

Sustainability of Pension Systems in the Baltic States

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ABSTRACT

Objective: The objective of the paper is to identify how the concept of sustainability is understood and ensured in the pension systems of Estonia, Latvia and Lithuania; and what implications it brings to the performance of pension schemes.

Research Design & Methods: Analysis of various conceptual and methodological approaches to the notion of sustainability of pension systems. Comparative analysis of present pension legislation, as well as preceding stage of pension reforms, accompanied by a number of numerical models.

Findings: The understanding of sustainability is limited by narrow 'fiscal' meaning in Latvia, compared to more a multifaceted concept that includes the principle of social fairness and which can be traced in the logic of Estonian and Lithuanian legislators.

Implications & Recommendations: In the long-term, pure financial appreciation of sustainability is misleading, low level of credibility may cripple a financially sound but socially unfair system; the perceived unfairness of redistribution can undermine the public support to, and, therefore, sustainability of pension systems.

Contribution & Value Added: The originality of this work lies in studying how differences at policy formulation stage and in the very design of pension schemes influence pension system sustainability in countries with a very similar initial conditions and socio-economic environment.

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INTRODUCTION

The notion of sustainability has many dimensions and many aspects. Firstly, this term emerged in environmental sciences, but quite soon this approach was caught up by scholars in other fields, as well as by politicians, and now can be addressed to economic sectors and individual enterprises, ecosystems, countries, lifestyles, etc. When this “yardstick” is applied to social insurance, particularly, to public pensions provision, it is worth comparing interpretations of the term purported by different actors. Since 2001, the provision of adequate, safe and sustainable pensions is a confirmed common objective at EU level. Generally, the main challenge pension systems sustainability is seen in the ageing of modern European societies and increasing burdens on public finances undermining fiscal sustainability (EC, 2010). However, social practices in the area of social security, or social sustainability (Rasnaca & Niklass, 2014, p. 13) are less commonly considered as a risk factor to a pension system.

We would like to consider how the concept of sustainability is understood and, consequently, ensured in the pension systems of the Baltic States. These countries have very much in common historically; they inherited the same social security systems from the former Soviet Union and underwent concurrent reforms in 1990s. In the middle of 1990s countries in transition were under the influence of a three-pillar model of pension systems propagated by the World Bank (World Bank, 1994). Therefore the general structure of reformed Latvian, Lithuanian and Estonian systems is practically the same and includes:

1. mandatory public pay-as-you-go pillar;
2. mandatory private funded pillar (voluntary in the case of Lithuania, but the vast majority of the working-age population are participating); and
3. voluntary private pension funds.

Funded pillars function similarly, with some minor variations in secondary elements of their design, and their sustainability depends mainly on the overall ability of financial markets to cope with the global challenges that the world economy is and will be facing. Experts point out that “financial crisis in 2008 and 2009 and currently ongoing crisis in euro zone countries indicated that the pension systems in Baltic countries were not properly protected against the real economic risks, which were related to long term unemployment and decrease of return rates below inflation rates, for instruments such as term deposits and government bonds, which historically were considered no risk financial investments” (Bitinas & Maccioni, 2014, p. 17).

Among significant differences between the three Baltic States pension systems, public pension benefit formulas stand out. In order to trace the “roots” of those differences one has to look back into policy formulation stages. The aim of the paper is to identify how the concept of sustainability is understood and ensured in the pension systems of the three Baltic countries.

LITERATURE REVIEW

Policy Formulation: Pension Reforms in the Baltic States

Many authors have stressed linkages between the policy formation and implementation processes. Danish researcher Soren Winter (1990) has identified that successful implementation is likely to be positively related by the level of attention by the policy proponents in the policy formation process. Level of attention is affected by the length of the decision-making period, the number of participants, and the number of competing issues on the agenda. Attention to one particular policy is affected by the way policies are grouped into the reform packages. Therefore, limited attention tends to produce decisions where no direct relationship and internal consistency among policy formation, policy goals and designs, policy implementation can be expected (Winter, 1990, pp. 25-26).

Pension reform in Latvia was performed with the active participation and with the guidance of the World Bank experts, who, inter alia, recommended Latvian legislators to adopt a then innovated Swedish concept of notional defined contribution individual pension accounts. Swedish specialists played a leading role in designing the reform in Latvia, while Latvians almost fully relied upon their experience and competence. From the very beginning, the working pension reform preparation group consisted only of two experts from the Latvian Ministry of Welfare and three Swedish experts. Despite that, all political parties in the Saeima (Latvian Parliament) supported the principles of pension reform presented by the working group to the government and then to the legislature in the beginning of March 1995. As a result, the law has passed the parliament very fast (in November 1995), the debates were short and no wide audience participated in discussions (Vanovska, 2006). Dominating issues on public and policy agenda were connected with severe banking crisis in Latvia in the spring and summer 1995 and national elections in autumn 1995. Latvia was the first country in the world to launch the notional defined contributions (NDC) system in January 1996. Under this scheme, the entire state-provided pension is dependent on individual's contributions to his or her notional pension account. As noted by Katarine Muller (2006), "it also led to the adoption of transition rules for the new NDC system that were highly arbitrary and created many horizontal inequities among similarly situated persons."

In Lithuania, a more dominant role was played by the Lithuanian Free Market Institute (LFMI), an NGO supported by the Cato Institute, a libertarian think tank in Washington, D.C. which has long sought to dismantle social security in the US. Romas Lazutka (2006) describes how, through a series of critical newspaper articles in the mid-1990s, the LFMI planted the seeds of public discontent with the state pension system. These articles portrayed the Chilean pension system as ideal for Lithuania. As to other intra-government actors, the Lithuanian Ministry of Social Security and Labour initially showed the typical Bismarckian-Beveridgean stance, defending social security and opposing the move towards mandatory prefunding. As elsewhere, this Ministry proved too weak to prevent pension privatisation, however.

Estonians were more cautious; they did not use any external assistance, demonstrated a much stronger self-reliance, and organised broad public and political debates on the reform. The draft law (prepared in 1997) was discussed in tripartite negotiations among the

Cabinet, employers, and trade unions to allow for the different potentially affected interests to be integrated in the draft. Compared with Latvia and Sweden, the Estonian state-provided pension scheme financed from the social security tax, consists of three different layers: a minimum flat pension rate, a contribution-related share (calculated based on coefficients rather than on exact contributions), and a share dependent on the length of employment. A possibility of implementing NDC was considered but rejected. The policymakers specifically stated that the system was developed independently and did not copy any existing systems in other countries (Tavits, 2003, p. 647). Their current so called “point system” resembles German and French schemes, and was launched three years later, in 1999. We fully agree with the conclusion of researcher M. Tavits that “the Estonian reform process was open, driven by collaborative networks, and relied on local activism, whereas the Latvian reform process was closed and accommodated fewer interests” (Tavits, 2003, p. 649).

Sustainability: Conceptual and Methodological Approaches

Generally, international experts recognize that the study countries have managed to achieve a relatively high level of sustainability. For instance Allianz Global Investors research group are computing what they call a “Pension Sustainability Index” (PSI). Three such reports edited by Dr Renate Finke have been published: in 2009, 2011 and 2014. The authors of the PSI are awarding Latvia and Estonia with the best scores not only among Eastern Europe: Latvia takes the first place and Estonia the second one, then follows Russia (that would lose such high score should the very recent pension reform be taken into account by Allianz experts), and Lithuania takes the fourth place in the region, - but also compared to many developed countries – better than the United Kingdom, Canada, Finland Germany, Austria, France, Luxembourg and many others.

For the purpose of this article, the fundamental issue is not the high scoring, but the meaning of “sustainability” that the above experts are attributing: what factors are taken into account. In the methodology description Allianz provides the “overview of sub- indicators that would weight results positively:

- The national pension system has been designed to meet the needs of an aging society, e.g.:
 - the first pillar PAYG system offers moderate benefits and covers a large percentage of the workforce;
 - the legal retirement age is high and/or is linked to life expectancies;
 - funded pillars are in place to provide additional old-age income.
- National demographics do not put much pressure on reform, e.g.:
 - the old-age dependency ratio is favourable;
 - any changes in the work-to-retirement balance are expected to be moderate;
- The government is in a position to cushion reform pressures, e.g.:
 - public pension payments are low;
 - the state has deep pockets so that it can either take on more debt or increase the burden on the economy to finance rising pension payments.”

Another think tank of pension financial experts, Australian Centre for Financial Studies, starting from 2009, annually calculates another index: Melbourne Mercer Global Pension Index. The team of the researched includes professors from Oxford University, University of Toronto, University of Melbourne, and other institutions. This year it has been calculated for the 6th time, and covered 25 countries across the world (the Baltic States are not included in this short list). The overall index value for each country represents the weighted average of the three sub-indices. The weightings used are: 40% for the adequacy sub-index + 35% for the sustainability sub-index + 25% for the integrity sub-index. Each sub-index is based on a set of indicators. The sustainability sub-index considers a number of indicators that include: economic importance of the private pension system, its level of funding, the length of expected retirement both now and in the future, the labour force participation rate of the older population and the current level of government debt. Thus, one can find practically the same set of parameters as are used by Allianz Group.

These approaches are also similar to the one of the World Bank experts whose definition of sustainability of a pension system is the following: “a sustainable system is one that is financially sound and can be maintained over a foreseeable horizon under a broad set of reasonable assumptions” (Holzmann *et al.*, 2008).

The same logic can be found in the indicator of financial sustainability gap S2, devised by the European Commission’s Working Group on Ageing, with a focus on how population ageing contributes to the fiscal sustainability gap (Zaidi, 2010). The S2 indicator approximates the gap (as % of GDP) that must be closed permanently in order to ensure that governments will be able to finance all future public budget obligations. The indicator provides a compact measure to approximate the size of risks to public finance sustainability when a long-term perspective is taken. The S2 indicator can be decomposed into two components so as to also point to the sources of the risks and appropriate policy response required. Firstly, there is the gap arising due to the starting fiscal position, referred to as the Initial Budgetary Position. Secondly, there are the additional costs related to population ageing and expenditures on pensions, healthcare and long-term care. This component is referred to as the Long Term Changes. While Estonia demonstrated low values (lower than EU average), both Lithuania and Latvia were classified into the group of the countries with high sustainability gap, thus having higher risks of underfinancing future obligations.

Aaron George Grech of London School of Economics argues that “there appear to be four concerns in terms of ensuring pension system sustainability. From a political economy perspective, the adequacy of the system for the average voter needs to be ensured. If a system is not seen as beneficial by the electoral majority, namely by not helping them maintain their pre-retirement living standards, it could be voted out. Similarly, if a system is not seen as able to alleviate poverty, the political pressures that led to the setting up of social assistance to elderly people during the early part of the twentieth century might re-emerge. In the process of achieving these two goals, policymakers need, however, to take into consideration the balance of transfers between different generations. Political pressures for reform can arise either because systems are not achieving the goals that individuals expect of them or because individuals are unhappy about the deal they are getting compared to previous generations. Individuals can be concerned about the level of taxes they pay to finance the system, but also by the level of their pension transfers compared

to previous generations. Social sustainability can only be achieved if policymakers understand these tradeoffs and optimise pension systems in this light.” (Grech, 2010, p. 11) The aspect of adequacy will not be discussed in detail in this paper; those interested are invited to address the author’s article “Pensions Adequacy in the Baltic Region” (Rajevska, 2014). Here I would like to draw the reader’s attention to one more dimension, tangentially mentioned by Dr Grech. This dimension can be traced in other sources, as well.

Thus, according to OECD definition (OECD, 2009), “fiscal sustainability implies four main characteristics:

- solvency, or governments’ ability to finance existing and probable future liabilities/ obligations;
- growth, or the capacity of government to sustain economic growth over an extended period;
- *fairness, or governments’ ability to provide net financial benefits to future generations that are not less than the net benefits provided to current generations*; [emphasis added – O.R.] and
- stable taxes, or the capacity of governments to finance future obligations without increasing the tax burden.”

A similar, yet more multifaceted approach to pension’s sustainability can be found in EU documents (EC, 2010):

“Member States are committed to providing [...] the financial sustainability of public and private pension schemes, bearing in mind pressures on public finances and the ageing of populations, and in the context of the three-pronged strategy for tackling the budgetary implications of ageing, notably by: supporting longer working lives and active ageing; *by balancing contributions and benefits in an appropriate and socially fair manner*; [emphasis added – O.R.] and by promoting the affordability and the security of funded and private schemes; [...]”.

Krzysztof Hagemeyer and John Woodall (2014) note that the understanding of the “socially fair manner” is likely to differ significantly as between different societies, at different times, and in differing economic conditions:

“The designs and shapes of pension systems are usually the result of social contracts, which may be more or less explicit in character. Societies define their objectives through an ongoing debate around a following set of questions:

- What should “retirement” (as a status) represent: simply the condition of a person who is no longer able to work, or rather a well- deserved period of rest after working life?
- At what age or after how many years of a working career should retirement (as an event) typically take place?
- What level of benefits is seen as appropriate by the society as representing an adequate guarantee to its elderly members – should this comprise only the alleviation of poverty for those unable to support themselves, a (defined) minimum income for all residents in old-age, or a guaranteed level of replacement rates (as a proportion of pre-retirement income)?
- What is the desired degree of solidarity in financing the incomes of retired persons; should individuals save for themselves, should the younger generation(s) support the

elderly as a matter of principle; or should support be restricted to a minimal level for those unable to save enough for their own needs?" (Hagemeyer & Woodall, 2014).

For example, Latvian researches add the following criteria to the list of necessary conditions making Latvian pension sustainable: a) a substantial part of the retired persons' welfare will be depending on family support (Puķis & Dundure, 2012); and b) reversal of gender discrimination should be achieved (Dundure, 2013).

Furthermore, the EU documents stress that "the sustainability of PAYG pensions ultimately depends on the strength of the underlying economy, such as fewer people working and paying contributions, lower economic growth and depending also on institutional arrangements on national public debt" (EC, 2012b). Therefore, not only financial indicators should be looked at when assessing sustainability, but also (and even more important) other parameters of economic life: productivity, competitive ability, embeddedness into global chains, infrastructure, and many others.

MATERIAL AND METHODS

The analysed literature led to formulation of two research hypotheses:

1. Differences at policy formulation stage in the levels of involvement of foreign actors resulted in significant dissimilarities at implementation stage.
2. Different actors read different meanings in the notion of sustainability. A narrower, purely fiscal, or a broader, socially oriented interpretation of the term can be traced in the design and performance of pension schemes in three Baltic States.

In order to see what understanding of sustainability prevails among legislators of the study countries, the institutional designs of existing pension systems are analysed. Comprehensive descriptions of the status quo can be found in the most recent ASISP country reports on pensions, health and long-term care: for Estonia (Vork & Paat-Ahi, 2013), Latvia (Zilvere, 2013) and Lithuania (Medaiskis & Jankauskiene, 2013). Normative acts and regulations in force are obtained at the web-sites of state social insurance bodies: the Social Insurance Board of the Republic of Estonia (<http://www.sotsiaalkindlustusamet.ee>), the State Social Insurance Agency of the Republic of Latvia (<http://www.vsaa.gov.lv>) and the State Social Insurance Fund Board of the Republic of Lithuania (<http://www.sodra.lt>). All three institutions also provide statistical data on pensions.

RESULTS AND DISCUSSION

Pension Systems of the Baltic States – Current Status

The first-pillar benefit in Estonia and Lithuania comprises of two main components: a basic non-contributory one (in Estonia it is absolutely flat and presently – December, 2014 – equals to EUR 126.82, in Lithuania it depends on the length of service and lies in the interval from EUR 62.56 to EUR 125.11), and an insurance component, constructed quite similarly in the two countries and based on what is called a point-system. A person is annually awarded with a number of points that are equal to the ratio between his/her salary and nationwide average insured wage in the respective year (average insured wage differs from average wage, since the first takes into account those unemployed, on sick-leave, on maternity or child-care leave, etc.). Thus, if one's salary was equal to the average insured

wage – s/he gets one point, if it was twice higher than average – two points, if twice lower – 0.5 points, and so on. The points earned throughout the working career are then summarized, and the sum multiplied by the monetary value of one year. There is also the third component for the pre-reform service period (however, it is losing its importance as the years go by), and it is calculated likewise. In Estonia, all pre-reform years of service (i.e. those before 1 January 1999) have a value of one point, irrespectively of actual earnings. In Lithuania for each pre-reform year of service (i.e. those before 1 January 1994), a person gets as many points, as was his/her average ratio in post-reform working career (or as was his ratio in 1984-1993 if reliable wage data for this period is available).

Both the basic component and the monetary value of one year are from time to time revised and approved by the government. In Estonia, the law prescribes annual revisions according to strict and univocal rules: a) in no case these values can decrease, even in periods of deflation and/or downfall in average insured wage; and b) the basic component grows faster than the monetary value of one year. In Lithuania, both figures are approved discretionary, which makes easier to manipulate the flattening (by increasing the basic part) and differentiation (by increasing the one-year value) of pensions. There is no rule prohibiting diminution, and in 2009 the monetary value of one year was even lowered by 21.4% (but the basic part was concomitantly increased by 9.1%).

Latvian first-pillar benefits do not include any basic flat component. The benefit is earned by all insured individuals by “directing” part of their social insurance contributions to the personalized notional pension capital account. No actual money transfer takes place, this capital exists only as a record in State Social Insurance Agency database, and the whole scheme is known as NDC: notional (or, in another abbreviation expansion, also ‘non-financial’) defined-contribution. The pension value is the sum of notional capital at retirement divided by the projected life expectancy at retirement age. The notional capital for the pre-reform period (years of service prior to 1996) is calculated based on average actual personal earnings in 1996-1999, and this rule is extremely unfair to those whose wages were low, unemployed or those employed in shadow economy (that was quite widespread in 1990s).

The below diagram (Figure 1) shows a theoretical old-age pension benefit for a person with 40 years of employment record whose wage during all his/her working life was changing in accordance with changes of average countrywide wage. Although in the case of average wage the resulting figures for Estonia and Latvia are quite close, the difference for those having earned twice more or twice less than average is very clearly visible. Lithuania has the lowest nominal pension benefits, but if one expresses them in purchasing power (and not in EUR), the difference will become much smaller. Latvia also implies the highest income taxes on pensions, as well as to employment earnings (Skačkauskienė, 2013).

It is recognized (see, for example, Chlon-Dominczak & Strzelecki, 2013) that NDC systems almost lack redistribution instruments, and therefore are not adequate for countries with a relatively large gap between the rich and the poor (and Latvia has the highest GINI index in Europe) – material stratification is not smoothed in old age, and combined with low replacement rates, it leads to massive poverty: almost 60% of Latvian pensioners get a net pension benefit lower than the official subsistence minimum, meanwhile 0.5% get more than 1000 euro per month, and there are pensions of 5000 euro and higher.

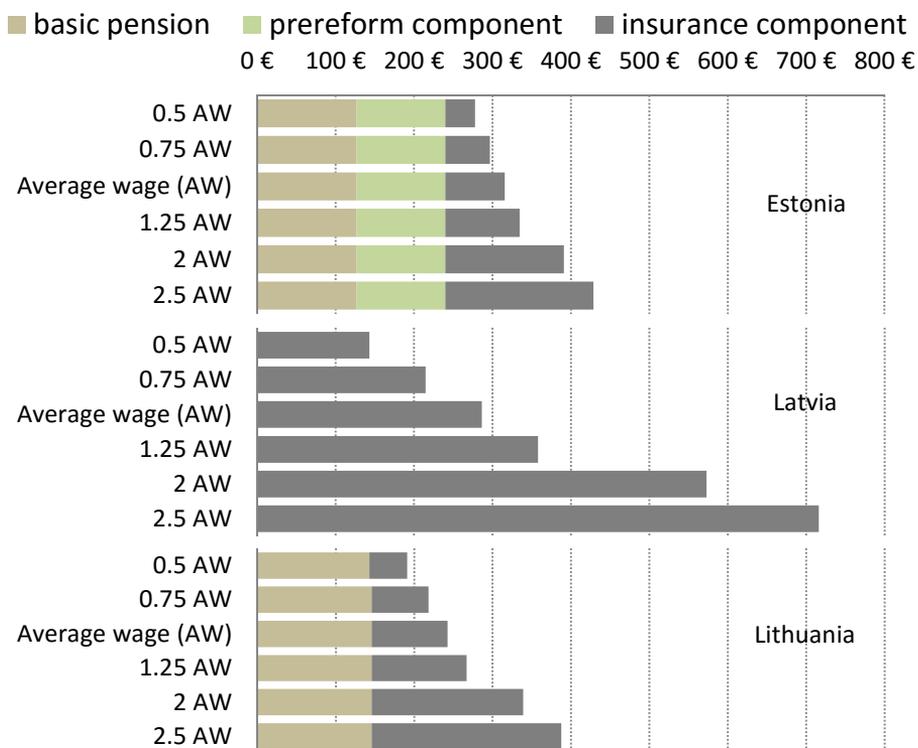


Figure 1. Pension benefit for a person retiring in December 2014 with 40 years service record (EUR) depending on his/her wage

Source: own calculations based on statistical (historical average insured wages in Latvia) and normative data of national social insurance boards.

The accrued notional capital is annually valorised (up-rated) in line with increase in the covered wage bill. These annual indices imitate the role of interest rates in funded schemes. When the total amount of wages on a nationwide scale drops below the last year figure – the interest rate is negative, and all prospective pensioners will suffer lower pensions. This mechanism was incorporated into the system in order to maintain financial sustainability in times when the cardinality of cohorts entering the labour market is lower than the cardinality of cohorts retiring from the labour market. It was anticipated that the constant growth in wage rates and labour productivity would neutralise the effect of decreasing working population and the index therefore would manage to remain above one. Massive emigration, accompanied by wage-cuts and sharp rise in unemployment in the crisis years resulted in negative pension capital indexation in three successive years 2009-2011, and the average amount of a newly-awarded pension benefit dropped by 15% in the first quarter of 2012 compared to the first quarter of 2009. Abolition of the so-called “supplements” (one euro per each pre-reform year of service, i.e. prior to 1996) for newly awarded pensions from 2012 had enhanced this tendency. It was calculated, that a person with 45 years’ service record who was receiving the average nationwide wage throughout his/her career retiring in 2009 got a 24% higher benefit, than a similar person retiring in

2012 did. Pension indexation rules have been recently amended in Latvia, the pre-crisis formula was prescribing annual indexation according to changes in the consumer price index, but it was revoked in 2009, and since then the government has only made ad hoc indexation of small pensions (not exceeding 285 euros) in 2013. In 2014 another ad hoc indexation took place: indexation was applied to all pensions, but only to the part below 285 euros. Further on, the threshold amount for indexation will be set at 50% of average insured wage, and the indexation ratio is to be based on both consumer price index (75%) and increase in the covered wage bill (25%).

Thus, both Latvian and Estonian pension systems include similar balancing mechanisms of matching the assets with liabilities by annual wage-bill index (total amount of wages paid nationwide). Estonian legislation prohibits diminution in benefits for the newly-qualified pensioners: for the same service record (same contributions) they will get as much as those who already enjoy retirement, while valorisation of notional pension capital in Latvian scheme generates serious distortions: if we compare two pensioners with the same service record – for instance, 45 years of service and average salary, a person who retired in 2010 received (and is still receiving) a 24% higher benefit than one who retired in 2012.



Figure 2. Pension benefit for a person retiring in December 2014 with 40 years service record (EUR) and average wage, depending on NDC valorisation rules (what-if simulation)

Source: own calculations based on statistical data of the State Social Insurance Board (historical average insured wages) and Central Statistical Bureau of Latvia (consumer price indices and GDP).

This is not an intrinsic feature of NDC – valorisation rules differ among countries, for instance indexation of notional capital in Poland is linked not only to the wage-bill index, but also to consumer price index (and in no case can it be lower than inflation), in Sweden, valorisation ratio is linked to average wage growth (3-year sliding average), in Italy – to GDP growth (5-year sliding average). Should Latvia have also adopted such valorisation principles, the benefits would be significantly different (Figure 2).

Indexation of notional pension capital in Latvia can be negative, and it was negative during the three consecutive years 2009-2012. The effective value of contributions made prior to 2008 has contracted by almost one third from 2009 to 2012.

The system is designed so as to achieve the balance between the inflows and outflows as fast as possible and at the expense of individual participants, who bear all the risks.

There are possibilities of premature retirement (up to two years before the legally stipulated retirement age in Latvia, three years in Estonia and five years in Lithuania), but in such case the amount of pension is reduced. The premature pension benefit makes 50% of an ordinary calculation in Latvia irrespectively of the time left until the official pension age, while in Estonia and Lithuania, the amount the premature benefit is reduced by 0.4% for each month falling short of the legally stipulated retirement age (4.8% per year). As to the postponed retirement, in Estonia the pension benefit is increased by 0.9% for each month by which a person postpones his or her application for the pension (that is 10.8% per year), in Lithuania the pension is increased by 8% for each year of postponement. In Latvia, since the factor of average life expectancy is a part of general formula, the benefit is automatically increased when a person opts to retire later than the official pensionable age and no additional incentives for late retirement are provided.

The second pillar is mandatory in Estonia for people born in 1983 and later and in Latvia for people born on July 1, 1971 and later. Participation is voluntary in Lithuania irrespectively of age, voluntary for those born between July 2, 1951 and June 30, 1971 in Latvia, and was open for voluntary subscription until October 31, 2010 for those born in 1942-1983 in Estonia. Those who have joined the 2nd pillar voluntarily do not have the right to "change their mind" and leave the pillar, with the only exclusion for the period from 01/04/2013 till 30/11/2013 in Lithuania, where they could switch back to fully PAYG scheme in Lithuania while their accumulated accounts will be managed by pension accumulation companies until their retirement age (by the end of the transition period 24 thousands or 2.1% of the 2nd pillar participants had used this opportunity). Practically, almost all potential voluntary participants have exercised their right to join the II pillar because of massive advertising campaign by private pension funds. However, recent studies (Bartkus, 2013) demonstrate that capital growth in the majority of pension plans is insufficient to provide the adequate amounts of future pension annuities (as was anticipated at the time of introduction of the funded pillar).

In Estonia and Lithuania, if a participant dies before reaching the pension age, units of mandatory funded pensions are inheritable. In Latvia, on a contributor's death, funds are returned to the first pillar and subsumed in the overall pensions budget.

While the role of funded pillars is increasing with the ageing of population they do not contribute to ensuring compliance with the equitability goal: benefits in funded schemes are very much depending on rates of return produced by the pension plan(s) chosen by a participant, and on volatile security markets. Thus the rule "same benefits for same contributions" conflicts the very nature of funded pillars. No redistribution from lifetime rich to lifetime poor is provided in these pillars, as well. Even more, promotion of third pillar voluntary pension plans (by granting tax reliefs on the contributions made to private funds) can be successful only among those persons who have enough "extra" money that can be directed to long-term savings. Those who live from paycheck to paycheck can

hardly afford to withdraw any additional amounts from their household budgets and cannot, therefore, expect any significant third-pillar supplement to their mandatory 1st and 2nd pillar old-age pension benefits. This effect is further enhanced by the level of financial literacy: as shown in recent international research findings (Lusardi & Mitchell, 2011), people with higher levels of education – who, as a rule, have higher incomes and therefore make larger contributions to pension funds, - are better informed in financial matters and are less vulnerable to risks of choosing an inappropriate investment strategy. These conclusions are supported by Latvian researches as well in respect of this country (Stavausis, 2013). Less educated persons, whose incomes are lower, are more exposed to the risk of making a wrong investment choice. In this context, funded pillars are rendering a disservice to lifetime poor, causing further distortion in income distribution at old age. The larger share of total pension tax goes to the second pillar – the higher degree of inequity the system generates.

The design of Latvian system was strongly influenced by the narrow understanding of sustainability, i.e. pure balancing assets with liabilities; such aspect fairness (or equity in other terms) is lacking in Latvian pension scheme.

CONCLUSIONS

The approach realized in Latvian pension legislation can be considered as a solution for financial sustainability in its very narrow sense. In our opinion, it is to a great extent rooted in the strong influence of the World Bank experts on pension reform orchestration in 1990s. In the Latvian pension scheme, all the risks of contemporary globalized economy to the maximum extent have been transferred to the taxpayers. Pension systems in Estonia and Lithuania demonstrate more signs of a fair distribution of benefits and risks both in the I and II pillars, and therefore have better compliance with the principles of social sustainability. Meanwhile, the Estonian system is the most transparent and has the most clearly defined “rules of the game”.

A pension system cannot be sustainable when people do not trust in it. The level of credibility granted to pension system by the population is significantly higher in Estonia. Public opinion polls show that Estonians are much less concerned about whether their income at old age will be sufficient to live in dignity, demonstrating more positive results than EU average. Estonians return higher ratings when requested to evaluate the situation with pension provision in their country and its anticipated development; they are, on the one hand, more aware of coming population ageing, but, on the other hand, less worried about this fact. They demonstrate significantly higher level of credibility in their pension system. The numbers of emigrants from Latvia and Lithuania are by an order of magnitude greater than from Estonia, in general – Latvian and Lithuanian people are less motivated to pay taxes honestly, thus reducing the taxation base and increasing the burden on those who are paying, and in the long-term, such policy does not seem sustainable at all. In our opinion, the misleading purely financial perception of sustainability prevailing among Latvian decision makers is caused by the nature of policy design at the policy formulation and implementation stages.

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