

## **Financial crisis and social protection reforms: Hungary and Latvia**

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Hungary and Latvia have been particularly hit by the recent crisis. Both countries had experienced a high growth from 1996 to 2007, as a result of domestic demand dynamics. As domestic interest rates were higher than Euro/Swiss interest rates, large proportion of bank credit was issued in Euro and (in the case of Hungary) in Swiss francs. Growth was accompanied by chronic and increasing current account deficit. Indebtedness and current deficits became unsustainable in 2008, when both countries signed stand-by agreements with the IMF. The situation is particularly dramatic in Latvia, where GDP is expected to decline by over a quarter from 2008 to 2010.

The two countries engaged in stabilization, involving pro-cyclical budget and monetary policies. These depressed domestic demand even further. As a means to stimulate exports, HUF was also devaluated. Yet, in Latvia, stabilization measures were applied without currency devaluation. Consequently, Latvian stabilization strategy is based on internal devaluation (i.e. wage reduction) and is therefore more demanding on internal demand contraction.

Stabilization policies represented a constraint on social spending in both countries. This pressure was even more pervasive in Latvia. In this paper we aim to establish how distinctive stabilization strategies translated into different national crisis-induced adjustments in social provisions. These are defined as a set of different income maintenance and income guarantee schemes. We will analyze particularly the evolution of pension, unemployment, family and social assistance benefits.

These adjustments involve quantitative and qualitative changes. We will analyze social provision changes from 2008 to July 2010 and evaluate how they can be accounted for by the crisis and stabilization strategy and what is the role of national-specific trends of social policy restructuring.

Although it is still early to evaluate the complete impact of the financial crisis, we consider that a first appraisal is instructive and certainly not premature if we wish a follow up on reforms. This is inevitably a work in progress, since some reforms will be amended. Furthermore, data is lacking on some dimensions, and particularly there is no national-level data for poverty risks or income inequalities after 2008.

Other authors have already analyzed how the recent crisis affected welfare provisions. Drahekoupil and Myant (2009) contrast the impact of the crisis across post-communist varieties of capitalism. This is also the aim of Bohle (2010), who also

contrasts developments in Hungary and Latvia, as representatives, respectively, of Central European embedded neoliberalism and Baltic (disembedded) neoliberalism. This work recovers Greskovits and Bohle (2007) distinction of welfare regimes in post-socialist countries.

Rather than focusing on regimes or varieties of capitalism, our paper focuses on the evolution of national social protection arrangements. The evolution of Hungarian welfare state is largely documented (e.g. Cerami and Vanhuyse 2009; Haggard and Kaufman 2008, Inglot 2008, Szira and Tomka 2009). The dynamics of the welfare state in Latvia have received less attention, but their history and features are also detailed in the literature (e.g. Aidulaite 2004, Bite and Zagorskis 2003, Groduma 2002, Rajevska 1997, 2005).

This literature shows that social protection evolution in the two countries has been simultaneously cumulative and path breaking. A punctuated-evolution framework (Campbell 2004) can explain this pattern. Here, cumulative institutional evolution is disrupted at critical junctures. A crisis can open a window of opportunity, facilitating certain changes. This was the case of systemic transformation crisis in the 1990s. Does the recent crisis facilitate the introduction of path-breaking reforms? Some IMF- and World Bank-related publications (e.g. IMF 2008, 2009a; Mitra *et al.* 2009) maintained that the present crisis is an opportunity to promote specific welfare system changes, such as increasing the role of means tests.

How can we understand social protection reforms in Hungary and Latvia from 2008? Can they be explained by the dimension of the crisis and by the stabilization strategies introduced in the two countries? Or are they in line with social protection reforms from 1990?

Our paper starts establishing the stylized facts of social protection evolution and

crisis in Hungary and Latvia. The situation in each country is addressed in separate chapters. These present briefly social protection reforms from 1990-91 to 2007, followed by the presentation of the crisis, stabilization policies and recent social protection reforms. We then turn to a comparative account of how crisis and stabilization influenced the evolution of different welfare provisions and how these can be understood in the context of the national welfare state reform paths.

## **1. Hungary**

### **1.1 Welfare state arrangement dynamics**

The precise account of Hungarian welfare state reforms is well documented in the literature (e.g Haggard and Kaufman 2008, Inglot 2008, Szikra and Tomka 2009). In spite of some continuities, these authors highlight that major reforms were introduced. Our aim here is outline the major feature of reforms, in order to understand how these influenced recent welfare reforms.

Like other regions in the Austro-Hungarian Empire, Hungary introduced a social insurance system in the late 19th century. This covered only a minority of workers and included sickness insurance, old-age pensions and disability pensions.

These arrangements did not disappear under socialism. Rather, after retrenchment in the early years, social insurance became universal in the early 1950s. Pensions were reformed and combined employment-related ingredients with Soviet-style division of workers into groups.

Hungarian socialist economy was importantly reformed in 1968. “Goulash Communism”, as identified by Kornai, combined plan and market. This improved access to goods and services. Furthermore, family allowances and maternity benefits

developed importantly in the 1960s and 1970s. Nevertheless, poverty was not a high priority objective and Hungarian sociologists denounced pauperization from the 1970s (Ferge 1997; Haney 2002).

Some thought this gradualist approach could be sustained during systemic transformation. In the field of social protection, Antal government's welfare reforms were incremental (Ferge, 1997). For example, the introduction of social assistance in the early 1990s addressed both destitution dating back to *central planning* and the growing hardship deriving from economic transformation.<sup>1</sup>

In the period 1990-93, Hungarian GDP lost a cumulative 15.6 percent. Systemic crisis carried significant labor market changes. Cumulatively, employment dropped by 30 percent up to 1995. These involved both inactivity and unemployment expansion. Employment rates lost fourteen percentage points from 1990 to 1994 (Transmonee database). Unemployment increased steadily up to 1994, and was over two digits in 1992-96.

### *Figure 1*

Figure 1 shows growth resumed from 1994. Nevertheless, faced with considerable macro-imbalances (such as inflation and current account deficit), Hungary adopted a stabilization package in 1995 (known as the Bokros package). This slowed growth, but improved inflation and current account balance. Economic growth resumed to a high level for 10 years after 1997, when it came to a halt due to the economic crisis, which we will examine later.

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<sup>1</sup> Indeed, in 1980s, poverty rates were as high as 10 percent (Sibos, 1994). These more than doubled in 2 years (*idem*).

Dramatic wage drops accompanied employment reduction. Moreover, wages continued to decline after economic growth resumed. In 1996, real wages had lost 23 percent relative to 1989. This led to a decreasing wage share during the 1990s (Molnár and Galla 2008). Real wages caught up rapidly in the first half of the 2000s. Nevertheless, real wage growth over the last 20 years was clearly inferior to GDP growth. While in 2009 GDP in volume was 26 percent higher than its 1989 level, the corresponding real wage growth was only 13.4 percent (which makes up a 0.67 percent average annual growth).

While systemic transformation did not entail a big-bang social policy transition, significant social protection reforms were introduced in the fields of unemployment insurance, pensions as well as family provisions. Pension reforms were certainly the more noticeable and International Financial Institutions outstandingly influenced their design (Müller 2003, Orenstein 2008).

Different and successive reforms had distinct (sometimes contradictory) impact on social protection. In general, 1990-91 reforms introduced unemployment insurance and separating pension and insurance budgets; this enhanced decentralization and social insurance ingredients. Conversely 1993-98 major reforms include unemployment benefit retrenchment, public pension determination changes, pension partial privatization, as well as the introduction of private health funds. These changes expanded social assistance and private insurance ingredients. As we will see, reforms were afterwards amended and sometimes reverted. They translated into generally decreasing benefits, but with some fluctuation.

Unemployment benefit was reformed repeatedly between 1991-93. Early changes increased the reference period and redistribution. Conversely, 1993 reforms reduced the proportion of average wages that was paid and abridged its length (from

24 months to 360 days). Consequently, average unemployment benefit as a proportion of average wages fell by over 20 percentage points during the 1990s. At the end of statutory period, the unemployed could receive means-tested unemployment assistance. The proportion of those unemployed for less than a year (i.e who were longer entitled to unemployment insurance) decreased from 68 percent in 1993 to 50 percent in 1996; this was 52 percent in 2000 (Eurostat). By 2007, 31 percent of the unemployed received unemployment insurance, while 15 percent were only protected by non-contributory schemes (ILO Social Security Database).

As was the case with unemployment insurance, early 1990s pension reforms enhanced social insurance: particularly, pension fund was separated from the budget and minimum and basic pensions were introduced. Nevertheless, redistribution remained limited and the state pension system continued to different brackets. Redistribution was further limited by different reforms: reference wages were increased in 1992;<sup>2</sup> voluntary private pensions plans were introduced in 1993; and the pension system was partially privatized in 1998. These reforms increased the benefit-contribution link, which was further enhanced by the introduction of Swiss indexation in 1996.<sup>3</sup>

These reforms translated into a non-redistributive pension system.<sup>4</sup> In the early years, the average net pension gained relative to wages. This was followed by a relative loss and state pensions lagged behind wages from 1999 to 2003 (when real wages were increasing very rapidly). Nevertheless, pensions rapidly recovered their relative level in 2007 (Figure 2).

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<sup>2</sup> The traditional pension formula integrating the best three over the last five years was reformed to integrate the average wages from 1988.

<sup>3</sup> Prior to 1996, pensions were indexed to average wage increases. In the Swiss indexation, pensions are indexed to an average of price and wage increases. It therefore protects pensioners less from the evolution of the lifestyle.

<sup>4</sup> For example, in 2008, Gini coefficient for pensions was as high as that on wages (33.6) and above that of total incomes (27.2) (OECD).

## *Figure 2*

The balance between public and private pensions in Hungary is rather complex. It is true that the introduction of compulsory private pension plans contracted the role of the public system. Nevertheless, while participation in private compulsory schemes exceeded earlier expectations, some of its members (particularly older persons) made use of regular switching-out possibilities and opted for the public pension alone system (Figure 3).<sup>5</sup> This can be explained by two factors. On the one hand, some persons opting for the mixed system realized they had made a bad choice.<sup>6</sup> On the other hand, the real rate of return in Hungary from 1998-2007 was 2.6 percent. As a consequence, the state pension system remains at the heart of the Hungarian pension system.

## *Figure 3*

Furthermore, voluntary pension accounts are merely a tax-reduction instrument (Simonovits 2009); as such, contributions are partly *de facto* budget transfers.

We can observe a similar pattern of state disengagement coupled with a persistent state commitment in the Hungarian health system. Early 1990s reforms strengthened the social insurance dimension and decentralized management. Voluntary private health insurance was introduced in 1993. Public health spending as a proportion of GDP declined over the 1990s, from 4.3 percent in 1991 to 3.3 percent

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<sup>5</sup> The mixed pension system was compulsory for new entrants and voluntary to others. Originally, people had to make a decision by 1999, but this option was left open until 2002, and was again open in 2008.

<sup>6</sup> Since persons in the mixed system lost  $\frac{3}{4}$  of their public pension, older workers actually lost when they joined the mixed system.

in 1998 (OECD). This was accompanied by a decline in the proportion of public sources in health funding, from almost 90 percent in 1991 to 70.6 percent in 2007 (WHO).

In spite of this decline, social insurance remains at the heart of the reformed health system. On the one hand, Health Insurance Fund management was recentralized in 1998. On the other hand, public health spending as a proportion of GDP increased during the 2000s, to 5.8 percent in 2007. Public spending still represents the bulk of health spending. By the mid-2000s, voluntary health funds covered only approximately 1 percent of health care expenditure (WHO).

There is a continual, but reduced, state engagement, which was accompanied by the growth of out-of-the-pocket payments. These changes were hardly linear. Out-of-the-pocket payments were expanded by the Bokros stabilization package in 1995, but some cuts were reversed afterwards (e.g. dental reimbursements). In 2006, in the context of a new stabilization package, new reforms introduced Co-payments, which were later cancelled after the March 2008 referendum (over 80 percent voted against doctor and hospital fees).

In any case, the amount of private payments is certainly increased by informal payments. These have been estimated to represent 7 to 11 percent of total health expenditures in 1989-96 (Gáal 2004). While their integration would not change the balance between public and private spending, they would considerably increase private spending.

The case of health spending shows that the definite impact of stabilization packages is not straightforward. This can also be observed in the context of family benefits. 1960s-70s Family benefits were largely left unchanged up 1995. The 1995 Bokros package aimed at reforming family benefits, through the use of means-tests

(in family allowances and in maternity benefits for non-working mothers). Nevertheless, this did not shift the system radically. In particular, the constitutional court ruled against the original targeting proposition.<sup>7</sup> The measure was largely contested and social scientists were frequently against.<sup>8</sup>

In 1998, family allowances were switched back to universal provisions, although at lower level. While the family allowance represented 14 percent of average wages in 1991, this had declined to 6 percent in 1999 (Transmonee database). Simultaneously 1998 reforms introduced tax allowances (not tax credits), which are favorable to middle, rather than poor classes and are therefore contrary to the spirit of means-testing.

Social assistance in Hungary has also resisted means-tests and remains dominated by categorical benefits. No guaranteed minimum scheme was introduced in Hungary. Mitra *et al.* (2009) estimated that the poorest quintile was covered by social transfers in 2004, although only 10 percent received regular social assistance.

Overall, this brief account of social protection changes in Hungary highlights that considerable reforms were introduced, but that neither implied a sharp shift. State social insurance remains at the heart of the welfare system, although private insurance has gained some importance. This involves notably pension plans as well as self-insurance, since persons increasingly financed their welfare spending out of their savings.

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<sup>7</sup> Although the original design intended to exclude the top 20 percent of income distribution, the introduced package only excluded the top 10 percent (Sibos and Ringold, 2005).

<sup>8</sup> This austerity package was inspired by Kornai's propositions for targeted assistance (Ferge, 1998). The World Bank later backed the use of means-tests (1996). Nonetheless, an important number of social scientists challenged the social minima as excessively low (Haney 2002); furthermore, some existing studies considered that universal family allowances were actually a good option to target child poverty (Ferge, 1998; Sibos and Ringold, 2005).

The outcomes of these reforms were also mixed. On the one hand, Hungary has a rather high inequality level. On the other hand, social provisions reduce considerably total poverty risks (at 60 percent equivalized income).

Income inequality increased during the 1990s and then stabilized at a rather high level. Gini coefficient was 0.30 in 2000; this was considerably higher than Czech Republic, Slovakia or Slovenia. Gini coefficient declined to 0.27 in 2008 and is now close to the values in those countries; this was due to an improvement in the relative situation of the middle classes.

This can partly be explained by the evolution of social provisions. Pensions, which are the most important social transfer, are not redistributive and their concentration increased during the 1990s (Mólnar and Galla 2008). This was a result of the increasing benefit-contribution link. Other social transfers are redistributive: family benefits and unemployment benefits clearly decreased income inequalities in 1997 and 2002 (Mólnar and Galla 2008).<sup>9</sup>

According to the Eurostat, Poverty rates in Hungary are among the lowest in the EU. This is partly a result of social transfers. In 2008 social transfers reduced (relative) poverty rates by almost 60 percent (Eurostat). This effect has increased since 2000 (Figure 4).

#### *Figure 4*

Nevertheless, three comments are in order. First, Eurostat uses relative poverty

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<sup>9</sup>Nevertheless, unemployment benefits represented a decreasing and marginal part of household income in these years (less than 1 percent in 2002) even among the poorer households (6.2 percent in the first decile) (Mólnar and Galla 2008).

rates, which are tricky to compare between countries with very distinct average income. For example, in 1999, the official poverty line (lower than the Tarkí poverty line) was equivalent to 73 percent of the equivalized average income (Fóti 2003). Second, poverty rates increased considerably during the 1990s (Mólnar and Galla 2008). Relative poverty rates (at 60 percent of equivalized income) increased over the 1990s (Figure 4). Third, poverty rates are very distinct across the population. While pensioners face poverty risks lower than average, these are considerably higher among the Roma population and among the unemployed. For example, in 1993, 1997, 1999 poverty rates for the unemployed were three times higher than average (Mólnar and Galla 2008).

To conclude, Hungarian social provisions were considerably and repeatedly reformed since 1989. The outcome was a complex system, organized around social insurance and involving some private and self-insurance. Social protection was only limitedly redistributive, but effective in reducing extreme poverty. We will see in the next section how these provisions were influenced by the financial crisis.

## **1.2 Crisis and social protection adjustments**

Social protection developments were accompanied by a remarkable growth throughout 1997-2006 (see Figure 1 above). During this period GDP grew above 5 percent. Investment grew importantly in 2000s and Private consumption grew above GDP in the early 2000s. Internal demand growth was fuelled by credit, especially credit issued in Euro and Swiss francs.

Nevertheless, growth was accompanied with macroeconomic imbalances. While inflation was lower than in the preceding decade, it was above inflation in other

countries; this harmed international competitiveness.<sup>10</sup> As a result, Hungary developed a chronic and cumulative current account deficit. Furthermore, fiscal deficit was considered alarming by EU authorities, and Hungarian government had been forced to adopt a stabilization package in 2006.

In this context, Hungary was immediately touched by the 2008 crisis. Credit crunch and foreign demand drop can explain why growth slowed down in 2008. Situation worsened in 2009, when Hungarian GDP is estimated to have fallen by 6.3 percent (IMF 2010).

While the crisis is expected to be less dramatic than the transition crisis of 1989-93, it represented a visible break in the previous ten-year growth-record. Additionally, household demand stopped fuel growth. According to IMF (2010) estimative private consumption dropped by 7.2 percent in 2009 and should continue to decrease by 3 percent in 2010. Gross fixed capital formation is estimated to have dropped by 7 percent in 2009 but should restart to grow in 2010.

While 2008 perspectives seemed less gloomy, IMF approved a €10.5 billion loan in November 2008. This loan was supplemented by a €6.5 billion engagement from the EU's balance of payment financing facility (disbursed €5.5 billion up to now). The World Bank made €1 billion available, but up to now no documents were signed.

IMF and EU loans carried similar conditionality. This involved, particularly, fiscal consolidation. IMF letter of intent defined the instruments to securing fiscal consolidation as: “*(i) keeping nominal wages in the public sector constant throughout 2009, (ii) eliminating the 13th monthly salary for all public servants, (iii) capping the 13th monthly pension payment for pensioners at HUF 80,000 and eliminating the*

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<sup>10</sup> Between 1990 and 2007, real exchange rate HUF to USD increased by 93 percent (IMF data).

*13th monthly pension payment for all early retirees, (iv) postponing the indexation of selected social benefits, and (v) trimming operating expenditure allocations to all ministries across the board.”* (IMF 2008). As a consequence, over 2009, private sector real wages increased by only 0.3 percent, while public sector real wages fell by 8.7 percent (HCSO).

Hungary abandoned its peg against the euro and moved to a floating exchange rate in early 2008. This led to a devaluation, which improved the current account deficit. In 2009, imports dropped by 15.3 percent (IMF 2010). Nevertheless, exports also decreased importantly (by 9.5 percent).

Exchange rate depreciation against the Euro increased the value of loan issued in foreign currencies and made it harder for households and firms to repay their loans. Economic slowdown worsened the situation. In this context, bank loan arrears increased. The proportion of non-performing loans (with over 90 days arrears) increased from 4.7 in 2008 to 10.1 percent at the end of 2009 (Magyar Nemzeti Bank, 2010). Both HUF and foreign currency-designated loans dropped.

As a consequence of economic slowdown and credit crunch, Hungarian housing prices went down by 8.3 percent in the third quarter of 2009 (FHB index). They are expected to drop by an additional 9 percent in 2010 (FHB projections). This should affect average household wealth negatively, but could be facilitate access to housing to lower deciles if the credit market were more dynamic.

External demand contraction, associated with the reduction of credit to firms has contributed to reduce investment and employment. In 2009, *“large firms significantly reduced permanent employment, in contrast to small and medium-size firms, which actually increased their permanent employment.”* (Ramalho 2009).

In this context, unemployment rate increased by 3 percentage points between end of 2007 and end of 2009. In the second half of 2009, the rate of unemployment was 10.5 percent and climbed to 11 percent over the first half of 2010 (HCSO). Unemployment rate had not been this high since 1995.

Consistently, unemployment spells increased. Over 46 percent of the unemployed in 2009 had been looking for a job for over a year. As we have seen previously, are not entitled to unemployment benefit.

Men in manual occupations in manufacturing and with only primary to vocational education were particularly hit by unemployment increase (HCSO). These also represent an increasing proportion of part-time work. Nevertheless, the proportion of those unemployed with college and university education increased significantly in 2009.

These quantity (employment plus working hour) adjustments were accompanied by wage reduction. In 2009, real wages dropped by 2.4 percent and the real minimum wage lost 1.4 percent. Real wage contraction was particularly impressive in public administration, where net wages contracted by 12.4 percent in real terms (HCSO).

Economic crisis had rapid fiscal implications: it depressed fiscal revenues and it increased social benefit demands. State budget receipts decreased by 0.6 percent in 2009; income taxes fell by 9 percent and social contributions fell by 6.2 percent (HCSO 2010). Over 2009, income taxes fell by 15 percent and social contributions by 7.3 percent.

Spending in social benefits increased in nominal terms by 2 percent in 2008 relative to 2007 (this increase was beneath the 6 percent inflation rate). In the first three quarters of 2009 total spending on social benefits in cash increased by 3.2 percent. This was followed by a decline; over 2009, spending on cash social benefits

decreased by 0.3 percent and spending on benefits in kind fell by 2.2 in the first quarter of 2010 (HCSO 2010).

The fiscal effect of this crisis should be understood in a context of pro-cyclical policies. These constraints were partly self-imposed, because in 2008, Hungarian parliament issued a fiscal responsibility law restricting fiscal deficits, thus limiting counter-cyclic fiscal policies (Cordero 2009). The restraint was further hardened by IMF conditionality. November 2008 stand-by agreement with the IMF included measures to bring the government deficit down from 4.9 percent of GDP in 2007 to 3.4 percent in 2008 and to 2.5 percent in 2009; this was revised afterwards to 4.1 in 2009 (IMF 2009).

*“Even though the IMF has accepted upward revisions of the fiscal deficit target, the prevailing goal has continued to be one of containing spending.”* (Weisbrot *et al.* 2009: 41). Pro-cyclical fiscal policy put an important strain on social spending. Decisions over spending cuts carried change in social benefit spending structure. Unemployment-related spending went up by 46 percent, while spending cuts hit family allowances, sick pay as well as pensions.

Maternity allowances, child-care allowance and child-care fee are now available for a more limited period of time. The universal childcare allowance childcare allowance was more importantly reduced; particularly it is only paid until the child 2<sup>nd</sup> birthday (3 previously) and only paid to persons under 20 (23 before). These measures are oriented by the aims to control spending and to promote incentives to labor market participation.

In 2009, per capita childcare allowance (GYES) declined by 2.2 percent, while the average child care fee (GYED) increased by 6 percent. Nevertheless, the

employment-related system was also downgraded. Minimum contribution record was increased from 180 to 365 days and Maternity leave will be paid only after childbirth. New regulations on parental benefit were enacted in May 1<sup>st</sup> 2010, but concern only children born after that date (this was a Constitutional Court imposition).

Sick allowances were reduced. The proportion of the previous wage paid was reduced from 60-70 percent to 50-60 percent. The duration shortened and ceiling established at 150 percent of the minimum wage. Expenditure on sick pay per day was reduced by 0.7 percent and the number of sick-pays days was reduced by 2.5 percent (HCSO).

Other social spending cuts included phasing-out energy price subsidies until 2010 and eliminating housing loans interest subsidies (in 2009).

The 13<sup>th</sup> month pension was abolished and retirement conditions were tightened. The minimum contribution period is now 20 years. Early retirement penalties were also increased. From 2012 retirement statutory age will be increased (from 62) by six months each year until it reaches 65. Disability pensions were reformed in 2008 and oriented around return to work.

Pension indexation was also changed. Previously, pensions were indexed according to the Swiss indexation, i.e. 50 percent of wage increases plus 50 percent of inflation indexation. The new indexation method depends on the GDP growth: (i) if GDP growth is beneath 3 percent, pensions are indexed to inflation alone; (ii) if GDP growth is 3-4 percent, pensions will be indexed to 20 percent of wage growth and 80 percent inflation; (iii) if GDP growth ranges between 4-5 percent, indexation will be 40 percent of wage growth plus 60 percent inflation; and (iv) only if GDP growth is above 5 percent will Swiss indexation be applied. This pension indexation adjustment

can have a mix effect, since with low wage growth, pensions should actually grow above wages. Meanwhile, average pensions declined by 1 percent in 2009 (i.e a 5.2 real loss).

Furthermore, public pension cuts were aggravated by pension fund losses. Hungarian Pension funds were among the most strongly hit in the OECD during 2008 (OECD 2009). Overall, the cumulative losses from January 2008 to June 2009 were above 13 percent in nominal terms. World Bank (2009) maintains this loss has limited implications in the medium and long run. Nonetheless, it affects directly the pensions of those close to retirement. Furthermore, Hungarian funds' real rate of return from 1998 to 2007 was only 0.6 above GDP growth; such underperformance *“signals issues regarding industry structure, regulation, and financial market development that have to be addressed”* (World Bank 2009).

Hungarian government addressed this problem in two main ways. On the one hand, information procedures were hardened.<sup>11</sup> On the other hand, those aged over 52 were encouraged to switch back to the social insurance system until the end of 2009. 10 393 persons switched to the public pension alone from March to September 2009. During 2008-2009, 26 880 persons switched back to the public system only system (HFSA). This represented an increase in relation to previous years, but it should be noted that switching back to the social insurance model was even more important in the years 2000-03, when 111 690 persons left the second pillar (HFSA) (see Figure 3 above).

Whereas switching back to the public pension alone system is expected to limit the impact of asset losses on those closer to retirement, this actually implied a change

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<sup>11</sup> The HFSA has introduced a new communication strategy, emphasizing the importance of the disclosure of ten-year performance records, including an explanation of weak returns (HFSA Financial Market Trends No. 96 Volume 2009/1).

of the balance between public and private pension schemes. It also carried a redistribution of pension assets and liabilities. In 2010 there were some rumors on pension fund nationalization; however this is very unlikely because of IMF and World Bank opposition to such a measure. From June 2007 to June 2009, voluntary pension fund membership contracted by 4.5 percent (HFSA).

Therefore, fiscal constraints justified quantitative cuts but also qualitative changes. Neither was very expressive. The medium term impact of these changes is unknown. We have seen previously stabilization did not have a linear impact on welfare provisions. For example, in 1995, the use of means-tests was limited by Constitutional Court ruling and was reverted three years later. Later, health co-payments were introduced as part of a stabilization package in 2006, but abandoned two years later. Recently, the Constitutional Court imposed once again limits on family allowance cuts.

Nevertheless, this does not mean stabilization did not have an impact on welfare provisions. Family benefits were reduced during the 1990s and again in 2010. Hungarian Constitutional Court rulings on the subject mainly forced governments to slow down benefit cuts.

Furthermore, while reforms have enhanced private insurance, social insurance remains at the heart of the Hungarian welfare system. The complex Hungarian pension system is a remarkable example of the tensions between private and public insurance. We have seen how entitlements and contributions have been repeatedly switched between public and private schemes. Furthermore the different brackets erode the state system's Bismarkian basis.

In order to analyze these developments comparatively, let us look into Latvia's social protection adjustments in the face of the systemic transformation and the

current crisis.

## **2 Latvia**

### **2.1 Social protection dynamics in Latvia**

Social insurance was introduced in Latvia in the early XXth-century. Pensions and sickness funds developed under Russian domination. Their coverage was enhanced during independence (1920s and 1930s), when sickness funds became self-managed. No unemployment insurance existed, but the unemployed were entitled to social assistance.

Under Soviet rule, Latvian welfare provisions were universal but entitlements were occupation-related. Since trade unions had a delegation on social welfare provisions allocation and determination, the jobless and non-unionized workers were frequently excluded. Nevertheless, these were a marginal group. Furthermore health care was available free of charge for all.

Pensions and maternity benefits were employment-related and financed out of taxes on employers' wage fund. Pensionable age was low (55 for women, 60 for men), but benefits were low and pensioners were over-represented among the poor (Shilneva 2005). Maternity benefits paid the previous wages 56 days before childbirth and for an identical period afterwards.

Welfare provisions were swiftly reformed after independence in 1991. Social insurance budget was separated from state budget. Social assistance was decentralized to municipalities, who were to self-finance half their social expenditure.

Over the 1990s, Latvia experienced the deepest systemic crisis in Eastern Europe. GDP lost over 50 percent from 1991 to 1993 and a second downturn occurred in 1995 (Figure 5). Income loss was aggravated by high inflation, which, in the early-

1990s, was over 100 percent. By 1999, real GDP was still at 65 percent its value ten years before; real wages lost 35 percent over the same period.

Crisis was followed a steed growth from 1996 to 2007, when GDP nearly doubled. This was accompanied by strong (but beneath GDP) real wage growth.

### *Figure 5*

Unemployment followed GDP evolution in the early 1990s and increased steadily up to 1995, when it reached almost 19 percent. It lagged behind GDP recovery, and unemployment rate was still over 14 percent in 2000. As in Hungary, activity rates declined dramatically; Latvian employment ratio lost 17.5 percent during the 1990s. These losses were amplified by population outflows; during the 1990s, total net migration totaled 132 500 (representing 5.5 percent of 1999 Latvian population).

A flat-rate Unemployment benefit was established in 1992. An insurance-related scheme was only established in 1996. The proportion of the previous wage paid declines with unemployment duration and increases with employment record.<sup>12</sup> Entitlement was exhausted after 9 months .No specific social assistance scheme protects the unemployed after insurance exhaustion. This, along with a high turn down by the services, explains low coverage (IBRD 2010). By 2008, at the wake of the financial crisis, only 35 percent of the unemployed received unemployment benefit (ILO Social Security Database).

<sup>12</sup> More precisely, up to 2009, unemployment benefit calculation, as a proportion of previous wage, is given by:

<i>Insurance record</i>	<i>1-9 years</i>	<i>10-19 years</i>	<i>20-29 years</i>	<i>Over 30 years</i>
Less than 3 months	50%	55%	60%	65%
4 to 6 months	37.5%	41.25%	45%	48.75%
7 to 9 months	25%	27.5%	30%	32.5%

The number of pensioners increased significantly during the 1990s.<sup>13</sup> Special pension schemes were the main ways into retirement. Although Latvian pension system abandoned rapidly the occupational discrimination characteristic of the Soviet era, some engagements associated with that period (e.g. service and special pensions) proved to be an enduring legacy.<sup>14</sup>

In the first half of the 1990s, the pension system was virtually flat. In 1996, the public pension system was reformed into a notionally defined contribution scheme. In this system, pensions are determined based on a fictitious individual contribution account, whose capital is divided into monthly payments using life expectancy at retirement. Furthermore, early retirement was penalized.<sup>15</sup>

The implementation of the notionally defined contribution scheme in Latvia involved important adaptation. Firstly, individual accounts could not be established because individual records did not exist. Therefore it was decided that pensions would be calculated based on accumulated pension capital from January 1, 1996 and average insurance contribution wage from 1990 until 1999.

Secondly, while pension reform was not controversial at first, its application created great distress<sup>16</sup> and gave way to successive amendments, introducing redistributive features: (i) individuals with over 30 years of insurance and with low wages during 1996-99 are credited with average national wage; (ii) from 1998, only

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<sup>13</sup> While the number of old-age pensioners increased by 7 percent during the 1990s, the number of disability pensioners increased by 21 percent and the number of recipients of service pensions (perceived in occupations involving hard work) increased by 125 percent. Also the number of pensioners under special regulations (perceived by Chernobyl victims) increased particularly in the second half of the 1990s.

<sup>14</sup> In 1996, 91 percent of the recipients of service pensions were under 60 and all special pension recipients were under 60 (95 percent were under 55).

<sup>15</sup> Early retirement was phased out up to 2008 but its extinction was rescheduled to 2012.

<sup>16</sup> "The outcome was shocking for the society. Variance between the lowest and highest pension was enormous." (Bite and Zagorskis 2003).

low pensions were indexed;<sup>17</sup> and (iv) a minimum pension was set, depending on state social benefits as well as the length of the working period.<sup>18</sup>

Furthermore, pension reforms maintained a differentiation between old-age pensions and service pensions (paid to those working under hard conditions) and pensions under special regulations (paid to victims of Chernobyl and their family).

As a consequence, the existing Latvian pension system is very different from the notionally defined contribution blueprint.

### *Figure 6*

Figure 6 presents the evolution of the ratio of average net pension to the average net wage. This increased importantly with the 1996 reform. Nevertheless, pensions remain, on average, quite low and beneath the subsistence minimum (Figure 7).

### *Figure 7*

Latvia introduced voluntary private pensions in 1998 and compulsory private pension plans were enacted three years later. The mixed pensions system, combining state-run pay-as-you-go pensions and funded pensions was compulsory for those

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<sup>17</sup> From 1998, only low pensions were indexed to CPI and, in 2002, extremely low pensions were indexed to both wage and price variations. The situation changed in 2008 when wage increases were lower and, in that year, pensions lower than 135 LVL were adjusted to CPI whereas those pensions ranging from 135 to 225 LVL were adjusted to the average of price and wage variation.

<sup>18</sup> Minimum pension is calculated based on the following table:

<i>Contribution record</i>	<i>As proportion of state social benefits</i>
none	1.0
< 20 years	1.1
21 to 30 years	1.3
31 to 40 years	1.5
> 40 years	1.7

under 30 and voluntary for those aged 30 to 49. Private pension funds attracted a considerable number of members, particularly between 2004 and 2008.<sup>19</sup>

The reform required the public scheme to share payroll taxes with compulsory pension plans. The proportion going to the later was expected to increase progressively to 10 percent in 2010, but, as we shall see, this figure was downgraded in May 2009.

Health insurance reforms also involved considerable national adaptation. “*The Latvian health care system consists of a unique mix of tax-financed statutory health service provision, within a social insurance institutional structure embodying a purchaser–provider split, together with a mix of public and private providers.*” (Tragakes *et al.* 2008: 35). Health was decentralized in 1994 and recentralized in 1996, due to concerns about equity and administrative costs. Presently, SCHIA allocates the resources it receives from Treasury and signs contracts with all statutory health care providers.

Latvia health system was universal and, until very recently, free of charge for certain groups (persons under 18, chronic diseases, Chernobyl victims and the disabled). Most patients pay a fee for consultations and hospitalization and a proportion of medication costs.

From 1996 out-of-the pocket payments represented over 40 percent of total health expenditure. While this figure is in itself high in international perspective, it includes only rather conservative estimations of informal payments (Tragakes *et al.*

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<sup>19</sup> Nevertheless, the numbers of pension members include inactive members, who do not make contributions; these were 22 percent in 2005 and as much as an 11-15 percent in 2006-08. The number of new members declined considerably from 2008, as a consequence of the financial crisis.

2008). Private insurers' spending remains residual and mostly contracted for by employers.

Up to now, family transfers remain largely universal. These include child-care benefits (depending on child age), State Social Benefits (depending on the number of children), birth grant and an Alimony guarantee fund (introduced in 2005). These allowances are generally low but were importantly increased in 2005.

Both maternity and sickness benefits were reformed into social insurance in 1997. Maternity insurance was not changed importantly from the Soviet period; it retains the same duration and remains partly akin to sickness insurance. The benefit was equal to previous average wages until 2010. Paternity leave was introduced recently and insured fathers are entitled to a ten day Paternity benefit, calculated in the same terms as the maternity leave.

Poorer households can apply for municipal social assistance. Social assistance was importantly reformed over the last twenty years, involving particularly under the efforts to promote means-tests. In the early 1990s, municipalities received discretion in social assistance administration coupled with an obligation to finance 50 percent of their spending. This translated into considerable regional inequalities.

There were different attempts to develop means-tests (Rajevska 2005). Nevertheless, since municipalities considered the official subsistence minimum (and even the lower crisis subsistence minimum) too high. As such, there was no agreement on a national-level means-test. In practice, social assistance was dominated by categorical benefits.

A 15 LVL guaranteed minimum income (GMI) was introduced in 2003.<sup>20</sup> It amounted to 27 LVL in 2008 (48 LVL in Riga).<sup>21</sup> It is paid for a maximum of 9

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<sup>20</sup> This value was rather low and represented only 17 percent of the minimum living standard.

months a year. Pensioners and disabled are entitled to a more generous GMI of 90 LVL.

In conclusion, Latvia reformed importantly its social protection. Reforms involved the introduction and expansion of social and private insurance as well as social assistance restructuring. These developments were structured by a restrictive fiscal policy and a prevalence of conservative ideas (Rajevska 2005). Indeed, economic growth 1996-2007 was accompanied by a general decline in spending on social benefits as a proportion of GDP (Eurostat). Not surprisingly, income inequalities as well as poverty rates are high and persistent.

Income inequalities and (relative) poverty rates in Latvia are among the highest in the EU. Income inequalities increased considerably throughout the 1990s, when Gini index grew from 0.26 to 0.33 (Transmonee database); it increased further to 0.34 in 2008 (Eurostat). This is an extremely high value, particularly by EU standards.

According to Zaïdi (2009), this rise in inequalities is due to a rise in the returns of education. It would thus be a symptom of a weak redistribution.

Poverty rates are high, even though the 60 percent equivalent income threshold is low. The situation is clearly worse if we use an absolute poverty threshold; throughout the 1990s, per capita income was beneath the official subsistence level (UNDP).

Increasing poverty in the 1990s was the result of macroeconomic conditions (unemployment, hyperinflation, low wages), but poverty did not decline with economic prosperity. Poverty risks remained rather stable from 1996 to 2003, and rose slightly in 2006-08 (UNDP). Poverty risks are particularly high for women, the unemployed and pensioners.

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<sup>21</sup> This was less than half the national per capita poverty line of 90 LVL.

High poverty risks can also be tracked to generally low social transfers. In 2000, social transfers only reduced poverty rates by 27 percent; this declined to 13 percent in 2008. This proportion doubles if we include pensions among social transfers, but is still lower than in Hungary.

The World Bank has been pushing for the use of means tests (e.g IBRD 2010). In fact, only half of the poorest quintile receives social transfers (Mitra *et al.* 2009). Guaranteed minimum income scheme was expected to reform deeply municipal assistance. The development of means-tests has, however, been less straightforward than expected. One of the reasons can be that income information is quite poor and meant-tests inefficient.<sup>22</sup> Curiously, although state social benefits are categorical and therefore not means-tested, they are more pro-poor (Gassmann 2005).

## **2.2 Recent crisis in Latvia and crisis-induced social protection adjustments**

The macroeconomic conditions in Latvia are somewhat similar to those in Hungary, but much more dramatic in their dimension. Additionally, as we will see, Latvia introduced a modified stabilization strategy.

As we can observe in Figure 5 (see above), Latvia experienced an extremely high growth from 2000. Nevertheless, growth did not eliminate vulnerabilities. This was fuelled by domestic credit, benefiting from extremely low euro interest rates and associated with a housing bubble. Macro imbalances cumulated: The current account deficit was over 22 percent of GDP in 2006-07; inflation reached 10 percent in 2007 and was 15 percent in 2008.

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<sup>22</sup> Milanovic (2000) remarks that although in 1997-98 social assistance distribution is strongly pro-rich if we consider income distribution, it becomes slightly pro-poor if we consider deciles for equivalent expenditure.

Latvia experienced a dramatic downturn from 2008. According to IMF forecasts, the 2008-10 drop would attain cumulatively 26.6 percent (IMF 2010a).<sup>23</sup> According to IMF estimates, GDP will continue to drop in 2010 and it should take a decade before Latvia returns to its 2007, pre-crisis, level.

Inflation swings seem to be a result of domestic demand. Inflation was nurtured by credit expansion in the mid-2000s. It dropped with economic slowdown.

Faced with a rampant current deficit, Latvia took-up a €1.7 billion loan with the IMF in December, 2008. Due to the gravity of the situation, the loan was unusually high<sup>24</sup> and swiftly ratified. This was a part of a loan package from different sources: the EU provided a loan of €3.1 billion, the Nordic countries granted a €1.8 billion, the World Bank supplied €400 million, the Czech Republic €200 million, and the European Bank for Reconstruction and Development, Estonia, and Poland €100 million each.

The World Bank supplied two identical loans: the first *“to strengthen the banking sector and maintain long-term financial stability”*, the second *“to protect vulnerable groups during the economic contraction through the government’s social safety net program, and in the medium term, lay the foundation for structural reforms in the social sectors.”*

As in Hungary, IMF-EU loan involved substantial fiscal restraint. This involved public servant wage cuts as well as public spending cuts. IMF press release maintained, the Fund *“supports the protection of social spending embedded in the program.”* (Press release n. 08/332, December 19, 2009) Nevertheless, as we will see, Latvian authorities did introduce dramatic social benefit cuts in mid-2009.

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<sup>23</sup> This makes up an average contraction of 12.2 percent per year. As a matter of comparison, during the 1929-1933 downturn, US economy lost 30 percent, making up an average contraction of 7.5 percent a year (Weisbrot 2010).

<sup>24</sup> Equivalent to 1200 percent of Latvia's quota in the IMF.

Unlike Hungary, Latvia authorities decided to keep the peg against the euro. Consequently, restoring competitiveness relied exclusively on labor cost compression. This is equivalent to an *internal devaluation* or *real depreciation*. “*Supporting structural reforms and wage reductions, led by the public sector, will further strengthen competitiveness and facilitate external adjustment.*” (IMF Press release n. 08/332, December 19, 2009).

The choice not to devalue was plainly criticized by several economists (for example Paul Krugman, Edward Hugh, Mark Weisbrot to name only a few). Devaluation is usually a part of the stabilization package. The only experience of stabilization without devaluation (Argentina in 1998-2002) can hardly be considered a success and was abandoned after four years.

Still, EU advisors, the Nordic lenders and Latvian government were all favorable to keeping the peg. As of June 2010 Latvian government continues to reject Lat devaluation. Supporters of the currency peg feared the wave of loan defaults and bankruptcies, which would certainly follow the devaluation. Indeed, as much as 89 percent of bank loans was expressed in euros. Nevertheless, as Paul Krugman pointed out “*other things equal, a nominal devaluation and a real depreciation achieved through deflation should have exactly the same effect on debt service*” (Krugman 2008).

Eventually, real estate and credit bubble busted and non-performing loans increased. By the end of the first quarter of 2009, loans with payments overdue amounted to 20.5 percent of the aggregate loan portfolio of Latvian banks; this proportion increased to 27.7 percent by May 2010 (Latvian Financial and Capital

Market Commission). In spite of a government assistance<sup>25</sup> and a drop in interest rates on euro-denominated loans arrears incidents therefore continue to cumulate.

Therefore, internal devaluation has not prevented the development of credit arrears. These constitute a source of banking sector vulnerability (IMF 2010a). Furthermore, as IMF (2009a) noted, an overvalued lat will continue to be a source of current account distress. Furthermore, Weisbrot and Ray (2010) show that without devaluation exports and foreign investment take longer to recover and public debt mounts. Indeed, crisis in Latvia was much deeper than originally expected (IMF 2009, Cordero 2009).<sup>26</sup>

In spite of keeping the lat pegged to the euro, Latvia chronic current account deficit was turned into a surplus in 2009, mainly due to import reduction. This could only be achieved through domestic demand sinking and wage cuts. To be sure, exports decreased by 17.5 percent in 2009. Employment contraction was most significant in exporting firms (Ramalho 2009)

Furthermore, stabilization without currency devaluation carried *social costs*, particularly employment contraction and wage reductions.

Latvia civil servants were particularly hit by the stabilization package. Bonuses and holiday allowances were frozen throughout 2009 and, in July, monthly wages were reduced by 20 percent (MFRL 2010). Public servants' remunerations lost 24 percent in 2009 relative to 2008 (Table 1). Wages (excluding bonuses) in publicly owned firms were reduced by 36 percent in December 2009, relative to 2008 average. This concerned particularly board members. If we exclude those employees, the corresponding reduction was 2 percent (MFRL 2010). By March 2010, Wages

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<sup>25</sup> The government approved a scheme in 2009 that guarantees loan repayments if banks agree to restructure mortgages. The scheme freezes part of the loan for a period of two years and reduces monthly mortgage payments.

<sup>26</sup> While the original letter of intent projected a 5 percent decline during 2009, real GDP fell by 18 percent year-on-year over the first quarter of 2009 (IMF 2009).

(excluding bonuses) in publicly owned firms were reduced by 38 percent relative to 2008 (15 percent in the case of non-board or council members) (MFRL 2010).

### *Table 1*

These wage cuts did not exclude employment reduction. Public employment was reduced by 22 percent between 2008 and April 2008 (MFRL 2010). By December 2009, the number of public servants had already contracted by 19 percent relative to a year before. The number of employees in public firms had been reduced by 11 percent over the same period (*idem*).

In 2009, average wages in the private sector lost 5 percent. Labor cost reductions in the private sector were achieved chiefly through employment cuts and work hours reduction. Work hours decreased by 50 percent in construction and by 33 percent in processing industry (MFRL 2010). Between the third quarters of 2008 and 2009, employment contracted by 16 percent.

Employment contraction translated into an expansion of emigration<sup>27</sup> and unemployment. Unemployment increased by over 10 percentage points in one year. Unemployment rate was 15.8 percent by the end of 2009 and 18.3 percent in the first quarter of 2010. This was the highest rate of unemployment in the EU.

Unemployment touches particularly the young, who experience a specific unemployment rate above 30 percent (EU 2010). The proportion of those unemployed for over a year has been growing steadily from early 2009 and represented 34 percent of the unemployed in the first quarter of 2010.

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<sup>27</sup> According to a Bank of Latvia press release (December 2009), “*In the first half of 2009 the emigration of Latvian residents to Great Britain reached 8.3 thousand, increasing more than twofold within a year. Emigration to crisis-ridden Ireland was 3.6 thousand in the first 11 months of 2009 - 3 percent more year-on-year.*”

As the economy continues to contract, further employment losses are expected over the next two years. *“More than 10 percent of employees, including 20–30 percent of those in central government administration, are expected to lose their jobs through 2011”* (IMF 2009: 22). Employment losses and real wage cuts are, after all, key to internal devaluation.

Crisis combined with stabilization had dramatic consequences on Latvian budget and social spending. Budget receipts declined, while the need for social spending increased. However, the stabilization package involved significant cuts.

GDP drop depressed tax collection. Over 2009, VAT revenues went down by 28.5 percent, corporate tax collection dropped 60.8 percent, personal income tax revenues declined by 29.1 percent. Social security budget was also negatively hit by a 13.4 percent revenue decline.

The Government signed an agreement with the social partners in June 2009. This agreement included measures to increase revenues, such as public firm profit appropriation, increasing some taxes (alcohol and gambling) as well as reducing the non-taxable minimum for the personal income tax from LVL 90 to LVL 35 (i.e from EUR 126 to 49.38). Contributions to the second pillar were also rescheduled (see below).

Public spending reduction measures included :

1. Wage cuts in the public sector (as we have seen previously);
2. Administrative fusions, reductions of spending in different Ministries and cutbacks in different grants;
3. A 70 percent reduction of retirement pensions for working pensioners and a 10

percent pension cuts for non-working pensioners;

4. A 10 percent cut of the national family allowance;

5. A 50 percent decline in parental benefit;

6. Unemployment benefit restructuring, making it flat-rate after a certain time,<sup>28</sup>

7. A contraction of sickness benefits duration (maximum duration was reduced from 52 to 26 weeks or a total of 52 weeks in three years' time),<sup>29</sup> and

8. Health spending cuts.

In 2010, benefits were further cut. Unemployment, sickness, maternity and paternity benefits were divided into two brackets: if calculated benefits are below 11.51 LVL a day they are paid in full amount, otherwise daily benefits will be 11,51 LVL plus half of the sum over 11,51 LVL.

Between 2008 and 2010, the health budget was cut by 25 percent. This was to be achieved through co-payment increases and reducing the list of exemptions; only children and the *needy* are exempt from health co-payments. Elective surgery was suspended (unless patients pay for it in full). There is also anecdotic evidence of difficulties to pay suppliers in sectors depending on central budget. For example, in Summer 2009, "Recipe plus", the largest Latvian wholesaler of drugs threatened to

<sup>28</sup> The previous and new unemployment benefit determination can be represented as:

<b>Insurance record</b>	<b>1-9 years</b>	<b>10-19 years</b>	<b>20-29 years</b>	<b>Over 30 years</b>
Less than 3 months	50%	55%	60%	65%
4 to 6 months	37.5%	41.25%	45%	48.75%
7 to 9 months	25%	27.5%	30%	32.5%
From 2009	45 Lats from 5 <sup>th</sup> month	45 Lats from 7 <sup>th</sup> month	-	-

<sup>29</sup> Based on a special opinion of expert committee, the sickness benefit could be extended but for not more than 52 weeks.

stop supply to Stradins Clinical University Hospital due to arrears of 0.9 million lats (1.3 million euros).

In addition, some anti-cyclical social spending was introduced. GMI threshold was increased in 2009, from 37 to 40 LVL. The public works program pays a 100 LVL monthly wage to its participants.

Table 1 shows the evolution of average benefits. Clearly, there are contrasting dynamics. Average old-age and service pensions increased slightly, in spite of cuts. Average unemployment and sickness benefits decreased by 6 to 7 percent between June 2009 and April 2010. Over the same period, maternity and paternity benefits decreased by 1 to 2 percent and average family state benefit contracted by 4 percent and had not been this low since 2006. Average child-care and child-birth benefits remained barely unchanged.

### *Table 2*

Fiscal strain was increased by incapacity to pursue expected pension cuts. In December 2009, Latvian Constitutional Court ruled out pension cuts. This decision lifted the pension reductions applied to both working and non-working pensioners. Latvian Government should pay pensions back in full from February 2010 and the previously withheld part of the pensions paid back, in one payment, in April 2010. These make retroactive payments equivalent to 1.5 percent of GDP. A new IMF/EU agreement allows Latvia to meet the cost of paying full pensions by expanding the 2010 budget deficit to a maximum of 8.5 percent of GDP.

Nevertheless, overall, there were considerable pension adjustments. Pension

indexation was frozen for two years. In the future, pensions will only be indexed to inflation; this will entail replacement rate decreases in periods of wage growth. Early retirement pension penalties increased from 20 to 50 percent of normal pension; it will no longer be an option after January 2012.

While the IMF and World Bank called for retirement statutory age increases (currently 62), in 2009, Ministry of Welfare maintains retirement statutory age should be increased after the crisis is over.

Reforms also involved rebalancing private and public pensions. Particularly, contribution shares were changed. Original pension reform blueprint had established that 8 percent of pension contributions would go to private funds in 2010 and should increase to 10 percent. Actually, this proportion was reduced to 2 percent in 2009-10. In 2009 it was decided that these should reach 4 percent in 2011 and 6 percent from 2012.

Overall, Latvia pension plans returns were -21.8 percent in 2008. Actually, Latvian pension funds average real rate of return for 2001-07 was already negative at -3.5 percent (World Bank 2009). Pension plan financial situation was further aggravated by contribution losses; over 2009, contributions made to pension plans also diminished by 14.9 percent.

Latvian income tax is only limitedly redistributive (only on income bracket). Worsened by stabilization, since the lower limit was reduced to extremely low levels: from LVL 90 to LVL 35 (i.e from EUR 126 to 49.38), which are well below the subsistence level of LVL 148 (EUR 208.80).

Overall, Latvian welfare adjustments in the face of the present crisis translated

mainly into benefit cuts. Most of these can be understood in the context of a twenty-year trend of state disengagement and fiscal austerity. This is a context of decreasing universal provisions, accompanied by squat social insurance. Unemployment benefits are extremely low and only cover a small proportion of the unemployed. Health-copayments increased. Pension indexation was downgraded and the government tried to curtail the benefits.

On the other hand, changes were not as dramatic as announced. Average benefits were not reduced as importantly as expected and, above all, the Constitutional Court ruled-out pension cuts. Curiously, the intended pension cuts also fit the trend of ad-hoc pension reforms and differentiation proliferation.

Furthermore, the changes in contribution divide between funded and unfunded pension systems can introduce a noteworthy amend in the Latvian pension system. This has changed the balance on contribution division in favor of social insurance.

Additionally, there are discussions over future use of means-tests in family provisions. The World Bank considers this is advisable but not immediately, because it could increase poverty risks (see report). This is somewhat a paradox, since if means-tests were the best option to protect the poor at a lower cost, they should be introduced when poverty concerns are at their highest and lack of resources is most preeminent.

To conclude, crisis in Latvia does appear to have opened a window of opportunity to accelerate state disengagement. Nevertheless, this was accompanied by the backlash of what had been the most important reform in social protection: namely a permanent review of the contribution divide between public and private pensions.

### **3 Contrasting the two national experiences**

#### **3.1 Comparing the crisis-induced adjustments**

After presenting the crisis-induced social protection adjustments in Hungary and Latvia, we depict their major similarities and differences in Table 3.

*Table 3*

Faced with the crisis and the need to pursue stabilization policies, both countries downsized certain social provisions. Particularly both countries cut down pension benefits, increased early retirement penalties and changed pension indexation. Latvia aimed at very dramatic pension reductions which were ruled-out by the Constitutional Court.

Nevertheless, more equitable and slow cuts can be introduced and might phase-out pension adjustments in Latvia. Anyhow, the weight of adjustment was further postponed in both countries, since they are both planning to increase retirement statutory age from 2012.

In both countries, the reforms changed the balance between public and private schemes. In Hungary, there was considerable switching back to the social insurance scheme. In Latvia, the contribution divide was revised and is now more favorable to the public scheme.

Family allowance changes include benefit decline and duration reductions. Entitlement conditions were tightened. In both countries, most important cuts can only concern newborns. Universal provisions suffered the most from cutbacks. Hungary reduced particularly universal benefits. Latvia is considering introducing means-tests.

Sick pay was also reformed in the two countries. Furthermore, both countries reduced other provisions. Hungary abolished energy subsidies and housing loan interest subsidies. Latvia reduced the minimum non-taxable income.

Finally, the major differences between the two countries concern Health and unemployment benefit. Latvia increased co-payments and reduced exemptions. This will increase private spending and reduce the part of public spending in total health expenditures. No co-payments were introduced in Hungary.

In the face of escalating unemployment, both countries were confronted with increasing needs for unemployment benefit. While no major change was introduced to this scheme in Hungary, Latvia changed calculation rules, particularly for those with a meager contribution record. In general, the Latvian system became less employment-related.

We now consider how these differences can be accounted for by the specific experiences of the crisis and by the national experiences of social protection reforms.

### **3.2 Accounting for crisis-induced adjustments: crisis and stabilization**

As we have seen, both economies had experienced a strong growth from 1996 to 2007. This was fuelled by domestic demand and particularly by credit issued in foreign currencies. Nevertheless both economies were vulnerable and their current account deficit escalated. These conditions made the two economies particularly vulnerable to the financial crisis and export-market contraction.

Both countries adopted a stabilization program, including pro-cyclical fiscal policies. Nevertheless, these packages were different. Hungary opted for a standard

package, including exchange rate devaluation. Latvia decided to keep the Lat pegged to the Euro.

Fiscal constraints translated into more restrictive entitlements to social benefits and benefit cuts. These were more expressive in Latvia. Furthermore, fiscal needs can explain the changes in contribution divide between private and public pension schemes in Latvia.

Therefore, the dimension of the crisis, combined with the adoption of a specific stabilization strategy can explain why benefit cuts were more significant in Latvia. Nevertheless, this does not explain completely choices made. Particularly, there are qualitative differences between Hungary and Latvia (e.g. (health co-payments) which cannot be accounted for by fiscal discipline. Furthermore, while stabilization forced countries to reduce fiscal spending, the crisis itself nurtured claims over social benefits. In order to understand these features, we have to reconsider the role of previous reforms and legacies on crisis-induced social provisions adjustments.

### **3.3 Accounting for crisis-induced adjustments: previous social provisions reforms (1990 to 2007)**

National chapters presented the conditions and reforms that influenced the specific organization of social protection in the two countries. Table 4 outlines the major similarities and differences between social protection systems and reforms in Hungary and Latvia from 1990-91 to 2007.

#### ***Table 4***

Recent reforms can be understood partly in the context of two decades of social

provision changes. Indeed, in most cases, they have accelerated existing processes. Already in the 1990s Latvia had experienced a more expressive economic crisis, higher unemployment and emigration. In the past, Latvia has also committed more firmly to fiscal discipline and to a less generous system of social provisions. This can partly explain less generous social provisions. Recent reforms have reduced these benefits even further.

The two countries shared a similar legacy including differentiated occupation pensions, universal family policies and the prevalence of categorical benefits. Some of these ingredients have been maintained. Particularly pensions are not redistributive and family provisions are universal. Furthermore, in spite of attempts to foster means-tests, social assistance continues to be dominated by universal and categorical provisions. Nevertheless, there has been a progress of means-tests in Latvia. These might be enhanced even further and applied to family provisions in the near future.

In spite of similar background, the welfare system had a deeper social insurance legacy in Hungary (Inglot 2008, Szira and Tomka 2009). This legacy was revived in the early 1990s. By contrast, in the early 1990s, Latvia introduced flat-rate unemployment insurance and pensions; these arrangements were motivated by fiscal strain, but did not promote income maintenance. Unemployment benefits introduced only limitedly income maintenance. Last year, Latvian authorities reduced income-maintenance in unemployment benefits.

Generally, social provisions are less redistributive in Latvia and have a lower impact on poverty reduction. Latvia tax system is less redistributive, since it has only one tax rate. Overall, and in spite of pressing needs, Latvia appeared more prone to draconian cuts. In the case of pensions, the cuts involved were so extensive and inequitable, that they could not be enforced. Other high cuts could be pursued and

inscribe in a national trend of social provision reduction.

Private insurance was introduced from the mid-1990s. Three-pillar pension schemes and private health insurance were thought to compensate for decreasing social insurance. Nevertheless, these did not completely live up to their promises. Switching back to social insurance pensions was rather common in Hungary. In both countries, increasing self-finance became a way to cope with marginal private health fund spending. This was particularly noteworthy in Latvia, where the proportion of public sources on health spending declined more visibly. These will decline even further with recently increased co-payments and reduced exemptions.

Pension reforms were the most important feature of social provision transformation over the last 20 years. Both countries introduced three-pillar pension schemes. These were designed to reduce public pension spending. Nevertheless, contribution diversion to compulsory private plans actually exacerbated pension budget imbalances. This fiscal strain was made even clearer in recent years. Countries tried to counter these difficulties through changes in contribution divide (Latvia) and adjustment of balance between pension assets and liabilities (Hungary).

While none of the pension reforms changed the nature of the (three pillar) system, the role of state pensions has nonetheless been clearly amplified. These inscribe in a pattern of recurrent pension reforms, which have changed progressively pension arrangements in the two countries. These gave rise to distinctive national settings, structured by fiscal strategies and implementation problems.

Furthermore, confronted with inactivity increase in the 1990s, both countries reformed their social protection in order to increase incentives to return to work. Early retirement penalties were introduced before, and increased recently. Sick pay and

family allowances were also downgraded in the two countries. Hungarian family allowance reform was particularly oriented toward increasing incentives to female participation.

To conclude, the specific history of previous social provision reforms can explain national differences in recent crisis-induced reforms. These new reforms can be understood in that context. Latvia, the less generous, was the country introducing more impressive cuts, in spite of more pressing needs. Additionally, Hungarian governments did not embrace changes abandoned in the past, even though these might carry considerable fiscal gains. This was the case with means-tested family allowances or health co-payments.

### **Concluding remarks**

This paper has contrasted social protection reforms in Hungary and Latvia from 2008. We have seen that these developments can be accounted for by the previous reform path as well as different stabilization strategies. We have also seen that recent reforms have accentuated previous reform trends. Particularly, social spending cuts and social protection were more considerable in Latvia because this country experienced a deeper crisis, with more draconian fiscal austerity and because this country had already less protective social provisions.

In a punctuated evolution framework (Campbell 2004), long periods dominated by path-dependent evolution are interrupted by significant changes at critical junctures. There have been intentional attempts to use the window of opportunity opened by the crisis. Both IMF and World Bank specialists have underlined spending

cuts should be used to promote specific reforms.

Mitra et al (2009:13) maintain “*Many countries in the region inherited social programs from central planning with room for rationalization and targeting (...) Reforms can help consolidate programs, eliminate most untargeted privileges, and refocus design and eligibility criteria.*” Furthermore, IMF (2008) findings on Hungary include “*Short-term savings in social transfers could be achieved by increasing means-testing and tightening eligibility criteria.*”

IMF specialist Marek Belka (2009) maintained on December 2, 2009: “*The IMF has paid close attention to the social dimension of the programs. For example, the fiscal strategy in Hungary, Latvia and Romania aims at protecting the poor and low-income earners from the impact of the global crisis, through better targeting of expenditure (Hungary), strengthening the social safety net (Latvia), and higher social spending (Romania).*” Still, curiously, IBRD (2010) considers introducing means-tests in family provisions in Latvia immediately would increase poverty.

To be sure, such reforms did not start with the recent crisis; they are not specific of these countries either. Furthermore, if we adopt a punctuated evolution perspective, we are puzzled by the persistent *crisis context*. Nevertheless, as we have seen, the actual evolution of Hungarian and Latvian welfare systems still use means-tests only very limitedly.

We have up to now neglected another question. Stabilization strategies have been criticized for decades. The social costs are one of the central problems highlighted by the critics. In this perspective, stabilization policies become part of the problem (rather than solving it). These social costs were actually experienced in post-communist countries in the 1990s. Recent stabilization in Hungary is not very

different from traditional conditionality.

Nonetheless, Latvia's experience is distinctive. On the one hand, the amount of the credit package was unprecedented. On the other, stabilization has proceeded without non-devaluation, thus imposing an even more impressive fiscal austerity. Non-devaluation has had (and will continue to breed) real wage losses and social provision cuts.

Export performance is lagging in Latvia and depends on attracting FDI. The capacity to foster exports thus depends on real wage decline. However, there is a colossal body of literature explaining that labor market adjustment may not be as swift as predicted by mainstream economics. Furthermore, as the elasticity of employment to GDP was close to one in Latvia over 2009, the non-devaluation strategy increases the needs for social security spending.

While Latvia had already less protective social provisions, breeding higher inequalities and poverty, social spending cuts were more expressive in this country. While there is no official data on the evolution of poverty rates after 2008, a recent Eurobarometer survey on poverty perceptions conducted by Gallup (EC 2010a) reveals 66 percent of the Latvians and 62 percent of Hungarians judge poverty increased in their local area over the last year. 17 percent of the Latvians and 14 percent Hungarians admit they have fell behind at least one bill or credit repayment. And 37 percent of Latvians and 30 percent of Hungarians declare they have been running out of money to pay for ordinary goods. The situation was aggravated by health co-payments in Latvia; 52 percent of Latvians (33 percent Hungarians) found it harder to pay for healthcare over the last six months.

To conclude, recent cuts in Latvia were facilitated by a combination of a huge

crisis and an already frail welfare system. Opting for stabilization without exchange devaluation, Latvia is bound to incur in even higher social costs. The weak social protection and recent cuts will certainly exacerbate incomes losses and unemployment.

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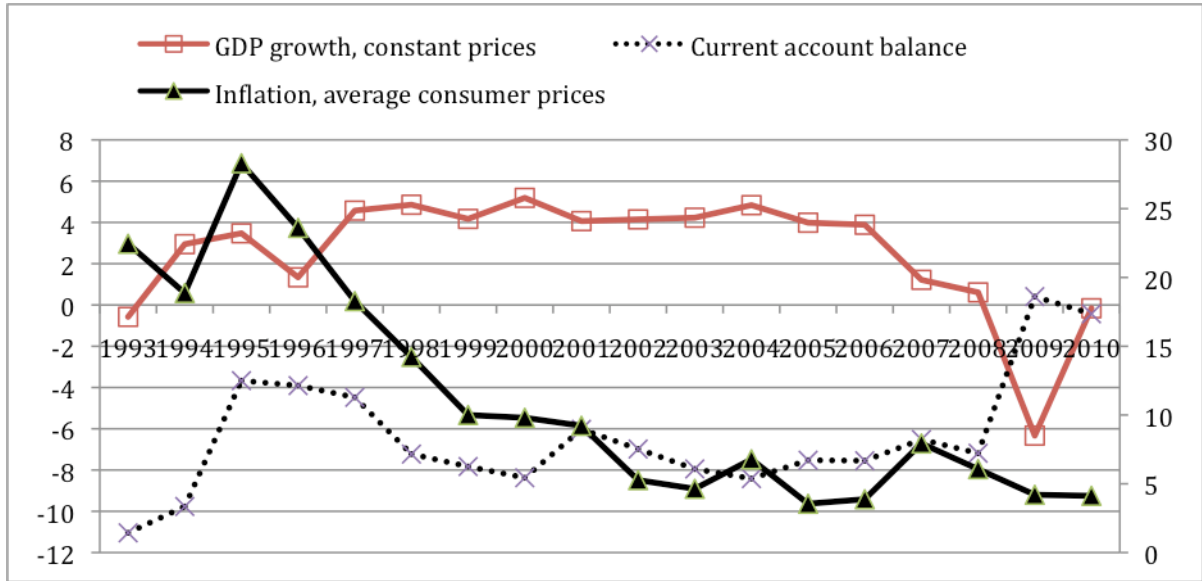
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**ANNEX  
FIGURES AND TABLES**

**Figure 1  
Macro dynamics in Hungary from 1993**

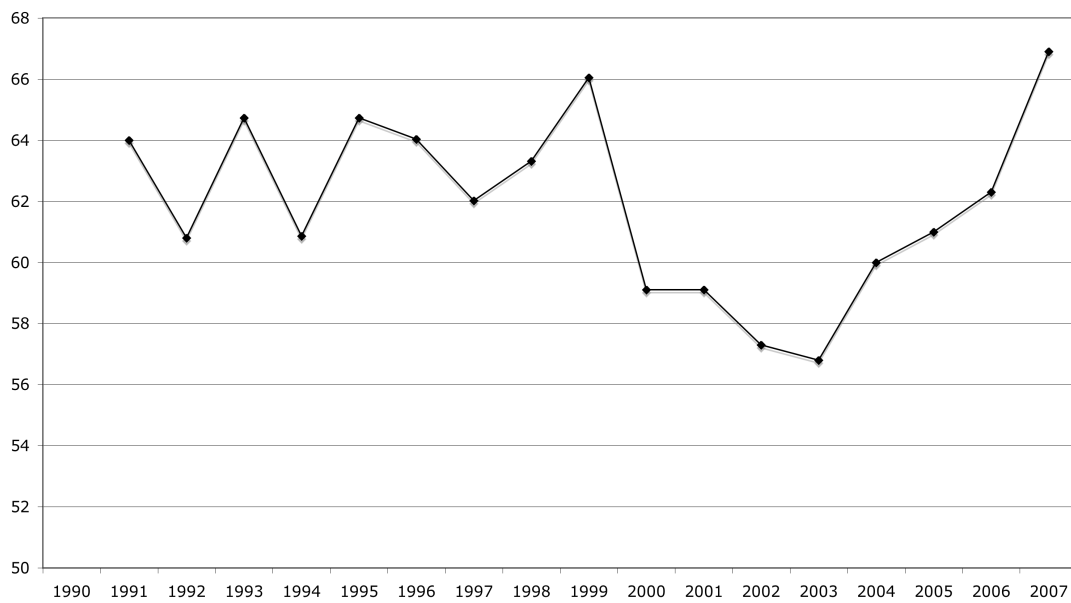
GDP growth (left axis), current account (left axis) and Inflation (right axis)  
(IMF projections from 2009)



Source: IMF.

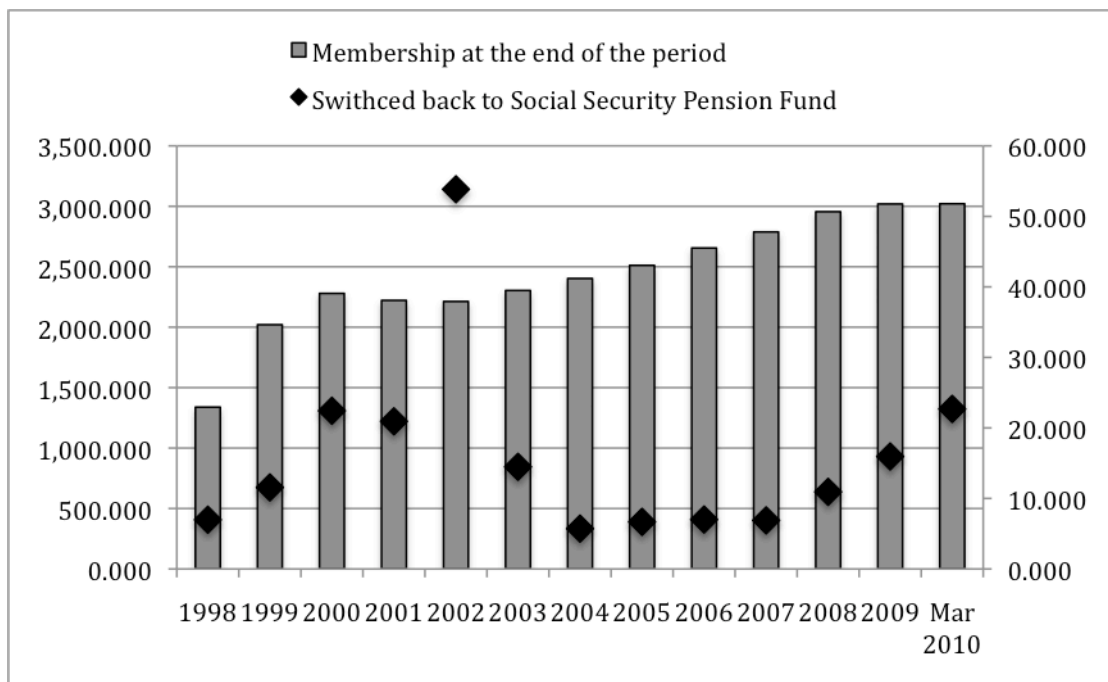
**Figure 2**

**Hungary : Pension Net Replacement rate**



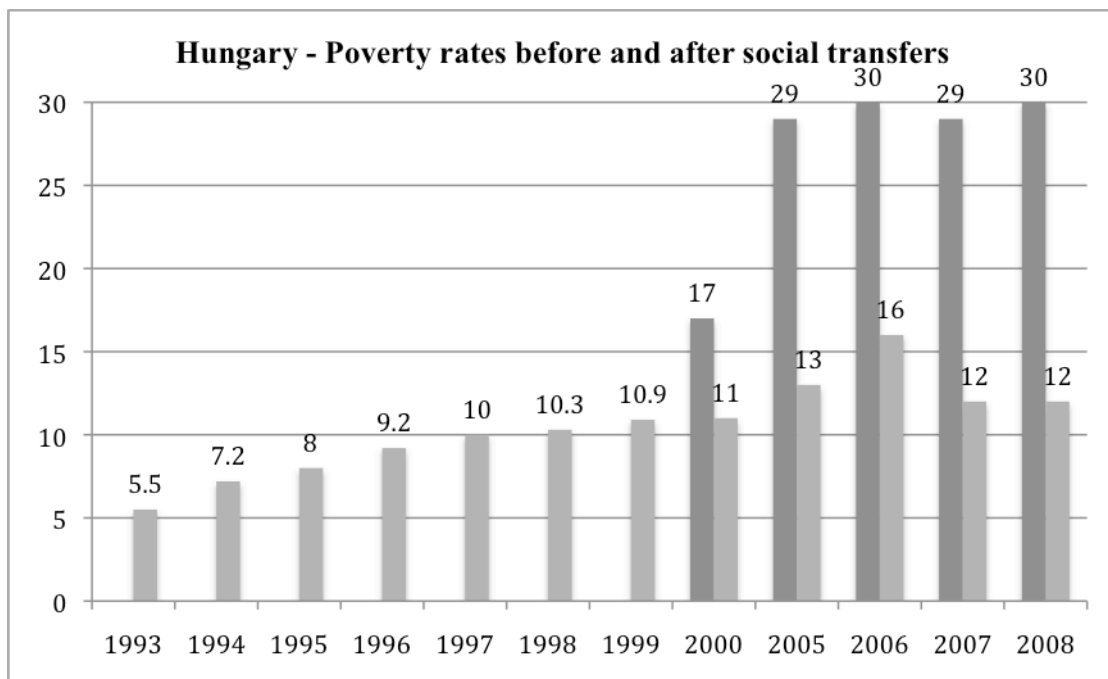
Source: Hungarian Statistical Office.

**Figure 3**  
**Mandatory pension fund membership in Hungary (in thousands)**  
 Members (left axis) and switching back to social security (right axis)



Source: HFSA.

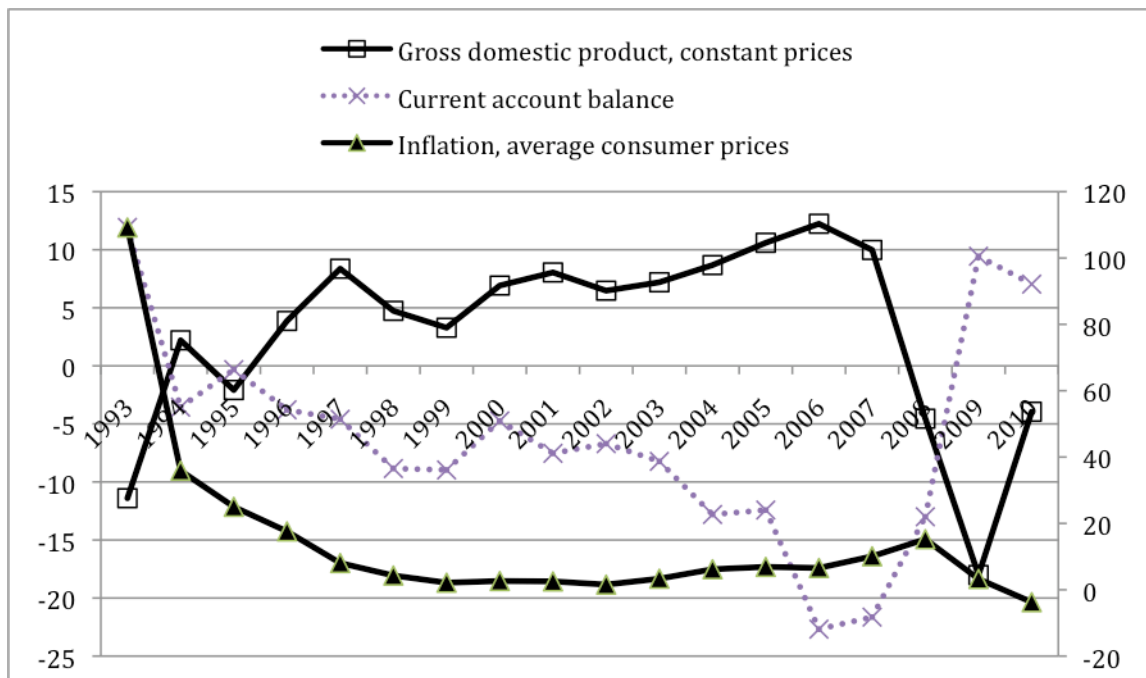
**Figure 4**



Source: HSO household budget surveys (1993-2000) and Eurostat (from 2005).

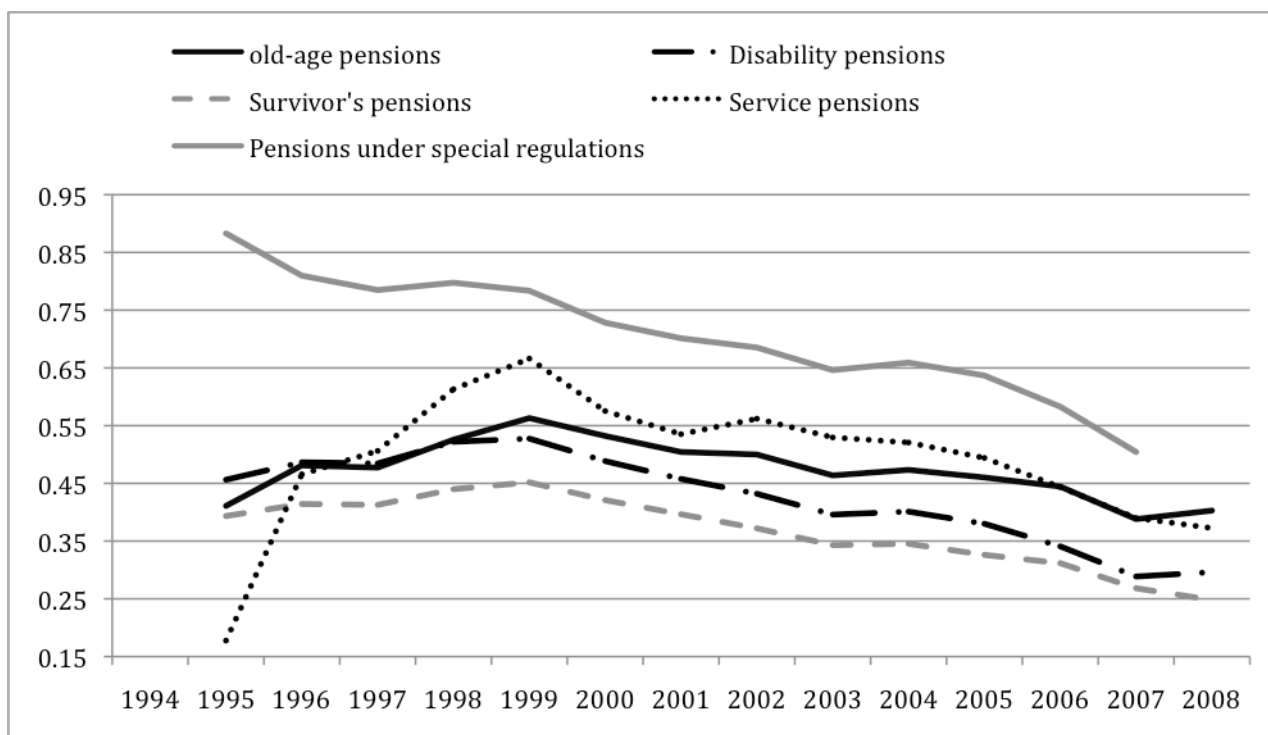
**Figure 5**  
**Macro dynamics in Latvia from 1993**

GDP growth (left axis), current account (left axis) and Inflation (right axis)  
 (IMF projections from 2009)



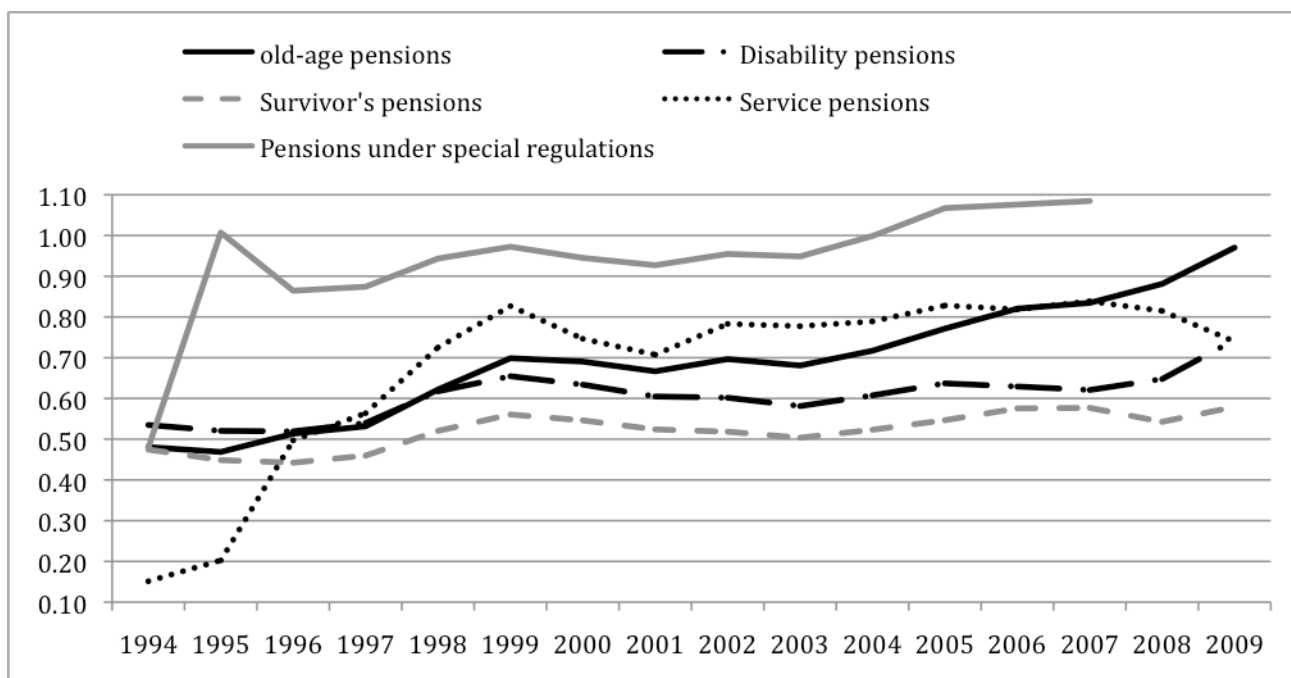
Source: IMF.

**Figure 6**  
**Latvia: Net replacement ratios, 1995-2008**



Source: Latvia Statistical Office.

**Figure 7**  
**Latvia: Net average pensions as a proportion of the Subsistence Minimum**



Source: Latvia Statistical Office.

**Table 1- Wage and employment evolution in Latvia in the Public sector, in percent of the average value in 2008**

	<i>December 2009</i>	<i>March-April 2010</i>
<b>Wages</b>		
Budget institutions	-24%	-25%
Public firms	-36%	-38%
- Without board members	-2%	-15%
<b>Employment</b>		
Budget institutions	-19%	-22%
Public firms	-11%	-11%

\* Data is from April 2010 for budget institutions and for publicly owned firms

Source: MFRL

**Table 2 - Average Social Benefits in Latvia**

	Jan-09	Jun-09	Dec-09	Apr-10
Old age pension	175.66	178.21	180.05	181.87
Service pension	153.10	160.44	167.11	172.88
Unemployment benefit	179.40	174.87	151.84	132.27
Sickness benefit	297.69	316.64	268.16	246.39
Maternity benefit	1 191.02	1 255.40	1 203.45	1 130.31
Paternity benefit	206.52	244.90	209.20	231.98
Family state benefit	9.39	9.39	Dec-09	8.00
Child-care benefit	32.95	32.75	180.05	33.00
Child-birth benefit	430.11	432.07	167.11	424.80

**Table 3- Crisis-induced social protection adjustments**

	<b>Similarities</b>	<b>Dissimilarities</b>
Pensions	Benefit cuts; Changed indexation; tightened early retirement; statutory age increase>2012; Downsized private pillar	Pension cuts in Latvia ruled out; Contribution divide changes; switching-out in Hungary.
Family	Cuts and duration reduction More restrictive entitlement.	Latvia is considering means-tests.
Unemployment benefits	Increased spending.	Benefit cuts in Latvia.
Other benefits	Reduced sick-pay benefit and duration; other cuts.	
Health		Increased co-payments in Latvia; no co-payments in Hungary

**Table 4 - Confronting welfare state arrangements in Hungary and Latvia**

	<b>Similarities</b>	<b>Differences</b>
Organization	Universal provisions remain important Negligible Means-tests Reforms enhanced social insurance at first and private insurance afterwards	Stronger social insurance in Hungary
Unemployment benefits	Low replacement Low income maintenance	Lower benefits in Latvia Lower coverage in Latvia
Pensions	3-pillar schemes Low redistribution (will to promote the contribution-benefit link) Early retirement penalties Differentiated systems	Considerable national adaptation in Latvia High switching-out in Hungary
Health system	Decentralization, followed by re- centralization Low private health fund spending	Higher Private spending in Latvia Sizeable social insurance in Hungary
Family benefits	Universal Tax allowances	Means-test in Hungary, 1995-98
Poor assistance	Mainly categorical Decentralized	No GMI in Hungary