



*Twinning Project AZ/13/ENP/SO/24*

Support to the State Social Protection Fund on the introduction of funded element within the insurance-pension system, establishment of non-state pension funds and development of legal framework for regulating their activity

**Latvian and Sweden pension system reform. Pension system's pillar - Notional defined contribution pension scheme (NDC PAYG)**

Activity 4.1. In-depth presentation of the state pension system of the EU MS to relevant SSPF staff and other stakeholders

# Content

Pension system reform in Latvia and Sweden

Social insurance and pension system in Latvia

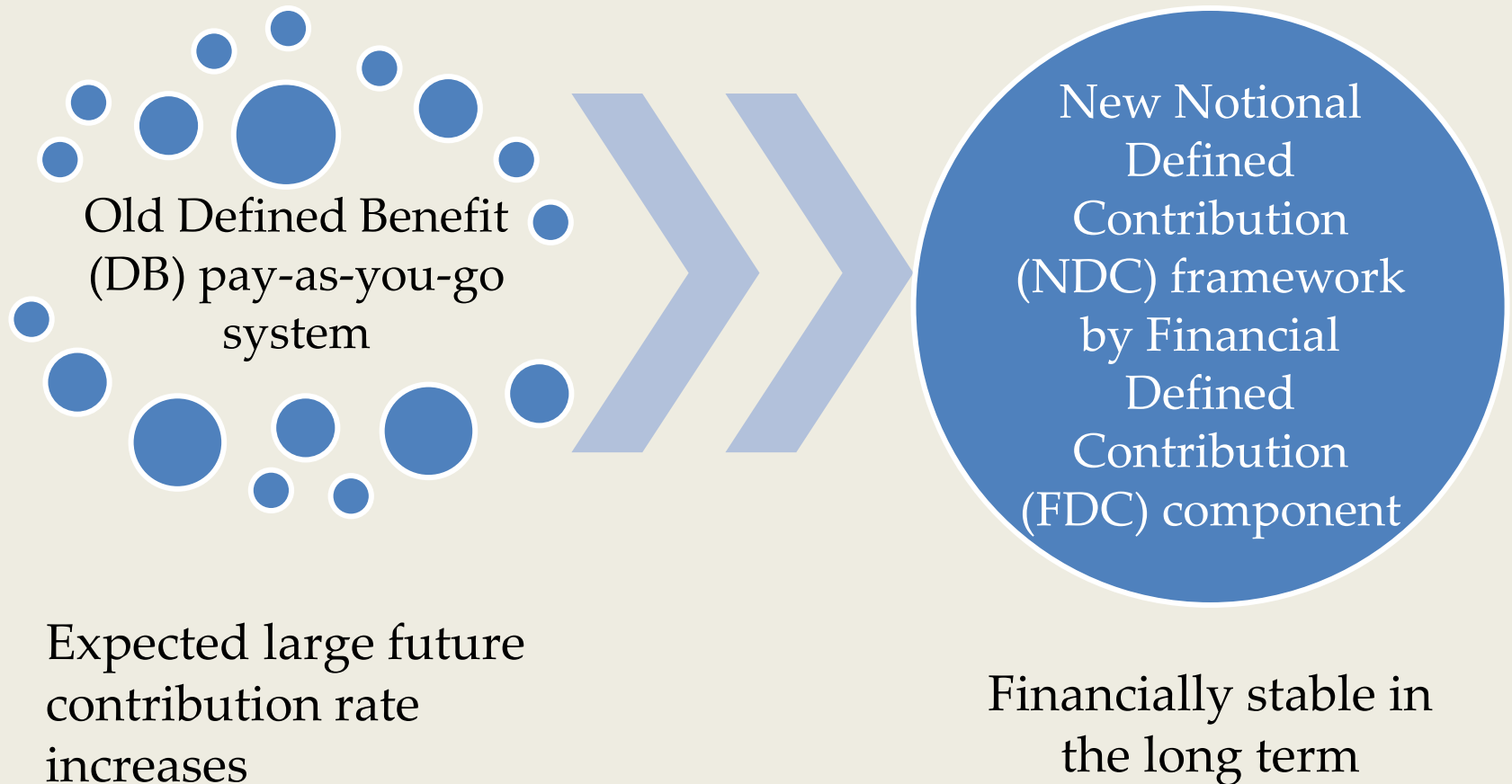
Comparison of pension systems

Conclusion

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## **Pension system reform in Latvia and Sweden**

# Pension reform



# Aims of the pension reform

To deal with ageing

To increase individual responsibility

To increase participation in labor market

To strengthen economic and capital market

To divide demographic and financial risks

To create financial stable system

To increase replacement rate

# Main principles of new pension system

Life income principle

To follow the changes in life expectancy

To follow the changes in national income/wages

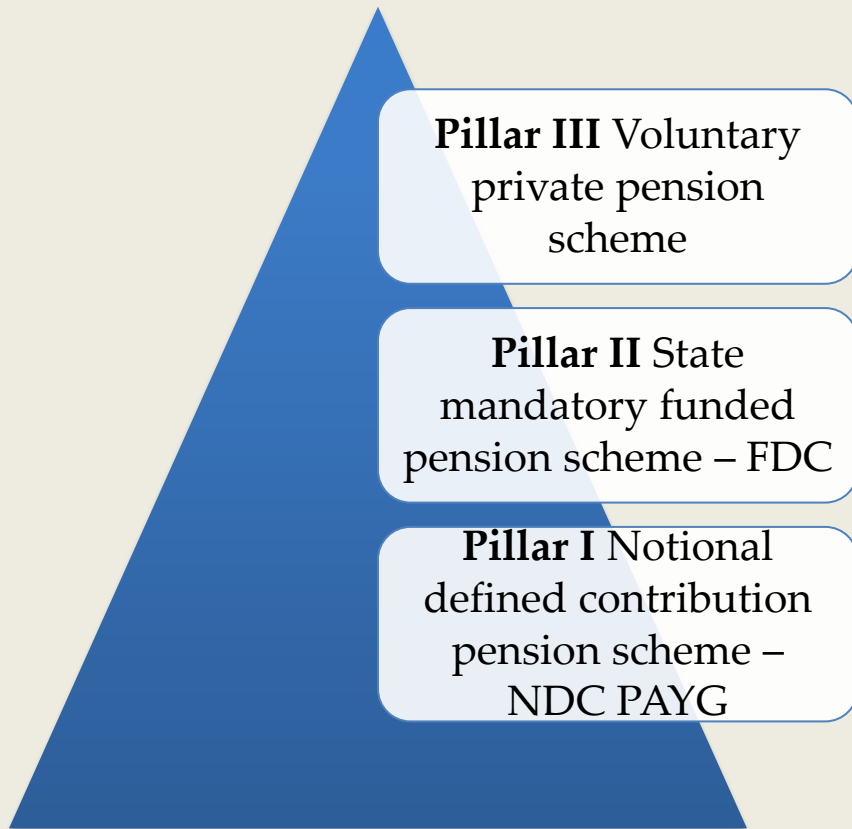
Protection of insured persons by saving more money for retirement

Framework for flexible retirement

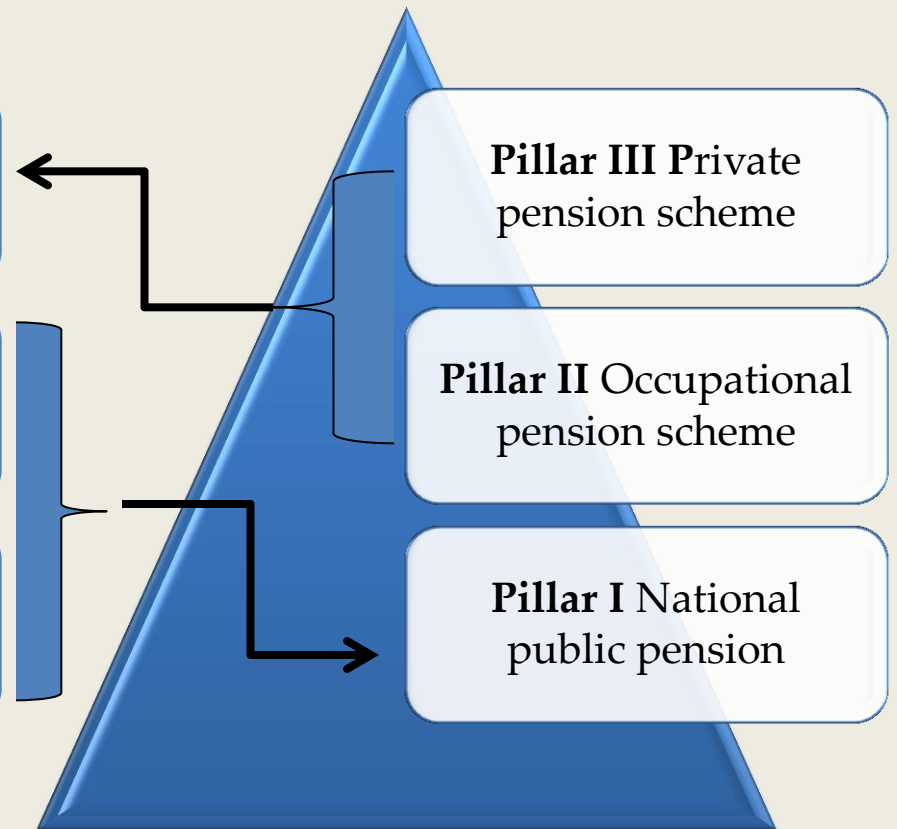
Compulsory system (NDC, FDC)

# New pension systems

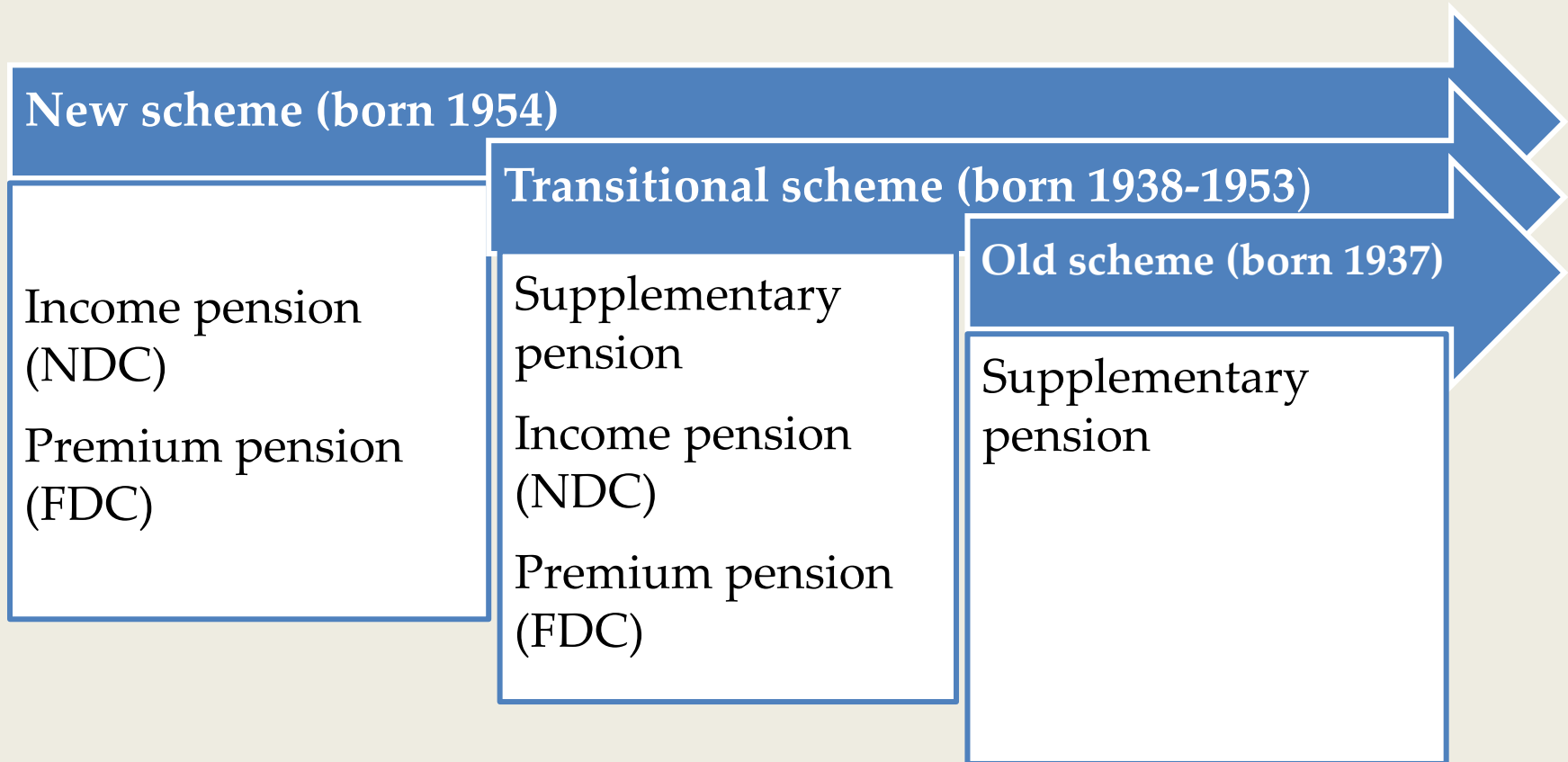
- **Latvia (1996)**



- **Sweden (1999)**



# Swedish National pension scheme





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## **Social insurance and pension system in Latvia**

# Principles of the state social insurance system

Solidarity of generations - current benefits and pensions are financed from the current social insurance contributions

Pension and benefit amount depends on contributions made

# Compulsory social insurance

All employed and self-employed persons, at the age of at least 15 are subject to social insurance

## Contribution rate

- total – 34.09%
- for employer – 23.59%
- for employee – 10.50%

**earmarked for the public old-age pensions: 20% of wage**

Pay for real risk (for example, self-employed don't pay for unemployment)

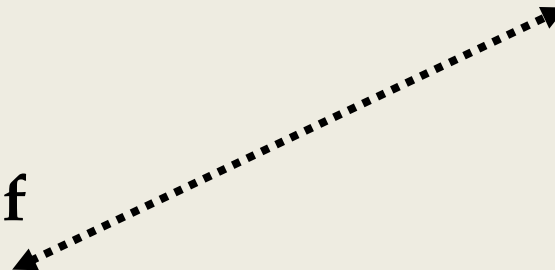
# Organization

**Ministry of Welfare  
(policy)**



**State Social Insurance  
Agency (administration of  
pensions and benefits)**

**State Revenue  
Service  
(administration of  
taxes)**



# Branches of state social insurance in Latvia

State pensions insurance

Social insurance against unemployment

Social insurance against work injuries and occupational diseases

Disability insurance

Maternity and sickness insurance

Parental insurance

# Social insured persons

Employee

Self-employed persons

Persons insured by state

# Ceiling

The maximum earnings ceiling

The minimum for self-employed persons

## **Social insurance budget**

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graph TD; A[Social insurance budget] --> B[State pension special budget]; A --> C[Employment special budget]; A --> D[Special budget for occupational accidents]; A --> E[Disability, maternity and sickness special budget];
```

**State  
pension  
special  
budget**

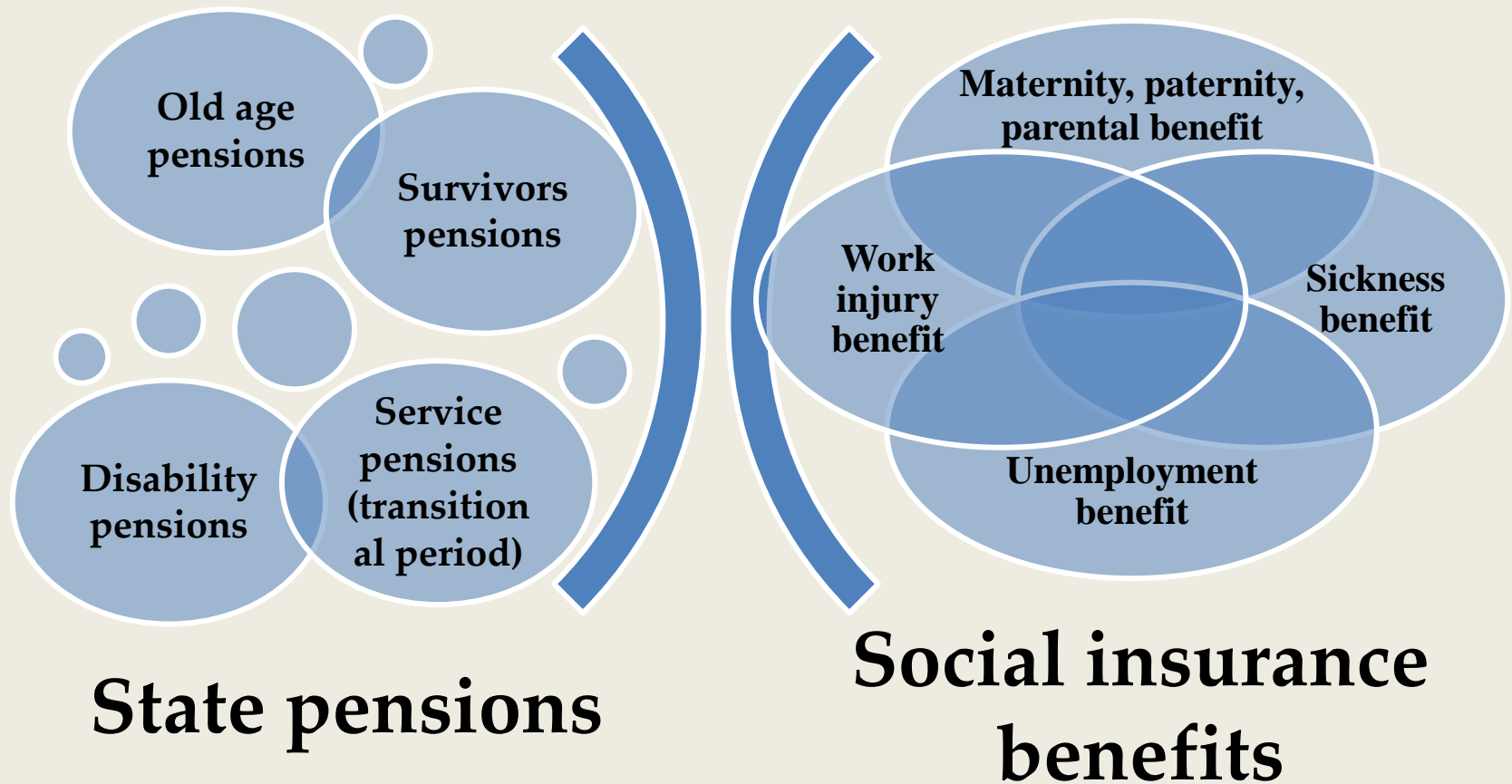
**Employment  
special  
budget**

**Special budget  
for  
occupational  
accidents**

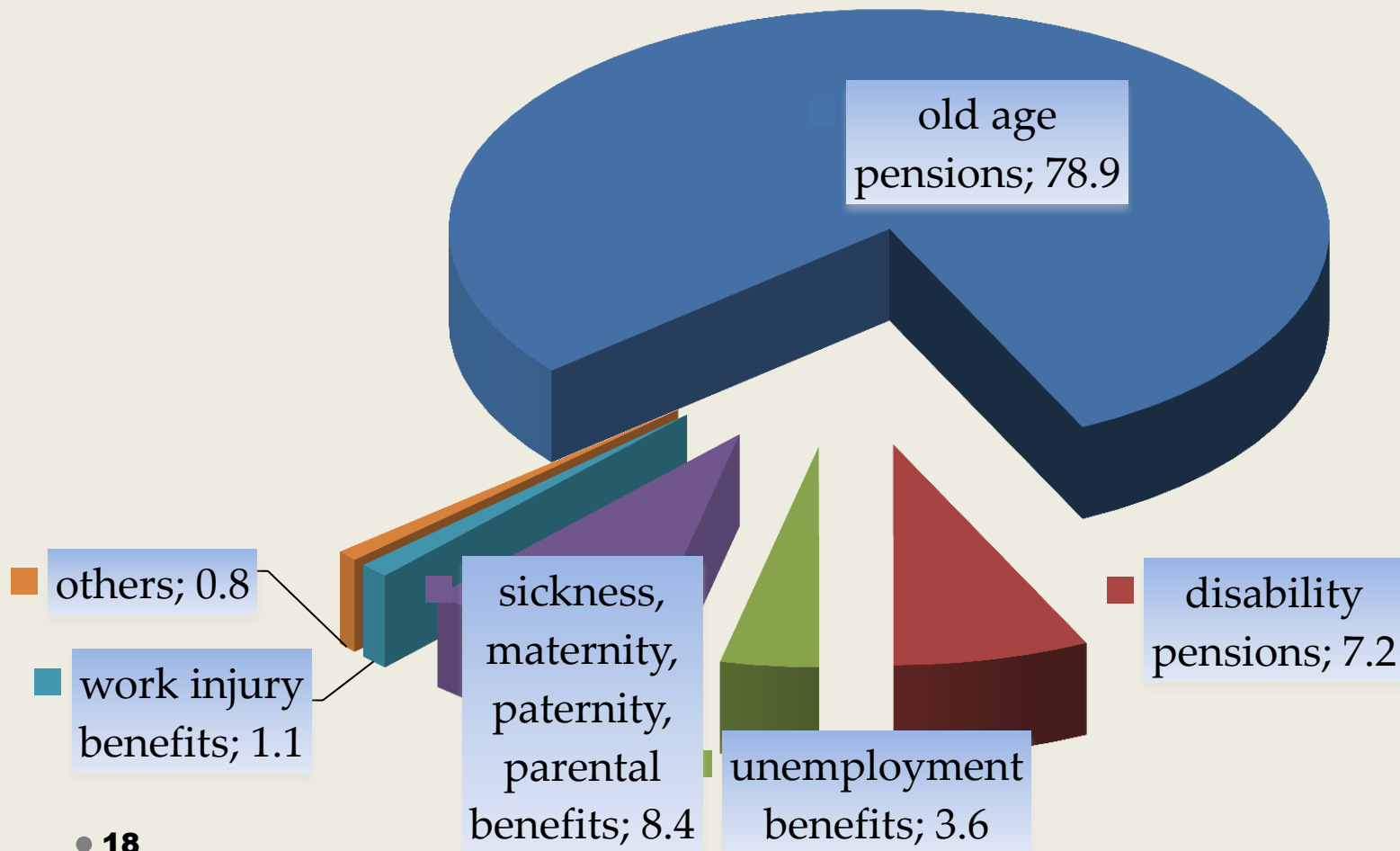
**Disability,  
maternity and  
sickness  
special budget**



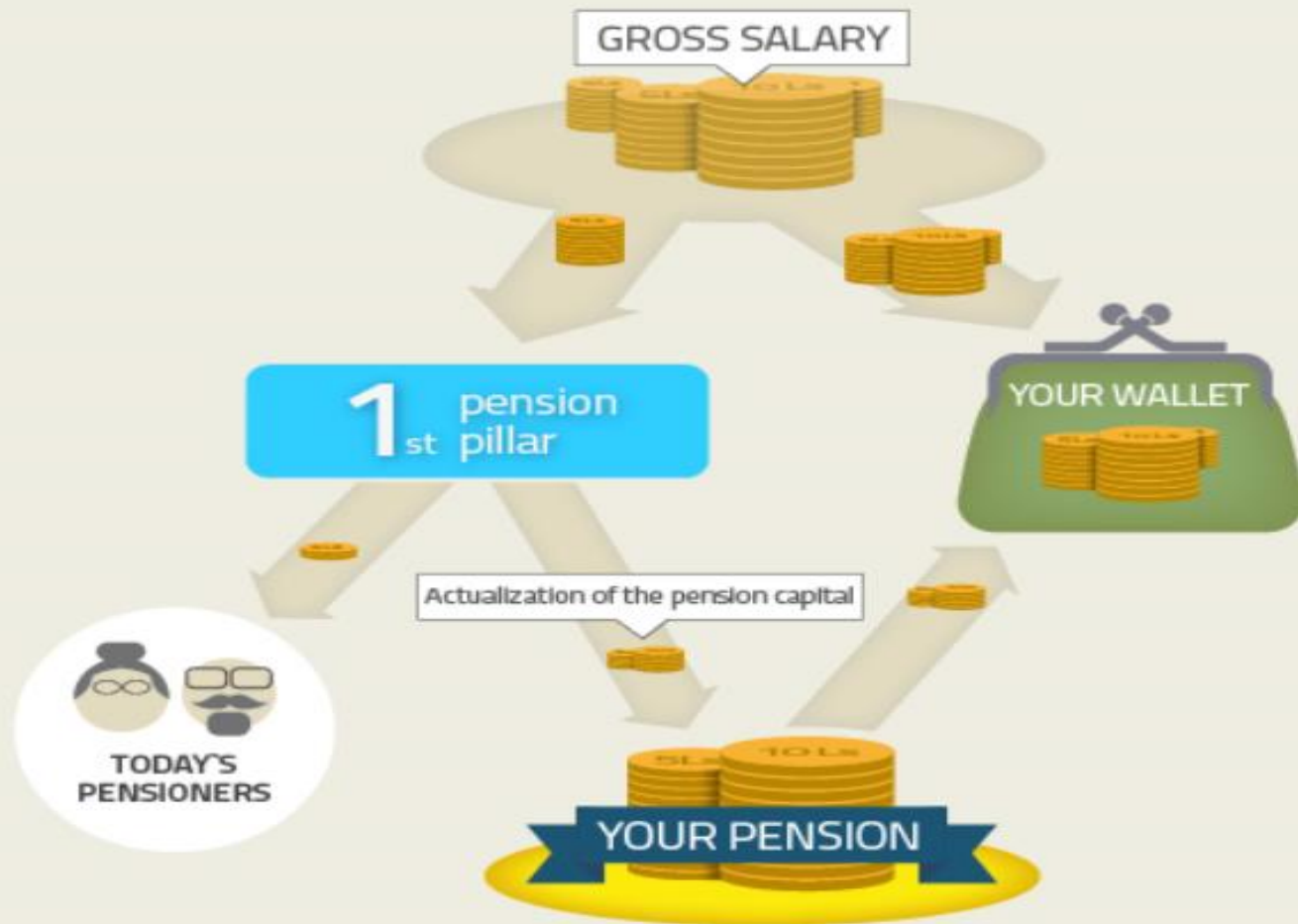
# Social insurance pensions/benefits



# Expenditures of the social insurance budget in 2013 (%)



# Pension Pillar I



# Basic principles

PAYG

Based on contribution made

Long transitional period

## Figures (2013)

Actual retirement age – 61.5

Early retirement - 16.5% from newly granted

Minimum pension – 15.5% from newly granted

Replacement rate for newly granted pensions – 37.1%

Expenditure for old age pensions from GDP – 6.9%

# Pension Pillar II



# Basic principles

Based on redistribution of contribution

Contribution rate - 4% in 2014 (5% in 2015, 6% from 2016)

Participation - mandatory (voluntary during a transition period until 2034)

Private management

Individual flexibility

Life annuity or PAYG pension

## Figures (2013)

Coverage- about 89% (2013) of economically active population

Assets – 7,2% (2013) of GDP

No guaranteed rate of return

Actual rate of return in last 10 years: + 4.3%



# Pension Pillar III



# Basic principles

Voluntary contributions made by the employer or individual

Private management

Types of funds - Open/Closed-ended private pension funds

Minimum retirement age – 55

Capital is inheritable or transferable to beneficiary

Tax incentives for both – employers and individuals

No guaranteed rate of return – DC scheme

## Figures (2013)

Coverage over 22.4% of economically active population (2013)

Actual rate of return in last 10 years:  
+4.04%

Assets – 1% of GDP (2013)

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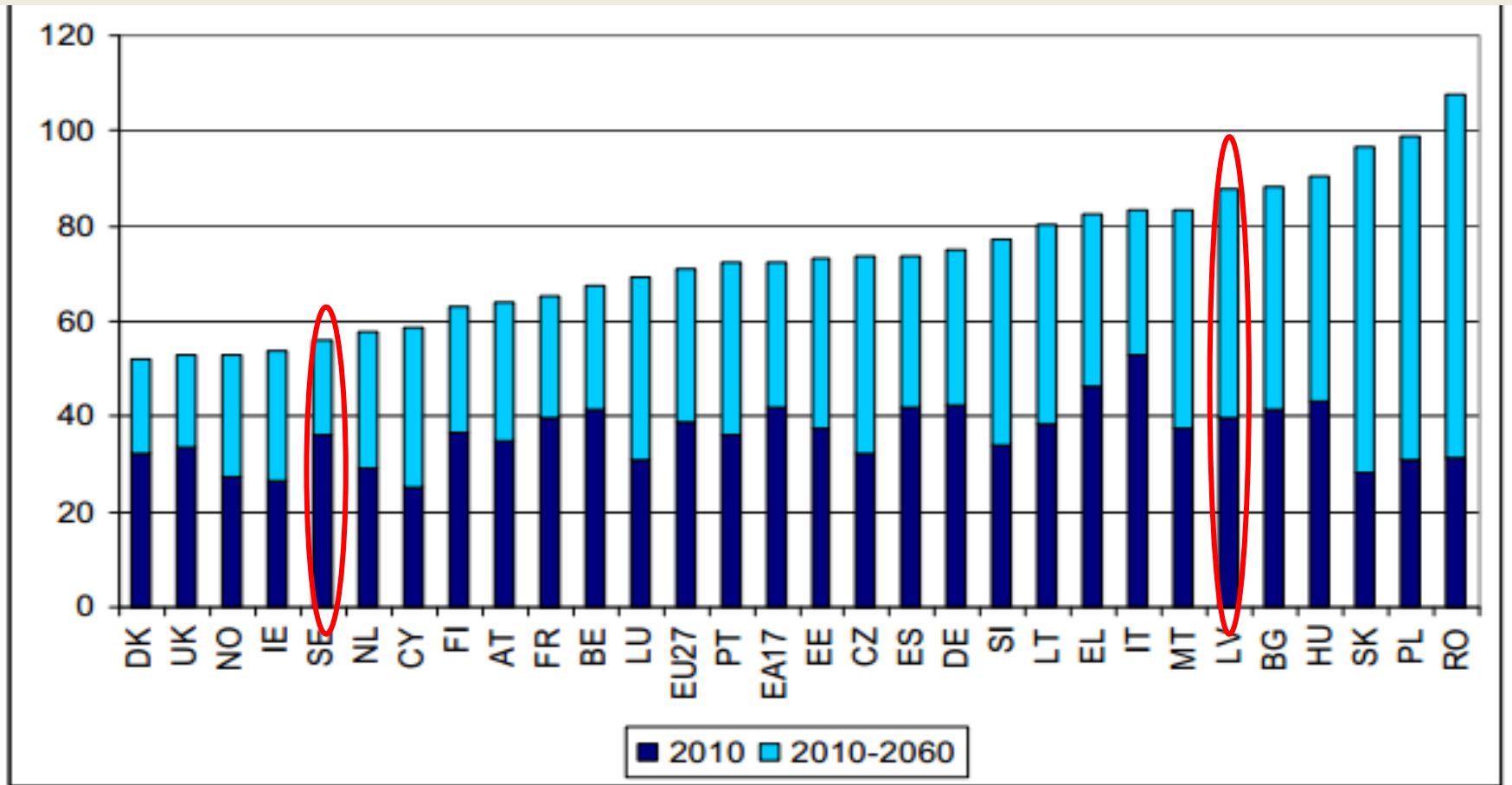
## Comparison of pension systems

# Indicators

	Latvia	Sweden
Fertility rate 2012		
2010	1,31	1,94
2060	1,51	1,90
Life expectancy at birth (male)		
2010	68,3	79,4
2060	81,1	85,5
Life expectancy at birth (female)		
2010	78,0	83,4
2060	87,2	89,3
Population above working age (%)		
2010	17,3	18,3
2060	35,6	26,3

*Projections by European Commission Economic and budgetary projections for the 27 EU Member States (2010-2060)*

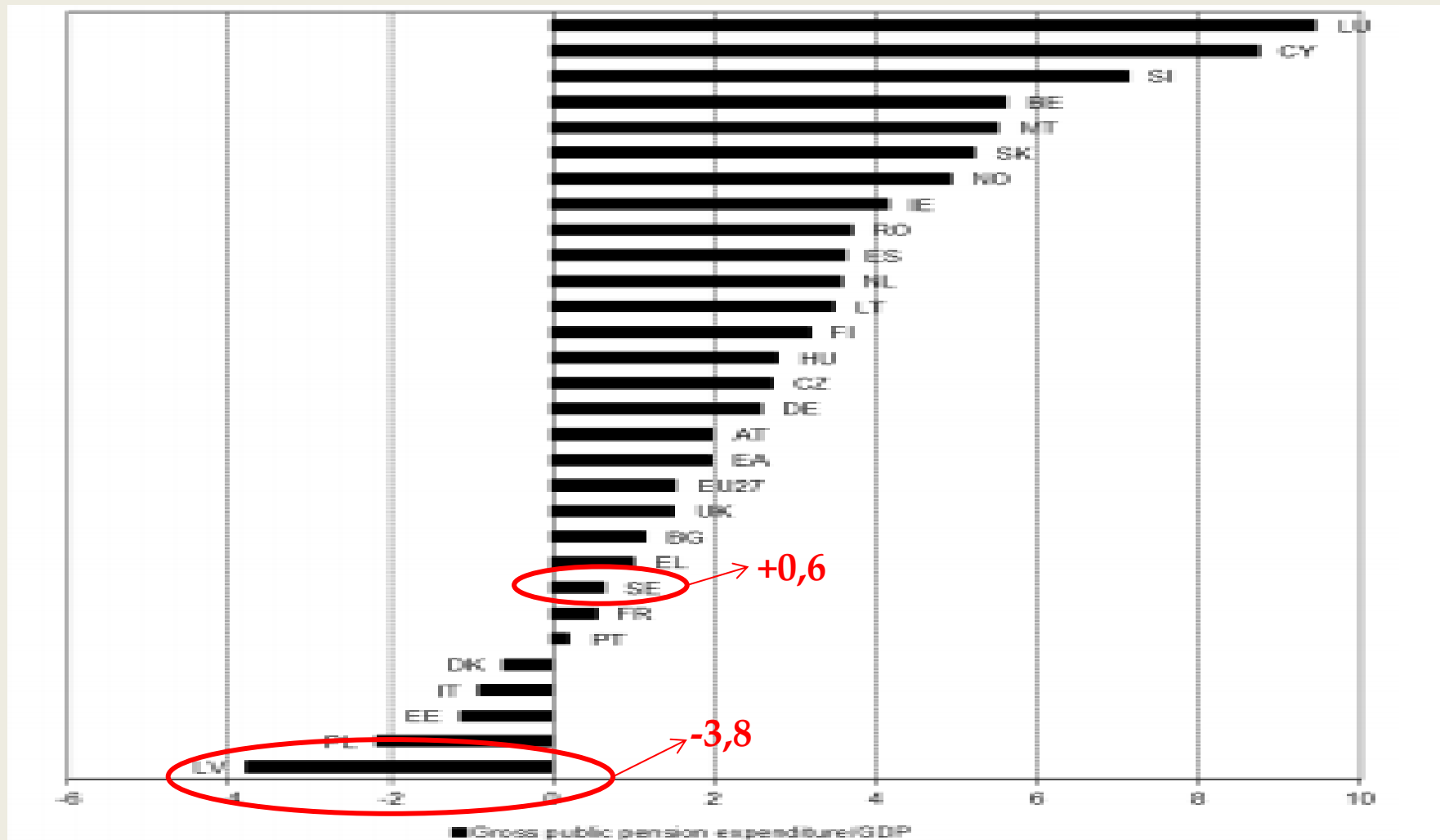
# Old-age dependency ratio



**Source:** Commission services, EPC.

**Note:** Inactive population aged 65 and above as a percentage of the employed population aged 15 to 64.

# Changes in gross public pension expenditure over 2010-2060 (in p.p. Of GDP)



# Individual accounts - contributions

## Latvia

- Based on individual notional accounts
- Redistribution of social insurance contribution between the NDC and FDC schemes
- Contributions rate for old age pension 20% – 16% for NDC and 4% for FDC (2014)

## Sweden

- Based on individual notional accounts
- Redistribution of social insurance contribution between the NDC and FDC schemes
- Contributions rate for old age pension 18,5% – 16% for NDC and 2,5% for FDC



# Non-contributory rights

## Latvia

- The **state budget** pays contributions to the NDC and FDC schemes for:
  - persons during child care period receiving child care benefit for adoptee
  - spouses of persons in the military service residing in the respective foreign country
  - persons caring for a child under 1.5 years of age (non-insured persons)
- The **social insurance budget** pays contributions to the NDC and FDC schemes for recipients of sickness benefit, paternity benefit, maternity benefit and parental benefit

## Sweden

- Periods of child birth, higher education and military service is transferred from the general **state budget** to the NDC and FDC schemes
- Periods of sickness, disability and unemployment is transferred from the **social insurance budget** to the NDC and FDC schemes

# Account values

## Latvia

- New contributions and transfers to the system for non-contributory rights
- A rate of return based on the growth in the **average wage rate and contributors** in the NDC scheme

## Sweden

- New contributions and transfers to the system for non-contributory rights
- A rate of return based on the growth in the **average wage rate** in the NDC scheme

# NDC pension based on

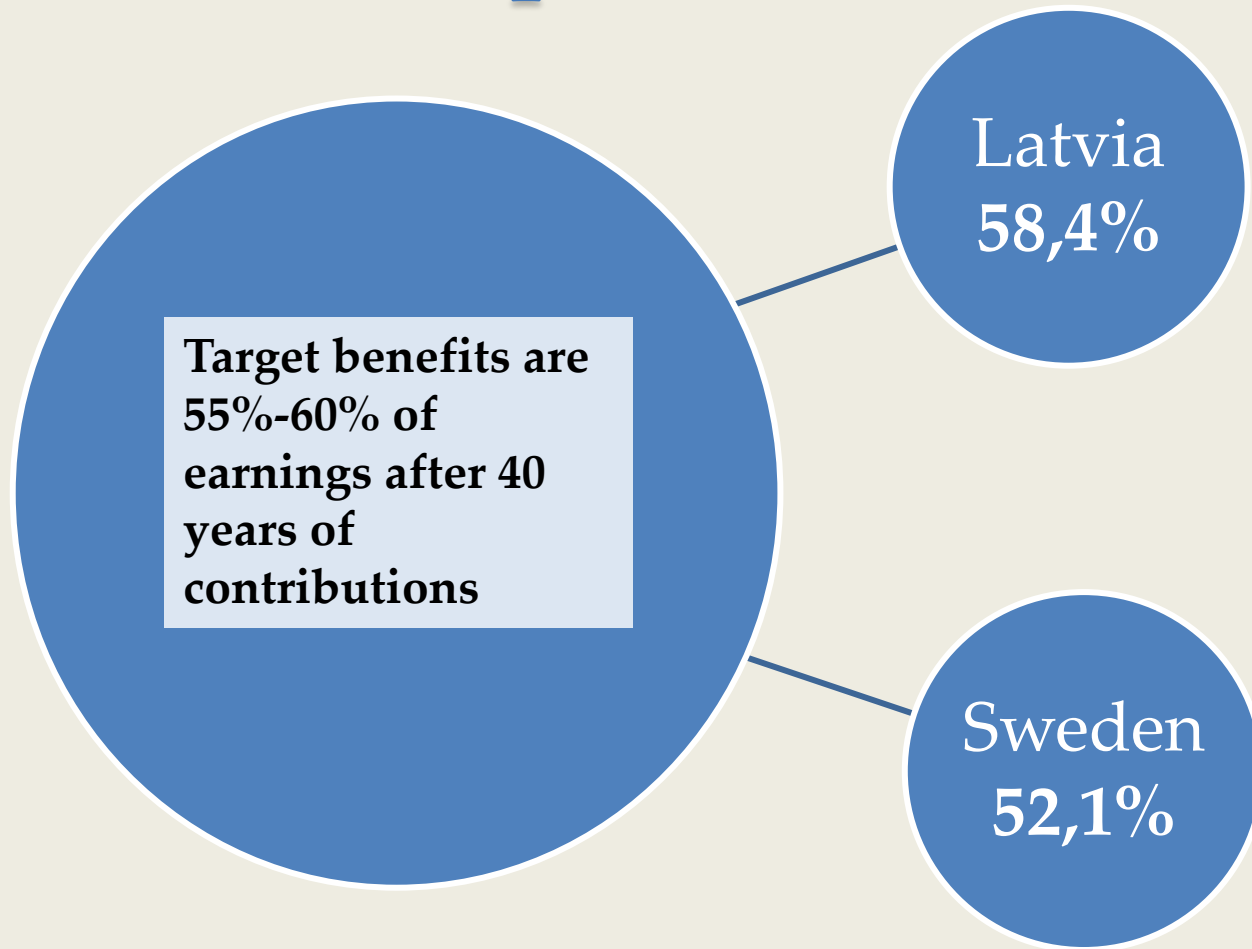
## Latvia

- Life-time earnings
- Age of retirement
- Life expectancy for a cohort
- Development of the economy
- No partial retirement
- Full pension while continuing to work
- Pension can recalculate based on new contributions
- Pensions are taxed

## Sweden

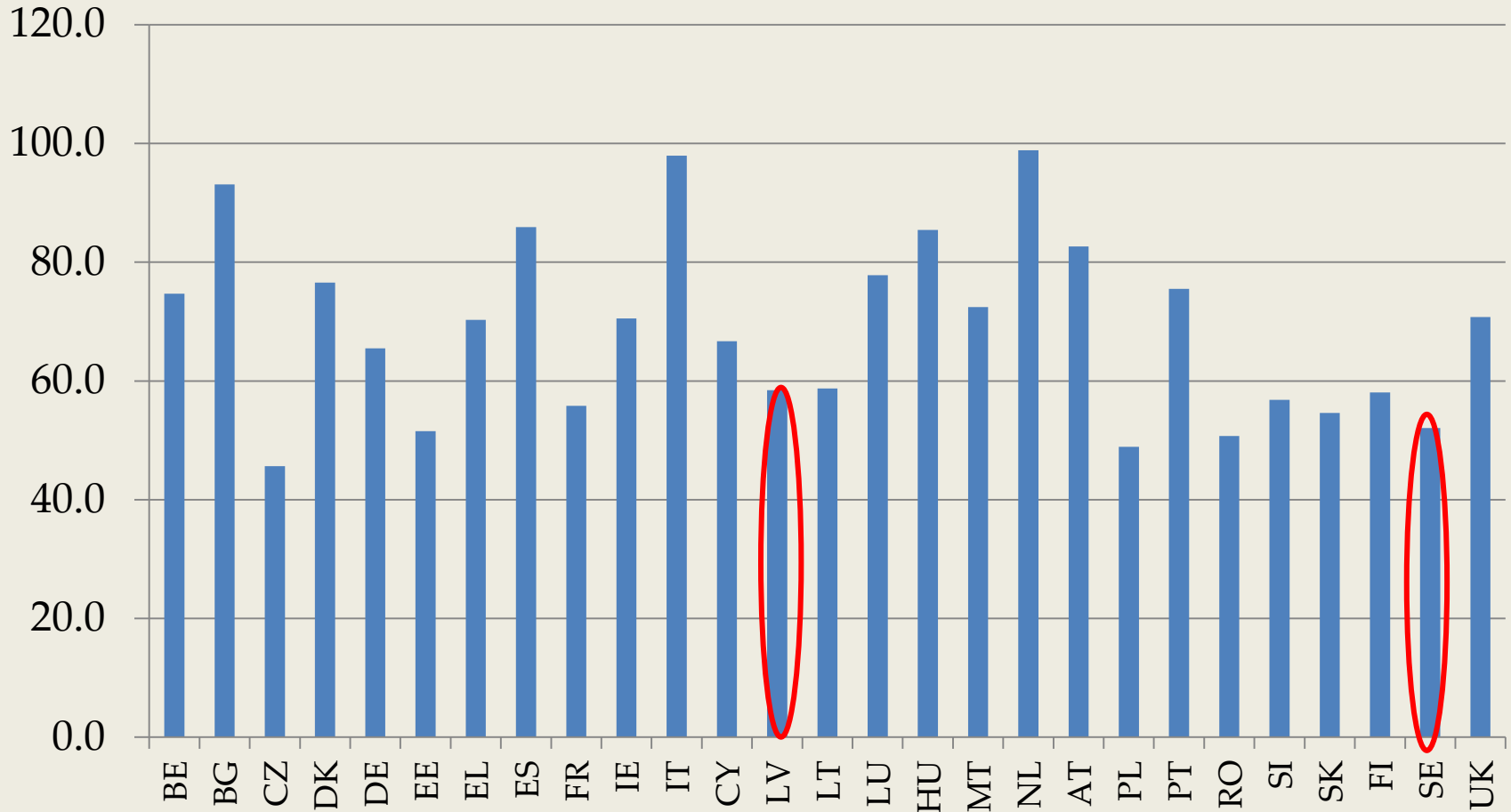
- Life-time earnings
- Age of retirement
- Life expectancy for a cohort
- Development of the economy
- Pension can be drawn at 25, 50, 75 or 100 percent while continuing to work
- Partial pension can recalculate based on new contributions
- Pensions are taxed

# Total NET Replacement rate (2052)



**Main Assumptions:** Current and Prospective TRR of a male worker with a career length of 40 years, retiring at the age of 65 in 2052 (prospective rates), full-time work, at average earnings and with contributions to all mandatory, typical or relevant pension schemes. OECD calculations.

# Total NET Replacement rate, % (2052)



# Conditions for the entitlements in Latvia

Retirement age increases (for both sexes) – from 62 years 3 month in 2014 until 65 years in 2025

Early retirement - 2 years before the statutory retirement age (increases until 2025 - 60 years 3 month in 2014)

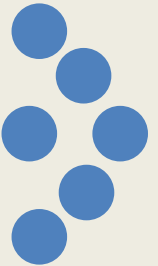
Minimum insurance period – 15 years (20 years from 2025)

# Old age pension formula in Latvia

K – pension capital after  
1996



$$P = K / G$$



G – life expectancy at  
retirement



# Pension capital index (contributors x average insurance wage

1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
1,03	1,03	1,03	1,03	1,03	1,03	1,03	1,03	1,03	1,03	1,03	1,03	1,03	1,03	1,03	1,03	1,03
1,03	1,12	1,12	1,12	1,12	1,12	1,12	1,12	1,12	1,12	1,12	1,12	1,12	1,12	1,12	1,12	1,12
	1,1536	1,117	1,117	1,117	1,117	1,117	1,117	1,117	1,117	1,117	1,117	1,117	1,117	1,117	1,117	1,117
		1,2886	1,069	1,069	1,069	1,069	1,069	1,069	1,069	1,069	1,069	1,069	1,069	1,069	1,069	1,069
			1,3775	1,0835	1,0835	1,0835	1,0835	1,0835	1,0835	1,0835	1,0835	1,0835	1,0835	1,0835	1,0835	1,0835
				1,4925	1,0453	1,0453	1,0453	1,0453	1,0453	1,0453	1,0453	1,0453	1,0453	1,0453	1,0453	1,0453
					1,5601	1,1645	1,1645	1,1645	1,1645	1,1645	1,1645	1,1645	1,1645	1,1645	1,1645	1,1645
						1,8168	1,1754	1,1754	1,1754	1,1754	1,1754	1,1754	1,1754	1,1754	1,1754	1,1754
							2,1354	1,1712	1,1712	1,1712	1,1712	1,1712	1,1712	1,1712	1,1712	1,1712
								2,501	1,2333	1,2333	1,2333	1,2333	1,2333	1,2333	1,2333	1,2333
									3,0845	1,3593	1,3593	1,3593	1,3593	1,3593	1,3593	1,3593
										4,1927	1,3106	1,3106	1,3106	1,3106	1,3106	1,3106
											5,495	0,9622	0,9622	0,9622	0,9622	0,9622
												5,2873	0,7978	0,7978	0,7978	0,7978
													4,2182	0,9945	0,9945	0,9945
														4,1950	1,0618	1,0618
															4,4542	1,0758
																4,7918



# The guarantee benefit

## Latvia

- **Minimum of pension**
  - available from retirement age
  - insurance record – 15 years
  - financed from social insurance budget
  - level of benefit depend on lenght of social insurance record
- **State social security benefit**
  - available from 5 years above retirement age
  - insurance record - less as 15 years
  - financed with general revenues

## Sweden

- For persons who have low pension or no earnings-related pension
- Available from age 65
- Inflation-indexed supplement to the total benefit provided by the NDC and FDC earnings-related schemes
- Financed with general revenues
- Prorated with regard to years of residence - with 40 years needed for a full amount

# Retirement age

## Latvia

- Men and women: 62 years and 3 months (2014)
- The legal retirement age is gradually increased by 3 months per year until reaching 65 years in 2025
- Early retirement
- Actual retirement age (2010):
  - male – 61,1
  - female – 60,8

## Sweden

- Flexible retirement age from 61
- Right to keep employment until 67
- No early retirement
- Actual retirement age (2010):
  - male – 62,7
  - female – 65,7

# Transitional rules

## Latvia

- Limited transitional rules
- Period up to 1995: is estimated by years of pensionable service and average insurance contribution wage from 1996 until 1999 (inclusive)
- The amount of pension shall be based on the national average insurance contribution wage for those persons who have completed at least 30 years of pensionable service and whose average wage in the period from 1996 until 1999 was lower than the national average insurance contribution wage
- Persons who born before 1981 and started to work after 1996 are completely in the new system

## Sweden

- Gradually transition rules
- Persons born in 1938 will receive 4/20 of their benefit from the new system and 16/20 from the old system; persons born in 1939 5/20 and 15/20 etc.
- Persons born in 1954 and later are completely in the new system

# Old age pension formula in transitional period in Latvia

K - pension capital after 1996

K<sub>s</sub> – pension capital until 1996 what is estimated by individual average wage 1996-1999

G – life expectancy at retirement



The diagram features a central blue circle containing the formula  $P = (K_s + K) / G$ . To the left of this circle, there are two horizontal rows of blue dots. The top row consists of six dots, and the bottom row consists of six dots. To the right of the central circle, there is a horizontal line of four dots, followed by a cluster of seven dots arranged in a roughly circular pattern.

$$P = (K_s + K) / G$$

# Additional guarantees in Latvia

Lower retirement age for some groups

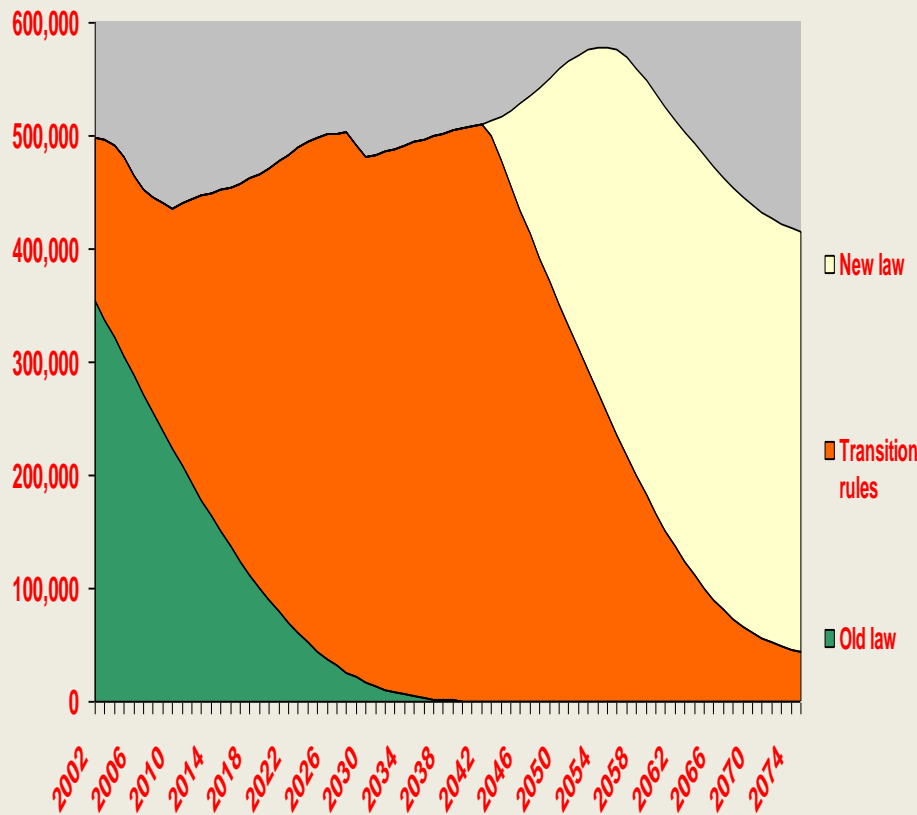
Amount of disability pension is maintained after retirement

Service pensions

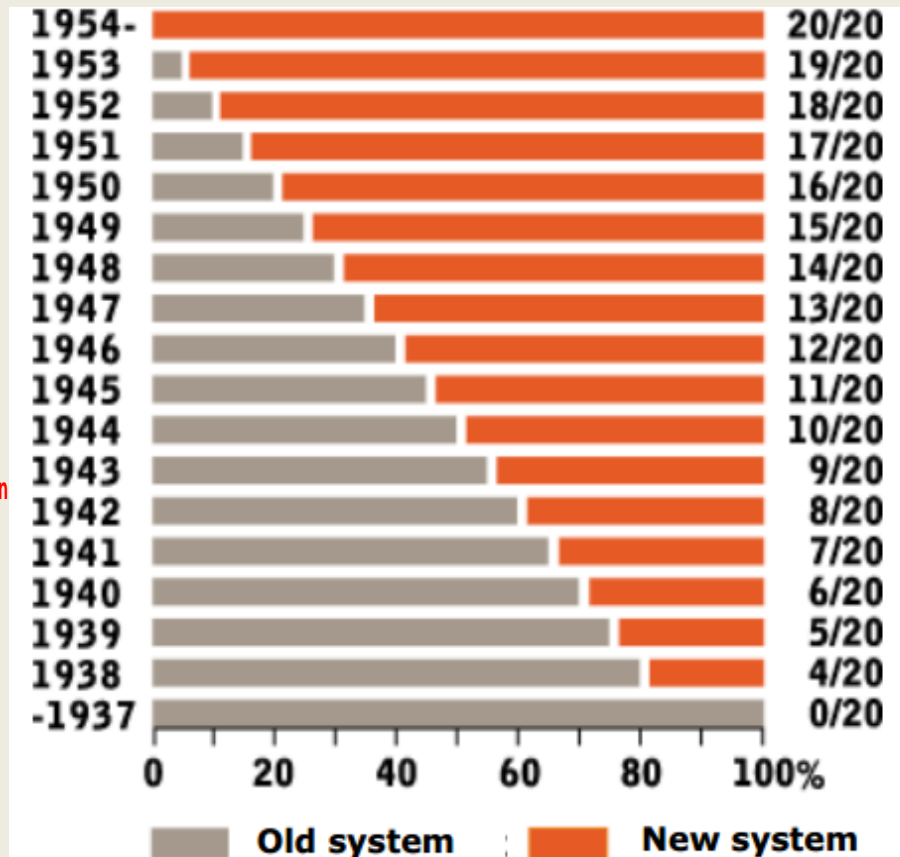
Additional payment for each insurance period (work) year accumulated until December 31, 1995 (2006 -2012)

# Transitional rules

Latvia (transition for those born before 1981 and work until 1996)



Sweden (transition for those born 1938-1953)



# Administration

## Latvia

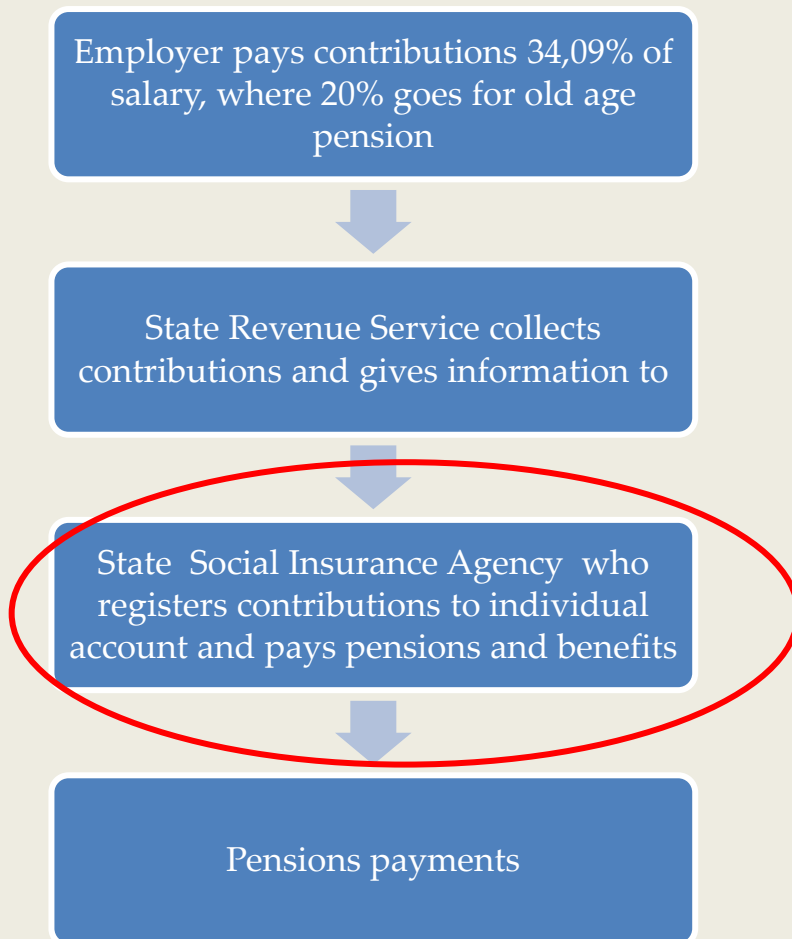
- The tax authority collects contributions (together with other taxes)
- NDC accounts are kept by the State Social Insurance Agency

## Sweden

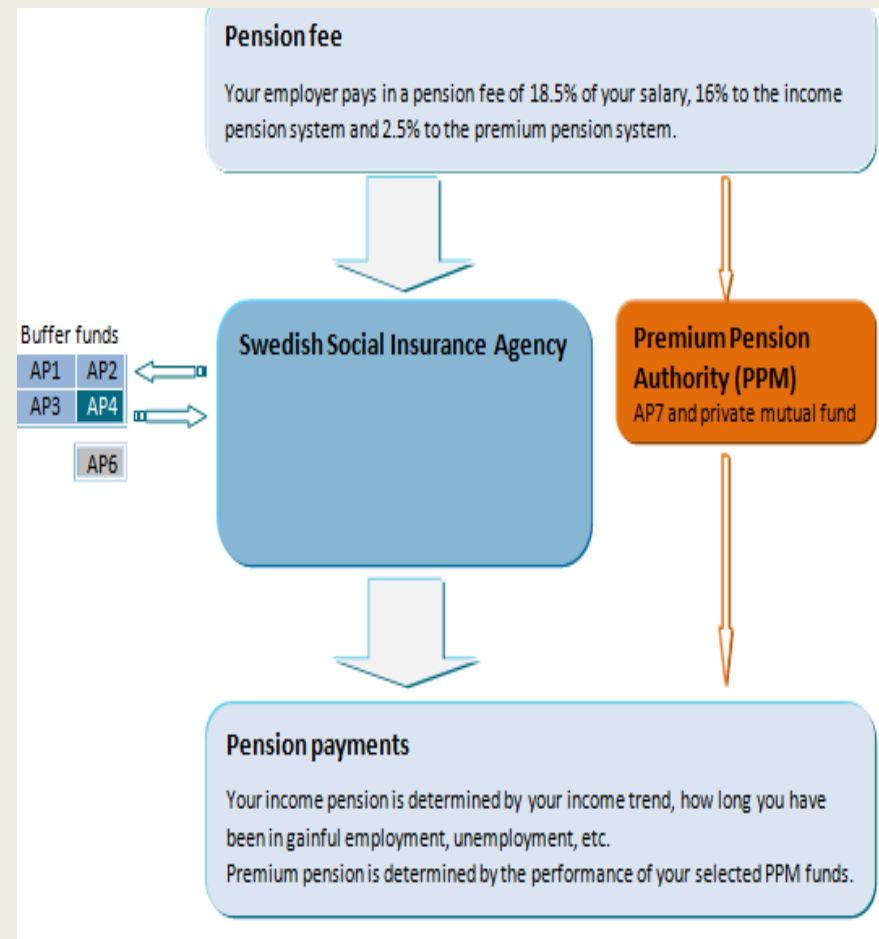
- The tax authority collects contributions (together with other taxes)
- NDC accounts are kept by the National Social Insurance Board

# Administration

## Latvia



## Sweden





# Reserve funds in the NDC scheme

## Latvia

- A reserve is formed by the excess of revenue over expenditure
- Reserve fund 7,7% from GDP (2009)

## Sweden

- The buffer fund arises due to fluctuations in the sizes of birth cohorts
- Reserves will help in financing the transition period – when the large cohorts born in the 1940s are only partially within the new system
- Reserve fund 27% from GDP (2010)

# Financial stability of the NDC system

## Latvia

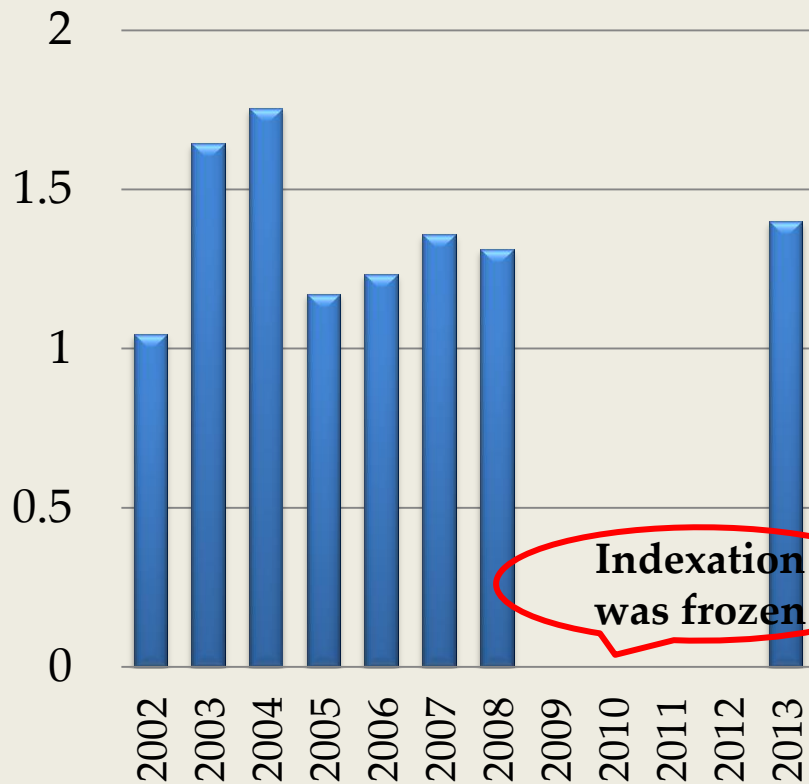
- Pension credits = contributions
- Indexation of pension capital is tied to average wage and contributors growth
- Indexation of pension is tied to CPI/wages changes
- Annuity divisor reflects life expectancy
- Reserve funds
- Increases of retirement age

## Sweden

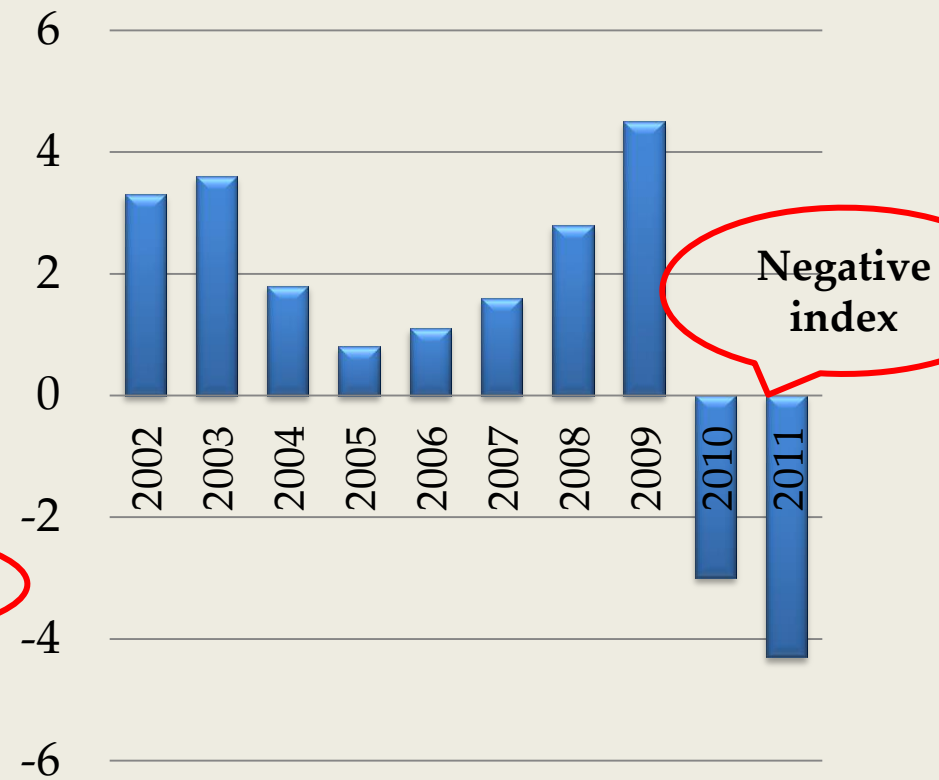
- Pension credits = contributions
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# Pension indexation

## Latvia



## Sweden



# Information Problems

Complex products

Long time horizon

Low interest

Financial illiteracy

Many providers – many messages

Difficult to get the whole picture

# Public information

## Latvia

- Local insurance officies
- *E-services*
- Program for calculating own pension

## Sweden

- The Orange Envelope



- Local insurance officies
- Program for calculating own pension

...

# Conclusion

# Still few challenges of the pension system

**Shadows economy**, low average salary and poverty risks in future

**Education** of society, pensions awareness

**Consumer protection** issues on financial instruments, DC schemes without guaranties, cost structure

**Information access** on individual pension savings, pension forecast tools and consultancy needs

Increase **responsibility** on Individual participation

Consistency and **sustainability** of tax legislation

**Trust** issues for government and financial institutions

# Response to fiscal challenge in Latvia

Increase in employee social contribution rate by 2 p.p. from 2011

Frozen pension indexation (2009-2012)

Decrease early retirement pension amount until 50% from the pension from 2009 (before - 80%)

Suspend supplements to the newly granted old-age and disability pensions from 2012



# Response to fiscal challenge in Latvia

More gradual increase in contribution rate to 2<sup>nd</sup> tier

Rate of return on NDC accounts equal to the wage bill growth – changes in wage level and number of covered workers

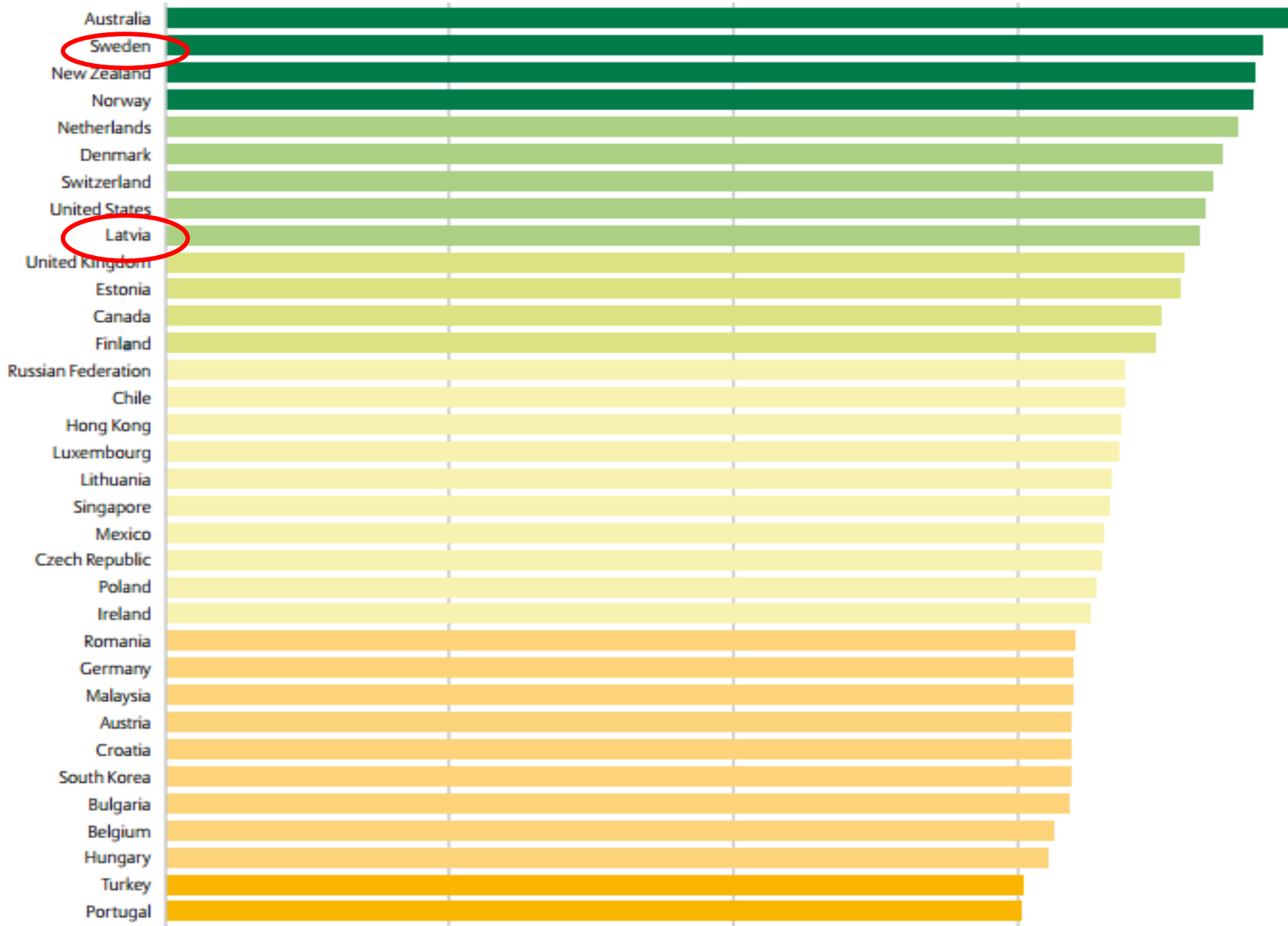
Transfer additional payments from the social insurance budget to the state basic budget

# Financially stable in the long term

The Pension Sustainability Index by the German company Allianz Global Investors

- Swedish pension system 2nd best in the world
- Latvian pension system 9th best in the world

# Pension Sustainability Index



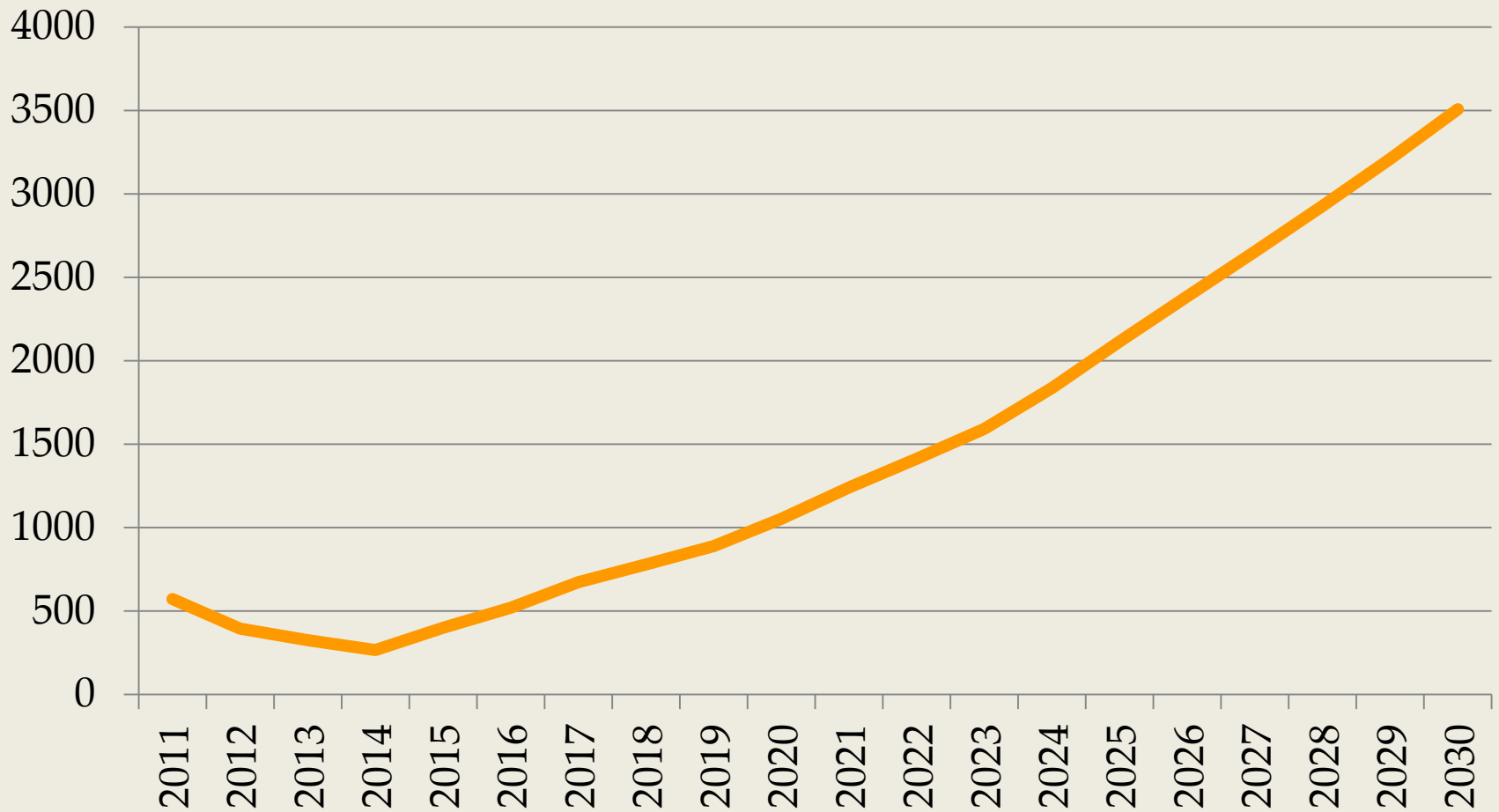
# Continue of pension's reform in Latvia

Gradually increase the retirement age: until 65, starting from 2014 until 2025 (3 month each year)

Keep early retirement and gradually increase the early retirement age: until 63, starting from 2014 until 2025

Increase the minimum insurance period up to 15 years starting from 2014, and up to - 20 years of 2025

# Special budget deficit/reserve, 2010-2030 (million Euro)



# Assessment of the operation of the pension system

Less **dependent** from demographical situation

Based on **individual responsibility** as well as on corporate participation (develops labor market)

Develops **long term savings** in economy

Stimulates development of **domestic financial institutions/infrastructure** and financial instruments market

**Self steaming instrument** – long term savings can be invested in economy (public & private partnership) to support economical growth and wealth



# THANK FOR YOUR ATTENTION!

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Versicherungswissenschaft  
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