Summary of the impact analysis of the changes to the pension system

The debate that has been launched in Estonian society about the options for pension savings is to be welcomed, as it is hoped that it will make people think more about pensions and how to secure their old age. We agree that the legal framework for funded pensions needs to be updated so that the savings that people have built up can give them the largest possible additional income in retirement. Investment restrictions on pension funds have been eased already in recent years and service fees have been reduced, but it now seems that the framework regulating withdrawals from funded pensions needs to be updated.

The pension reforms proposed by the government are very fundamental as they would make the funded pension that has until now been mandatory voluntary. This would mean there would no longer be a mandatory funded pension, or second pillar pension, in Estonia. This change would have an immediate impact on the Estonian economy in the coming years, and it would also have a long-term impact on the state budget and the expected size of pensions in future.

What pension system does the OECD[1] recommend for its member states?

The OECD emphasises that the first and second pillars complement each other, but cannot replace each other. The different pension pillars help to reduce different types of risk and achieve different goals, such as poverty reduction, redistribution, sustainability, or smoothing of consumption. For this reason the OECD recommends using three pillars in the pension system, with a first pay-as-you-go (PAYG) pillar and second and third pillars that pay pensions out of savings previously built up.

The OECD finds that the second pension pillar makes the first pillar more reliable and that fairer pensions are paid through the first pillar. It finds that the second pension pillar encourages work and saving for retirement, and it encourages older people to remain in work. The second pillar may also help the development of capital markets, which supports growth in the economy.

How will the changes to the pension system affect the size of pensions and the level of taxes over the long term?

The more that the currently planned changes reduce the pension savings that have been built up in the second pillar, the greater the pressure will be in future to increase the pensions paid through the first pillar and to raise taxes. Despite the rise in the retirement age agreed last year, the ratio of people working to those in retirement will continue to fall over the coming decades. The critical point will arrive in 2060, when there will be 1.6 people working for every pensioner, down from 2.2 workers at present. The deteriorating ratio of workers to pensioners will raise the pressure to spend more on pensions and to increase the tax burden.

As the different pension pillars reduce different risks, they together give greater confidence that old-age pensions will be large enough. Like the OECD recommendations, our calculations indicate that the first and second pillars complement one another, as they reduce risks of different types. The pension paid out from the first pillar does not depend on international financial markets for example, while the pensions paid from the second and third pillars depend directly on them. As the second pillar pension does not depend so much on events in Estonia however, the funded pension is important if the Estonian population declines by more than expected, the Estonian economy grows by less than forecast, or the currently agreed rise in the retirement age is not fully rolled out over the decades.

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[1] We consider the OECD to be the international economic analysis organisation with the best reputation as an expert on pensions.

The longer that people have been saving in the second pillar, the more that withdrawing their savings and spending them will affect their future pension.

How has joining the second pillar affected the savings of individuals?

An investor acting alone can increase their pension savings only a little. The savings habits of individuals in Estonia typically show a lack of diversity in financial assets. The majority of financial assets are held in bank deposits and only a small role is played by financial assets that are riskier but have a better return over the long term, such as shares and investment funds. One reason for this financial behaviour is that people are not prepared to take risks in investing. Survey data show that three quarters of people are not prepared to take any financial risk with their savings. If no financial risk is taken, pension assets can only grow weakly.

People are notably more passive about building up voluntary pension assets than about using the automatic second pension pillar. Comparing the assets and liabilities of those who have and have not voluntarily joined the second pension pillar indicates that the second pillar accounts for a major share of the net assets, which is assets minus liabilities, of those who have chosen to join the pillar. Because of the second pillar, those who have chosen to join have on average 8500 euros more in net assets than those who have not joined the pillar. Our analysis indicates that those who have not joined the second pillar have not independently invested the additional 2% of income that this frees up.

How changes to the pension system will affect the Estonian economy

Withdrawals of money from pension funds will make growth in the economy more volatile. Growth will at first increase because of the sharp rise in consumption, and real estate prices and imports will also increase. Once the initial impact of withdrawals of pension assets fades though, growth in the economy will weaken.

The costs of volatility in the economy are social problems and slower long-term growth. A rapid and temporary rise in incomes will boost growth at companies focused on the domestic market, but will make life harder for exporting companies, which may become less competitive as costs rise. If the volatility causes the unemployment rate to rise, the professional skills of workers may deteriorate, leaving them less productive in future.

How changes to the pension system will affect financial stability in Estonia

The steady reduction in investment restrictions on pension funds has given them better options for investing funds in Estonia as well. Funds have used these options and from June 2018 to June 2019 the amount of pension assets invested in Estonia increased by 32.5%. A total of 761 million euros has been invested in Estonia, or 17% of the aggregate portfolio of pension funds. Pension funds have invested 3627 million euros, or 83% of their aggregate portfolio, in assets abroad.

Pension funds have been active in recent years in venture capital and private equity and have played a large role in bringing additional capital to Estonia. The largest part of the investment in Estonia is of 334 million euros in bonds, followed by 153 million euros in shares in investment funds, and 75 million euros in equity. The majority of the investments of pension funds in Estonia has gone into real estate and banking. This raises the question of how the resulting gap in funding for Estonian companies will be filled.

Investments in Estonia are in general not very liquid, and so it takes time to withdraw from an investment, meaning assets may be sold at a low price if large amounts are withdrawn at once. The planned changes to the second pillar would make pension funds sell their assets over a relatively short time

frame, and this could result in them making a loss on their transactions. This would then cause losses for shareholders. The risk of money being withdrawn from the funds will remain high in future, and so they will probably prefer to invest in more liquid instruments, and to put less in assets directly linked to Estonia.

Selling illiquid assets takes more time, and the funds will probably have to sell their assets at a discount under these circumstances. The 23 pension funds that operate in Estonia have invested differently, as 12 funds have made highly liquid investments and should find it easy to cover withdrawals, while the other 11 may find it harder to exit their investments as they have invested to a greater extent in less liquid assets. The five pension funds with the largest amount of low-liquidity assets have invested a total of 151 5 million euros, of which 300 million euros is in assets with little liquidity. On top of the assets in Estonia with low liquidity, selling off securities in international financial markets to exit investments rapidly may give lower income than expected or even cause losses, as the pension funds have calculated that their investments are made for the long term.

When changes are made to the pension system, the following questions need to be answered. How can the interests of fund investors be protected when withdrawing money from the second pension pillar will probably cause some funds to sell assets with low liquidity, even though this may reduce the value of the assets of both those leaving the fund and those remaining in it? How can the negative impact on fund investors be eased if it is probable that relatively fewer illiquid investments will be made in future and so expected returns will be lower?

Recommendations

1. Before making fundamental changes to the pension system, it is important to explain clearly what the results expected from the proposed new system are and to get the widest possible agreement on them. The comprehensive picture should make clear the relative size of the pension that the state will provide in the future, the amount that people are expected to contribute themselves, and the cost of the pension system.
2. We do not recommend making it voluntary to save for pensions, as the consequence could be that old-age pensions will be smaller in future. This step would also increase the pressure to raise taxes in the future.
3. If it is still really desired to make the second pension pillar more voluntary, we recommend the following:
    - if people start to spend their pension savings immediately, it will make growth in the economy more volatile. To balance this, it would be wise for the government to avoid spending additional tax revenues, and to lengthen the minimum period for withdrawing pension savings;
    - if the second pillar is to be made voluntary, it would be worth considering ways of encouraging people to save for their retirement through a funded pension;
    - ways should be sought to protect those shareholders who have put their money into the second pillar pension funds that have invested most in the Estonian economy and have the least liquid assets.