Comprehensive Pension Reform in Estonia

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On 3 June 1997, the Government of Estonia approved the basic principles of a fundamental reform of Estonia's pension system. This report describes the major reasons for (and goals of) such a reform, the broad outlines of the proposed reform package, and a likely timetable for its implementation.

A. Major Reasons for Pension Reform

The main motivating factors behind pension reform in Estonia closely resemble those in other European countries, where the previous single-tier, pay-as-you-go (PAYG) system's ability to provide a desired minimum level of benefits in the setting of an aging population is increasingly in doubt. In 1996, pensioners constituted 25.4 per cent of Estonia's population. This share will increase further in the coming decades. A phased increase in the minimum retirement age, while partially easing the financial pressures on the pension system, cannot alone offer a long-term solution.[1] Furthermore, recent and expected future increases in life expectancy will erode many of the savings from an increase in the minimum retirement age.

However, the current pension system's problems are not demographic alone. While the system dependency ratio (social tax contributors per pensioner) has fallen to around 1:7, the ratio of the working age (20–59) to pension age (60 and above) populations is a much higher 3:05. The difference between these two ratios reflects the fact that there are more pensioners than elderly citizens (e.g. due to disability or early retirement) and fewer social taxpayers than income earners (e.g. due to business or grey market activities). Reducing the gap between these two ratios requires action on two fronts.

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1 Beginning in 1995, the minimum pension age (initially 55 for women and 60 for men) has been increased by six months per year. The concept recently approved by the government envisions continuation of this increase until reaching a uniform minimum retirement age of 63.

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The first is limiting access to the system beyond a simple increase in retirement ages. Spreading a given amount of resources over a smaller but better focused group of pensioners would allow an increase in average pensions relative to those under the unreformed system. In cases where the government wishes to pay 'non-standard' benefits, e.g. to politically repressed persons or to cover periods of unemployment, it should finance these directly from the state budget. This will increase the 'insurance' dimension of the pension system.

The second set of actions aims to strengthen the link between current social tax contributions and future pension benefits, so as to broaden the number of persons covered by the social tax and increase incentives to pay this tax.

Estonia has so far lagged behind many other Central and Eastern European countries in pension reform. As this reform was long seen as the purview of current pensioners alone, it was difficult to create broad consensus for a fundamental reform. The comprehensive concept proposed by the current government stresses that pension reform affects all Estonians, both young and old, raising the probability of a solution which will gain broad political support.

B. Major Goals of Pension Reform

Comprehensive pension reform has three types of goals; general, social and economic.

I. General goals

The planned pension reform aims to ensure the long-term stability of the newly established rules of the game. Estonians should become convinced that the new system will remain broadly unchanged for the foreseeable future. Stable rules will cut social tensions by making benefits more predictable and also increase incentives to pay social taxes.

The new pension system should be as simple and transparent as possible, including understandable benefits formulas and a clearer linking of benefits to previous tax and other payments.

Finally, pension reform must be structured so that it does not come at the expense of any one broad group in society. Only in this way can widespread support for reforms be mobilized. Since the reformed system should be more efficient than the one it replaces, this should in principle be possible.

II. Social goals

A key social goal of pension reform is assuring minimum European benefits standards. First, upon accession to the EU, Estonia will be required to adopt the *acquis communautaire*, including in social matters. In the absence of fundamental

reforms, assuring the required benefits standards would require substantial growth-reducing increases in social tax rates. Such a result would be inconsistent with Estonia's desire to achieve rapid convergence towards Western European living standards. Secondly, the new pension system should ensure a societally mandated level of redistribution towards the lifetime poor, i.e. an adequate level of intra- and intergenerational 'solidarity'. Thirdly, the new system should increase the equitability of the pension system through elimination or reduction of hidden, often unintended redistributions, e.g. from those who die early to older people. Fourthly, the financing mechanisms of the new system should ensure its long-term solvency and short-term liquidity.

III. Economic goals

Comprehensive pension reform should promote economic growth through the use of less distortionary means of financing, and particularly through promotion of higher national savings rates. The latter can in turn reduce Estonia's present reliance on foreign capital inflows, thus allowing faster reduction of the current account deficit. A rapidly growing economy is the only setting in which a declining share of wage earners can finance the support of a growing number of pensioners without a general decline in living standards.

Pension reform should reduce the share of the grey economy by creating greater incentives to pay social taxes. It is also through this reform that overall fiscal stability can be promoted by placing the pension system on a sustainable financial basis. This can help to free resources for growth-promoting investments, such as health, education and the environment. Finally, the new pension system should promote the development of financial markets through the creation of additional demand for long-term financial instruments.

C. Outline of the Proposed Pension Reform Package

The basic concepts approved by the government envision the gradual introduction of an increasingly 'standard' three-pillar pension system, following recommendations of the World Bank and the example of many Western and Eastern European countries.

The first pillar is a reformed version of the current compulsory state PAYG system, which is financed from social (payroll) tax revenues (the tax rate attributable to pensions is currently 20 per cent of gross wages). Its main goals are providing a minimum level of pension benefits and a desired degree of redistribution towards the lifetime poor. Reforms include clarifying and tightening rules of access, introducing individual accounting of social tax payments (and their tighter linking to future benefits), and increasing the predictability of the size of future benefits.

The second pillar is a fully-funded pension based on *the defined contributions*

principle. Employees will be required to channel a fixed share of their income to a privately-managed, licensed pension fund of their choice. Their future benefits from this system will be linked to the sums paid in and the efficiency with which these have been invested. The role of the state will be limited to defining the contribution rate, regulating and supervising the private funds, and providing limited guarantees (at least to cover cases of fraud).

The third pillar is analogous to the second pillar, with the main difference being the voluntary nature of participation. Income earners will be allowed to channel a limited share of their gross income to such a pension fund, deferring the payment of taxes until the date on which the accumulated benefits are paid out. The main role of the state is again to regulate and supervise the private funds.

The second and third pillars aim to supplement the basic (first pillar) pension, and to create an additional pool of savings to finance higher rates of economic growth. In addition, all three pillars together provide co-insurance, by reducing the dependence of benefits on the actual performance of one single system.

D. Timetable for Implementation

Pension reform will begin with the introduction of the third pillar during 1998. The required legislation was finalized and was submitted to the government early in 1998. In addition, a new draft social security tax law was presented to Parliament. This envisions personalization of social tax payments beginning in 1998, allowing the government to begin tracking individual social tax payments. By 1999, the collection of the social tax will be handed from the Social Insurance Board to the Tax Board.

Reform of the first pillar will be a phased process over several years. This will begin in 1998 with the transfer the financing of some 'political' pension supplements (e.g. to politically repressed persons) and of social benefits for child invalids to the state budget. This is intended to reduce the share of pension benefits for which no contribution has previously been paid, increasing the perceived fairness of the system and tightening the link between social tax payments and subsequent benefits.

Major reforms of the first pillar, including precise formulation of the new general benefits rules and a further reform of access to the pension system, will most likely be phased in from January 1999.

The final stage of pension reform will be the introduction of the second pillar, either in 2000 or 2001. As this requires residents to make mandatory payments into privately-managed pension funds, this can be introduced only after the establishment of a solid regulatory and supervisory framework.