The government of Estonia proposes to tie the pension age to life expectancy and increase solidarity in the state old-age pension

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MAGNUS PIIRITS AND MÄRT MASSO – EUROPEAN SOCIAL POLICY NETWORK

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The government of Estonia proposes to tie retirement age to life expectancy and to have a more flexible retirement process to ensure the long-term financial sustainability of the pension system. It also plans to change the pension calculation so that the first pillar pension depends less on individual earnings and more on years worked, to tackle inequality and poverty. The draft legislation will be finalised in the first quarter of 2018.

Description

In Estonia, as in many European countries, the pay-as-you-go pension system is not financially sustainable in the long-run due to population ageing. The old-age dependency ratio (i.e. the ratio of persons aged 65+ to people aged 20 to 64) was 30.9 in 2015 (Eurostat) and will increase to 53.4 in 2050 (EuroPop2015). The current pension index (which uprates the state old-age pension) takes into account the change in the number of contributors to the system but not the change in the number of pensioners. Therefore, the first pillar pension system would still not be financially sustainable in the long-run.

Also, pensions are rather low in Estonia. The income of many pensioners is close to the relative poverty threshold (EU definition, i.e. 60% of median (equivalised) income). In 2015, the ratio of the average old-age pension to net earnings is 42% (Statistics Estonia), and 37% of people aged 65+ are at risk of poverty compared to 17.4% at EU level (Eurostat). Additionally, the inequality of pensions will increase in the future. The income quintile share ratio (S80/S20), i.e. the share of income in the highest income quintile divided by that in the lowest income quintile, for persons younger than 65 is one of the largest in the EU (6.7 vs 5.5 for the EU28 average in 2015), whereas it is one of the lowest for people aged 65+ (3.4 vs 4.1). If the ratio of pension to average earnings stays the same in the future but the distribution becomes more unequal, then a larger proportion of pensioners will not have access to an adequate pension.

To tackle the challenges, the current government has proposed to substantially reform the old-age pensions system. Discussions on this reform started in January 2017 and followed those launched by the previous government, which had to resign, due to a vote of no confidence, in November 2016.

The five main changes proposed for the pension reform are as follows:

a) retirement age linked to life expectancy by 2027;

b) actuarially neutral flexible retirement age by 2021;

c) first pillar new entitlements tied to years worked by 2037, with a transition period from 2020 to 2036;

d) indexation fully dependent on social tax revenues and the change in the number of pensioners by 2023;

e) possibility of joining the second pillar for the cohorts born in 1970-1982 (the cohorts born before 1983 had the opportunity to join the second pillar until 2010 but about a quarter of them did not join it).

Although the government has discussed the reform several times, no final decision has been made yet. Nevertheless, the government expects to finalise the draft legislation in the first quarter of 2018.

The social partners have been engaged in the discussion, and have participated in several seminars. However, the Estonian Trade Union Confederation (EAKL) has criticised the government for not sufficiently involving the social partners in the actual design of the proposed pension reform and related draft legislation. More than that, they are asking for the minimum monthly pension to be increased to 1.25 times the absolute poverty line (201 EUR in 2015), and the average pension from the three pillars to 55% of average earnings. They are also calling for a flexible retirement scheme (Estonian Trade Union Confederation).

Outlook & Commentary

The pension reform has been a topic of discussion in the Estonian public media, as well as among policymakers, social partners and experts. The discussion grew rapidly after the Minister of Social Protection proposed that the retirement age should be increased from 65 to 70 by 2040 to guarantee the sustainability of the pension system. Coalition partners, the opposition, experts and trade unions questioned the need for such an increase. Experts rather recommended linking retirement age and life expectancy. They also stressed that life expectancy has increased faster than healthy life years. Experts have also highlighted that what matters most for improving the sustainability of the system is not so much an increase in the statutory retirement age but an increase in the effective retirement age.

To take into account public health concerns (low healthy life years), the reform proposes to introduce a more flexible retirement age and to give people more discretion. For example, a person would be allowed to retire three years before retirement age but he/she would half-retire, i.e. he/she would continue to work, but part-time, and would receive half a pension. The intention is that flexible pensions should be actuarially neutral.

The proposed change in indexation would make the pension system more sustainable because it would take into account both contributions to the system and the number of people to whom pensions must be paid. The new pension index would be fully dependent on social tax revenues (currently 20% is based on the consumer price index and 80% on social tax revenues).

At the beginning of the 1990s, the statutory retirement age was 55 for females and 60 for males. It then increased to 63 for males in 2001 and for females in 2016. This increase did not increase the take-up of early retirement among the elderly (Puur, Leppik and Klesment, 2015). This suggests that the effective retirement age would also increase but the situation is not fully transferable. Therefore, together with the retirement age, active labour market policies will be considered and the question of how to increase healthy life years needs to be answered.

Currently, 70% of old-age pensions are dependent on the individual earnings of the person who has contributed his/her entire life to the current pension system (Võrk, Piirits and Jõgi 2015).

Low-wage earners born around 1980 have worked most of their lives at a time when pension entitlements depended mostly on salary. Compared to the generation before and after them, whose pension entitlements also depend on the length of employment, they would stay in an unfavourable situation. The transition period (2020 to 2036) will diminish this intergenerational discrepancy.

Further reading

Allan Puur, Lauri Leppik and Martin Klesment (2015). "Changes in pension take-up and retirement in the context of increasing the pension age: the case of Estonia in the 2000s". Post-Communist Economies, Vol: 27, No: 4, pp 497-516.

Andres Võrk, Magnus Piirits and Evelin Jõgi (2015). "The Impact of Introduction of Funded Pension Schemes on Intragenerational Inequality in Estonia: A Cohort Microsimulation Analysis". https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2648150

Estonian Trade Union Confederation. "Ametiühingu Peep Petersoni kiri peaminister Jüri Ratasele: 'Oleme valmis läbirääkimisteks pensionireformi elluviimise teemal!'" (Trade union leader Peep Peterson's message to Prime Minister Jüri Ratas: 'We are ready to negotiate the implementation of the pension reform!'), http://www.eakl.ee/?pid=75&nid=783&lang=5

Sotsiaalministeerium 2016. Riikliku vanaduspensioni jätkusuutlikkuse analüüs (State old-age pension sustainability analysis), 2016, available at http://sm.ee/sites/default/files/content-editors/Uudised_pressiinfo/vanaduspensioni_jatkusuutlikkuse_analuus_2016.pdf

Author

Magnus Piirits and Märt Masso, Praxis Centre for Policy Studies