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Estonia's statutory funded pension scheme: a turning point?

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The main problems with the Estonian statutory funded pension scheme (second pillar) are its low rate of return, high management fees and the rigidity of the pay-out system. According to the 2019 government's coalition agreement, this scheme will be voluntary (i.e. it will be possible to opt out) as of January 2020. The proponents of the idea believe that people will then invest better, while opponents think that people will save less for their retirement.

Description

The Estonian pension system consists of three main schemes:

i) A state pension insurance (a pay-as-you-go system, the "first pillar").

ii) A statutory funded pension scheme (defined contribution scheme, the "second pillar") – those born before 1983 had the possibility to join the scheme between 2002 and 2010, after that they could no longer join it (so those who chose to join then are now participating in the scheme, but those who did not cannot join the scheme). For those born in 1983 or after, joining the scheme is mandatory.

iii) Voluntary funded pension schemes (defined contribution schemes, the "third pillar").

If the person participates in the second pillar, 4% of the social contributions are shifted from the state pension insurance scheme to the compulsory funded pension scheme, and an additional contribution, 2% of the gross wage, is paid by the employee into the second pillar. At the beginning of 2019, 725,471 persons were members of the mandatory prefunded scheme (Pensionikeskus), i.e. about 93% of people aged 19-63.

One of the main problems with pension funds in Estonia is their low real investment rate of return. OECD statistics show that the Estonian real investment rate of return is one of the lowest among OECD countries. In 2017, the real investment rate of return was negative (-0.1%). The nominal and real average annual investment rates of return over the last 15 years are 3.0% and -0.2%, respectively (OECD 2018).

At the same time, management fees for the Estonian pension funds are among the highest in OECD countries. Also, the management fees of ordinary investment funds are lower than fees for the Estonian pension funds. The Act that came into force in January 2019 has lowered the management fees by one third, but has made it possible to take a performance fee for good results (except for funds that are not allowed to invest in equities). The performance fee can be taken if the pension fund net asset value is higher than the growth in revenues from social contributions. Also, the Ministry of Finance has scrapped some investment rules and 100% of the fund can now be invested in equities (previously, 75%) (Investment Funds Act 2019).

The statutory funded scheme is also criticised for its pay-out rules. First, the pay-out phase may be too restricted, allowing little flexibility: payments are mostly made on the basis of the pension contract as lifetime annuities. Secondly, there are only three insurance companies which provide annuities, with high costs. The principal mode of benefit payment from the scheme is in the form of a fixed-amount annuity contract. Thus, the nominal value of the pension is the same, but its real value is reduced.

In April 2019, a new Estonian government was appointed. The government's coalition agreement includes proposed changes to the pension system. It foresees, in particular, that the statutory funded scheme will be maintained. But from 2020 onwards, while joining the second pillar scheme will remain automatic for those born after 1983, it will be possible to opt out of the pension fund at any time. The pay-outs will be made within two years and the beneficiary will have to pay income tax. In addition, it will be possible to transfer payments and shift the contribution (2%+4%) from the pension fund to an individual investment account (i.e. a personal bank account that can only be used for investment purposes). The pay-outs from the pension fund to an investment account will be made within two years from submitting the application. It will be possible to withdraw money from an investment account at any time, paying income tax (Coalition agreement 2019).

Policymakers, social partners and experts agree that the statutory funded scheme's performance should be improved, but they have diverging views on this government agreement. Those in favour of the agreement (e.g. the coalition partners) find that it is up to the people to decide where to invest (real estate, forest, land, funds, etc.). In their view, people should not be forced to save money in funds with a low real investment rate of return and high management fees. Those against the agreement (e.g. a number of experts (e.g. see ERR 2019), opposition parties) think the current system should be improved rather than made more complicated – with more choice and probably higher costs of own investment and greater differences between pensioners in the future. In addition, opponents argue that people would save less for their retirement voluntarily, and a mandatory prefunded scheme is useful as it helps to offset the reduction in the size of the working age population and the increase in the number of pensioners due to population ageing. The Ministry of Finance has pointed out that if people take out the money from the statutory funded scheme in order to spend it, then their future pension will be much lower than expected. It also warned that large amounts of money spent on consumption would lead to increased inflation.

A public appeal against this government agreement has been made by Estonian economic experts, because they do not think there is a better alternative to the mandatory funded pillar right now (ERR 2019).

Although the government has included this idea in the coalition agreement, it does not have broad support in the Parliament.

Outlook and commentary

The controversial idea of making the statutory funded scheme voluntary (either entirely or through the possibility of opting out) has for a long time been a topic of discussion in the Estonian public media, as well as among policymakers, social partners and experts. It is not possible to say exactly what this change would entail, because the coalition's proposal is still quite vague.

Analysis based on the Household Finance and Consumption Survey (HFCS) shows that people would save less for their retirement voluntarily than with the compulsory statutory funded scheme (Meriküll 2019).

There are several other weak points in this idea: i) the order of actions is not appropriate (the statutory funded scheme should be improved first and then made voluntary, so there would be a better basis for people to decide whether or not to opt out of the second pillar); ii) the idea is not evidence-based (no in-depth analysis has been carried out to assess it); iii) the system would lose good features (such as automatic saving and stability); iv) it would be possible to withdraw money before reaching the pensionable age; and v) less would be collected for retirement. Moreover, as not all of the people would opt out of the system, the Government must deal with the second pillar issues and improve the system anyway.

The authors' calculations show that the statutory funded scheme would be beneficial to people who earn more than 60% of the average salary, as their rate of return within the scheme would be higher if the current rate of return (4% nominally) continues.

Finally, the Bank of Estonia has estimated that this plan would reduce Estonia's economic growth in the long term, increase inflation and imports, because people would have more money to consume. However, this would increase economic growth in the short term.

Further reading

ERR (2019), Majandustegelaste avalik kiri: teine pensionisammas on vajalik [Public letter from economic experts: the second pension pillar is necessary].

Investment Funds Act (2019), Riigi Teataja, RT I, 13.03.2019, 65

Coalition agreement (2019), Basic principles of the Government coalition of the Estonian Centre Party, the Conservative People's Party of Estonia, and Isamaa for 2019–2023, pp 21-22

Meriküll, J. (2019), Keskpanga blogi: kas inimesed koguksid pensionieaks vabatahtlikult sama palju kui kohustusliku kogumispensioniga? [Would people save for retirement voluntarily as much as they do under the compulsory funded pension scheme?].

OECD (2018), OECD Global Pension Statistics. Pension Markets in Focus, Statistical tables.

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