation and subsidization of pensions in Latvia and the EU require fundamental reform. The state grants various tax incentives for both companies where employee contributions are made in favour of third-pillar pension funds and individuals who are themselves engaged in such contributions. Third-pillar pension contributions to the pension fund which do not exceed 10% of gross salary are not subject to income tax. However, a decrease in mandatory social insurance contributions should be considered to ensure the motivation of employees for the third pension level. Currently the government of Latvia is highlighting that everyone needs to start thinking about their pensions themselves. This is being done during a time of disadvantage; in the period of the economic boom, when everyone had high incomes, no one spoke about it. Today, when the situation with the government budget is negative, people have started thinking about it. They do not understand and think that it is not fair to give a lot of their income to pensioners now, and at the same time they need to save money for themselves. Also, it is important to reduce the shadow economy and ensure social contribution compliance by supporting honest entrepreneurs and creating favourable conditions for conversion to the official economy, and to continue transformation of the State Revenue Service into a client-oriented tax administration.

The problems that the Latvian economy is facing today and will face over the next ten or twenty years, such as migration, low birth rates, the aging of society and changes in the national economy and the economy in general as a result of the crisis, lead to the fact that the burden on the social *security* budget will keep growing.

Economists claim that such a ratio, in which there are so few employees and so many dependants, especially pensioners, cannot be sustained in the long term. Latvia, like the entire EU, is undergoing significant demographic changes, and this process influences structural changes in the number of inhabitants. There will be slower economic growth in Latvia as a result of internal and external factors.

It is necessary to consider migration issue (immigration and emigration) policy seriously, so that it contributes to a qualified workforce and enhances economic growth. The government should develop a broad return-migration programme for Latvian citizens, including integration into the labour market and training and social inclusion measures.

The Latvian economic situation has been improving over the last 5 years, as shown by the main development indicators (see Table 3). Given global economic trends, the weak economic growth in the EU, and the recession in emerging markets, Latvian economic growth has slowed down in the last 2 years. But rather optimistic economic growth rates do not reflect the situation in terms of pensions and the authors conclude that the quality of life for older people will decrease in light of future demographic trends. This is why everyone should start thinking about their pensions now.

Table 3

Key indicators of economic development in Latvia, 2011-2015					
	2011	2012	2013	2014	2015
(Growth, in comparison with the previous year, %)					
Gross domestic product	5.0	4.8	4.2	2.3	2.7
Private consumption	2.9	3.0	6.2	2.6	3.3
Public consumption	3.1	0.4	2.8	3.1	3.1
Formation of total equity capital	24.2	14.5	-5.2	0.1	2.6
Exports	12.0	9.8	1.5	1.7	1.0
Imports	22.0	5.4	0.3	0.3	1.6
Consumer prices	4.4	2.3	0.0	0.6	0.2
(% of GDP, unless indicated otherwise)					
General government sector balance	-3.4	-0.8	-0.9	-1.4	-1.4
General government debt	42.7	40.9	38.2	40.0	33.9
Changes in the number of employed persons	1.3	1.6	2.1	-1.1	1.7
Unemployment rate	16.2	15.0	11.9	10.9	9.9

Source: The National Economy of Latvia Macroeconomic Review, 2016

Since the previous population census carried out in 2000, the size of the population has decreased and in 2015 it constituted 1,986,096 inhabitants. The decrease in population has been due to natural population movement (the death rate increased the birth rate) and international migration.

The negative changes in structure and the number of the inhabitants are explained by the low birth rate and comparatively high death rate per 1000 inhabitants of Latvia. During the last seven years the situation has not improved. Every year a negative natural increase is created and this means that the death rate is higher than the birth rate.

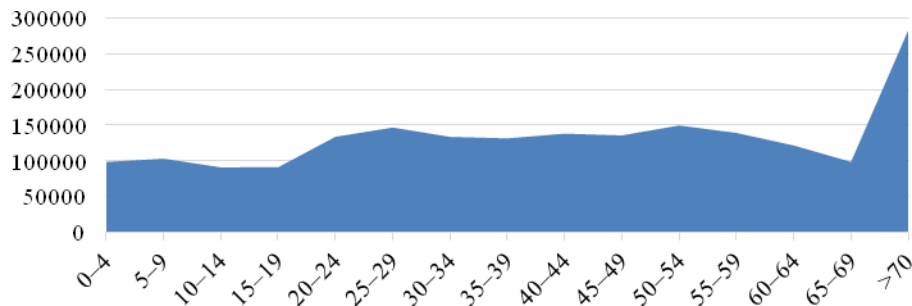


Figure 4. The age structure of the inhabitants of Latvia (2014) Source: CSB, 2015

In studying the age structure of the inhabitants of Latvia in 2014 (see Figure 4), the authors have come to the conclusion that the number of children up to age 15 is considerably lower than the number of people who have reached employment age in Latvia. This means that the demographic situation in Latvia has been worsening over the last few years and thus, the demographic load has been increasing.

The generation that in 5-10 years could be economically active citizens and become taxpayers is very small in number. Demographers of Latvia point out the unwillingness or inability of the government to tackle the problem. Latvia has a favourable geographical location, so it will not remain empty; this is why the flow of immigrants could be the only way out of the situation for future pensioners. It is obvious that the government is not capable of solving this problem.

Most leading Baltic bank experts admit that the habit of saving for the future is more developed in Lithuania and Estonia. Lithuania is traditionally regarded as a nation of savers. 39% of the inhabitants make investments for their future. But Estonians have a greater possibility to save because the level of income is higher than in the other Baltic countries. 27% of the respondents are saving for old age, while in Latvia only 18% are doing so. This means that the ostrich policy is used or people rely on different alternatives which might add income to their pensions – continuing work after reaching retirement age or relying on their children's or other relatives' support. But it cannot guarantee an adequate income level in retirement.

The average monthly old-age pension in Latvia was 259 EUR in 2013, which, in comparison to the average pension benefit in 2009, rose by 26.7 EUR (10%), and it constituted 273.4 EUR in 2015; in turn, in 2015 average gross wages and salaries increased by 6.9%, reaching 818 EUR. The distribution of all pension benefits hardly changed in the period of 2009-2012 due to the fact that pensions were not indexed. Inhabitants with a length of service of less than 10 years were insured with the state social security allowance. The state social security allowance is guaranteed at 64.03 EUR.

There is a tendency across almost all European Union countries for the benefit ratio, which shows the ratio between the average gross public pension benefits and the average gross salary, to decrease. (Eichhorst *et al.*, 2011) This is especially important for Latvia, which already has the lowest benefit ratio of all the countries, and it is predicted to become even smaller. These ratio tendencies show that in the future, supplementary pensions – for example, private pension funds – will become even more important in order to maintain a high life quality.

According to the current pension system and due to the demographic situation, the working people of today will receive lower pensions. This problem remains because the current demographic situation means that the number of retirees will grow, while the number of working people and taxpayers will continue to decrease. The pension system in Latvia has been formed in accordance with the principles of the classical finance pyramid. It works well when the number of new participants grows, that is, the number of taxpayers increases and the country experiences significant economic growth.

Pension reforms are needed in every country in order to reduce risks; however, they are carried out taking into account different conditions and limitations which are affected by demographic situations. Germany and Southern Europe – namely Italy, Portugal and Spain – are affected by the most severe demographic problems. As for the UK and France, this problem does not have such an impact on the population due to the higher birth rate (Borsch-Supan *et al.*, 2005). In the case of Latvia, the demographic situation is extremely important. Not only is the ratio between the birth rate and death rate negative, as mentioned above, so-called “envelope salaries”, unemployment and migration to other countries also influence the pension system as the revenue from taxes decreases, so that less contributions to the

pension fund are made. As a result, the state is forced to raise taxes, which slows down economic development.

Financial literacy and personal planning is a subject which has not gained much popularity in Latvia. Sociological research carried out by the Financial and Capital Market Commission in cooperation with the investigation centre SKDS on the financial literacy of inhabitants of Latvia revealed the participation level of inhabitants in using financial services. According to FCMC chief Kristaps Zakulis (2014), knowledge and activities related to various financial questions have also been clarified.

Pensioners who retired during the last two years and who had received a so-called “envelope” salary confess that they have felt a significant decrease in their income. If we compare the pre-pension income to the pension volume, the average drop in income constitutes 52%. This means that these retired persons have to live on a small income; accordingly, every fifth inhabitant of Latvia supports financially elderly relatives by allocating 138 EUR monthly. If the illegal economy does not decrease, given an ageing population and lack of long-term savings of a proper volume, in the future, the state budget might experience significant pressure. (Sauka & Putnins, 2015).

4. CONCLUSIONS

The level of Latvian economic efficiency is falling behind the average efficiency level in the EU significantly. The current model of economic development is characterised by low added value. The economic development of Latvia must be geared toward a high value-added and science and knowledge-based economic model.

In order to reduce the impact of increasing labour costs on the competitiveness of Latvian manufacturers, it is necessary to improve the competitiveness of the tax system. Fundamental reform of taxation of pension schemes should be considered so that an increase in private investment ensures sustainable development of the pension system.

It is necessary to increase the contributions to Pension Level 2 gradually. Pension Level 2 savings should be invested in more profitable financial instruments in Latvia and other countries.

It is necessary to ensure tax policy reform in the field of pension contributions in Latvia and the EU requires a fundamental reform. Re-estimation of contribution rates with revision of tax incentives for both employers whose employee contributions are made in favour of third-pillar pension funds and individuals who are themselves engaged in such contributions should be considered.

The Latvian government should encourage Latvian securities market development in order to stimulate the Latvian population's pension saving investment in the Latvian economy. This could be achieved by raising capital (equity and borrowed) of state-owned enterprises through the local securities market. Its small size and lack of choice for investors are the main reasons for the underdeveloped securities market.

The government, in collaboration with the Financial and Capital Market Commission, should carry out an information campaign about benefits, opportunities for investments and Pension Level 3's future role. The social tax should be decreased gradually by motivating people to apply for Pension Level 3. An accumulation system should be introduced when working people make contributions to private pension funds and later receive a pension from these savings.

Closed pension funds for employees of state structures and companies with state capital should be opened in order to promote this activity.

As regards the gradual increase in pension age, it is necessary to facilitate the system and availability of health care. This would enable pensioners to take care of their health and work effectively. It would include the necessity of having mandatory state-funded health checks every year.

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