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Crisis country case study

Latvia

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ISSA crisis case study: Latvia

Summary

As a consequence of the crisis Latvia experienced the sharpest downturn in the European Union (EU) with an 18 per cent fall in GDP in 2009 and a greater than 10 per cent increase in unemployment from 2007 to 2009. With the social insurance budget recording a deficit in 2009 for the first time since 2002, wage reductions in the public sector formed part of the government's adjustment strategy which included controversial fiscal consolidation moves (e.g. a cut in early retirement pension benefits by 50 per cent).

However, the government not only tightened its belt but also implemented competition initiatives (e.g. the Action Plan for Economic Stabilization and Growth Revival Programme of Latvia and the Action Plan to Improve the Business Environment) and expanded social assistance (e.g. increased unemployment benefits) and active labour market policies. Moreover a Social Safety Net Strategy in conjunction with the World Bank was introduced to increase access to healthcare and deliver a compensation mechanism for low-income groups to cover their patient contributions.

Social security institutions covered

The Ministry of Welfare; the Financial and Capital Market Commission; the State Social Insurance Agency (SSIA); and the State Employment Agency.

Overview of the social security system

In a move away from the paternalistic Soviet-style "social provision" model, Latvia has modernized its social security system to meet emerging political, economic and social needs. Social insurance systems are now based on the pay-as-you-go (PAYGO) principle and coverage of insurance systems is limited to persons participating in the labour market and generally funded by employer and employee contributions. People not insured are entitled to state social allowances paid from the state general budget or means-tested social assistance benefits provided by municipalities. Municipalities also provide childcare services and services for the elderly and the disabled.

The SSIA administers the payment of sickness and maternity benefits, paternity benefit, unemployment benefit, family benefits, compensation related to accident at work or occupational diseases, old-age and disability pensions as well as a pension in case of loss of supporter.

The state pension system guarantees a minimum pension. The amount of minimum pension depends on length of service and the amount of social maintenance benefit.

The three-tier pension system consists of:

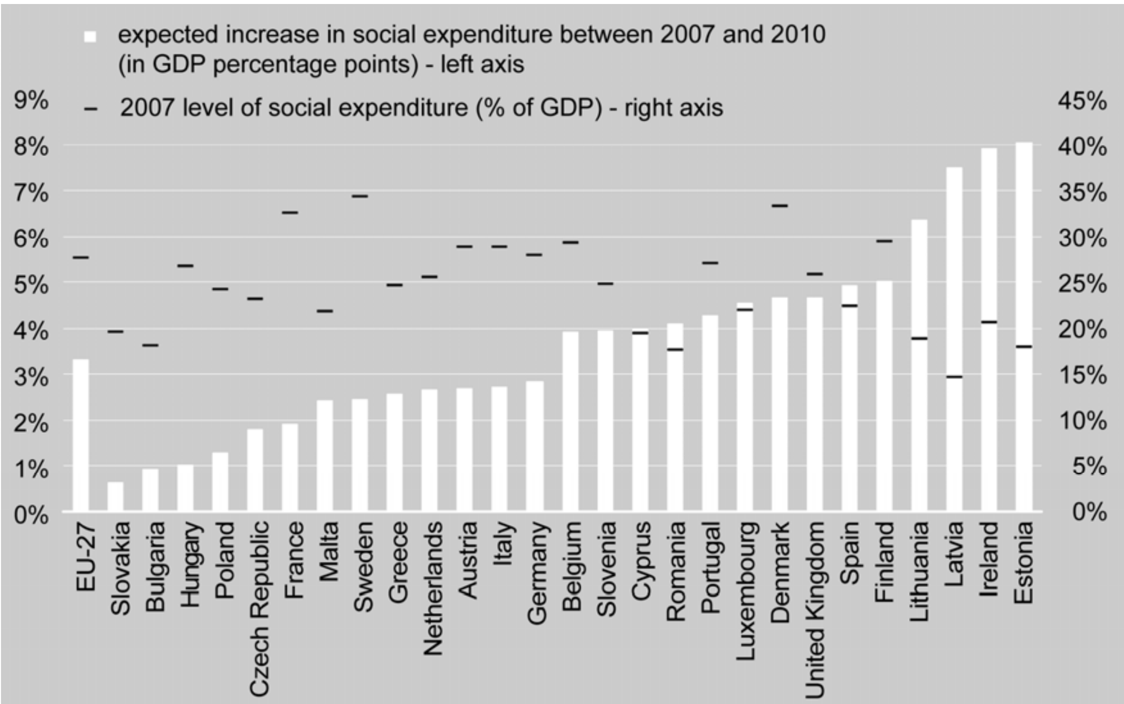
- The state compulsory pension scheme – based on defined contributions.
- The state mandatory funded pension scheme – compulsory for persons who were born after 1 July 1971.
- The private voluntary pension scheme – the third tier stipulates the free choice of any person to create additional savings for their pension by paying contributions into the private pension funds.

Impact of the crisis

The economy and labour force

According to European Commission estimates, Latvia experienced the sharpest downturn in the EU with an 18 per cent fall in GDP in 2009 (Council of the European Commission, 2009). With an economic contraction of this magnitude, employment and wage levels were adversely affected. The SSIA stated in its International Social Security Association (ISSA) crisis survey that the unemployment rate in Latvia increased by more than 10 per cent in two years (i.e. from 6 per cent in June 2007 to 17.2 per cent in June 2009). In terms of the number of registered unemployed, this was an increase from 52,321 (end of 2007) to more than 132,000 at the end of July 2009 (cited from Eurostat). Youth unemployment, at 30.5 per cent (Q2 2009), is the second highest in the EU. The International Labour Organization (ILO)'s latest (January 2010) statistics show that Latvia experienced a massive 160 per cent increase in unemployment from May 2008 to 2009 – the largest increase of any country surveyed (ILO, 2010).

Figure 1: ***Expected increase in social expenditure between 2007 and 2010 (% GDP)***



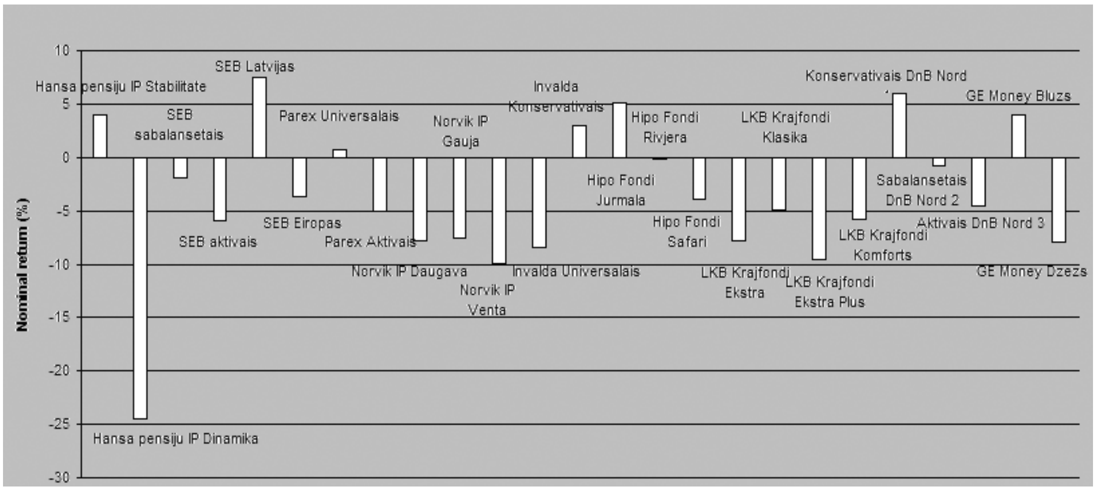
Source: Council of the European Commission (2009).

Figure 1 illustrates that by 2010 a large increase (roughly 7.5 per cent of GDP) is expected in total Latvian social expenditure.

Investment performance

Market turmoil has clearly harmed investment performance of social security funds in the short and medium term. A quick glance at the latest investment performance of 27 funds administered by the ISSA shows nominal investment returns ranging from 20.84 per cent to 0.83 per cent in 2009, i.e. recovering from a year earlier when returns were as low as -24.5 per cent for one fund as shown in figure 2. Generally speaking, the majority of funds remained in negative territory since the start of the financial crisis in 2007.

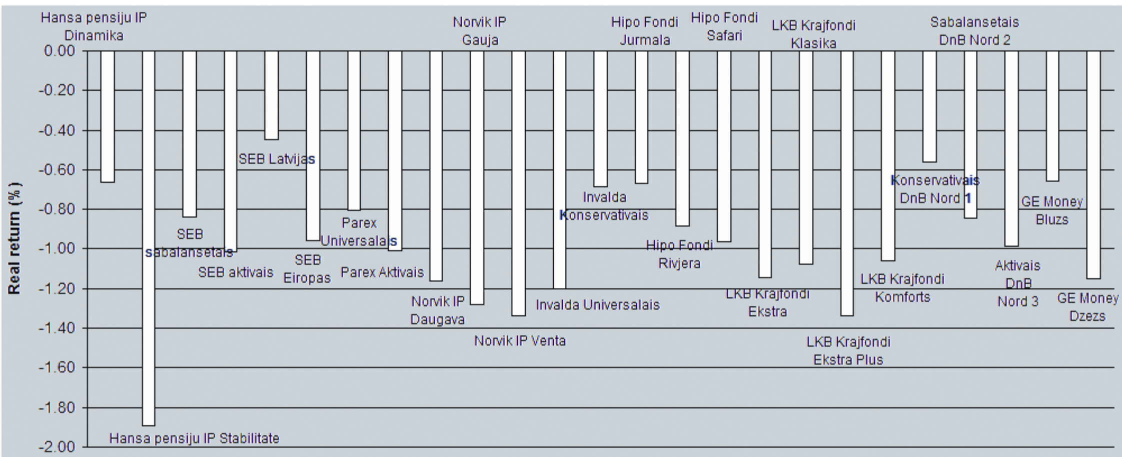
Figure 2: ***Investment performance of 25 social security funds (average nominal return), 2007–2008***



Source: ISSA crisis questionnaire (Latvia).

However, adjusting for the effects of inflation compounds the poor investment performance. Factoring in consumer price inflation running at 14.1 per cent in 2007 and 10.5 per cent in 2008, no funds recorded a positive average return, as seen in figure 3.

Figure 3: ***Investment performance of 25 social security funds (average real returns), 2007–2008***



Source: Calculated using CPI data from Economist Intelligence Unit (EIU (2010b)) and a negative interest rate formula. Real return = (1 + nominal return)/(1 + inflation) - 1.

Negative returns also undermine benefit levels for those Latvians claiming benefits (e.g. pensioners and future beneficiaries).

Administrative capacity

Sizeable fiscal and current account deficits and adverse financial impacts on social security funds diminished the capacity of the Latvian social security system to guarantee a basic social safety net.

In the ISSA's crisis survey the SSIA stated that it experienced social security financing difficulties. Given weakened administrative capacity to undertake much-needed large public investments in social, educational and health service infrastructure, the Latvian government turned to the European Regional Development Fund (ERDF) for an US-Dollar (USD)674.9 million investment for the period 2007–13 designed to improve energy efficiency in multi-family dwellings and in the social housing sector (Council of the European Commission, 2009). In August 2009 the Latvian government also sought financial assistance from the World Bank for a "Social Safety Net Strategy". The strategy boosts Latvia's ability to support ten measures of social welfare, employment, education, health and transportation sectors and focuses on the services and benefits delivered by national agencies and locally by municipal governments. World Bank financing will be available until the end of 2011 (Council of the European Commission, 2009).

In an attempt to shore up financial and economic systems, Latvia became a relatively large (7.1 per cent of GDP) recipient of International Monetary Fund (IMF) assistance (ILO, 2009). Latvia has a stand-by arrangement whereby IMF credits can be provided to finance a temporary balance-of-payments deficit. Given Latvia's relatively large and increasing budget deficit (general government debt as a percentage of GDP jumped over 10 per cent from 9 per cent to 19.5 per cent between 2007 and 2008 Economist Intelligence Unit (EIU, (2010a)), the margin for financial manoeuvre is narrow. Nevertheless, and as will be seen, the Latvian government is committed to enhancing the long-term fiscal capacity of social services to provide adequate protection.

Responses to the crisis

The Latvian labour market adjusted to the crisis through increases in unemployment and decline in real wages (the EIU forecasted an 8 per cent fall for 2009 (EIU, 2010b)), and falls in labour force participation and higher outward migration.

Adverse economic conditions clearly provided the impetus for greater state activism – whether through short-term bank bail-outs, business stimulus packages (e.g. the Action Plan for Economic Stabilization and Growth Revival Programme of Latvia and the Action Plan to Improve the Business Environment) and longer-term structural reform of social security. Fiscal tightening measures were pursued through cuts in some benefits.

Pension cut-backs

From 1 July 2009 old-age and service pensions were decreased by 10 per cent and by 70 per cent for working pensioners. This measure was planned to continue until 31 December 2012. The early retirement pension was decreased by 50 per cent of calculated pension for persons who retired after 1 July 2009. However, in December 2009 the Constitutional Court of Latvia ruled against this and pensions cuts were reimbursed in 2010.

Family state benefit and sickness cut-backs

In July 2009 family state benefits were also reduced. According to the SSIA, child benefit is now a low flat rate of approximately US dollar (USD)8 (and not linked to the number of children). Sickness benefit was also reduced from 52 to 26 weeks while parental benefits were reduced by 50 per cent for all working parents regardless of the child's date of birth.

Unemployment benefit increases

The total length of unemployment benefit was extended to nine months irrespective of the person's insurance length. This is a clear attempt to strengthen benefits for labour force participants given stricter qualifying conditions under prior provisions.

Expansion of social assistance and activation programmes

The government has not only tightened its belt, it also strengthened social assistance for vulnerable people by:

- Increasing minimum income benefits to support needy persons. Municipalities are obligated to provide housing benefits, making it easier for low-income persons to qualify for housing benefits.
- Providing training vouchers with a stipend for people at risk of unemployment in 2009 until 2010.
- Introducing active labour market policies, largely implemented through European Social Fund (ESF) funding.
- Increasing training programmes for the unemployed through ESF funding.
- Setting up a workplaces and stipend emergency public works programme in 2009 to assist the unemployed not receiving unemployment benefit. This measure was co-financed by the ESF and set up with technical assistance from the European Commission (DG Empl) and the World Bank. The programme was implemented as of September 2009 and is set to end in 2011. It involves low-skilled non-commercial community work such as cleaning, development and maintenance of public infrastructure and local social services with an allowance of USD137 per month (around 80 per cent of the net minimum monthly wage).

Income support provision

The tax-free income threshold was increased by USD188 and the general income tax rate was reduced from 25 per cent to 23 per cent. However, plans have also been made to increase the self-employment tax from 15 per cent to 23 per cent and expand the real estate tax to residential real estate (Council of the European Commission, 2009).

Social Safety Net Strategy

The implementation of the Social Safety Net Strategy in conjunction with the World Bank was designed to increase access to healthcare and ensure a timely and adequate service by introducing a compensation mechanism for low-income groups to cover their contributions.

Despite a large fall in the Latvian healthcare budget, the Ministry of Health has set priorities in the development of outpatient healthcare, guaranteeing emergency care, and the health of pregnant woman. Persons recognized as needy were exempted from patient contributions.

Lessons learned

Latvia's fiscal performance in 2009 was better than some commentators had expected. The crisis revealed how over-exposed large social security funds such as pensions were to complex financial instruments on the international market. The more conservative, less risky funds administrated under the SSIA performed better than the higher-risk internationally managed funds, e.g. Norvik (Iceland) and GE Money (USA).

Jobs are no guarantee against the risk of poverty but having a job remains the best safeguard against poverty and exclusion. In the EU as a whole, the risk of poverty faced by working-age adults without work is more than three times higher than for those in work (27 per cent against 8 per cent). This risk increases to 43 per cent for the unemployed. The at-risk-of-poverty rate for the unemployed is particularly high (above 50 per cent) in Latvia (European Commission, 2009).

Generally speaking, Latvia learned how social security can be used to support economic recovery and reduce the social impacts of the economic downturn. Yet with large and increasing unemployment rates, it remains to be seen whether or not social security will be effective in supporting employment in Latvia.

Conclusion

A large number of services of the Latvian social security system have witnessed a sharp contraction of their portfolio values in 2007–8, affecting their long-term sustainability. The social security system has responded by attempting to soften the impact of the crisis through both consolidation (e.g. pension cut-backs) and expansion of social assistance programmes and active labour market policies. Further pension changes, including an increased retirement age, are expected to come into effect from 2016.

Efforts to increase competitiveness through wage cuts were limited. According to the World Bank's employment rigidity index, Latvia is ranked 128 out of 183 countries surveyed (World Bank, 2010). Wage cuts in the public sector were adopted yet according to ILO and EIU data, wages in Latvia continue to increase in real terms year-on-year whilst hours of work have seen negligible changes over the same period. Given current circumstances and a lack of labour law reforms, a protracted Latvian labour market crisis could be a possibility.

The post-crisis situation will most likely be determined by the IMF programme agreed in December 2008 to stabilize the economy. Since this lending package (totalling USD10.1 billion) is built around maintaining Latvia's exchange-rate peg, internal devaluation, i.e. further public expenditure cuts, is foreseen. On a more positive note, structural reforms, notably in education and healthcare, are likely to continue given support from the World Bank for the Social Safety Net Strategy and the fact that these reforms continue to be public priorities. This will at least provide some minimum guarantee for Latvians in face of a prolonged or new labour market crisis.

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