


sotsiaal ministeerium

2005 National Strategy Report on Adequate and Sustainable Pensions; Estonia

Tallinn

July 2005

CONTENTS

1. PREFACE

The current document is the first national report of Estonia in the framework of the European Union open method of coordination (OMC) in the field of pensions. Under the open method of coordination, the Member States on the EU level agree upon common objectives, but the ways to reach these objectives are determined separately by each Member State. In addition to pensions, the OMC is currently used for coordinating social inclusion and long-term care policies.

According to the European Union law the formation and development of pension policy belongs to the competency of the Member States. Estonia considers important that the decision-making competency of the Member States in the key issues of social policy will be maintained.

According to the Treaty of Amsterdam, one of the common objectives of the Community and the Member States is to ensure proper social protection, having in mind the fundamental social rights set out in the European Social Charter. Estonia has ratified the European revised Social Charter and is committed to fulfil the obligations taken at ratification.

Estonia also considers important exchange of information and cooperation between the Member States in the field of pensions under the open coordination method. The 11 common pension objectives agreed at the EU Council Laeken summit in December 2001 match well with the vision, which successive governments have followed since the reforming of the pension scheme started in the 1990s:

1) pension scheme must fulfil social objectives – avoid poverty risk of the elderly and ensure acceptable replacement income;
2) pension scheme must be financially sustainable in the long run;
3) pension scheme must be adjusted according to changes in the society.

The present strategy report describes the key issues of Estonian pension scheme in the light of the EU common pension objectives and indicators, and analyses challenges for the pension scheme in meeting these objectives in the future.

The report gives first an overview of the demographic and economic developments and introduces Estonian pension system and its arrangement. Then the pension system is examined in the view to the common objectives and analysed in adequacy, sustainability and modernization aspects.

In assessing the current situation and future prospects of the Estonian pension scheme the report rests partly on the analysis of the compliance of the Estonian pension scheme to EU common pension objectives conducted by the PRAXIS Center for Policy Studies in 2004. Sources for data on the values of common pension indicators include also Eurostat, Estonian Statistical Office, Ministry of Social Affairs and Ministry of Finance.

2. INTRODUCTION

2.1. General socio-economic background

The general economic development of Estonia has been favourable since 1995, after the economic recession caused by transition from planned to market economy. **GDP** increased on average by 5-6% a year over the period 1995-2004. In 2004, GDP growth was 7.8%; the forecast for 2005 is 6.0% in the last year. GDP per capita in Estonia is catching up with the EU average – in 2003 the ratio was 48.1%, increasing to 49.8% in 2004. By 2005 it is forecasted to reach 52% (*source: Eurostat*).

The **employment rate** dropped sharply from mid 1990s as a result of economic restructuring and decline of population. At the same time unemployment increased fast. From 2002 the employment rate and the number of people in employment have increased while unemployment has decreased due to the favourable economic development.

According to Eurostat, the employment rate in the age of 15-64 was 63.0% in 2004, which was only slightly below the EU average (63.3%). Employment rate of older workers (55-64) has increased from 1995. This has been related to the increase of retirement age and payment of full pension to working pensioners. In 2004 the employment rate of older workers in Estonia – 52.4% – exceeded the EU target for 2010 (50%).

The **unemployment rate** in the age group 15-74 was 9.8% in 2004 that is slightly above the EU average (9.0%). The unemployment rate for men is slightly higher than for women, 10.3% and 8.1% respectively in 2004 (*source: Eurostat*).

In 1999-2002 **social protection expenditure** has increased in absolute value, reaching 16 billion EEK in 2002. However, the share of social protection expenditure in GDP over the same period has decreased from 16.4% in 1999 to 13.7%, partly due to the high increase of GDP. Expenditures on pensions accounted for 8.1 billion EEK or 6.5% of GDP in 2003 (*source: Ministry of Social Affairs*).

General **government expenditure** has remained around 40% of the GDP from the beginning of 1990s. The largest share – about 40% – of the total government expenditures accounts for social transfers, of which the biggest expenditure articles are pensions, health services and social benefits.

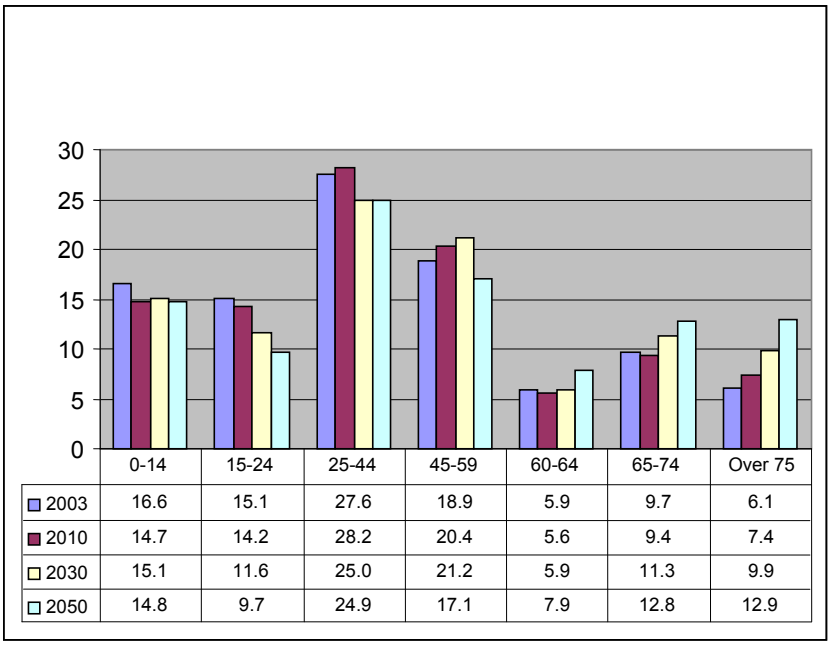
The general **fiscal position** of Estonia is good compared to other EU Member States. Total government sector budget surplus in 2004 was 1.8% of the GDP. The total government debt is rather small – 4.9% of the GDP – which is the smallest among the EU Member States (*source: Ministry of Finance, preliminary data*). Estonia is fulfilling the respective Maastricht criteria, according to which the government sector budget deficit shall not exceed 3% of GDP and the debt level shall be less than 60% of GDP.

2.2. Population

The population of Estonia has declined between the last two censuses (in 1989 and 2000) by about 12.5%, mainly due to negative natural growth and emigration. In 2003 the total population of Estonia was 1.35 million.

Similar to other European countries the population of Estonia is ageing which is a matter of concern. The share of population over 65 years of age was nearly 16% in 2003. According to forecasts this is expected to increase to 25% of total population by 2020.

Graph 1. Population breakdown by age groups in 2003 and projections 2050 (%)



	0-14	15-24	25-44	45-59	60-64	65-74	Over 75
2003	16.6	15.1	27.6	18.9	5.9	9.7	6.1
2010	14.7	14.2	28.2	20.4	5.6	9.4	7.4
2030	15.1	11.6	25.0	21.2	5.9	11.3	9.9
2050	14.8	9.7	24.9	17.1	7.9	12.8	12.9

Source: Eurostat

Life expectancy at birth is one of the indicators that reflect the social changes. Life expectancy decreased in the first half of 1990-s, reaching the low turning point in 1994, when it was 61.1 for men and 73.1 for women. 1995 onwards the life expectancy has increased. According to Eurostat, life expectancy at birth was 65.3 for men and 77.1 for women in 2002. According to the Estonian Statistical Office data the trend is raising, respectively 66.0 for men and 76.9 for women in 2003. However, as can be seen, the difference between life expectancy of men and women is significantly large. One of the main reasons for this is the relatively high mortality rates for younger men due to accidents. By the age of 60, the difference between mortality rates of men and women declines to about 6 years – respectively 15.4 years for men and 21.3 years for women in 2002 and respectively 15.4 and 21.1 in 2003 (*source: Eurostat*).

Table 1: Life expectancy at birth and at ages 60 and 65 by gender in 2002 and forecasts by 2050.

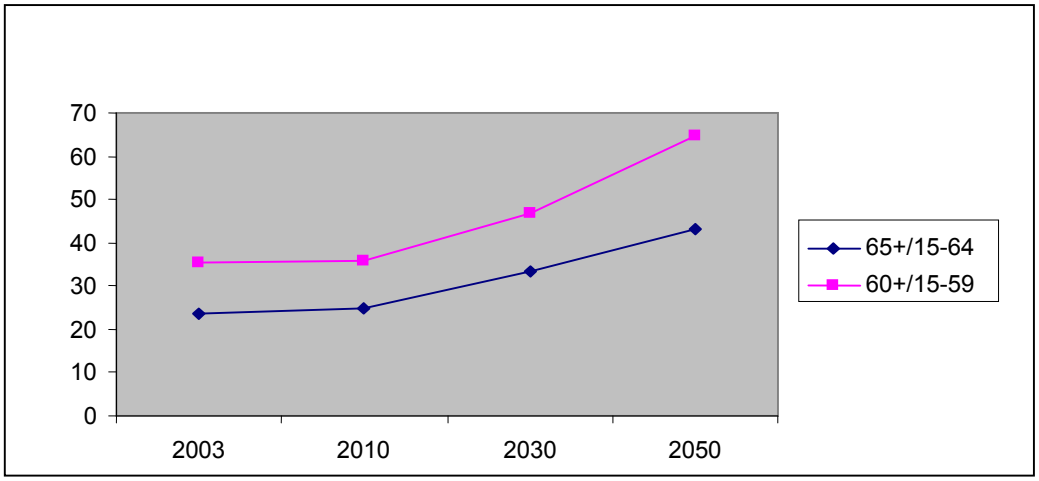
	At birth		**At the age of 60**		**At the age of 65**	
	Men	**Women**	**Men**	**Women**	**Men**	**Women**
2002	65.3	77.1	15.4	21.3	12.7	17.3
2010	66.6	77.0	...	...	...	...
2030	71.6	79.4	...	...	...	...
2050	77.4	82.0	...	...	...	...

Source: Eurostat

The demographic **old-age dependency ratio** is increasing due to ageing. The forecasts for this indicator are based on the Eurostat forecasts on population structure (see above Table 1) and the 2004 study by the PRAXIS Center for Policy Studies.

The share of persons aged 65+ (60+) to working age population aged 15-64 (15-59) was 23.5% (respectively 35.3%). The demographic old-age dependency ratio is expected to increase to over 43% (respectively 64.9%) by 2050 (*source: Eurostat*).

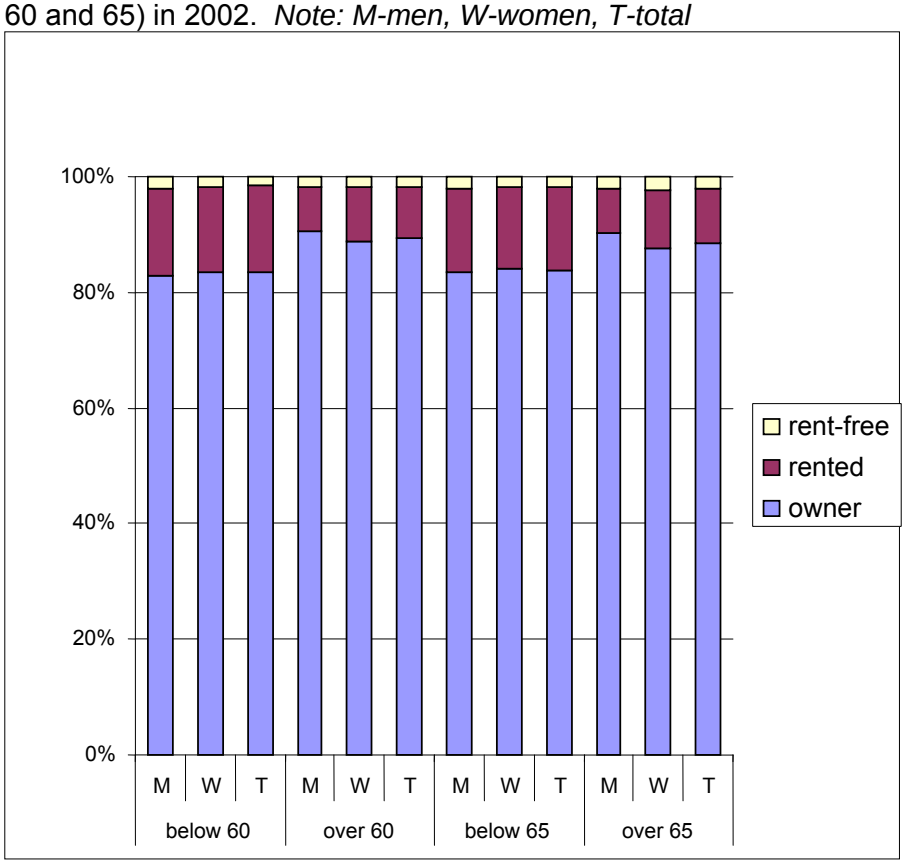
Graph 2. Demographic old-age dependency ratio in 2003



Source: Eurostat, from the 2004 PRAXIS study

One of the factors influencing the welfare and coping of elderly persons is household type and the housing tenure status. The Estonian Statistical Office data and the PRAXIS study demonstrate (see Graph 3) that the **share of owner-occupied** is high and has increased further over the last years, reaching nearly 90%. Respectively the share of households living in rented accommodation has declined. There has been no change in free accommodation. In case of elderly households, the share of owner-occupied accommodations is about 5 percentage points higher than in complementary younger age groups. Comparing elderly men and women, it is notable that slightly more elderly men own their accommodation, but the difference is only about 2-3 percentage.

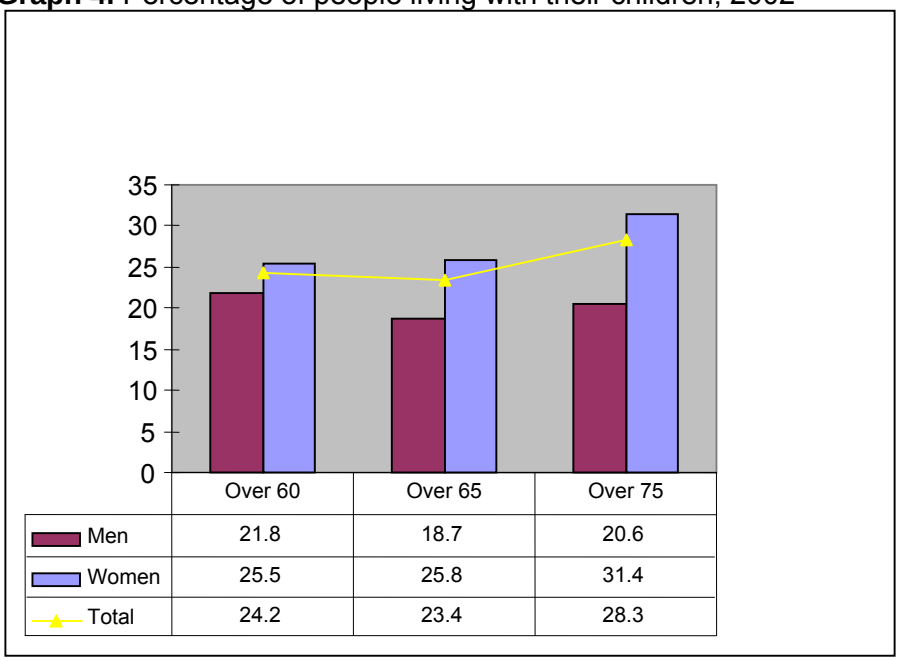
Graph 3. Housing tenure status of people aged 60+ (65+) and complementary age groups (below 60 and 65) in 2002. *Note: M-men, W-women, T-total*



Source: Estonian Statistical Office, referred through the 2004 PRAXIS study

About one quarter of **elderly persons** live with their children. This indicator has not changed considerably over the last years. More elderly women (75+) are living with their children compared to elderly men.

Graph 4. Percentage of people living with their children, 2002

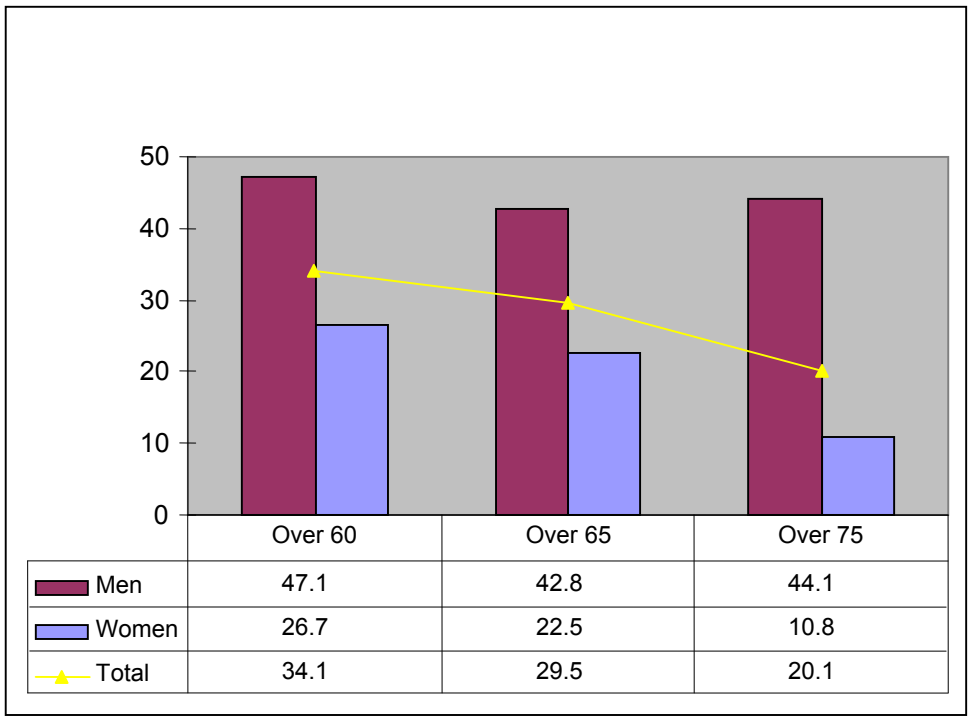


	Over 60	Over 65	Over 75
Men	21.8	18.7	20.6
Women	25.5	25.8	31.4
Total	24.2	23.4	28.3

Source: Estonian Statistical Office, referred through the 2004 PRAXIS study

About one third of elderly persons live with approximately same-age partner in two member households; there has been no significant change in last years. Nearly half of elderly men are living with a partner from the same age group in two-member households. From elderly women about one quarter are living with the same age group partner, while the share is decreasing with age, reflecting differences in life expectancy of men and women.

Graph 5. Percentage of people living with another adult aged 60+ 65+ and 75+), 2002

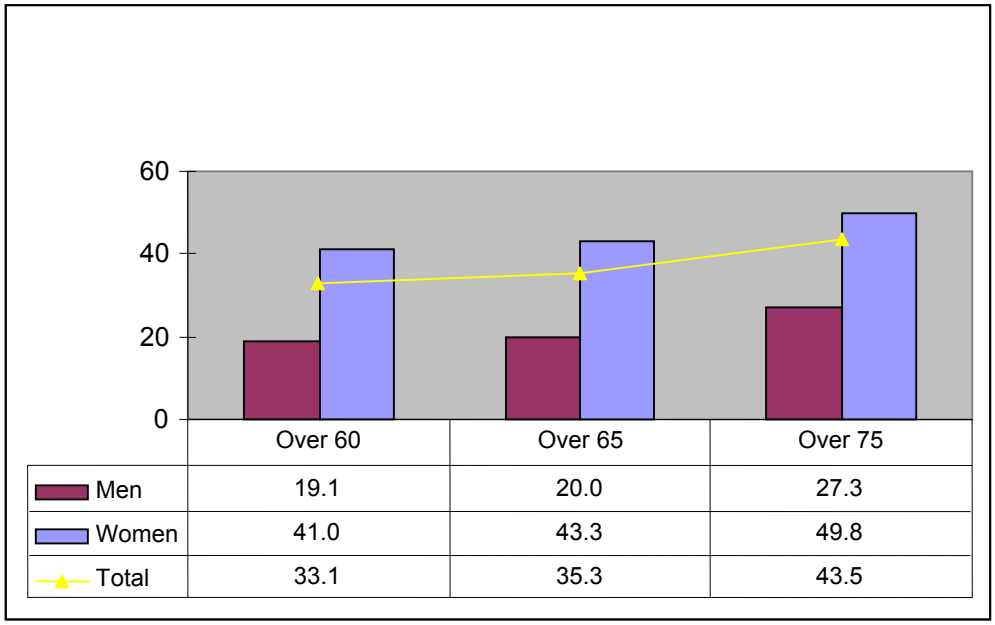


	Over 60	Over 65	Over 75
Men	47.1	42.8	44.1
Women	26.7	22.5	10.8
Total	34.1	29.5	20.1

Source: Estonian Statistical Office, referred through the 2004 PRAXIS study

Nearly one third of elderly persons aged 60+ **lives alone**, elderly men live alone on average two times less than women. About one half of women aged 75+ are living alone, whereas the respective share for men in the same age group is 27%.

Graph 6. Percentage of people aged 60+ (65+ and 70+) living alone, 2002



	Over 60	Over 65	Over 75
Men	19.1	20.0	27.3
Women	41.0	43.3	49.8
Total	33.1	35.3	43.5

Source: Estonian Statistical Office, referred through the 2004 PRAXIS study

According to the Estonian legislation, family has the primary responsibility to care for the elderly. Social welfare services for elderly are organized by local municipalities. The emphasis is on open care services to help elderly persons in their homes. Only if a family is not able to care for an elderly person and the local municipality is not in a position to offer suitable home services, is the elderly person referred to an institution.

The percentage of elderly persons living in social welfare institutions is rather small, but increases somewhat in higher age groups. In 2001 1.5% of people over 65 lived in welfare institutions. According to estimates this number has not changed significantly. Due to the change in calculation methods the data before 2003 is not comparable.

Table 2: Percentage of people aged 60+ (65+, 75+) living in institutions in 2003.

	Total	**Men**	**Women**
Over 60	1.5	1.5	1.5
Over 65	1.7	1.6	1.8
Over 75	2.8	2.1	3.1

Source: Ministry of Social Affairs

To sum up, Estonian population and economy have had notable changes since regaining independence. In a simpler meaning, the number of our population has decreased and the population has been aging, whereas economy has developed fast and grown considerably. Subsequently, an overview of the organisation of Estonian pension system is given.

2.3. Pension system

Estonia has launched the so-called three pillar pension system including:

1) state pension insurance;
2) mandatory funded pension;
3) supplementary funded pensions.

A multi-pillar pension scheme rests on the assumption that income in retirement age is to be formed from several different sources, each with different legal, organisational and financial principles. The current legal principles of state pension insurance are effective since 1999-2000. Then it was established that the right and the amount of the future old age pension is tied to the amounts of social tax paid by or on behalf of the person over the full career. Mandatory funded pension started from 2002. Possibilities for supplementary funded pension were created in 1998.

2.3.1. First pillar – state pension insurance

The first pillar of the Estonian pension scheme is state pension insurance based on pay-as-you-go financing and covers three social risks: old age, permanent incapacity for work and loss of a provider.

Protection ensured by state pension insurance includes two levels:

1) national pensions ensured for all residents of Estonia;
2) old-age, incapacity-for-work and survivor's pensions based on former work input.

A right to national pension on the basis of age starts from the age of 63, on condition that the pension applicant has lived in Estonia at least 5 years. National pension is paid in the fixed rate, in the so-called national pension rate.

In 2005, the retirement age for men is 63 and for women 59 years and 6 months. The age limit for women is rising and will be equalized with that of the men by 2016. The qualification period for old age pension is 15 years of pensionable service in Estonia.

Old age pension includes three parts: base amount, length-of-service component and insurance component. The base amount is a flat-rate element. The length-of-service component applies to periods of pensionable service through the end of 1998 and depends on the length of service (in years). The insurance component applies to pensionable service from 1999 and depends on social tax paid by the person (in case of self-employment) or on behalf of the person by the employer or by the state.

Since 1999, old age pension rights are acquired only on basis of social tax paid. Until 1999, pension rights were determined on the basis of the length of service. The pension formula includes a gradual transition from the old rules to the new rules. For persons who withdraw from work before 1999, the state pension depends only on the flat rate base amount and the length of service. For persons who entered the labour market in 1999 or later, the state pension also consists of two parts: base amount and insurance component. In essence, the three-part pension formula applies only to those generations who have acquired pensionable service both before and after 1999.

The new pension formula used since 2000 can be described as follows:

$$P = B + s \times V + \sum A \times V,$$

where:
P – amount of pension (in EEK);

B – base amount (in EEK);
s – pensionable length of service (up to 1999, in years)
∑A – sum of annual pension insurance coefficients;
V – cash value of one year of pensionable length of service and the pension insurance coefficient 1.0 (in EEK).

To calculate the annual pension insurance coefficient for a given individual, the amounts of state pension insurance part of social tax paid or calculated for the person in the specific calendar year are divided by the Estonian annual average amount of the pension insurance part of social tax. Hence, annual pension insurance coefficient reflects the ratio of social tax calculated on the earnings of the person to the Estonian average.

Real values of pensions are influenced by the values of the base amount (B) and the cash value of the annual score (V), which are subject to regular indexation (see below). From 1 July 2005, the base amount is EEK 858 (ca 28% of the average old age pension) and the cash value of annual score is EEK 42.83.

State pension insurance is financed mainly from the state pension insurance part of social tax[1]. The rate of state pension insurance part of social tax is 16% for persons having joined the II pension pillar and 20% for those who have not joined (see also p. 2.3.2). The expenses of national pensions and pension supplements are covered from other revenues of the state budget. If necessary, the state budget shall also cover any current deficit of the pension insurance budget, i.e. any difference between social tax revenues and expenditures on pensions.

Increasing of pensions in payment is performed through regular indexation. The index depends with equal weights (50%-50%) on the increase of social tax revenues and the increase of consumer price index. However, different government coalitions have in addition to indexation also applied supplementary *ad hoc* pension increases.

Besides the general state pension insurance, the Estonian pension system also includes some special schemes – old age pensions at favourable conditions and superannuated pensions, enabling representatives of specific professions or persons with specific social status to retire before the general retirement age. Also, some categories of civil servants (for example judges, prosecutors, officials of the State Audit Office, police officers, members of the Defence Forces, Chancellor of Justice) have a right to favourable special pensions.

2.3.2. Second pillar – mandatory funded pension

The second pillar of the Estonian pension system is a mandatory funded pension based on full pre-financing and covering only the risk of old age[2]. The II pillar pension funds are administered by private asset management companies. In essence, the II pillar is an individual savings scheme, where the size of pension depends on the total contributions over the career and rate of return of the pension fund.

Participation in the II pillar is mandatory for persons born in 1983 or later. People born prior 1983 and participating at the labour market can join the II pillar on voluntary basis[3]. The rate of the II

[1] The total rate of social tax is 33% of taxable sums (comprising mainly of wages), paid by employers, self-employed persons and, on some occasions, by the state. 13 percentage points of social tax is ear-marked for health insurance and 20 percentage points for pension insurance. In case of persons who have joined the second pillar, the 20% pension insurance part of social tax is further divided into state pension insurance part of 16% and funded pension part 4%.
[2] Estonian second pillar is not an occupational scheme.
[3] Relatively younger age groups can join the II pillar until 2010.

pillar contribution is 6% of wages – the employee pays 2% from gross wages, which is supplemented by the state with 4% of gross wage on the account of social tax paid by the employer (see also p.3.1.2).

The retirement age in the II pillar is the same as in I pillar. An additional requirement to receive a funded pension is the fulfilment of a qualification period of 5 years, which has to be passed from the date of commencing the payment of contributions. II pillar was launched in July 2002. Thus the payment of first benefits shall commence from 2009 (benefits on the basis of inheritance starting from 2007).

2.3.3. Third pillar – supplementary voluntary funded pension

The third pillar includes supplementary funded pension schemes based on pre-financing. The state encourages participation in such schemes with tax incentives. III pillar covers two social risks: old age and permanent incapacity for work. III pillar pension schemes are offered by voluntary pension funds and life insurance companies.

Certain conditions apply on voluntary pension products, in case to be eligible for income tax credits. The payment of benefits shall not commence before 55 years of age. The minimum period for participating at the pension scheme is 5 years. Contributions to voluntary pension funds and premiums paid under pension insurance policies of life insurance companies can be deducted from taxable income to the extent of 15% of annual income. Benefits are taxed with the lower-than-normal income tax rate - 10%, whereas life annuity is tax-free[4].

As the second and third pension pillars have been launched only recently, incomes of the current pensioner population largely depend on the state pension.

[4] The rate of income tax in 2005 is 24%. According to the adopted legislation, the income tax rate is set to decline to 20% by 2009.

3. TOWARDS THE EU COMMON PENSION OBJECTIVES

3.1. Adequacy of pensions (common objectives 1-3)

Common Objectives
Member States should safeguard the capacity of pension systems to meet their social objectives. To this end against the background of their specific national circumstances they should:
1. Ensure that older people are not placed at risk of poverty and can enjoy a decent standard of living; that they share in the economic well-being of their country and can accordingly participate actively in public, social and cultural life**;**
2. Provide access for all individuals to appropriate pension arrangements, public and/or private, which allow them to earn pension entitlements enabling them to maintain, to a reasonable degree, their living standard after retirement; and
3. Promote solidarity within and between generations.

3.1.1. Policy objectives

According to §28 of the Constitution of the Republic of Estonia "*An Estonian citizen has the right to state assistance in the case of old age, incapacity for work, loss of a provider, or need. The categories and extent of assistance, and the conditions and procedure for the receipt of assistance shall be provided by law. Citizens of foreign states and stateless persons who are in Estonia have this right equally with Estonian citizens, unless otherwise provided by law.*"

Constitution delegates decision over the focal issues of pension system – conditions for receiving pensions (incl. retirement age), level of pensions, as well as financing of the pension system – to the legislature (Riigikogu). Thus relatively large room is left for political choices over the pension system.

There are two main types of pensions established by the State Pension Insurance Act, which correspond to the notion of state assistance in case of old age within the meaning of the Constitution:

1) national pension ensuring fixed rate minimum income to residents at least 63 years of age, irrespective of their former work input;
2) old-age pension, which takes into account the former work input of the person – until 1999 length of service, starting from 1999 payment of social tax.

Although the law does not stipulate any particular criteria for establishing the rate of national pension, different government coalitions have followed a principle that the rate shall be higher than the subsistence level determined on the basis of the Social Welfare Act[5].

[5] It should be noted that the subsistence level is a minimum income for household, which should remain after the payment of housing expenses.

As in principle both I as well as II pillar pension are defined through contributions, legislation does not guarantee a specific replacement rate – ratio of pension to earlier earnings[6]. The pension amount accrues from flat rate base amount and from sum of annual pension insurance coefficients, which reflects the ratio of individual income in proportion to the average income.

When increasing state pensions, government coalitions have on one hand proceeded from economic and public finance conditions. On the other hand considerations have been given to the international commitments taken by the state.

In 1999, the Government approved the concept paper of Estonian policy for the elderly, according to which the state is responsible for the social insurance and economic subsistence of the elderly, ensuring a state pension, which is at least sufficient for economic independence and minimum purchasing power of elderly persons.

On 11 September 2000, Estonia ratified the European revised Social Charter (1996 version). At ratification, Estonia committed itself to be fully bound to the provisions of Article 12 of the Charter on the right to social security. According to the Social Charter, Estonia shall maintain its social security system at least at the level necessary for the ratification of the European Code of Social Security, while endeavouring to raise the social security system progressively to a higher level.

On 19 May 2004, Estonia also ratified the European Code of Social Security, considering itself also bound to the parts of the Code relating to old age, invalidity and survivor's pensions. According to the Code, the old age pension for a person with the length of employment of 30 years, as well as the pension for total incapacity for work and survivor's pension to a widow with two children shall comprise at least 40% of the net wage of the ordinary adult male labourer.

3.1.2. Current situation: policy tools and achievement of goals

The welfare of the elderly persons in Estonia depends currently largely on the state pension. State pension comprises on average 88% of total incomes of persons aged 65 or over.

The state pension coverage is practically universal. Around 97% of men and 99% of women who are residents over pensionable age receive pension from the state of Estonia. The majority of the rest receive pension from some other country (mainly from Russian Federation).

In 2004, the relative poverty line calculated by the Estonian Statistical Office on the basis on the household budget survey data amounted to EEK 2161 per consumption unit in a month (equivalence scales 1:0.5:0.3). As this amount is smaller than the income of the majority of old age pensioners, the poverty risk of the elderly turns out to be relatively small in Estonia.

On the other hand, the amounts of pensions have been relatively little differentiated in Estonia. This is also reflected by the income distribution indicators. The ratio between incomes of the highest and lowest income quintiles of persons aged 65 and over was 3.6, which was considerably lower than the same indicator for people up to the age of 65 – 6.9. In spite of a more equal income distribution, on average incomes of persons aged 65 and over are still lower than incomes of younger persons, comprising *ca* 70% of incomes of those under 65[7]. The amounts of the majority of old age pensions remain under the average disposable income of the household member, which in 2002 amounted to EEK 2500 per month.

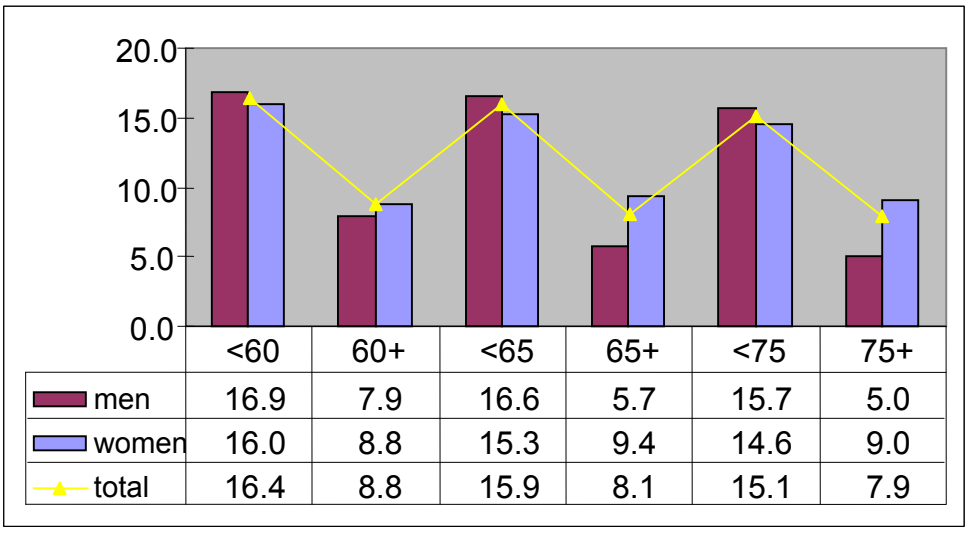
[6] Some special pensions are an exception, where the law stipulates a specific replacement rate.
[7] Calculations by PRAXIS on the basis of the household budget survey data of the Estonian Statistical Office from 2000.

Observing the structure of incomes in income quintiles, one may see that belonging to an income quintile is determined by the person's earned income, the proportion of the pension decreases in the structure of incomes respectively to the increase of the number of the quintile. Detailed overview on the structure of incomes in age groups and income quintiles is in Table 2 in the Annex of the Report.

Analyzing the relationship between poverty risk and age, we note that poverty risk is relatively high for youth (15-24), decreasing somewhat in younger working life (25-39). Middle-aged persons have a relatively higher poverty risk (40-54). Starting from the age group of 60-64, poverty risk substantially decreases and compared to younger age groups the poverty risk of the elderly is lower. Differently from many EU Member States the poverty risk of persons aged 65 and over (15.8%) in Estonia is lower than that of persons aged under 65 (18.3%)[8]. This is above all caused by a large inequality of incomes among persons aged under 65, whereas the incomes of those aged 65 years and over are distributed more equally.

Although incomes of households with younger members (with those of working age and children) are on average higher than those of the elderly, there are among them also a considerable number of families whose income per consumption unit remain below the poverty line. In Estonia, social groups with the highest poverty risk include households of the unemployed, single parent households and families with many children. This explains why the relative poverty risk of persons under 65 is higher than that of persons aged 65 and over.

Graph 7. At risk of poverty rate, 2002



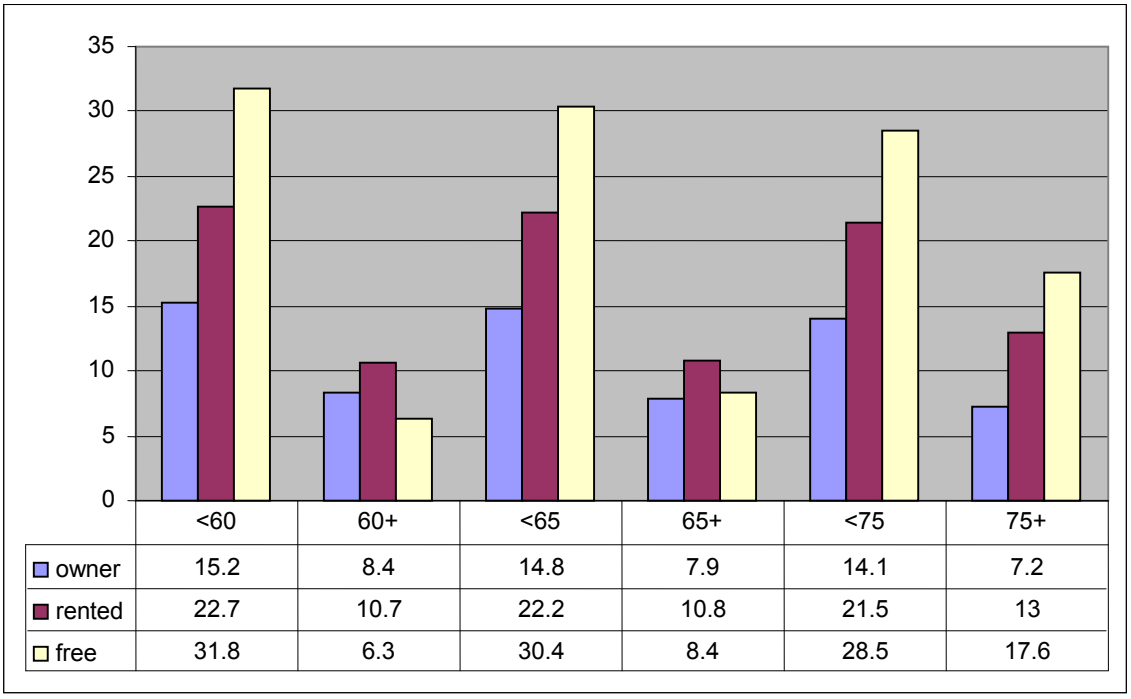
	<60	60+	<65	65+	<75	75+
men	16.9	7.9	16.6	5.7	15.7	5.0
women	16.0	8.8	15.3	9.4	14.6	9.0
total	16.4	8.8	15.9	8.1	15.1	7.9

Source: LFS

When taking into account housing tenure status to analyse the risk of poverty for elderly, it emerges that their risk of poverty is around two times lower than for younger age groups. In case of the people over 65 the highest risk of poverty is for people who rent their accommodation. The poverty risk increases with age for people who have rent-free housing. As for younger people, the highest risk of poverty is for people who have rent-free accommodation. The graph 8 describes the situation.

[8] According to Eurostat, the poverty risk of the elderly (65+) is higher than that of persons under the age of 65 in the following countries: Belgium, Denmark, Greece, Spain, France, Ireland, Cyprus, Malta, Austria, Portugal, Slovenia, Finland, and United Kingdom.

Graph 8. Risk of poverty for people aged 60+, 65+ and 75+ and below 60, 65 and 75 by the housing tenure status of their households, 2002



	<60	60+	<65	65+	<75	75+
owner	15.2	8.4	14.8	7.9	14.1	7.2
rented	22.7	10.7	22.2	10.8	21.5	13
free	31.8	6.3	30.4	8.4	28.5	17.6

Source: LFS

93.1% (92.7%) of people over 60 (over 65) who experience risk of poverty are owners of their housing and 5.9% (6.5%) live in rented accommodation. Additional data about people at risk of poverty and housing tenure status of their households is presented in Table 3 in Annex.

Analysing poverty risk of elderly by the type of household occurs that the risk of poverty of elderly is noticeably smaller than for the younger age groups, it emerges especially for households that consist only of elderly people (one person or a couple). At the same time the risk of poverty does not rise with ageing, it remains at the level of 7-8%. The aforementioned is characterised in Table 4 in the Annex.

At the same time the poverty risk of the elderly has a gender dimension – the poverty risk of women aged 65 and over (20.8%) is considerably higher than the poverty risk of men in the same age group (6.6%) (also see p. 3.3.2).

The I pillar of the Estonian pension scheme, state pension insurance, includes minimum pension guarantees – minimum income on the established level (at the rate of national pension) is guaranteed also to those elderly persons whose length of employment is very short or whose wages (incomes subject to social tax) have been very low during the whole career. The general subsistence benefit paid according the Social Welfare Act is a supplementary income guarantee.

Hence, Estonian social protection system has a total of 3 different minimum income guarantees:
1) the amount of old age pension (i.e. with at least 15 years of work in Estonia) granted to persons in retirement age shall not be lower than the rate of national pension;
2) all persons of at least 63 years of age, who have been residents of Estonia for at least 5 last years prior to applying for pension, have a right to national pension (currently EEK 1156 per month);
3) persons whose household incomes remain after the payment of housing expenses (within established limits i.e. maximum housing expenses for 18 m² per person, plus 15 m² costs for a household) below subsistence level (currently EEK 750 for the first household member and EEK 600 for every subsequent household member) have a right to a subsistence benefit.

The number of elderly persons, dependant on minimum guarantees is still relatively small. In 01.01.2005, the number of people receiving national pension on the basis of age was 3182 persons that is 1% of all persons in retirement age, while the share of pensioners receiving subsistence benefit was 2.6% of all pensioners. According to the Estonian Statistical Office, the cost of the minimum food basket was EEK 696 in 2004. Pensioner households needed and received subsistence benefit mainly only during winter months for the compensation of higher heating expenses – on average EEK 464 per one application.

Also some other benefit schemes help to reduce expenses for elderly persons. Some local municipalities provide free public transport to elderly persons and pay additional housing benefits. Pensioners have tax credit in respect of the land tax. Moreover, elderly persons dependent on care receive social benefits for disabled persons (nearly 70 % of total amount of benefits has been granted to elderly persons).

The average net replacement rate of the old age pension in the state pension insurance (calculated as the ratio of the average old age pension to the average net earnings of social insured persons, which are subject to the payment of social tax) has been slightly over 40%, remaining between 42-46% over the last decade. In 2003 this replacement rate was 42.8%. The average gross replacement rate has been 32-36% over the same period, amounting to 33% in 2003. However, this means that the average pension incomes of old age pensioners are less than half of the average earnings of employed persons.

Relative income level of elderly people was analysed next. Comparing 60+, 65+ and 75+ person's median income with <60, <65, <75 and 45-54 old person's median income, one may conclude that median income of elderly people decreases 1-2% depending on the age group. The aforementioned is characterised in Table 1 in the Annex.

The inequality of *per capita* income for elderly stems from general inequality of households in the society. The medium and total *per capita* income in the highest quintile is approximately 3.5 times higher than that of the lowest quintile. The personal income (total of the pension and wage) inequality for elderly is caused by the differences of pensions and differences with participating in the labour force. This indicator is 1.2 times smaller than the income inequality for *per capita* income. This means that the incomes from pensions are more evenly distributed than *per capita* income (see also table 5 in the annex).

The analysis of inequality of income distribution (S20/80) 60+, 65+ and 75+ people compared to (S80/20) income distribution among people under 60, 65 and 75 demonstrates that the inequality of *per capita* income for elderly is approximately twice lesser than inequality for younger age groups. The inequality of men (younger men's inequality/older men's inequality) is slightly greater than for women. This is due to greater inequality between younger men and women. Detailed information is presented with the table 6 in annex.

According to the calculations of the Ministry of Finance, the theoretical net replacement rate (calculated according to European Commission methodology) is 41.4% in 2005, while the gross replacement rate is 34%. Therefore, the theoretical net replacement rate for persons whose earnings comprise 2/3 of the average wage is ca 58%, while the theoretical net replacement rate to a person earning twice the average wage comprises ca 23%. By 2050 it forecasted that the theoretical net replacement rate of persons at 2/3 of average earnings will decline to 46%, while the replacement rate for pensions earning twice the average will increase to 31%. This reflects the increasing role of the contribution-related element of the first pillar as well as the directly defined-contribution second pillar.

Table 3: Theoretical replacement rates in Estonia in 2003 and forecasts

	Theoretical replacement rate (at 100% of average earnings)					At 2/3 of average earnings			At 2 times average earnings		
	2003	**2005**	**2010**	**2030**	**2050**	**2003**	**2005**	**2050**	**2003**	**2005**	**2050**
I pillar gross replacement rate	33.3	34.2	35.3	24.7	16.8	…	49.3	20.2	…	18.7	10.9
II pillar gross replacement rate	0.0	0.0	0.8	5.7	18.9	…	0.0	18.9	…	0.0	14.2
Total gross replacement rate	33.3	34.0	36.1	30.5	35.7	…	49.3	39.1	…	18.7	25.1
Total net replacement rate	42.8	41.4	42.9	36.4	43.0	…	57.8	45.6	…	23.4	31.3

Source: PRAXIS study 2004, Ministry of Finance

The 2004 study by the PRAXIS Center for Policy Studies analysed besides theoretical replacement rates also the actual individual replacement rates of state pensions granted in Estonia. The analysis was based on the data from the national pension insurance register. The actual replacement rates were calculated as the ratio of granted old age pension to the gross earnings of the person in the year prior of retirement. Actual replacement rates were calculated for persons who retired in 2001. Almost one third of all old age pensioners had the individual gross replacement rate of pension exceeding 60%. At the same time almost a quarter of the new pensioners lacked earnings in the period directly prior to establishing pension. The median individual replacement rate was slightly over 50% in 2001.

In general, Estonia has been able to meet the minimum standards of the European Social Charter and the European Code of Social Security, according to which the old age pension of a pensioner with an employment period of 30 year shall comprise at least 40% of the average net wage of ordinary adult male labourer employed in manufacturing. Still, the level of old age pensions exceeds the minimum standard only scarcely, which means that a more rapid increase of wages in some year may leave the relative level of pensions under the minimum required by the Code – this happened in 2001 (see the table below).

Table 4: Correspondence of Estonian old age pensions to the minimum standard of the European Code of Social Security in 1998-2003

	1998	**2000**	**2001**	**2002**	**2003**
Old age pension of a person with a thirty-year pensionable service from the average net wage of an ordinary adult male labourer employed in manufacturing (%)	41.4	44.4	37.4	41.6	40.5

Source: *Ministry of Social Affairs*

In addition to state pension insurance a funded pension scheme (II pillar) was launched starting from 1 July 2002. By the end of June 2005, ca 447 000 people or nearly 75% of labour force at the age of 16 until retirement age have joined II pillar.

As for the objective of pension adequacy it should be noted that II pillar pension funds do not provide a guaranteed rate of return. In fact, the fund managers are not allowed to guarantee any rate of return. However, participants of the second pillar can choose an acceptable risk level,

choosing between funds with three different investment strategies. Over two thirds of second pillar participants – 71% – have chosen a pension fund with higher risk level, which invests up to 50% of the fund assets into equities. Only 10% have joined conservative funds, which may invest only in fixed-interest instruments and are not allowed to invest into equities. The rest have joined funds with the medium risk level, which invest up to 25% of assets into equities. The cause for preference for higher risk lies on one hand in the advertisements of management companies, while on the other hand in the hopes of participants for higher return. Nevertheless, as a rule, the asset management companies recommend older workers to choose a fund with lower risk. According to AS Eesti Väärtpaberikeskus (Estonian Central Depository of Securities) in the age group of 45-60, 38% have joined the conservative fund and 34% the middle risk fund.

The I and II pillar are supplemented with voluntary III pillar pension schemes for which two alternatives exist:

- concluding a voluntary pension insurance contract with a life insurance company;
- acquiring units of voluntary supplementary pension funds.

After the launch of II pillar, also the number of people joining the supplementary funded pension or III pillar has increased. As of the end of 2004, according to AS Eesti Väärtpaberikeskus 70228 people had concluded a voluntary pension insurance contract. In June 2005, according to AS Eesti Väärtpaberikeskus, III pillar voluntary pension funds had a total of 10459 unit holders. Hence, ca 13% of labour force aged 16 to pension age have joined III pillar.

3.1.3. Future prospects and challenges

The current relatively low poverty risk of elderly persons has been tied to the wide coverage of the pension scheme and to the fact that old age pension has provided to the majority of pensioners an income, which is higher than the poverty line.

The implemented pension reform, including individual accounting of social tax payments, determination of pension rights on the basis of social tax in I pillar and calculation of II pillar pensions on the basis of defined-contribution principle have increased incentives to legalize earnings. At the same time, the closer link of pension to former work and contributions paid on earnings will also present new risks from the perspective of adequacy of retirement age incomes, especially for persons with short or interrupted careers.

1. Calculations by the Ministry of Finance indicate that the theoretical net replacement rate of the old age pension payable from the mandatory pension scheme to the employee of average wages should remain practically on the same level in the long run - 42.9% in 2010, 43% in 2050. At the same time, the structure of the total pension and the financing sources will change considerably. In 2010 principally only the I pillar pension, is expected to play the predominant role. However by 2050 the I and II pillar should have essentially equal roles in forming the average total pension. This means that the average replacement rate of I pillar pensions will decline, but this decline will be compensated by increasing II pillar benefits.

Considerable decline in the replacement rate of state pensions may still cause certain problems to fulfil the adequacy objective. In particular because the II pillar pension is directly contribution defined and there is no vertical redistribution in this system.

Development of the replacement rate of I pillar pensions greatly proceeds from the index used at the indexation of pensions. In a situation where increase of wages (corrected by a change in the number of employees) exceeds increase of prices, the current pension index results in a decline in the average replacement rate. Although, according to the 2004 PRAXIS study, even the current pension index is projected to result in a double increase of the real value (purchasing power) of pensions on a 50-year time horizon. Nevertheless it brings along a considerable decline (about

twice) in the replacement rate of the average old age pension over the same period. This gives rise to a question whether the current conservative pension index can ensure adequacy of pension levels in the long run.

2. In a situation, where since 1999 determination of pension rights is based only on the payment of social tax, the state has wished to ensure pension rights to some economically non-active people, paying social tax on behalf of these persons:

- child-raising parents receiving parental benefit, child care allowance or benefit for the family with seven or more children;
- conscripts of Defence Forces;
- caregivers of disabled persons, receiving caregiver's allowance;
- non-working spouse of the diplomat employed in foreign mission.

The state has paid social tax for ca 110 thousand economically non-active persons in a year (nearly 15% of all insured persons); including for ca 30 thousand parents on parental leave. At the same time the amount of social tax paid by the state has been small (in 1999-2005, EEK 700 per month), which in annual calculation ensures the pension insurance coefficient of ca 0.1 or only 10% compared to a person earning an average wage. This means that the longer a person is away from the labour market (including due to raising children) the smaller would be the an old age pension. This would be considerably lower than the average, or the person may end up only with the minimum rate.

PRAXIS Center for Policy Studies made calculations based on individual data of the state pension insurance register on social tax payments in 1999-2003. This analysis indicated that by the time new state pension provisions achieve full impact (i.e. by the time when persons who entered the labour market after 1999 reach a pension age) ca 7% of those reaching retirement age and have received minimum or very low wages may have problems in respect of fulfilling the required qualification period of 15 estimated years. An additional 10 % of persons would incur a right to old age pension, but due to the low sum of annual pension insurance coefficients the amount of pension to be granted would only be at the minimum rate. This implies that the share of those receiving pension at the rate of national pension would increase to ca 17% of all people of retirement age (currently ca 1%, see above). This problem concerns primarily those workers who have received minimum or very low wages, and also persons, who have been longer economically non-active, including parents staying several years on parental leave.

Stronger link between contributions and future pensions also increases dispersion of the amounts of pensions. This is already reflected in a larger differentiation of the values of new old age pensions granted in the recent years. The amounts of state pensions will to a larger extent reflect differences in earlier earnings. This means that the role of a pension as a deferred earning will increase while intra-generational redistribution will somewhat decrease. Nevertheless, certain elements of intra-generational solidarity will be maintained. The base amount of pension (which currently forms ca 28% of the average old age pension) and the minimum pension guarantees do not depend on the amounts of social tax paid by or on behalf of the person, reflecting solidarity in the pension system.

3.1.4. Strategies for securing future adequacy

In the long run, developments of pension adequacy are largely influenced by certain factors influencing the amounts of I and II pillar pensions. In case of I pillar, this means the development of consumer price index and revenues from social tax. The latter in turn depends on developments of the total number of employed persons and the real wages. In case of II pillar, the key factor is the internal rate of return of pension funds. Depending on developments in prices, salaries and number of workers it may be necessary to adjust the formula for calculation of the

index used for indexation of pensions, increasing the relative weight of social tax revenues and respectively decreasing the relative weight of consumer price index.

According to the coalition agreement of the Reform Party, Center Party and Peoples Union, which came to power in April 2005, the average old age pension will be increased to EEK 2700 per month by 1 July 2005 and to EEK 3000 by 1 April 2006, combining regular indexation with supplementary pension increases.

Starting 2006, the government plans to increase the amount of social tax payable by the state on behalf of non-active persons in order to increase pension rights acquired for the periods of raising children, etc and to decrease the negative impact of periods away from work due to raising a child to the size of future pension.

The launch of funded pension schemes – II and III pillar – has created additional possibilities for the preservation of the earlier living standard and joining supplementary pension schemes. The voluntary participation has been considerably active so far. The number of people having joined II pillar amounts to 75% of labour force, while 13% of labour force has joined III pillar. However, the influence of supplementary pension schemes on old age income will increase only after a couple of decades, while currently the accumulation period has only lasted for some years.

3.2. Financial sustainability of pension system (common objectives 4-8)

Common objectives

Member States should follow a multi-faceted strategy to place pension systems on a sound financial footing, including a suitable combination of policies to:

4. Achieve a high level of employment through, where necessary, comprehensive labour market reforms, as provided by the European Employment Strategy and in a way consistent with the BEPG;.

5. Ensure that, alongside labour market and economic policies, all relevant branches of social protection, in particular pension systems, offer effective incentives for the participation of older workers; that workers are not encouraged to take up early retirement and are not penalised for staying in the labour market beyond the standard retirement age; and that pension systems facilitate the option of gradual retirement;

6. Reform pension systems in appropriate ways taking into account the overall objective of maintaining the sustainability of public finances. At the same time sustainability of pension systems needs to be accompanied by sound fiscal policies, including, where necessary, a reduction of debt. Strategies adopted to meet this objective may also include setting up dedicated pension reserve funds;

3.2.1. Policy objectives

Since the beginning of 1990ies, different Estonian government coalitions have followed principles of conservative fiscal policy, drafting balanced state budgets and making budget expenses within

the limits of existing revenues. Also, the state pension scheme has operated within the framework of these principles.

Increasing of the employment rate has been one of the priorities of the government within the framework of general economic policy, but it is also important from the perspective of improving of the financial sustainability of the pension scheme. According to the Estonian National Development Plan for the implementation of the EU structural funds 2004-2006, the Government has set a target to increase the general employment rate to at least 64.3% by 2006, i.e. increase by ca 1.4 percentage points compared to 2003. An overview of national employment strategy and planned activities can be found in Estonian National Employment Action Plan for 2004 and in Estonian National Action Plan for Social Inclusion for 2004-2006.

The objective of prolonging working life has become topical due to rapid ageing of the population – increasing of the share of elderly in the total population and increasing of the median age of the population. Since 1994, retirement age is increased in Estonia, but as in Estonia withdrawing from work is not a prerequisite for granting a pension, increasing of the average age for granting a pension and increasing of the average age of exit from the labour market shall be regarded separate objectives.

3.2.2. Current situation

Compared to the other EU Member States the general fiscal position of Estonia is good. In 2004, the consolidated budget surplus of the government sector amounted to EEK 2.4 billion or 1.8% of GDP (*source: Ministry of Finance*). The total government sector debt is rather small, comprising 5.8% of GDP in 2003 and 4.9% of GDP in 2004. By this, Estonia meets the respective Maastricht criteria, according to which the government sector deficit can not exceed 3% of GDP and the total government debt must be less than 60% of GDP.

Estonian fiscal position is further improved by different reserves created by the Government. As of the end of 2004 the stabilization reserve established to minimize the general economic risks and to finance long-term structural reforms amounted to ca EEK 5 billion (ca 3.6% of GDP). At the same time the state pension insurance reserves amounted to EEK 1.5 billion or 1.1% of GDP. In November 2004, the government established an additional extraordinary cash reserve of the state pension insurance budget on account of the higher-than-expected tax revenues from 2003 in the amount of EEK 532 million. By the end of 2004, the total I pillar reserves thus amounted to EEK 2.0 billion or 1.4% of GDP.

In 2004, expenses on state pensions amounted to EEK 9.2 billion or ca 6.6% of GDP. These were financed mainly – ca 94% – from social tax revenues and rest – 6% – of other state revenues. The share of pension expenditures (as a percentage of GDP) in Estonia is one of the lowest in the EU. Only Ireland spends on pensions less than Estonia[9].

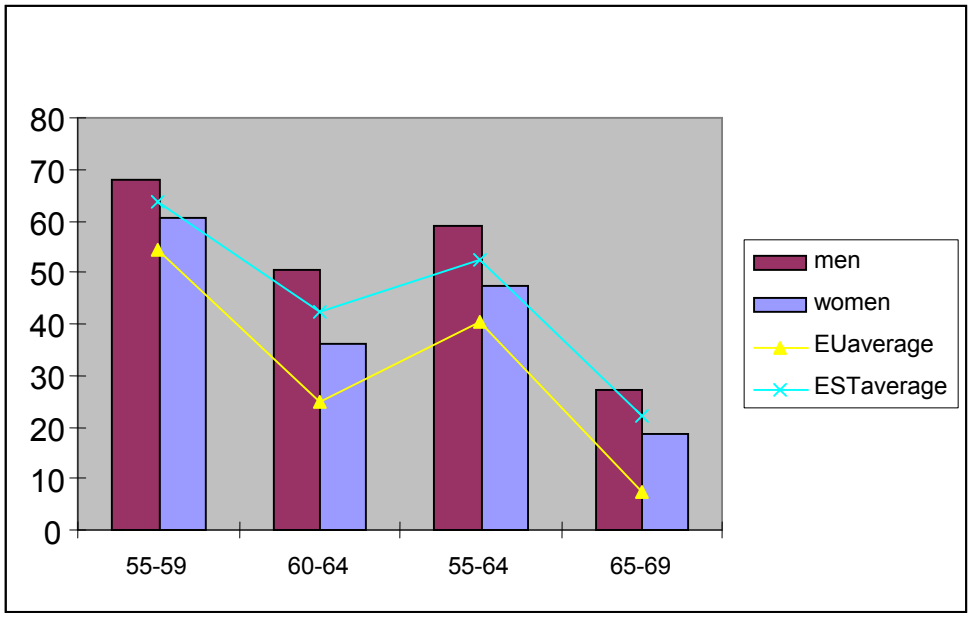
Sustainability of the pension scheme is directly influenced by the level of employment, including participation of older workers in the labour market. The EU Member States have set a target to raise the employment rate of the older workers (55-64) to 50% by 2010. In Estonia, in 2003 the employment rate of this age group (55-64) was 52.3%, which is one of the highest in the whole EU, considerably exceeding the EU average – 40.2%. In 2004 the aforementioned indicators have remained almost the same level – 52.4% and 40.5% respectively.

In 2004 the aforementioned indicators have remained the same. The employment rate of older workers was higher than in Estonia only in Sweden, Denmark and the United Kingdom. The

[9] In comparison of countries based on this indicator differences in population structure, average life expectancy, retirement age, taxation of pensions and other circumstances should be considered.

employment rate of older workers (55-64) in Estonia has increased since 1995. This trend has obviously been influenced by the increase of the pension age (since 1994) and the payment of full pension to working pensioners (since 1996).

Graph 9: Employment rates of older workers, 2003



Source: Eurostat

However, the study by the PRAXIS Center for Policy Studies indicates that there is some segregation in the employment situation of older workers – one group of older persons is excluded from the labour market some years before the retirement age, whereas another group continues to work also after the retirement age. Persons who loose a job shortly before reaching the retirement age, have often difficulties to re-enter employment and many of them opt for early retirement pension. At the same time, those who stay in employment when reaching the retirement age, often continue to work also in retirement age. The interest to stay in employment is often related to the wish to supplement pension with earnings from work. According the data of Social Insurance Board, in 2002 about 25% of old age pensioners earned some income, which was subject to social tax.

Besides increasing the employment rate of older workers (55-64), the EU Member States have set a target to increase the average age of exit from the labour force to 65 years by 2010. In 2002, the average age of exit from the labour force in Estonia – 61.6 years – was above the EU average - 60.4. However, in 2003 the same indicator for Estonia and the EU average were respectively 60.8 and 61.0. The average exit age from labour force thus remains about 4 years below the EU target level. Nevertheless, considering the fact that in Estonia life expectancy is significantly lower than in the western EU Member States, it may be noted that Estonians spend proportionally larger share of their lifetime in work compared to many other Europeans.

In 2003, the general employment rate in Estonia – 62.9% – is about the same as the EU average (63.0%), still remaining considerably under the EU target level of 70% to be reached by 2010.

3.2.3. Future prospects and challenges

The general fiscal position of Estonia to maintain financial sustainability of the pension system in the context of population ageing is relatively better than in many other Member States. However, this is partly due to the relatively lower level of pension expenditures compared to other Member

States. From the other side, the pension reform – adjustments made in I pillar as well as the launching of the II pillar – have increased the long-term financial sustainability of the pension system.

At the same time, redistribution of social tax burden related to the launching of II pillar has caused pension reform transition costs. Since for participants of the II pillar 4 percentage points of pension insurance part (20%) of social tax is transferred to their II pillar pension account, there is a corresponding transition from pay-as-you-go financing to a pre-financed pension scheme. This transition creates so-called pension reform transition cost as part of the implicit pension liabilities are made explicit. Direct transition costs resulting from the reform are expressed in the difference between expenditures and revenues of the state pension insurance, which has to be financed from other sources.

In 2004, transfers from social tax revenues to II pillar comprised ca 0.6% of GDP. In the first years after launching the II pillar – in 2002 and 2003 – the I pillar budget surplus increased, i.e. revenues from social tax exceeded expenditures on state pensions. In other words, despite social tax transfers to the individual accounts of II pillar participants there were no direct transition costs. This was caused by the high increase of social tax revenues. In 2004 direct transfer costs amounted to EEK 133 billion or ca 0.1% of GDP, which was financed by the government from the surplus of social tax revenues from previous years. According to the forecast of the Ministry of Finance, the existing reserves of I pillar will be exhausted due to pension reform transition costs by 2006 and in 2007-2012 the state pension insurance budget needs additional subsidies on account of other state budget revenues.

Financial sustainability of the pension system would be considerably improved if the EU target on employment rate (70% by 2010) would be achieved. This would however require increasing the number of employed persons by ca 70 thousand, which is quite complicated considering the current employment and demographic situation. Therefore, in the national development plan the Government has taken a more realistic objective – to increase general employment rate to 64.3 by 2005. The main labour force potential to increase the number of employed persons are the unemployed, in particular the young unemployed persons. Nevertheless, to achieve the employment objectives only getting unemployed persons to work is not sufficient, attention must be paid also on non-active, which means increasing the number of persons in employment, especially among women, elderly and disabled people.

According to calculations of the PRAXIS Center for Policy Studies achieving of the EU target employment rate (70%) would increase revenues from pension insurance part of social tax (20%) by ca EEK 1 billion or 0.7% of GDP compared to the current revenues. However, higher employment rate would help to improve the financial situation of the pension system only until 2020-s. Later the demographic processes play a dominant role, in particular the fact that small age cohorts due to low birth rate in 1990-s, are entering the labour market.

While the general retirement age in Estonia is currently 63 for men and 59.5 years for women, the pension system includes several possibilities for earlier retirement before the general retirement age – early retirement pension, old age pensions at favourable conditions and superannuated pensions. Also, in case of some special pensions (e.g. for military and police officers) the right to pension emerges before the general pension age (2.3.1).

In 2001 over 50% of men and almost one third of women were granted a state pension at an earlier age before the general retirement age using different options for earlier retirement. In 2004 42.1% of persons were granted a state pension before the general retirement age. Most of these persons applied for old age pension on favourable conditions (certain professions) followed by early retirement pensions, work incapacity pensions granted in pre-retirement ages, superannuated pensions and special pensions. The pressure for earlier retirement is stronger among men as the retirement age of men is higher. The average age of granting old age pension

is nearly by 2.5 years lower than the average labour force exit age. This means that although the average age of exit from labour force in Estonia is higher than the EU average, the general retirement age, as well as the average actual age of granting a pension, is lower than in the 'old' EU member states. Therefore, in parallel with the increase of life expectancy, increase of general retirement age and labour force exit age, from the perspective of sustainability of the pension system it is also important to achieve an increase in the average age of granting a pension.

From 2002, the Estonian state pension insurance scheme offers a rather favourable possibility to defer the granting old age pension. The amount of pension calculated according to the pension formula is increased by 11% per year of deferring the granting of old age pension. However, this possibility has been used very seldom, partly probably due to limited promotion of this option.

3.2.4. Strategies for tackling the financing gaps

In the mid-term perspective, financial challenges relate primarily to the redistribution of social tax burden in connection with the launching of funded pension system in 2002. This reform on the one hand increased the long-term financial sustainability of the pension system, but on the other hand created transition costs which require additional financing in the short-run. According to the forecast of the Ministry of Finance the state pension insurance budget needs to be subsidized in 2006-2012.

According to the coalition agreement of the Reform Party, Centre Party and Peoples' Union the government coalition continues to compensate the revenue loss of the state pension insurance budget due to the transfer of 4 percentage points part of social tax to II pension pillar funds.
In the context of ageing population it is important that parallel to the increase of general retirement age also the employment rates of older workers continue to increase. Considering that the retirement age for women will increase to 63 years by 2016, labour force supply in the age group of 60-64 will further increase in the next decade. However, the continuing increase of retirement age does not necessarily automatically transfer into increase of employment. Therefore, maintaining the competitiveness of older workers in the labour market is important.

Considering the relatively large share of persons retiring before the general retirement age, it is important from the perspective of sustainability to increase the average age of granting the pension parallel with the rising life expectancy, increasing general retirement age and average labour force exit age. This leads to the need to rearrange the system of old age pensions on favourable conditions and superannuated pensions, while respecting the pension rights, which have been already acquired.

From the viewpoint of the sustainability of the pension system, it is important to reform special pensions, which allow retirement before general retirement age and/or are often vastly higher than other types of state pensions. Some of the special pensions exceed average income in several times.

In the long-term perspective the financial sustainability of the pension system is not a major problem despite ageing of population. This is caused by relatively good fiscal position of Estonia and relatively low pension expenditures. However, in this context achieving of the pension adequacy objectives may become complicated.

3.3. Modernization of the pension system (common pension objectives 9–11)

Common objectives
Member States should
9. Ensure that pension systems are compatible with the requirements of flexibility and security on the labour market; that, without prejudice to the coherence of Member States' tax systems, labour market mobility within Member States and across borders and non-standard employment forms do not penalise people's pension entitlements and that self-employment is not discouraged by pension systems;
10. Review pension provisions with a view to ensuring the principle of equal treatment between women and men, taking into account obligations under EU law; and
11. Make pension systems more transparent and adaptable to changing circumstances, so that citizens can continue to have confidence in them. Develop reliable and easy-to-understand information on the long-term perspectives of pension systems, notably with regard to the likely evolution of benefit levels and contribution rates. Promote the broadest possible consensus regarding pension policies and reforms. Improve the methodological basis for efficient monitoring of pension reforms and policies.

3.3.1. Adequacy gaps caused by insufficient adaptation of the pension system to the labour market and employment patterns

Different from several other EU Member States, where pension schemes have been historically designed according to the situation of full-time workers, the main parts of the Estonian pension system (I and II pillar) are well compatible with the changing employment forms and increasing flexibility and mobility in the labour market.

Determination of pension rights in the I pillar on the basis of total incomes subject to social tax ensures equal treatment to all economically active persons, regardless of the form of employment and workload (part-time of full-time work). Also, different types of remuneration are treated similarly for the purpose of payment of social tax.

Nevertheless, while some types of pensions – namely, old age pensions on favourable conditions, superannuated pensions and special pensions, which include a condition that the person has pursued in a particular profession for a number of years – do not entail a problem from the adequacy perspective, but incur problems the perspective of labour market flexibility. These special regimes increase rigidity of employment relationships in some sectors, as workers are inclined to avoid changing jobs before fulfilling of the required qualification period which relates to the particular profession. At the same time, this may mean continuous working in health hazardous working conditions in order to fulfil the relevant qualification period for old age pensions on favourable conditions.

A further condition for granting an old age pension on favourable conditions, superannuated pension or special pension is that the pension is paid only if the person stops working at the given position or profession. This includes the risk of inactivity, as there is an incentive to give up the position to be eligible to pension before the general retirement age, whereas finding a new job in pre-retirement age (in particular after a sufficiently long career in a specific profession) is not easy. This risk is increased by the possibility established by law for some occupational groups of persons having a right to special pension (e.g. military and police officers) to end the service relationship on the basis of age a number of years before the general retirement age. For example, in the case of some military officers starting from the age of 50, and in the case of junior and senior police officers starting from the age of 55

Self-employed persons pay social tax on the net business incomes. There are no legal obstacles for self-employed persons to participate in the I and II pillar pension schemes. The Social Tax Act establishes for self-employed persons the minimum social tax obligation as 33% on EEK 700 per month, which is substantially lower than social tax calculated on the minimum wage[10]. If the self-employed person pays social tax only on the minimum amount, the pensionable service acquired for one calendar year will be actually less than 1/3 of a year and the annual pension insurance coefficient would be less than 0.15. This could in the long run result in a situation where the self-employed person would not have a right to old age pension due to non-fulfilment of the qualification period (15 years) or have a right to old age pension only at the minimum rate (national pension rate). The government plans to increase the minimum social tax obligation of self-employed persons, which among others would help to avoid the negative implications of tax optimization on the future pension of self-employed persons.

3.3.2. Gender equality and gender impact of pension system

The legal criteria of the Estonia pension system ensure equal treatment of men and women. The retirement age of women will be gradually equalized with the retirement age of men over the transition period lasting until 2016. The requirements for the favourable working periods which are the basis for pensions on favourable conditions and superannuated pensions are also equalised for men and women.

The share of women in the elderly population in Estonia is higher than the EU average, as differences in the life expectancy of men and women in Estonia are wider compared to many other EU Member States. In the beginning of 2003, the share of women among residents aged 65 and over was 67% and among those, aged 75 and over, 74%. The respective average shares for the whole EU were ca 60% and 67%. Women comprise 69% of old age pensioners in Estonia. At the same time, men outnumber women among recipients of early retirement pension and superannuated pension, were the shares of men are 65% and 77% respectively (*source: Estonian Statistical Office*).

The intra-generational solidarity of the current state pension scheme is reflected also in the comparison of average pensions for men and women. The average old age pension of women comprises nearly 97% of the average old age pension of men. At the same time, wage differences in the age cohorts approaching the retirement age are nearly 20%. The similarity of average pensions is mainly related to the fact that until 1999 pension rights were determined only on the basis of the length of service, while at the same time the employment rate of women has been relatively high. Furthermore, until 1999 one of the parents was granted an additional 2 years of service per each child. These credited periods are mainly used by women as they still reach retirement age before men.

[10] In 2005, the minimum monthly wage is EEK 2690.

Nevertheless, despite the fact the difference in pension level is only marginal, the relatively low poverty risk of women aged 65 and over – 20.8% – is considerably higher than that of men of the same age – 6.6%. One of the reasons is that for elderly women the state pension is more often the only source of income, whereas for men this is more often supplemented by some earnings from work.

According to the data of the Social Insurance Board, in 2002 nearly 25% of old age pensioners received earnings from work, which were subject to social tax. About 29% of male old age pensioners had at least some work income, while among female old age pensioners the share of working persons was 23%. (p. 3.2.2)

Since from 1999 pension rights are acquired only on the basis on social tax payments, wage differences of men and women will obviously start to influence developments in the average pensions of men and women. The development of the old age pension for women is further influenced by the fact that annual pension insurance coefficient for the periods of raising children is very low.

On the other hand, in the 1990s and in the beginning of the current decade the unemployment rate of men has been higher that that of women and the employment rate of men has declined relatively more than that of women. The factors will somewhat balance developments in the average pension of men and women.

The development of total pensions of men and women is influenced also by the fact that more women than men have joined II pillar (55% and 45% respectively). This presumably will result in a larger total pension (I + II pillar) for second pillar participants.

There are opposite influences also on the development of the amounts of II pillar pensions of men and women. As the II pillar pension is directly related to the contributions paid (and hence, depends directly on earnings), wage differences of men and women will be carried into pension differences. The holes in the accumulation period of the II pillar pension for women due to the raising of children are somewhat compensated by supplementary contributions by the state (launched from 2004) in the amount of 1% on the parental benefit. These supplementary contributions by the state are made during the period of receiving the parental benefit, which is up to 11 months. Such contributions still comprise only 1/6th of the former contributions of the parent on the former work income. Furthermore, additional contributions are not made in the period of maternity benefit (about 4.5 months) paid on the basis of the Health Insurance Act.

3.3.3. Other pension reform issues

Increasing of the retirement age has been the key measure to adjust the pension system to changes in the demographic situation in Estonia. The retirement age of men reached the target level of 63 years already in 2001, whereas the retirement age for women will be increased to the same level by 2016. Simultaneously, the possibilities for deferred and early retirement have increased flexibility in terms of choosing the suitable time of retirement.

However, the fact that in Estonia the retirement age as well as the factors for increasing and decreasing pension in case of respectively deferred or early retirement pensions are fixed means that continuing increase in the life expectancy would raise further questions about increasing the retirement age and correction of pensions by increasing/decreasing coefficients with *ad hoc* political decisions. Otherwise the financing burden of the pension system would increase; early retirement would become more attractive, whereas the deferring of pension would become less attractive. In this context, the system used in some EU Member State where the pension formula includes so-called automatic stabilizers – factors, which take into account changes in life expectancy, adjusting the pensions system to demographic changes –

could be considered in the longer run, more particularly after the equalization of retirement ages of men and women in 2016.

3.3.4. Transparency, adaptability and the policy of pension reform

Ensuring of the social adequacy and financial sustainability of the pension system has several important prerequisites: open discussion, public support and political leadership of the process. For informed open discussion it is important to have information on the current situation and future perspectives of the pension system available. This in turn assumes constant monitoring of the pension system, provision of information to the insured persons and pension recipients as well as developing political consensus.

During the launching of II pension pillar, in 2002, the government initiated an extensive information campaign to inform the population about the choices and possibilities as well as risks related to the new pension system.

In the framework of internetisation of public services and so-called e-state projects key information on the pension system has been made available on Internet: legal acts, explanations, pension application forms, pension insurance budget, revenues and expenditures etc. As for the II and III pillars Internet provides a possibility not only to study the provisions of the relevant legal acts. It is also possible to join a II or III pillar pension fund or conclude a pension insurance contract, to change a fund, to analyze investments and asset allocations of the pension fund, to compare productivity of different pension funds, etc via Internet.

Social Insurance Board as well as Estonian Central Depository of Securities provide information about the state pension insurance. Moreover the Central Depository distributes information about funded pensions.

The pension reform has increased transparency of formation of pension rights and financing of the pension system. As in essence both the Estonian I pillar as well as II pillar are defined-contribution schemes, one of the key issues of interest to insured persons is the development of rates of benefits – what will be the real value and replacement rate of the benefit at the time, when the person reaches retirement age. Over Internet each insured person can follow his/her own individual data in the state pension insurance register on the pensionable service and the sum of annual pension insurance coefficients. Participants of the II pillar may at any point of time look at the balance of their individual pension account over Internet.

Monitoring of developments of the pension system has been started from late 1990s. An important basis for this was established in 1999 with the foundation of the state pension insurance register. The Social Insurance Board and Ministry of Finance have also created a forecast model for the pension system, which enables to analyze developments in revenues and expenditures of the pension system (I and II pillar). Moreover, PRAXIS Center for Policy Studies has developed its own pension model, which enables to compare the forecasts of the government with independent prognosis.

4. CONCLUSION

In general the objectives of the new Estonian pension system correspond rather well to the EU common pension objectives. Pension reform, which has been implemented – changes made in I pillar as well as launching of supplementary pension schemes of II and III pillar – have largely taken the Estonian pension system closer to the principles behind the EU common pension objectives.

The pension reform has created new possibilities to increase incomes in retirement age. The reform has also increased motivation of working age persons to participate in the financing of the pension system while decreasing labour market distortions. Also the general interest, responsibility and knowledge of people about their future pension have been increased. The rules of the pension system and financing methods are more transparent and sustainable.

On the other hand, the pension reform has taken into the picture new risks, for example increasing of income disparities of persons in retirement age. That would be the case if the large income differences of current working age population are not changed and will be transferred into the pension differences.

Under the current rules financial sustainability of the pension system does not appear to be a major problem despite the ageing population. However, maintaining the adequacy of state pensions could become a problem, requesting additional modifications, e.g. adjustment of the pension index.

While the main elements of the Estonian pension system (I and II pillar) are relatively well compatible with the principles established by the EU common pension objectives, the Estonian pension system includes also smaller pension arrangements, which raise questions in the light of the EU common objectives. Special pension schemes for some categories of civil servants, superannuated pensions and old age pensions on favourable conditions give rise to questions in relation to the intra-generational solidarity of the pension system (EU objective No.3), lowering of the average labour force exit age and the average age of granting pension (EU objectives No.4 and 5), balance between adequacy and financial sustainability (EU objective No. 7) and flexibility of the labour market (EU objective No.9). Although it is not possible to abolish the aforementioned pension provisions quickly due to the legitimate expectations of persons employed in the professions concerned, limiting these special pension rights needs to be considered in the longer run.

5. ANNEX

Table 1. Relative income: the ratio of median equivalised income of people aged 60+, 65+ and 75+ relative to median equivalised income of people aged <60, <65 and <75 respectively, and of people aged 45-54, 2002

Age 60+			Age 65+			Age 75+		
Median income in EEK	Ratio of median income		Median income in EEK	Respective age group		Median income in EEK	Ratio of median income	
	Respective age group			Respective age group			Respective age group	
	<60	45-54		<65	45-54		<75	45-54
2129	0.804	0.799	2100	0.802	0.788	2098	0.837	0.787

Source: LFS

Table 2. Composition of income by source for people aged 60+, 65+ and 75+ and for complementary age groups for each income quintile, 2002 (%)

	<60				60+			
Quintile	Earnings from work	Pension	Social benefits	Other sources	Earnings from work	Pension	Social benefits	Other sources
1	56.6	11	22.3	10.1	3	89.7	2.1	5.2
2	75.3	7.8	10.8	6.1	2.7	95.5	1.3	0.5
3	81.9	6.6	6.3	5.2	4.2	91.2	3.1	1.5
4	84.6	3.9	4.5	7	19.3	75.1	3.3	2.3
5	89.3	1.6	2.7	6.4	60.9	35.2	1.4	2.5
	<65				65+			
1	53.9	15	21.3	9.9	2	91	1.7	5.3
2	65.1	20.2	9.4	5.3	1.2	97	1.4	0.4
3	74.7	14.4	6.1	4.9	1.8	93.8	2.9	1.4
4	81.1	7.95	4.3	6.6	10	84	3.6	2.4
5	88.3	3.2	2.6	6	35.5	56.7	2	5.7
	<75				75+			
1	48.7	22.4	19.3	9.6	0	97.4	2	0.6
2	53	34.8	7.8	4.4	0.3	97.3	2.2	0.2
3	60.2	30.1	5.5	4.2	0.5	95.7	2.7	1
4	76.1	13.3	4.3	6.3	2.3	91.9	3.6	2.2
5	86.8	4.7	2.5	5.9	14.2	70.8	1.9	13.2

Source: LFS

Table 3. Distribution of risk of poverty for people aged 60+, 65+ and 75+ and below 60, 65 and 75 by the housing tenure status of their households, 2002

	Men				Women				Total			
	<60	60+	<65	65+	<60	60+	<65	65+	<60	60+	<65	65+
Owner	86.4	95.5	86.7	97.1	85.1	91.8	85.7	90.6	85.8	93.1	86.2	92.7
Rented	11.0	3.5	10.7	2.2	11.7	7.2	11.3	8.2	11.4	5.9	11.0	6.3
Rent-free	2.5	0.7	2.4	0.4	3.1	0.9	2.9	1.2	2.8	0.8	2.7	1.0

Source: LFS

Table 4. Risk of poverty of people aged 60+, 65+ and 75+ by the composition of their households, 2002

	60+			65+			75+		
	men	women	total	men	women	total	men	women	total
Single	12.6	6.5	7.7	4.7	7.5	6.9	0.9	9.6	8.2
Couple	4.4	5.0	4.7	3.7	4.6	4.1	5.6	6.7	6.0
Couple +child (children)	15.9	15.1	15.4	12.9	16.2	15.0	5.8	10.6	9.4
2 adult generations	11.3	16.2	14.5	9.7	16.6	14.3	2.9	6.4	5.6
3 generations	11.7	13.8	13.3	14.6	14.1	14.2	16.4	11.6	13.1
Other	12.4	11.1	11.4	11.2	11.8	11.7	5.1	5.6	5.5

	<60			<65			<75		
	men	women	total	men	women	total	men	women	total
Single	26.4	16.8	21.2	27.3	12.8	18.7	23.9	10.3	15.1
Couple	12.1	10.7	11.4	10.6	9.5	10.0	8.2	8.0	8.1
Couple +child (children)	15.4	14.8	15.1	15.4	14.8	15.1	15.4	14.8	15.1
2 adult generations	15.5	15.3	15.4	15.4	15.3	15.4	15.3	16.2	15.7
3 generations	15.3	15.3	15.3	14.9	15.1	15.0	14.7	15.3	15.0
Other	28.1	23.6	25.9	27.6	22.9	25.2	26.7	22.3	24.4

Source: LFS

Table 5. Inequality of income distribution (S80/S20) for age groups 60+, 65+ and 75+, 2002

	Total 60+		Men 60+		Women 60+	
	Per capita	**Personal income***	***Per capita***	**Personal income**	***Per capita***	**Personal income**
20% (EEK)	1700	1554	1800	1597	1649	1538
80% (EEK)	2978	2074	3082	2325	2832	1980
Limit ratio	1.75	1.33	1.71	1.46	1.72	1.29
Average of lower quintile (EEK)	1365		1431		1342	
Average of upper quintile (EEK)	4801		4958		4700	
Average ratio	3.52		3.46		3.5	
	Total 65 +		**Men 65+**		**Women 65+**	
	Per capita	**Personal income**	***Per capita***	**Personal income**	***Per capita***	**Personal income**
20% (EEK)	1700	1554	1835	1627	1639	1524
80% (EEK)	2765	2050	3001	2260	2654	1961
Limit ratio	1.63	1.32	1.64	1.39	1.62	1.29
Average of lower quintile (EEK)	1366		1499		1326	
Average of upper quintile (EEK)	4520		4748		4374	

Average ratio	3.52		3.17		3.3	
	Total 75+		**Men 75+**		**Women 75+**	
	Per capita	**Personal income**	***Per capita***	**Personal income**	***Per capita***	**Personal income**
20% (EEK)	1670	1520	1950	1659	1608	1452
80% (EEK)	2885	2067	1302	2433	2654	1976
Limit ratio	1.73	1.36	1.59	1.47	1.65	1.36
Average of lower quintile (EEK)	1401		1676		1350	
Average of upper quintile (EEK)	4907		4373		5094	
Average ratio	3.5		2.61		3.77	

* Personal income: earnings from work, incl honorarium + pension (all types)
Source: LFS

Table 6. Relative income inequality: income share ratio S80/S20 for age groups 60+, 65+ and 75+ relative to the income share ratio for complementary age groups (2002)

	Total		**Men**		**Women**	
Limit	**60+**	**<60**	**60+**	**<60**	**60+**	**<60**
20%	1700	1583	1800	1555	1649	1613
80%	2987	4560	3082	4470	2832	4650
Limit ratio	*1.75*	*2.88*	*1.71*	*2.87*	*1.72*	*2.88*
Average of lower quintile	1365	1038	1431	1012	1342	1064
Average of upper quintile	4801	7207	4958	7091	4700	7325
Average ratio	*3.52*	*6.94*	*3.46*	*7.01*	*3.5*	*6.88*
(younger ratio/elder ratio)	1.97		2.03		1.97	
Limit	**65+**	**<65**	**65+**	**<65**	**65+**	**<65**
20%	1700	1596	1835	1565	1639	1631
80%	2765	4475	3001	4435	2653	4533
Limit ratio	*1.63*	*2.8*	*1.64*	*2.83*	*1.62*	*2.78*
Average of lower quintile	1366	1026	1499	1092	1326	1088
Average of upper quintile	4520	7113	4748	7177	4374	6937
Average ratio	*3.31*	*6.73*	*3.17*	*6.93*	*3.3*	*6.57*
(younger ratio/elder ratio)	2.03		2.19		1.99	
Limit	**75+**	**<75**	**75+**	**<75**	**75+**	**<75**
20%	1670	1620	1950	1597	1608	1639
80%	2885	4297	3102	4287	2654	4301
Limit ratio	*1.73*	*2.65*	*1.59*	*2.68*	*1.65*	*2.62*
Average of lower quintile	1401	1088	1676	1061	1350	1115
Average of upper quintile	4907	6937	4373	6963	5094	6916
Average ratio	*3.5*	*6.38*	*2.61*	*6.57*	*3.77*	*6.2*
(younger ratio/elder ratio)	1.82		2.52		1.64	

* *per capita income of first household member* in case of equivalent scales 1:0.7:0.5
Source: LFS