Ministry for National Economy

A study trip to Estonia

By
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3rd - 6th October 2010.

A Study Trip by the Experts of the Hungarian Ministry of National Economy in Estonia

Assigned by Mr. György Matolcsy, minister for the national economy, between the October 3rd and 6th Viktória Nagy and Tamás Bánkuty paid a three-day visit to Estonia to exchange experience, consult with fellow experts and to gather information.

Topics of the consultations:

- Family policy
- Flat tax rate policy
- Private pension funds

The objective of the study trip:

Exchanging experience and networking with the competent governmental organizations and market participants as well as shortly presenting the actual Hungarian situation in these three fields and gathering information of the Estonian systems.

The most important questions about these three fields:

Family policy

The Hungarian and Estonian fertility rate was identical in the year of 2000, but since then Estonia has made significant headway against Hungary.

- What are the main elements of the Estonian family support system?
- Which trends have become dominant in women's employment?
- How widespread are atypical employment methods?

- How do Estonian preschool childcare institutions work?
- How could the Estonian negative birth trends of the 1990s be turned around?

Tax system

Estonia has been the first country in the world with a flat tax system which Hungary is about to adopt.

- What effects had the flat tax rate system upon the budget?
- How did tax revenues change after its introduction?
- How are these revenues structured today?
- Which are the most important elements of the corporate tax reform of 2000?
- Which elements of the tax system can motivate young people to have more children?
- Did the flat tax rate system help tackle the problem of black economy?
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Private pension funds

To cut the budget deficit, between the 1st July 2009 and the 31st December 2010 Estonia modified the pension system's obligatory capital reserve system by suspending the compulsory payment of old age pension contributions and the central transfer of part of the social taxes to private pension funds.

- What are the main statistics characteristic of compulsory pension funds, like the number of funds, the number of their members, their working capital, their portfolio, the amount of annual contributions, their performance, net profit, costs and fund management fees?

- What have been the details, consequences and effects of the suspension of pension fund contributions? What have been the experiences? Has the EU acknowledged these contributions as state revenues and could the official deficit figure be reduced in this way?
- What was (and has been) the impact of the operation (establishment) of private pension funds upon the Maastricht criteria such as the budget deficit and public debt?
- What are the future plans about private pension funds and pension contributions from 2011?
- Has there been any state intervention about the private pension fund sector yet?
- What kind of state guarantee is behind the second pillar?
- Has there been the opportunity for a private pension fund member to return to the state pension fund system? If yes, what have been the conditions?

Consultations

Estonian Economic Research Institute

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Janos Rekasi, diplomat of foreign economic affairs, has assisted the Hungarian delegation during these consultations.

Conclusions about the main economic and social tendencies In Estonia

Consultations:

Marje Josing, the director of the Estonian Economic Research Institute, marje@ki.ee, www.ki.ee

Agnes Karpati, Hungarian lawyer living in Estonia, Revala Institute, agnes@revalainstitute.ee

What is behind the economic success of the country, and what has been the role of the flat income tax rate in this?

- The flat income tax rate has contributed significantly to the creation of an optimal, competitive business environment, but it has not been the sole solution. It is a complex question. This system has been working perfectly in Estonia, but much less so in Lithuania. As for its impact on the budget, it has been positive from its introduction, because the number of taxpayers has been increased and the willingness to pay taxes has been strengthened. Paying taxes is primarily a moral issue, so the tax system alone cannot change people's attitude to it. However, their willingness to pay taxes can be optimized by making taxes uncomplicated and transparent. The role of the state is to create an ideal environment by making taxation uncomplicated and education up-to-date. Furthermore, the significance of e-administration must also be emphasized. In Estonia, e-administration played a crucial role in whitening black economy. Today the proportion of black economy is below 10%, and it is typically characteristic of the construction sector.

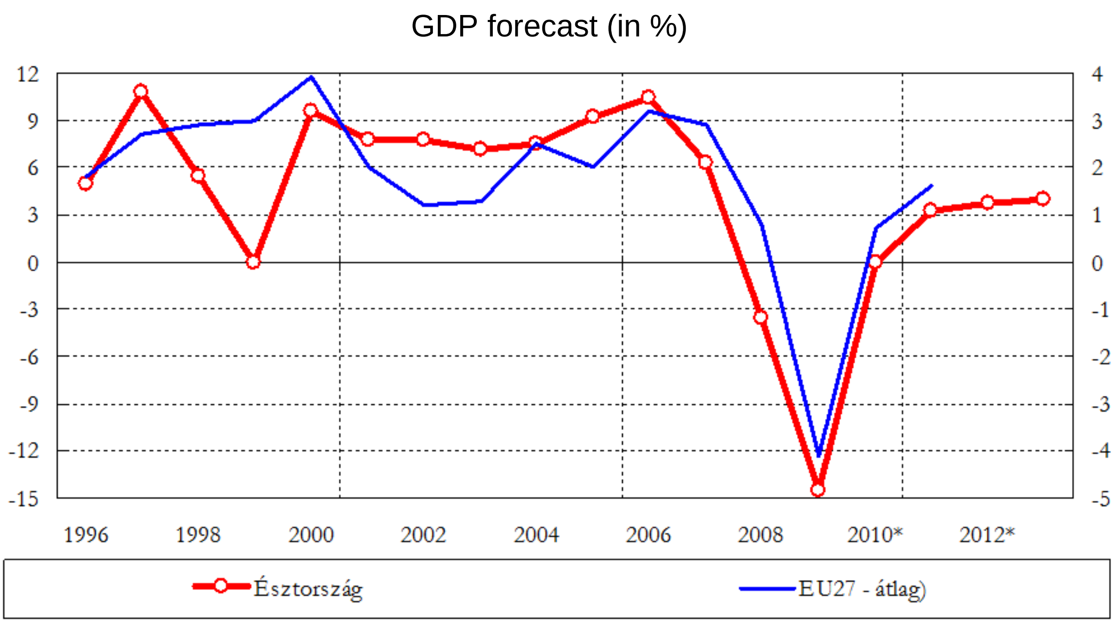
What have been Estonia's relationships to its neighbours like?

- It has been one of the factors behind the success of the Estonian economy that the country wants to belong closely to the Scandinavian neighbours, which are the main foreign investors and which demand a well-organized, orderly business environment. The banks of the country are owned by Swedish or Finnish investors too, which have a further positive impact on Estonia. The troubled relations with the Russians have also forced Estonia to expand its trade westward which has improved the economy too. The country imports raw materials and creates goods of high added value employing highly qualified workforce. There are four big state universities in the country. The only area where more money has been spent on during the economic crisis than before it was education. The basis of the country's faith and optimism about the future can be found in a modest history devoid of victories which nonetheless encourages Estonia to accomplish great deeds in the future. It is widely believed that one of the factors of the country's economic success is that it has never been ruled by a monarch.

Why has Estonia got the highest unemployment rate in the EU?

- In Estonia, parallel to unemployment, there are a number of available jobs, especially in light industry. As a result of the structure of private property ownership similar to the Hungarian model, workforce mobility has been very low. The state supports the hiring of the unemployed by returning half of the employed person's salary to the employer if he employs this person for more than one year. In spite of the economic crisis and the high unemployment rate, 40% of the households are able to save up and only 10% have day-to-day financial difficulties. This phenomenon might be traced back to the good example of the state which used to manage a budget surplus for a long time.

Effects of the economic crisis



During 2009 Estonia's GDP fell by 14% relative to the previous year, and so out of the tree Baltic states they had the best results. The low point was with a 16.1% recession in the second quarter of 2009, by the fourth quarter this figure moderated to 9.5%. The most important factors behind the slowing of the economy were the 29.8% regression in the gross accumulation of fixed assets and the fall in private consumption by 18.4%. The sectors most severely affected by the economic crisis calculated on the basis of the change in gross added value between 2008 and 2009 are the following: construction (-30.1%), financial services sector (-26.5%), processing industry (-25.8%), hotel and catering (-22.9%), trade (-19.7%). In spite of the economic crisis, the gross added value has even increased in forestry (16.6%), fishery (5.8%), and in public administration, security, and compulsory social insurance this figure has risen by 1.4%.

Year	GDP change (effective)
2007	7.2%
2008	-3.6%
2009	-14.1%

Unemployment is a severe problem of the Estonia economy. The unemployment rate of 13.8% in 2009 may be as high as 16.4% in 2010, and next year it is expected to be 12.5%. As the first phase of the crisis management programme, during 2009 Estonia cut the operational costs of public institutions and offices, the salaries of public sector employees, old age pensions, the state contributions to private pension funds as well as health insurance funds, and it raised the sum payable for unemployment insurance and inland revenues. To increase the trust of the financial sector the Estonian central bank secured a credit line of 1bn EUR from the Swedish central bank. The second phase of the crisis management programme was aimed at kick starting the economy partly by measures promoting investment and partly by optimizing the financing of companies. Estonia is trying to increase flexibility of the job market by several financial support programmes, training and retraining projects and new work regulation. The country has also introduced comprehensive legal regulatory measures to simplify and promote economic activities.

(Source: ITD Hungary)

Introduction of the Euro

Estonia will introduce the EUR from January 1st 2011. Out of the new member states of the European Union this Baltic country is the fifth to adopt the common European currency. Tallinn had entered the ERM-II exchange-rate mechanism already right after joining the EU, and their national currency had been pegged to the Euro. The decision that Tallinn could join the Euro-area can also be considered as an important signal to the other aspiring countries that having a stabile and sustainable economic policy will surely bear fruits. (Olli Rehn, economic and financial commissioner)

Year	Budget deficit/GDP	Public debt/GDP
2009	1.7%	7.2%
2010	2.4%	9.6%

That Estonia could have a clean break in 1991 as they did not inherit any Soviet-era debt was yet another advantage. This year the country’s budget deficit is expected to be around 2.4% of GDP, well below the 3% limit, and their 9,6% public debt is the lowest among the EU member states. In addition, for five years, between 2002 and 2007 the country always managed to have a budget surplus.

The Estonian e-administration

During the last twenty years Estonia has managed to create a well-functioning and secure e-state. It has become a daily routine for the citizens to make use of e-services let they be electronic elections, taxation, police affairs, health services, banking or education. Nowadays most citizens do not even consider going personally to these institutions or demanding the old-style administration any more. Almost any such activity can be accomplished by some clicks on the internet.

Although the term is new, one can define the exact meaning of e-government from a number of various aspects. It means namely far more than the digitalization of the services of the government or local municipalities. It is much rather a comprehensive transformation by which governments can exploit a wide range of opportunities offered by digitalization so that they can substantially improve the availability, quality and cost-efficiency of their services.

By having introduced modern technologies, the country has managed to catch up with its industrialized Western and Northern neighbours with a single “tiger leap” and become a country with one of the highest relative number of internet users in the world. Estonia is among the leaders in various rankings of e-preparedness. Besides the obvious advantage of having many internet users another secret of their success is regarded to be the ‘open market’ attitude meaning that any new e-service about to be introduced must be compatible with the existing systems. Yet another factor of the success of e-government is the Estonians’ openness and willingness to embrace innovations. Last but not least one must also mention the country’s geographical situation and its strong economic and cultural relationships with Finland.

The basic elements of the Estonian informatics policy were defined by the document ratified by the Estonian parliament in 1998 titled “Principles of the Estonian Information Policy”. Two additional plans were ratified in 2004 titled “Principles of the Estonian Information Policy 2004-2006” and in 2006 titled “Strategy of the Estonian Information Society 2013.” This strategy defines the general principles of development, the objectives and necessary steps to be taken in connection with the broad utilization of ICT (information and communication technologies) which would promote knowledge-based economy and society in Estonia.

Until now the Estonian information policy has focused primarily on the creation of infrastructure of information and communication establishing systems required by the objectives of various sectoral policies.

Successful e-government projects:

- Wireless internet: in Estonia Wi-Fi is rather a rule than an exception, as in a territory of 45 000m there are 900 hot spots most of which are free. Only in Tallinn there are almost everywhere free Wi-Fi hot spots in cafes, filling stations and public parks alike. In 2005 this service became available in every public park of the capitol and on the seaside too. There is Wi-Fi on commuter trains as well.
- Village Road 1-2-3 Project: Village Road 3 Project is an improved version of the Village Road 1 Project aimed at providing local governments with internet and of the Village Road 2 Project aimed at providing public libraries with internet. The Village Road 3 Project targets scarcely populated micro regions where private sector internet projects would not be profitable. The objective of this programme is to make internet access for local governments and inhabitants as easy as it is in more densely populated areas.

The “tiger leap” forward

In 1997 the very first significant measure to create an information society and an e-state was the decision to try to introduce people to the world of computers and information technology as early in their life as possible. Due to the “Tiger Leap Programme” started at that time the knowledge of computers has quickly spread.

E-services in Estonia:

- Electronic taxation (was 92% of tax declarations in 2010); it is automatic based on the information by employers
- Electronic application of higher education
- Electronic registry of title deeds and search engine
- Electronic company register (unbureaucratic registration within 18 minutes)
- Electronic application for old age pension
- Digital medical prescriptions – no paper waste
- E-patient system – appointment request and registration with a memory message
- E-police: from January 2011 Estonians do not need to carry their ID cards, driving licenses or their insurance cards because such information is available any time anywhere.
- E-elections: since 2005 in Estonia anyone can vote electronically at the parliamentary or municipal elections. With an ID card anyone can cast their vote from home or from abroad alike.
- E-ticketing: nowadays in Estonian cities only the tourists buy paper tickets for public transport, because the virtual tickets of the locals are registered on their ID cards and the ticket inspector can check its validity with a card reader.
- E-environment: wild animals can be observed in their natural habitat by web-cameras. Web cameras are also important in limiting vandalism.
- The 98% of all bank transactions are today conducted through the internet. The ID card guarantees a secure access.

To utilize almost any of e-services one only needs an electric ID card which is an obligatory document for a person’s identification and which can be widely used. In fact, it is a chip card which besides containing information about its owner can serve either as an identification tool or as a digital signature. E-documents are perfectly safe and accessible with a PIN code. It can actually fulfill the security requirements defined by the Department of Defense of the United States. 74% of the population between 16 and 74 years of age uses and profits from e-services. 63% of Estonian households have access to the internet. Internet is available in every school and public library. 97% of private companies use a computer daily and 99% out of them are internet users too. 66% of companies have their own homepage, and 40% of them can pay and 30% of them can issue e-bills. Independent of their sex, education and locality the two-thirds of all people use the internet. 60% of all the new private companies are established though the e-registration system.

(*Source: Szilvia Kákai-Szabo and György Nagyházi: The Estonian e-government, Strategic Workshop, Ministry for National Economy)*

The Estonian Tax System

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Flat income tax rate

The taxation system works upon the principles of broad tax base and low rates. There is an almost unanimous agreement among the political parties about the support of the flat income tax rate. However, until now there have only been central right coalition governments.

Since 1994 private persons and companies alike have been paying a flat tax on their annual income. The reasons of its introduction:

- One-time high inflation rate
- Uncomplicated administration
- Transparency

After gaining independence, Estonian administration had to be rebuilt from scratch and so simplicity was an important guideline. From its introduction right until 2004 the rate of tax was 26% followed by an annual cut of 1% until the 18%

rate would have been reached. This tendency was broken in 2008 by the economic crisis at a rate of 21%, which is also the actual figure.

Changes in tax rate

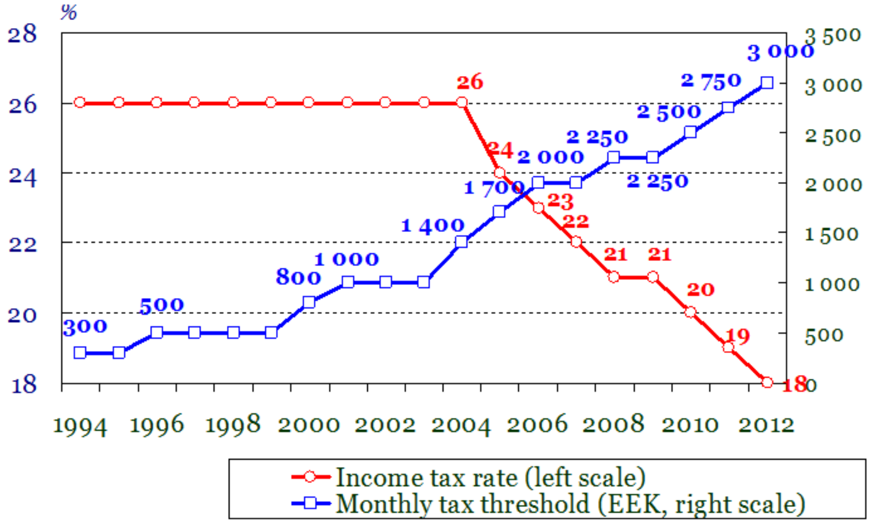
Year	%
1994-2004	26
2005	24
2006	23
2007	22
2008-tól	21

Personal income tax

There is a part of one's income changing from year to year which is not taxed, so there is a kind of 0% tax rate too in Estonia.

Year	Exempt of taxation (in €)
2003	767
2004	1074
2005	1304
2006-2007	1534
2008-2009	1726

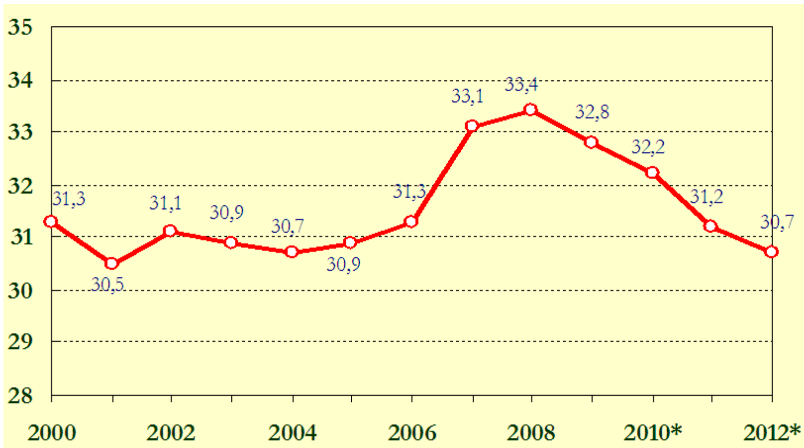
The below diagram shows the original tax reduction plan suspended in 2008 as a result of the economic crisis:



The personal income tax is also a tool to motivate young couples to have more children. Usually, out of the annual salary, 27 000 Estonian Kroons are tax-free, but the same sum is added to this base for each child from the birth of the second.

So if there are four children in a family, the tax-free part of the parents' income is 4*27 000 Kroons, 3*27 000 from that comes because of the second, the third and the fourth child, and 1*27 000 Kroons are originally tax-free.

The following diagram shows the change of tax burden relative to GDP:

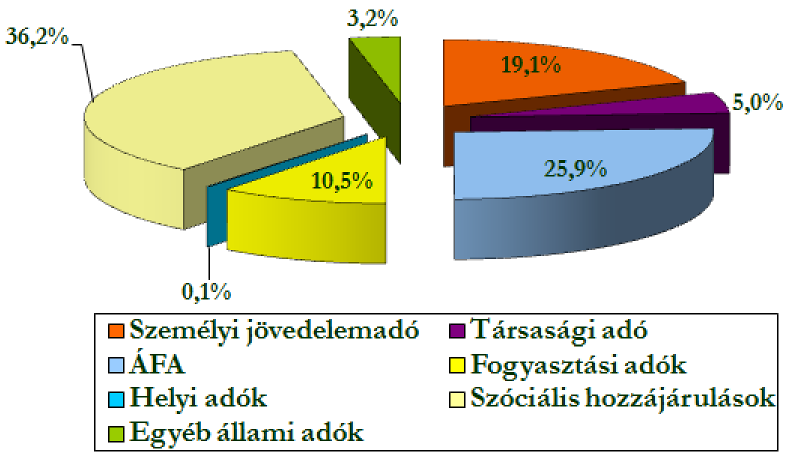


(Source: Estonian Finance Ministry)

The change in the structure of tax burden after 2002:

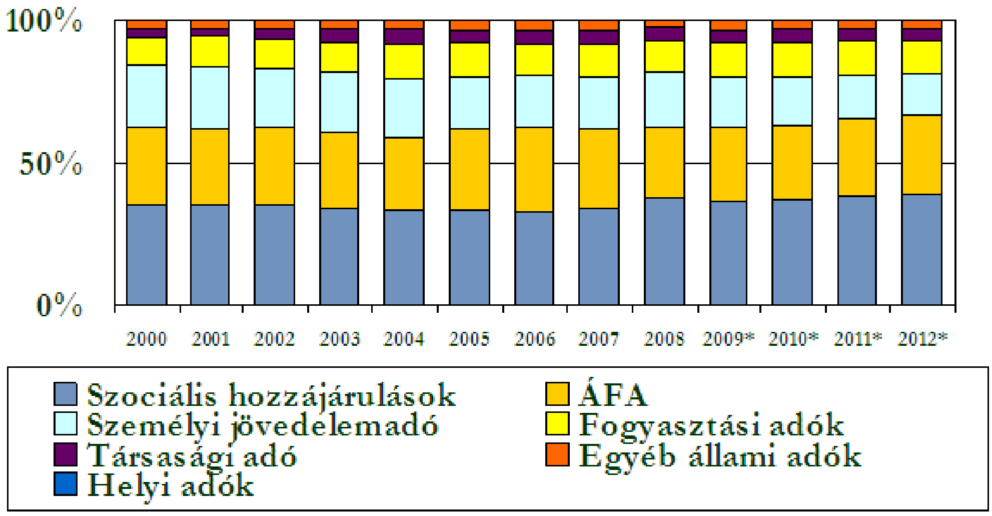
(Source: Estonian Finance Ministry)

The structure of tax revenues I.



(Source: Estonian Finance Ministry)

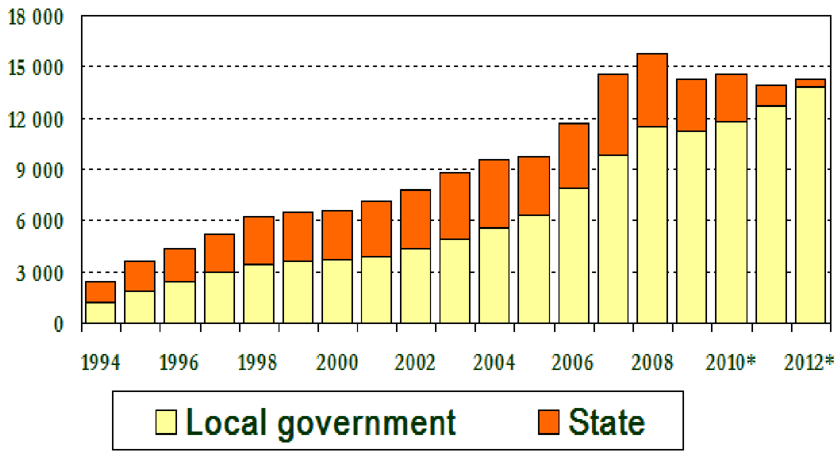
The structure of tax revenues II.



(Source: Estonian Finance Ministry)

The changes of personal income tax revenues from its introduction

(in million, Estonian Kroon)

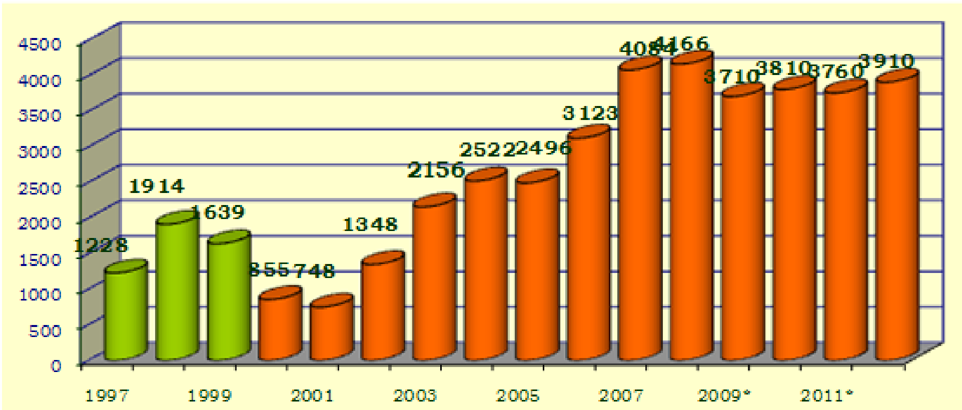


(Source: Estonian Finance Ministry)

Corporate income tax

Since 2000, companies do not pay tax on profit reinvested in Estonia. The most important objective of this new measure is to increase investments and to promote economic development.

The changes of corporate income tax revenue (in million, Estonian Kroon)



(Source: Estonian Finance Ministry)

The Estonian Demographic and Family Policy

Consultations:

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As the Hungarian Demographic Committee headed by Mrs. Maria Kopp has pointed out, the following factors influence the birth of the number of children planned: the popularity of atypical employment forms, the proportion of women's employment, the family support system and the situation of preschool childcare institutions. Precisely these topics have been studied in Estonia.

Part-time and other atypical employment forms in Estonia

Between 2008 and 2009 the unemployment rate rose, and today it is 14%. Parallel to this phenomenon the number of part-time jobs rose too. Between 2008 and the second quarter of 2009 the number of people in part-time jobs increased by 27 000, characteristically among women, young people and people close to retirement age. Nowadays there are 20 000 men and 42 000, typically young, women employed part-time. However, due to the economic crisis, a number of full-time jobs have also become part-time which has been a tendency also in Germany.

Among the other atypical employment forms fixed-time work contracts are not really popular, only 3% of the entire workforce is employed in this form. This work form is especially characteristic of seasonal jobs, so it can change from season to season, of which summer is the busiest. 2.3% of the employed work from home.

Change in the employment of women

Due to the economic crisis, the unemployment rate among men has risen most sharply, in the first quarter of 2008 their proportion was 74%, which figure changed to 55% by the beginning of 2010. In 2008 there were fewer women employed than men, and this trend has been reversed by now, similarly to the situation in Latvia and Lithuania. The reason behind this phenomenon is that the economic crisis has most severely affected sectors like the construction or manufacturing industry typically employing male work force.

The Estonian family support system

There are nine main forms of the central family support system. Due to the economic crisis, there were only minor modifications in them which have left the original programme largely intact.
The most important forms of support:

- A one-off sum of 320 EUR at the birth of a child.
- Child-care allowance is paid every month, and it is 19 EUR after the first two children, but from the third it is 57 EUR. Families get it until the child is sixteen, but in case of further education they receive it until the age of nineteen. This is the tool of the state to encourage families to educate children.
- Child benefit is paid every month, until the first birthday of the child it is 44.7 EUR, between the first and the third year it is 38 EUR. Between the ages of three years and eight years it is 19.2 EUR.
- Single parents get an extra 19.2 EUR a month.
- Parent benefit depends on the salary of a parent.

Types of the most important fixed-sum aid forms

Basic fixed-sum aid forms		Payment	In EUR
childbirth allowance	Baby bonus	One-off	320
child allowance		monthly	19, and 57 from the third child
child-care allowance		monthly	48 in the first year, between age one and three years 38

(Source: Estonian Ministry of the Family)

Parent benefit is the most important non-fixed-sum aid form paid until the child gets eighteen months old, and both parents can request it, but only one of them receives it. The amount of the benefit is the 100% of the average monthly salary of the parent. If the parent was out of work or his/her average salary was less than the minimum wage, then he/she gets the equivalent of 278 EUR per month.

From the parent benefit, the child allowance and the child-care allowance – calculated with its minimum -- an Estonian parent can receive 95 000 HUF until the child's first birthday, in addition to the one-off childbirth allowance (baby bonus) of 88 000 HUF. Consequently, the Estonian family support system generously aids families in the first eighteen months after the birth of a child, and because of the loss of parent benefit after that, the amount of aid is reduced radically.

Another form of family support is a discount on the tax base of the parents which was discussed in this paper before in connection with the tax system. Essentially, the non-taxable part of the tax base increases with the number of the children in the family.

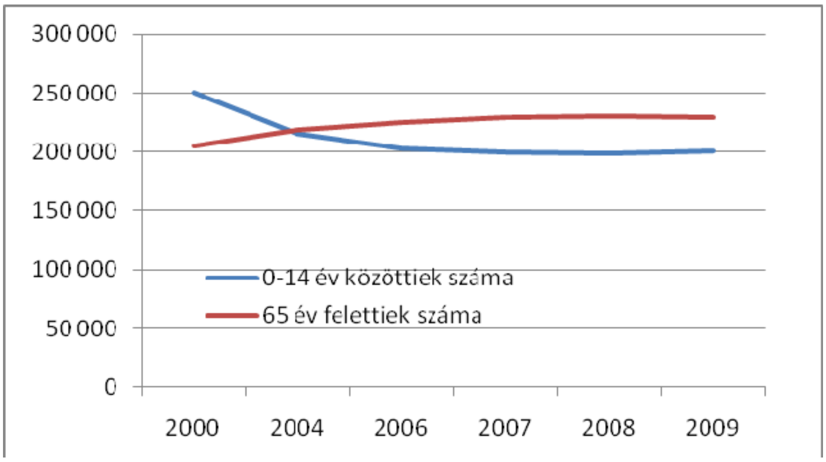
Preschool child-care institutions

In Estonia the child-care institutional system is tailored to the family support programme, and it presumes that a parent stays at home with his/her child for the first 18 months. Kindergartens are available between the ages of 18 months and 7 years. As the number of available places in state kindergartens was no more sufficient after a jump in the number of births, they started creating an alternative system after 2005 which has been in operation since 2007. This child care services system is not obligatory, high quality but expensive too, and it needs constant development and reform. Kindergartens are financed by local governments and they vary from settlement to settlement.

Demographical policy

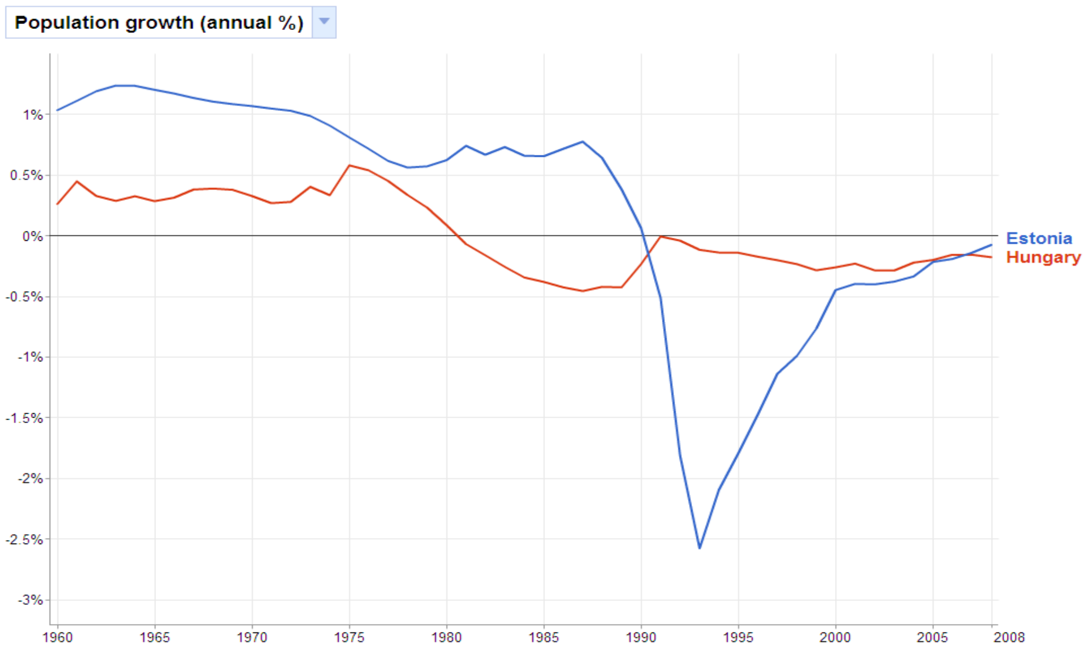
To sum it up, Estonia has been struggling with the problems of negative population growth, an ageing population and low fertility rate.

Aging population



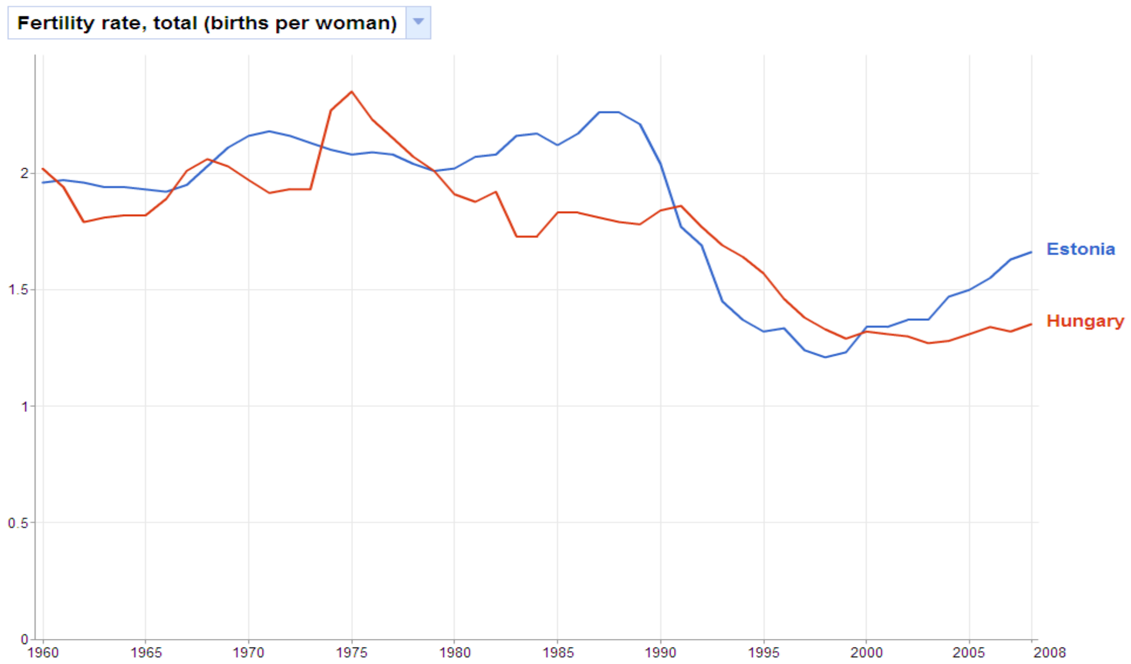
(Source: Health, Labour and Social Life in Estonia 2000-2008)

Negative population growth



(Source: Eurostat)

It is obvious from the above diagram that the Estonian and Hungarian fertility rate was identical in the year 2000, but since then Estonia has made significant headway against Hungary.



(Source: Eurostat)

The reasons behind the sudden rise in the number of births after a period of decline in Estonia:

- Estonia's fertility rate figures tend to fluctuate faster than Hungary's, because the country has a smaller population which reacts more quickly to changes.
- The Estonian family support system is stabile and predictable; there were no cost cuts even during the period of the economic crisis.
- Parents characteristically waited out periods of economic uncertainty to have a child
- During the period after gaining independence, women tended first to earn a livelihood before having a child.

According to the opinion of Mrs. Ene-Margit Tiit, the willingness to have children does not depend on factors which many people usually consider significant, like the number of marriages, the divorce rate and faith. Non-religious Danes have more children in average than religious Bulgarians. The birth rates in liberal Iceland and in conservative Ireland are equally high.

Predictability, stability and the faith of a society in its future are more important factors. Therefore, to keep up this stability and predictability, even during the period of the economic crisis the Estonian government did not cut back significantly on the funds of family support.

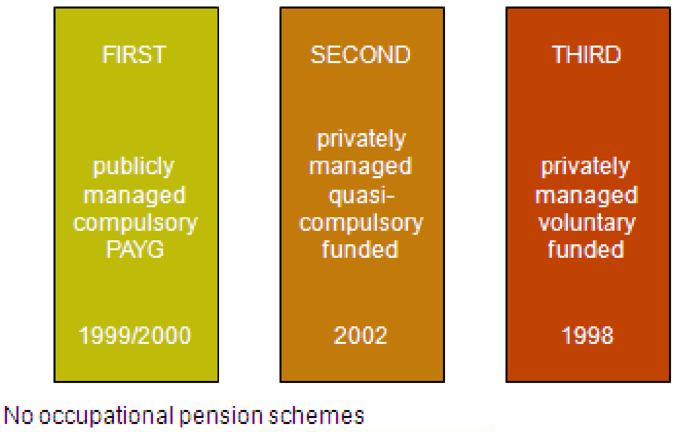
The Estonian Old Age Pension System,

With Special Regard on Private Pension Funds

About the Estonian old age pension system in general:

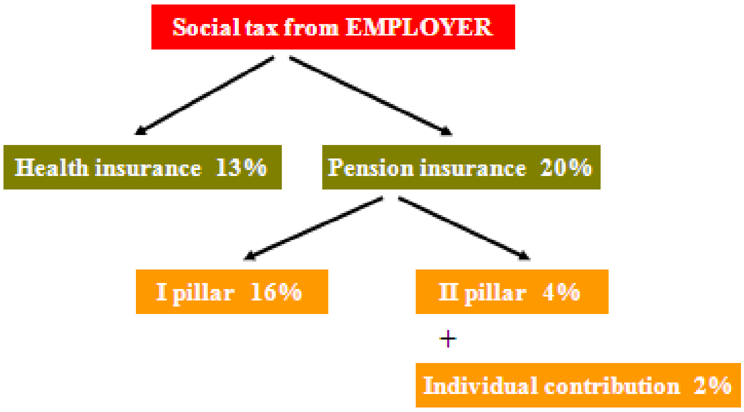
The structures of the Hungarian and the Estonian old age pension systems are very similar, as there are also three main pillars of the system in Estonia:

- The state pay-as-you-go pension system (first pillar)
- Compulsory private pension funds (second pillar)
- Voluntary private pension funds (third pillar)



The actual system has been working in the same form since the year 2000, when the private pension fund pillar was introduced upon the World Bank's advice. Private pension fund membership is compulsory for employees born after 1983 and it is optional for everyone else. A private pension fund member is titled to receive old age pension from the age of 63 years, but in case of his/her death the accumulated wealth is heritable.

The financing of the private pension funds:



According to the above diagram, an employee pays 2% of his/her gross salary as old age pension contribution, to which the state adds another 4% from the social tax paid by the employer if the employee is a private pension fund member. An employer pays 33% of his/her employee's gross salary to the state as social tax. Out of this sum 13% is booked as health insurance contribution, 20% as pension insurance contribution, out of which 16% is spent on actual pension payments (first pillar) and 4% will be spent on future pension payments (second pillar).

To sum it up, the state adds a further 4% to every individual's 2% contribution. (2+4%)

ESTONIA – Pension contribution payments			
From	*Rate*		*To*
employees	**2%**		**second pillar**
employers	20%	**4%**	**second pillar**
		16%	first pillar

This system had been in operation until the economic crisis began, and then in 2009 the Estonian government suspended private pension fund payments so that they could stabilize the budget and meet the Maastricht criteria.

Between June and December 2009 the Estonian government suspended entirely the transfer of pension fund contributions into the second pillar and the employer had to do the same: 0+0%.

After that private pension fund members can decide whether to continue paying their contributions into the second pillar or not. In this case the figures will change in the following way:

* 2010: 2+0% (for people close to retirement age: 2+4%)
* 2011: 2+2% (for people close to retirement age: 2+4%)
*2012: 2+4%
*2013: 2+4%
*2014-2017: 2+6%

(This is the basic concept, but from 2013 one can request to make contributions of 3% instead of 2%, and so his/her total pension fund contribution will be 3+6%.)

*2018: 2+4%

In other words, the state is going to compensate the private pension fund members, and it will complement individual contributions by 6% instead of 4% after an economic recovery.

However, if a private pension fund member decides to discontinue paying contributions to the fund from 2010, then the figures will change in the following way:

*2010: 0+0%
*2011: 1+2%
*2012: 2+4%
*2013: 2+4%
*2014-2017: 2+4%

(This is the basic concept, but one can request from 2013 to increase his/her contribution to 3%, and so his/her total pension fund contribution will be 3+6%.)

*2018: 2+4%

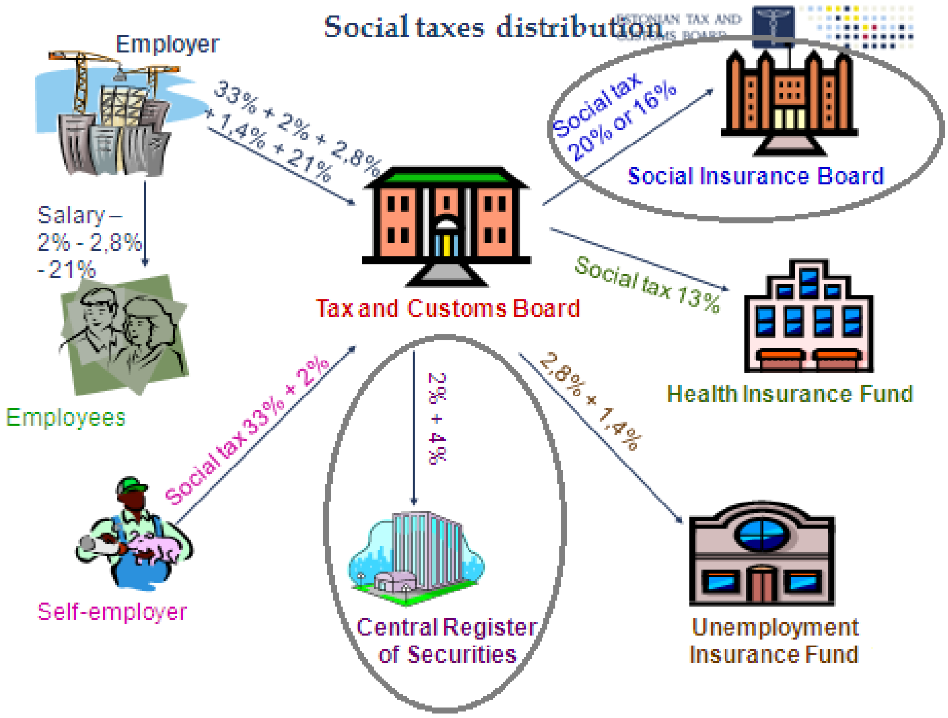
Logically, private pension fund members will be most generously compensated if they are willing to pay an additional 2% as contribution from January 2010. The state will not compensate private pension funds or the financial institutions operating them in any form. As an answer to our question about it, the representatives of the LHV bank said that the economic crisis was not caused by the state and they do not consider this measure to be unfair, as some necessary steps had to be taken to help the economy recover from the shock.

Furthermore, it has to be mentioned in connection with the financial proceeds of this suspension that the EU acknowledged the returns from the suspension of the private pension fund payments by the state (4%), which the state had booked as social tax revenues, as government revenue growth which in turn cut Estonia's official budget deficit too.

It is also worth noting that in Estonia besides the suspension of private pension fund payments between June 2009 and December 2010 until now there has not been any other state intervention, and there are no radical changes planned either in connection with the second pillar.

Social taxes and the collection of individual old age pension contributions:

Pension contributions are collected by the Estonian Tax and Customs Board and transferred within 15 days through the Central Register and Securities, a department of the Estonian National Bank, to the pension funds. The distribution of social taxes is demonstrated by the drawing below:



(Source: Estonian Taxation Office)

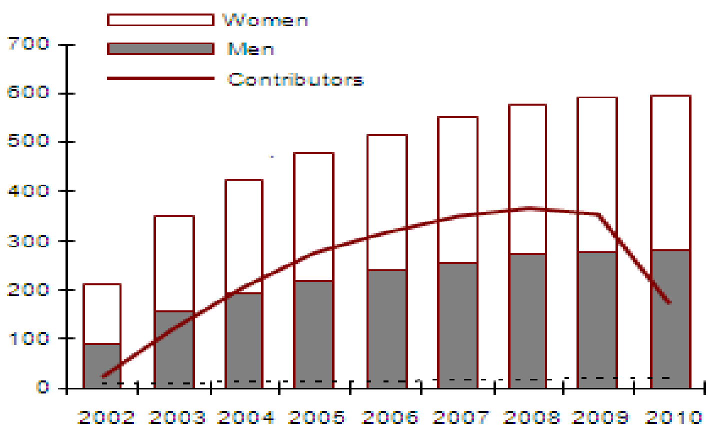
Types of private pension funds:

Categorized by the proportion of shares they hold, employees can choose from four kinds of funds:

- 0% equity (which means that all resources must be invested in fixed-income instruments or bonds), and every fund manager must have at least one of such funds in the portfolio.
- 25% equity (which means that up to 25% of a member's wealth can be kept in shares)
- 50% equity (which means that up to 50% of a member's wealth can be invested in shares)
- 75% equity (which means that up to 75% of a member's wealth can be invested in shares), and this type was first introduced in 2009.

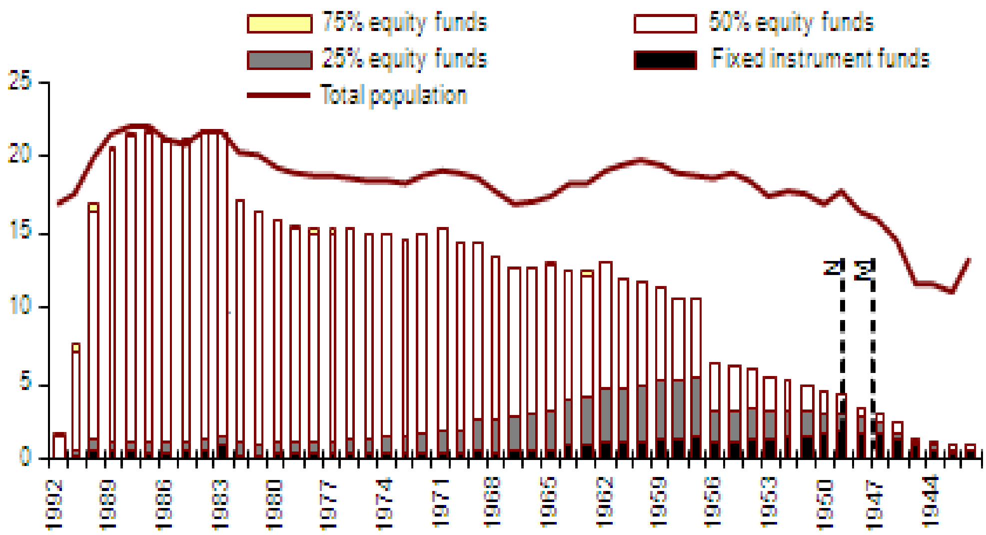
The number of pension funds and the size of the membership:

Actually there are 23 pension funds in Estonia owned by seven Scandinavian financial institutions. The total number of pension fund membership is 600 000 out of which, however, only two-thirds are active contributors. From all the members, 200 000 or one-third have decided to continue paying contributions in spite of the 2010 suspension. The diagram below shows the change in the number of pension fund members and their contributions:



(Source: Estonian Finance Ministry)

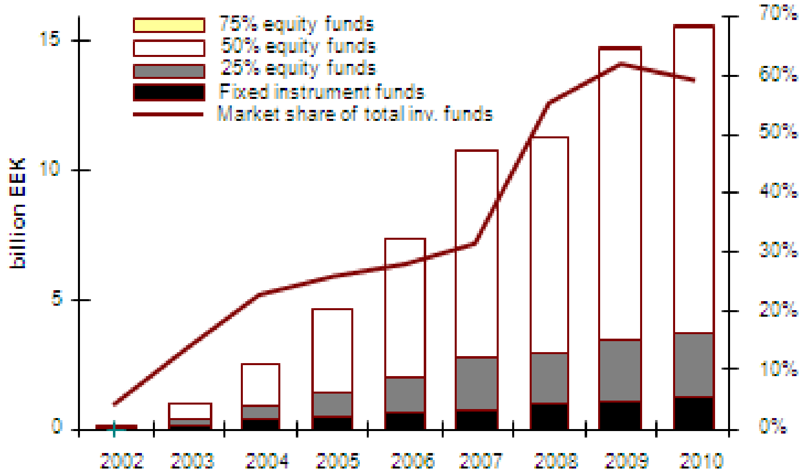
The following diagram shows the investment decisions and strategies of private pension fund members depending on their age:



(Source: Estonian Finance Ministry)

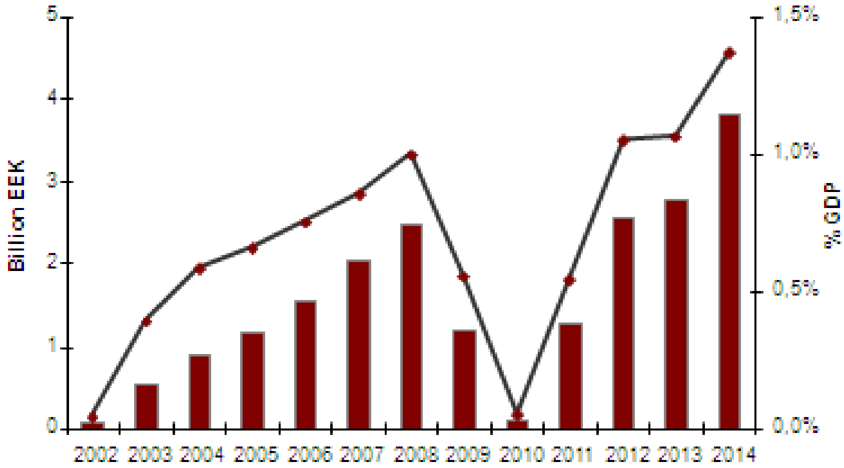
The change in contributions and funds' wealth:

In the middle of 2010 the total combined wealth of private pension funds was 16.1bn EEK and the accumulated contributions stood at 15.1bn EEK. The following diagram shows in detail the allocation of the resources of the second pillar and the market share of pension funds relative to that of all the investment funds available. The proportion of wealth of the funds investing 75% in equities had been very low in 2009, as they were established precisely in that year, but it was in single digits in 2010 too.



(Source: Estonian Finance Ministry)

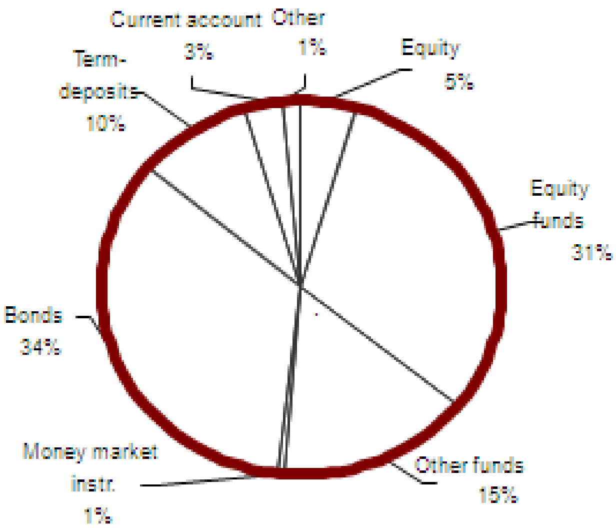
This diagram below shows the changes in the contributions transferred by the state to the second pillar. In 2008 the state transferred 2.3bn EEK from social taxes to private pension funds. This has been the last period when for the entire year the 2+4% rule was in place.



(Source: Estonian Finance Ministry)

Investment portfolio:

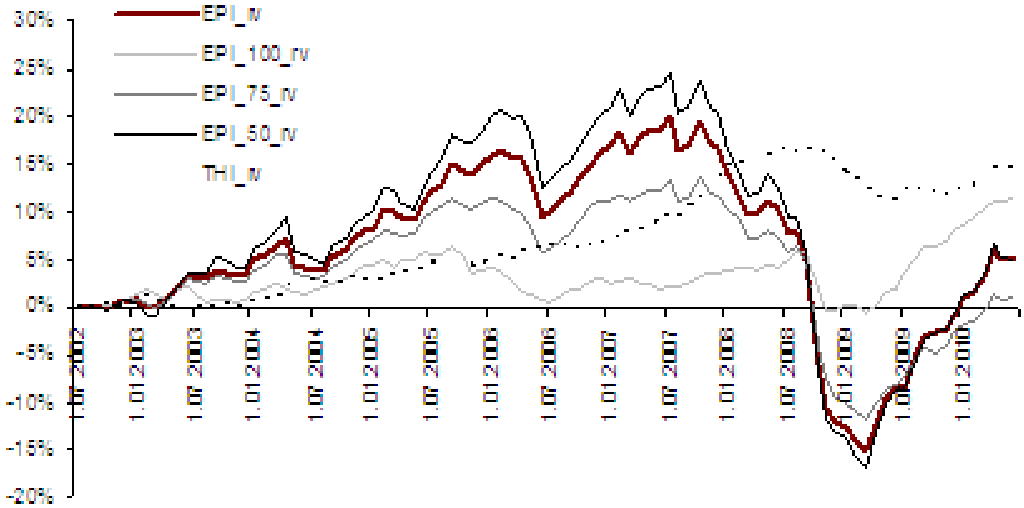
In the middle of 2010, in the combined investment portfolio of pension funds there was 34% invested in bonds, 31% invested in stock market funds, 5% in shares, 15% in other financial instruments and 10% in money market instruments.



(Source: Estonian Finance Ministry)

Changes in returns:

The below diagram shows the change in net assets (EPI) of the various investment policies as well as the change in consumer price index (THI). It is obvious that real returns have been negative, and even the best portfolios could not surpass inflation since 2008 either.



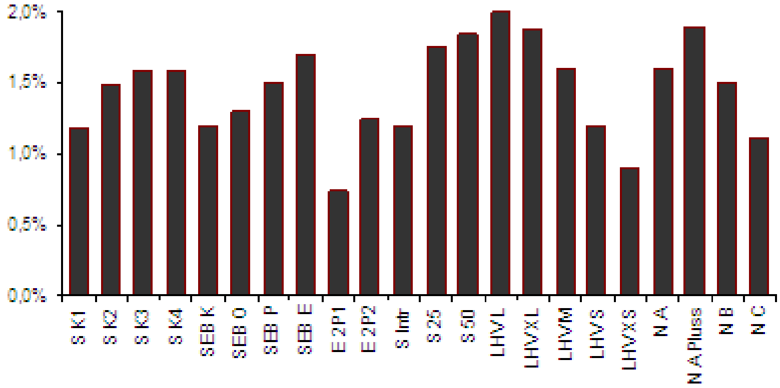
(Source: Estonian Finance Ministry)

Types and regulation of costs:

In connection with private pension fund membership and wealth management, there are three types of costs which, however, are not deducted from the contributions or the wealth of the members but from the fund management:

- Entry fee: abolished this year, maximized at 3% earlier, was usually 1%
- Exit fee: maximized at 1%, but if the member switches to another fund within five years of retirement, it is free
- Handling fee: maximum 1.2% for conservative funds, otherwise max. 2% of the total wealth

For the year 2010 the below diagram shows the handling fees of the funds:



(Source: Estonian Finance Ministry)

State guarantee behind the private pension fund pillar:

Estonia's state guarantees behind the second pillar work similarly to Hungary's. A central guarantee fund has been established which may be utilized in case of either the bankruptcy of a fund or in case of inappropriate management of the members' wealth causing a loss to the client. However, unlike in Chile or Poland, there is no guarantee on returns.

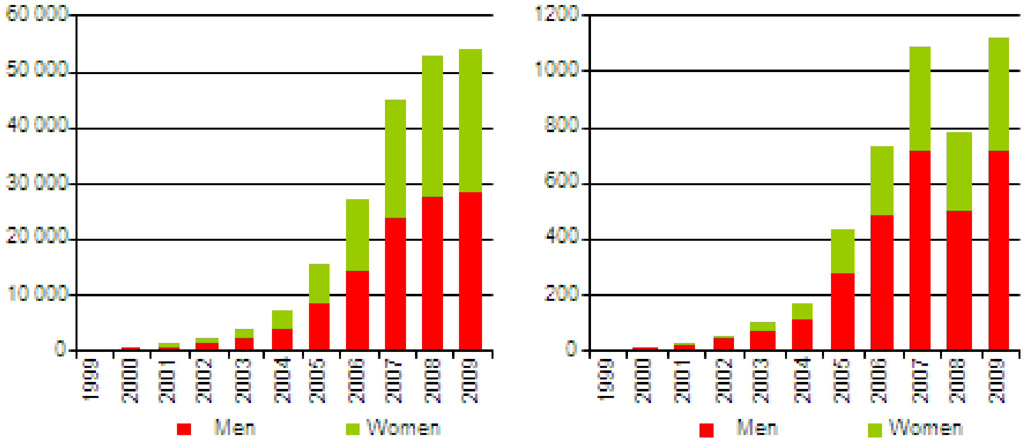
The following changes are being planned and about to be implemented in the old age pension system:

- Raising the age limit: actually the retirement age for men is 63 years and for women it is 61 years. By 2016, the retirement age will be gradually raised for women to 63 years, and for both sexes it is going to rise to 65 years by 2026.
- Indexation: since 2002, the indexation of the old age pension of the first pillar has been based 50% on CPI and 50% on the growth of social tax revenues. In 2008, these figures were changed by the Estonian government to 20% of CPI and 80% of social tax revenue growth, and a

law was passed which allows governments to modify indexation every five years if financial sustainability makes it necessary. Because of the economic crisis, in 2009 the government regarded the index of that time, 13.8%, too high and it was reduced to 5%, framing a law at the same time that the difference of 8.8% must be credited to pensioners over the next five years. It has also been made a law that such ad-hoc reductions may only be implemented for the next time only if the real GDP or social tax revenues would fall sharply. The measure, nonetheless, that a pension index cannot fall below 0% has not been modified. Even if there is deflation, this negative price change must be calculated into the index over the next five years.

Pension calculation: The pension allowance of the first pillar is made up by two main elements, one of them is a fixed monthly sum and the other one depends on income. It has been a long-term objective to shift calculation toward a more income-sensitive pension allowance.

The stronger motivation of third pillar contributions: nowadays it has 53 000 members and it manages 1.2bn EEK which is divided between men and women as follows:



(Source: Estonian Finance Ministry)