

The logo for the Mannheim Institute on the Economics of Aging (MEIA) is displayed in a bold, italicized, lowercase font. The background of the slide features a collage of grayscale images showing people in various settings, including a classroom and a group of people working together.

***meia***

# **An Evaluation of the 2005 Pension Reform in Finland**

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## **Part I: The Yardstick: How Should an Ideal Pension Reform Look Like**

- General criteria
- The problems to solve
- Why pre-funding?
- Why transparency?

## **Part II: Evaluating the Elements of the 2005 Pension Reform**

- Steps to make the system more sustainable
- Steps to increase labor force participation after age 55
- Steps to make the system more equitable

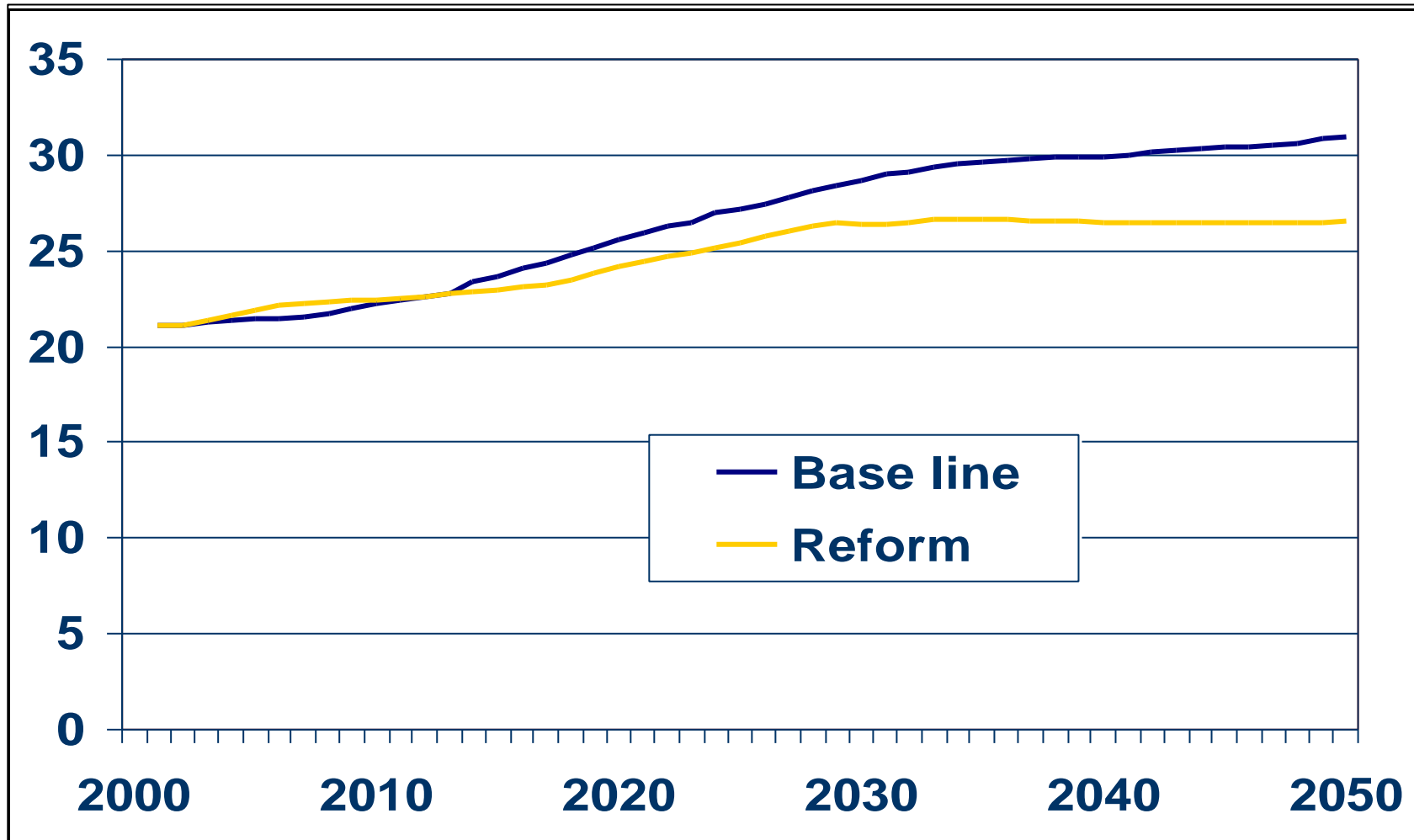
## **Conclusions: Further Steps**

- **Adequate:** Prevent poverty, replace sufficient lifetime earnings
- **Affordable:** No excessive contribution rates
- **Sustainable:** No unannounced hikes in contributions/cuts in pensions
- **Robust:** Intrinsic capacity to withstand shocks
- **Equitable:** Equal treatment of equal circumstances
- **Minimize distortions:** Avoid incentives to retire early, avoid large deadweight losses

## Adequate?

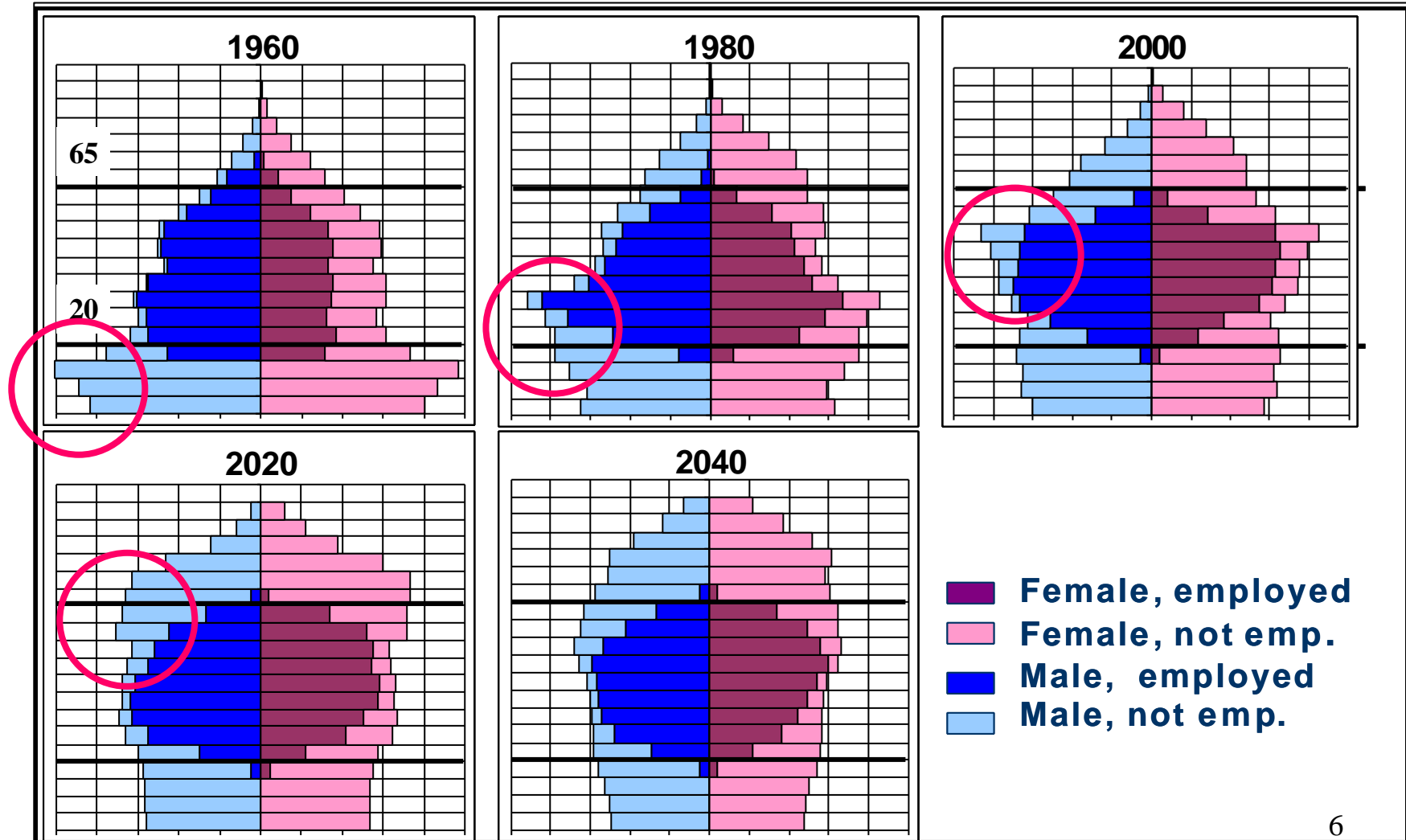
	Poverty limit 60 % of median income, new OECD equivalence scale
All	<b>10,8</b>
Wage earners	2,9
Unemployed	58,5
Lone parents	22,7
Pensioners, all	<b>10,2</b>
Formerly: Salaried employees	2,7
Workers	14,2
Self-employed in agriculture	20,0
Other self-employed	11,1

# Affordable?



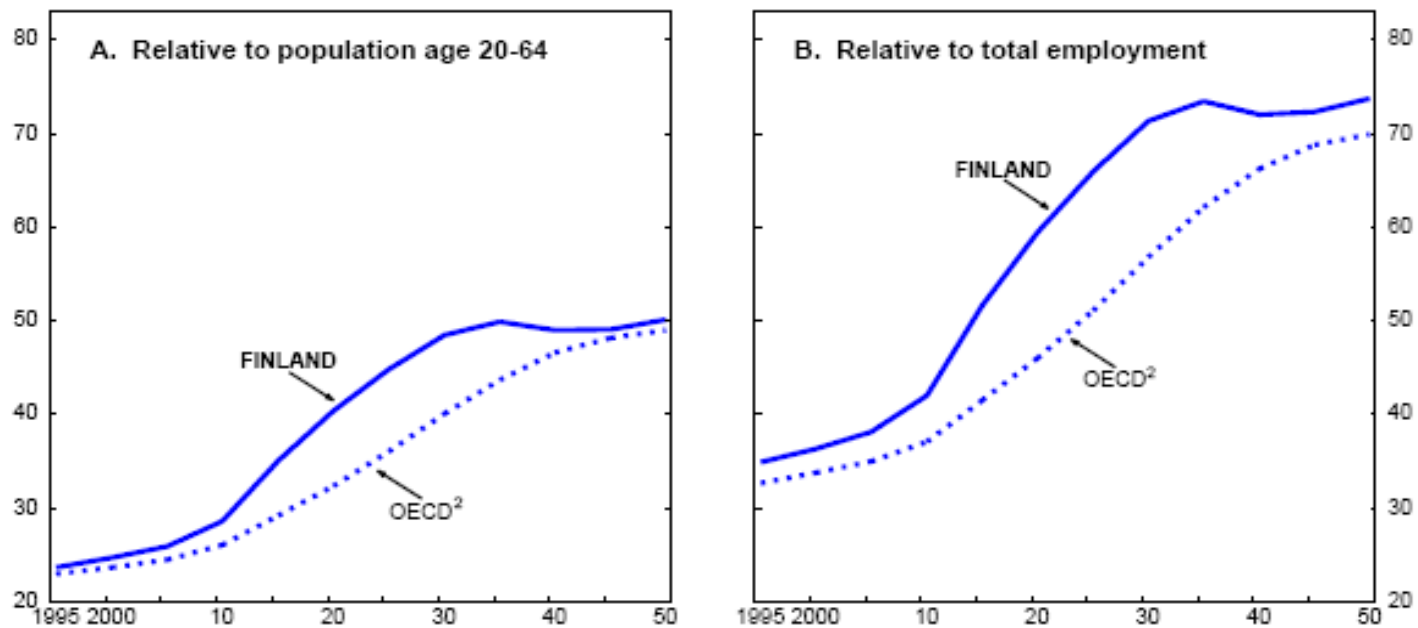
Source: Finnish Centre for Pensions, communicated by Ismo Risku

# Sustainable?



# Sustainable?

Figure 2. Old-age<sup>1</sup> dependency ratios  
Per cent

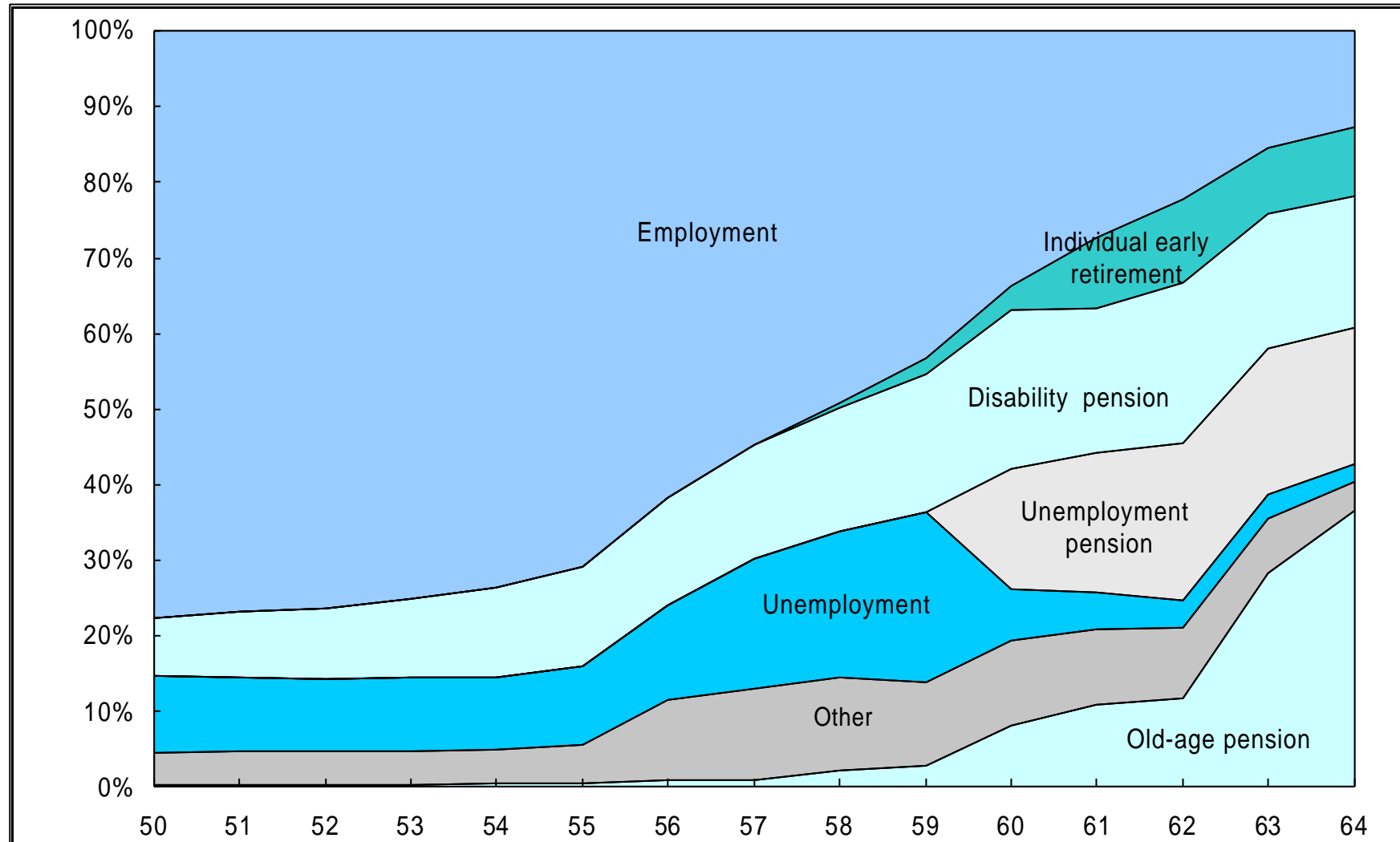


1. Persons aged 65 and above.

2. Average of the rates of individual countries (excluding Mexico and Turkey).

Source: Statistics Finland, Eurostat, United Nations and OECD Secretariat.

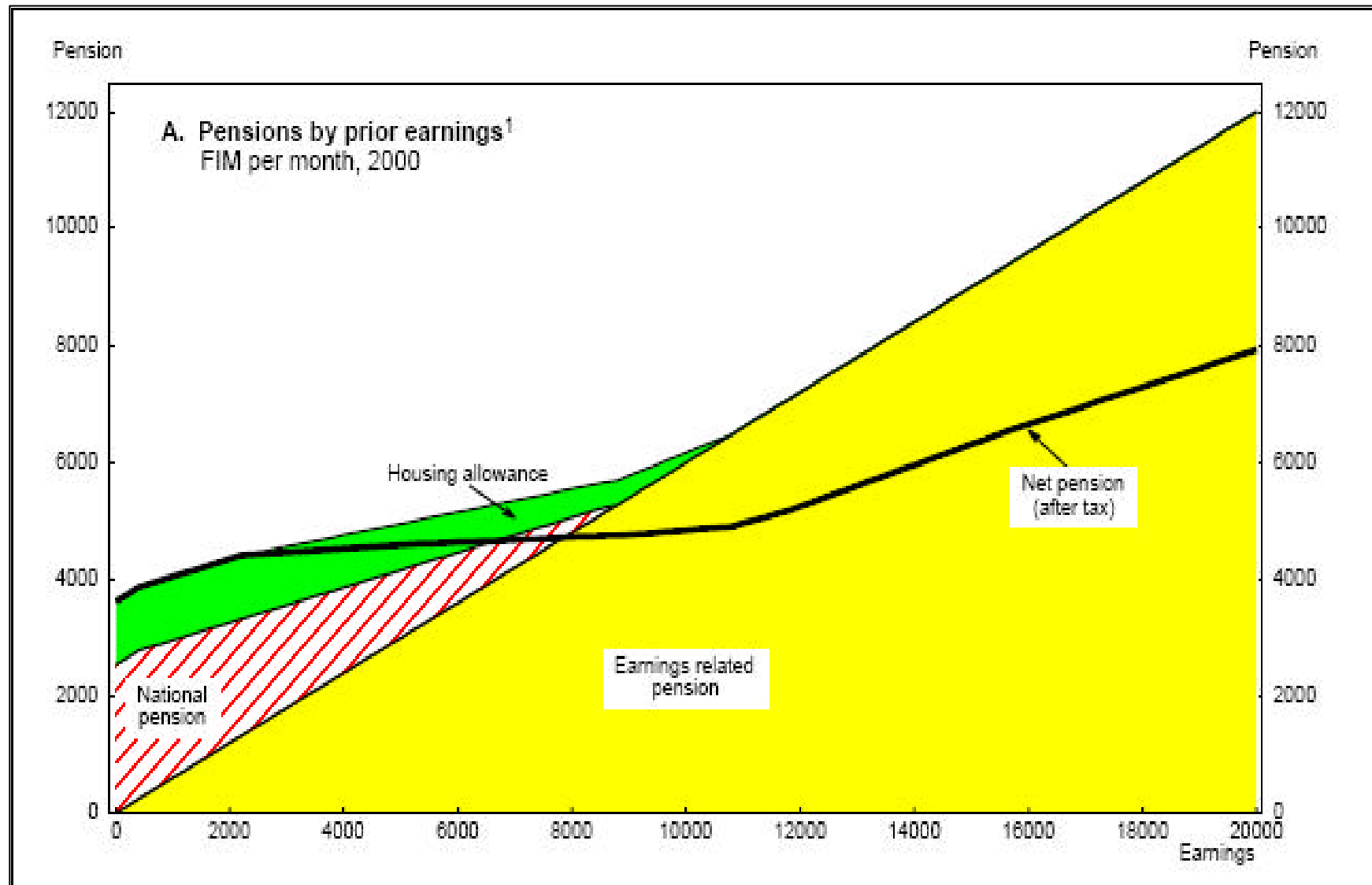
# Robust?



Source: OECD



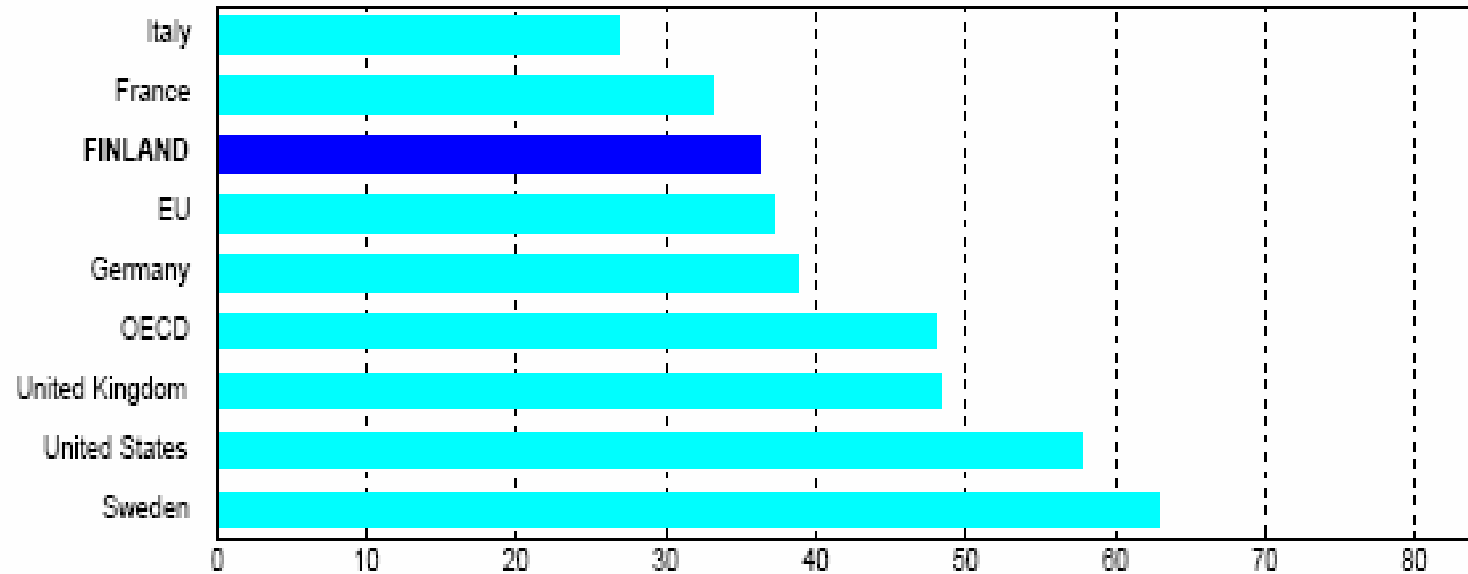
# Equitable?



Source: OECD

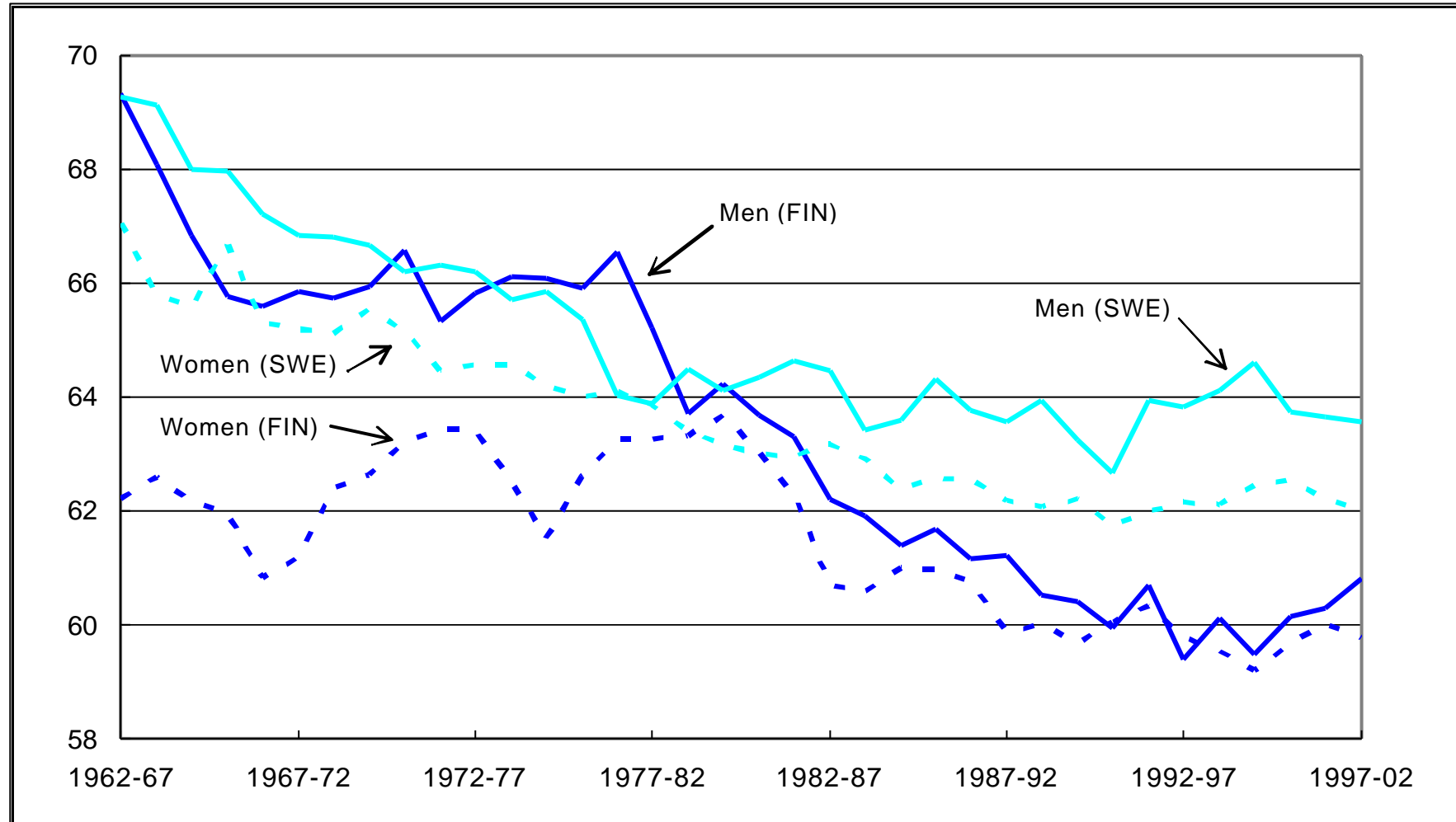
# Minimize distortions?

C. Age 55 to 64



1. Age group 16 to 24 for Sweden, the United Kingdom and the United States.  
Source: OECD (1999), Employment Outlook.

# Minimize distortions?



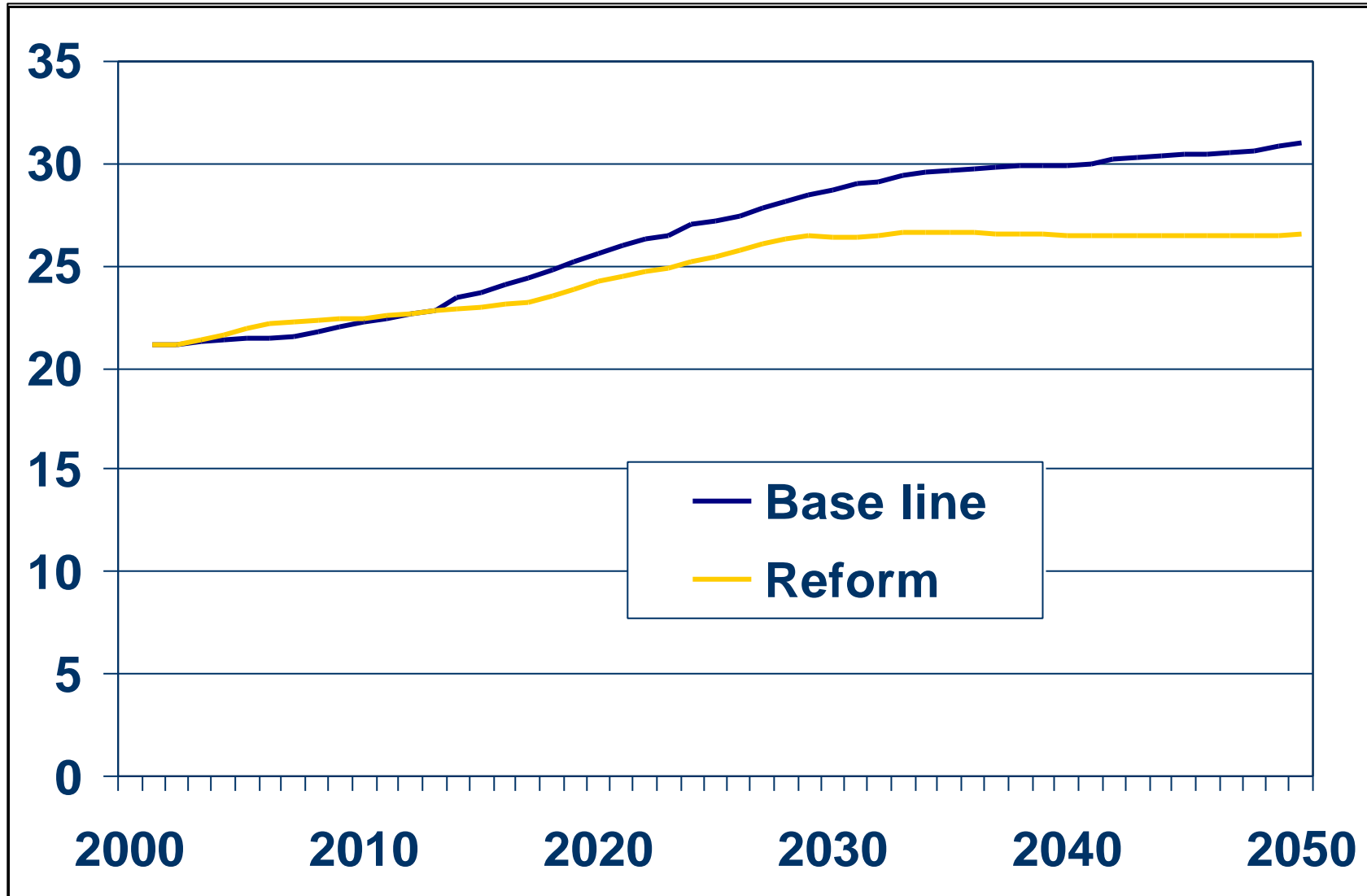
The yardstick:  
Two common themes

- **Why prefunding?**
- **Why transparency?**

## Part II: Evaluation of the Reform Elements

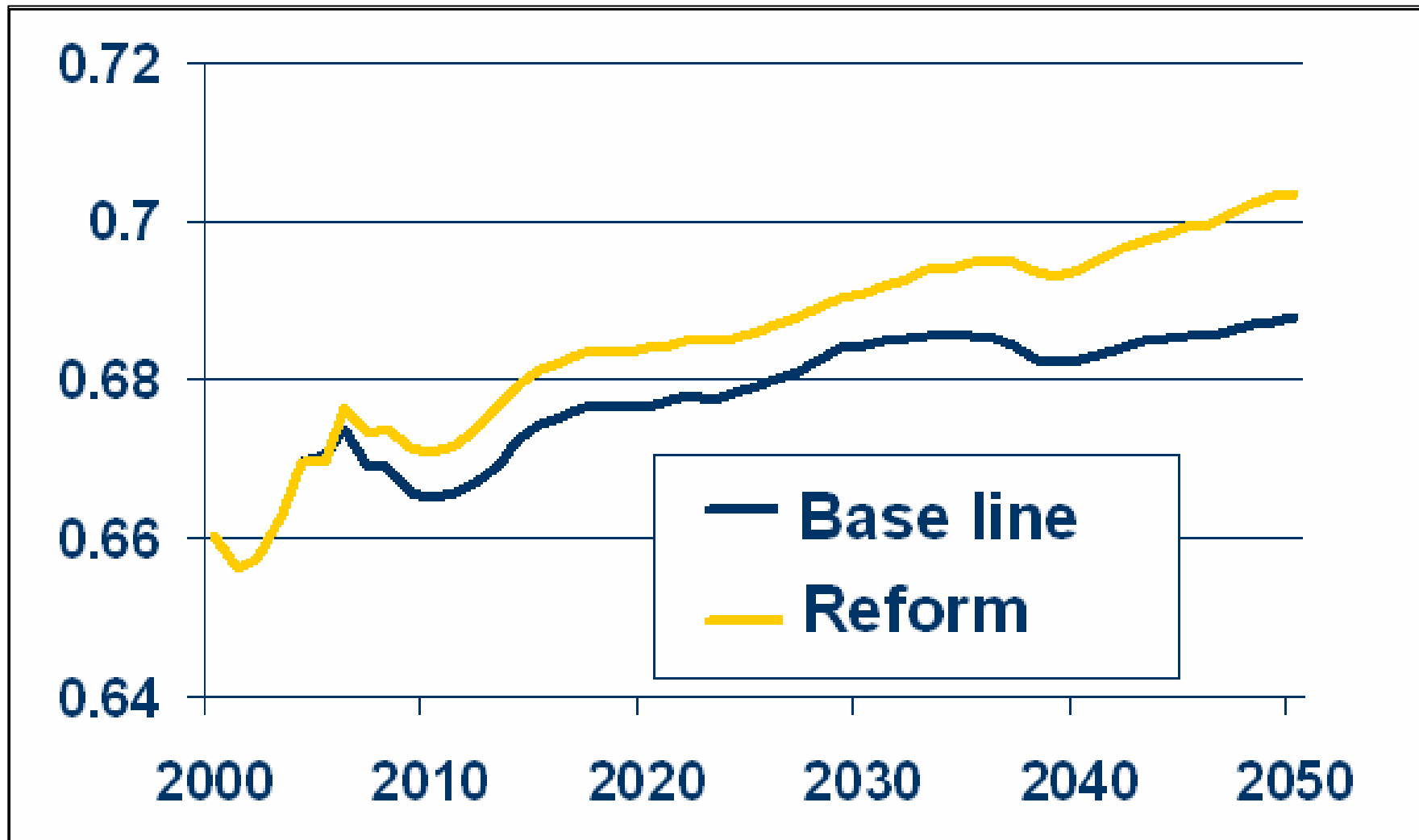
- **First Aim:** Make earnings-related system more sustainable
- **Second aim:** Increase labor force participation of older workers
- **Third aim:** Make the system more equitable and internally consistent
- **Specific goals set in projections:**
  - Are they sufficient?
  - Will they be achieved?

# Projected contribution rates



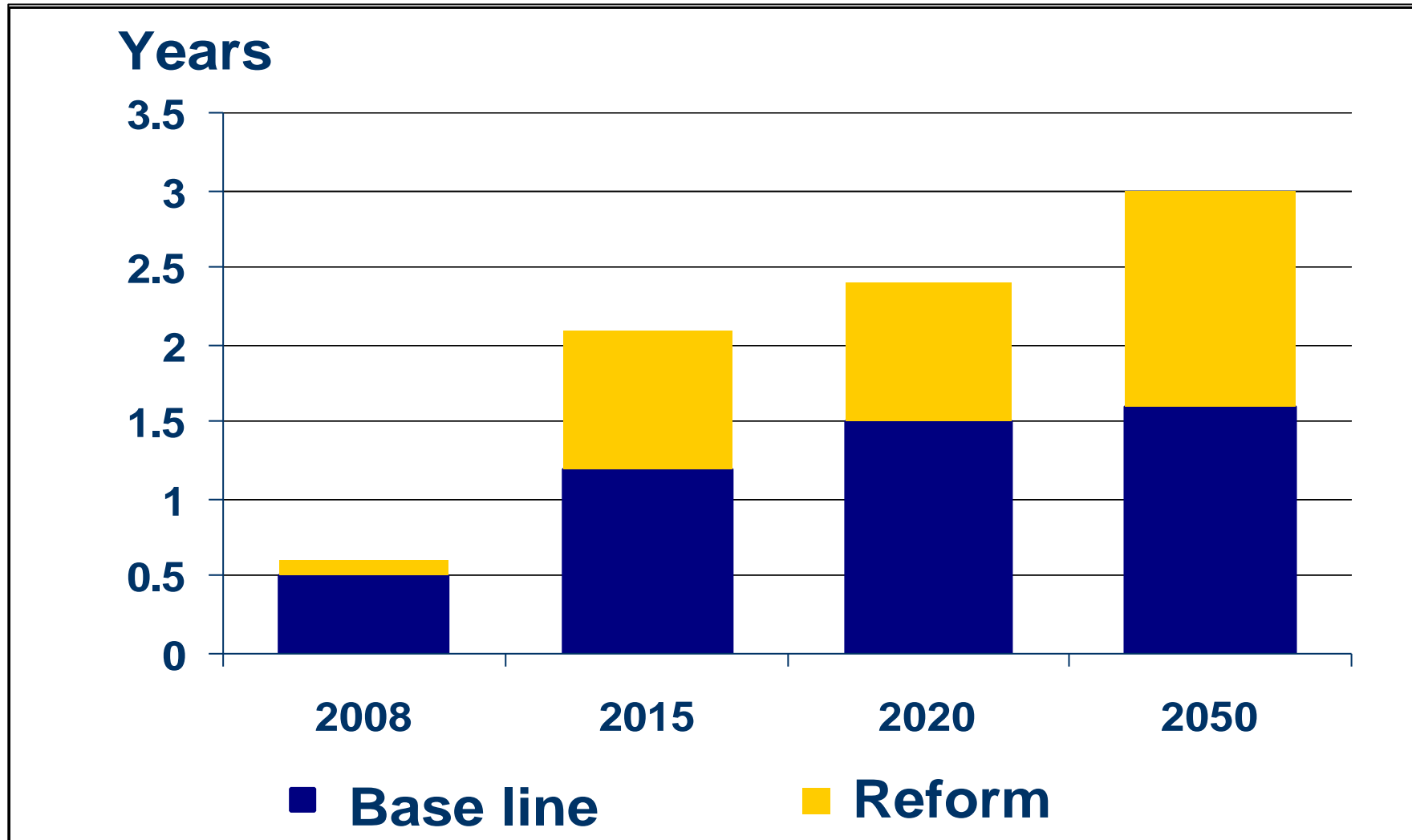
Source: Finnish Centre for Pensions, communicated by Ismo Risku

# Projected employment rates



Source: Finnish Centre for Pensions, communicated by Ismo Risku

# Projected retirement age



Source: Finnish Centre for Pensions, communicated by Ismo Risku



# Goals of the reform

## **1. Are they sufficient?**

- Well, contributions now 21.4%, increase to 27%
- Degree of ear-marked pre-funding still moderate
- Public vs. private saving; associated deadweight losses

## **2. Will they be achieved?**

- Well: still large early retirement incentives
- Still lack of transparency and confusing signals
- Long transition due to “only new entrants” feature

## Reform elements:

### **(1) Make earnings-related scheme more sustainable:**

- (a) increase the extent of pre-funding,
- (b) link benefits to life-expectancy,
- (c) reduce benefits by changing the indexation rules;

### **(2) Increase labor force participation of older workers:**

- (a) introduce a window of flexible retirement age,
- (b) sharply increase the accrual rate within the window of retirement,
- (c) increase the actuarial adjustment of early retirement pensions.
- (d) abolish the cap on the replacement rate,
- (e) restrict access to other pathways

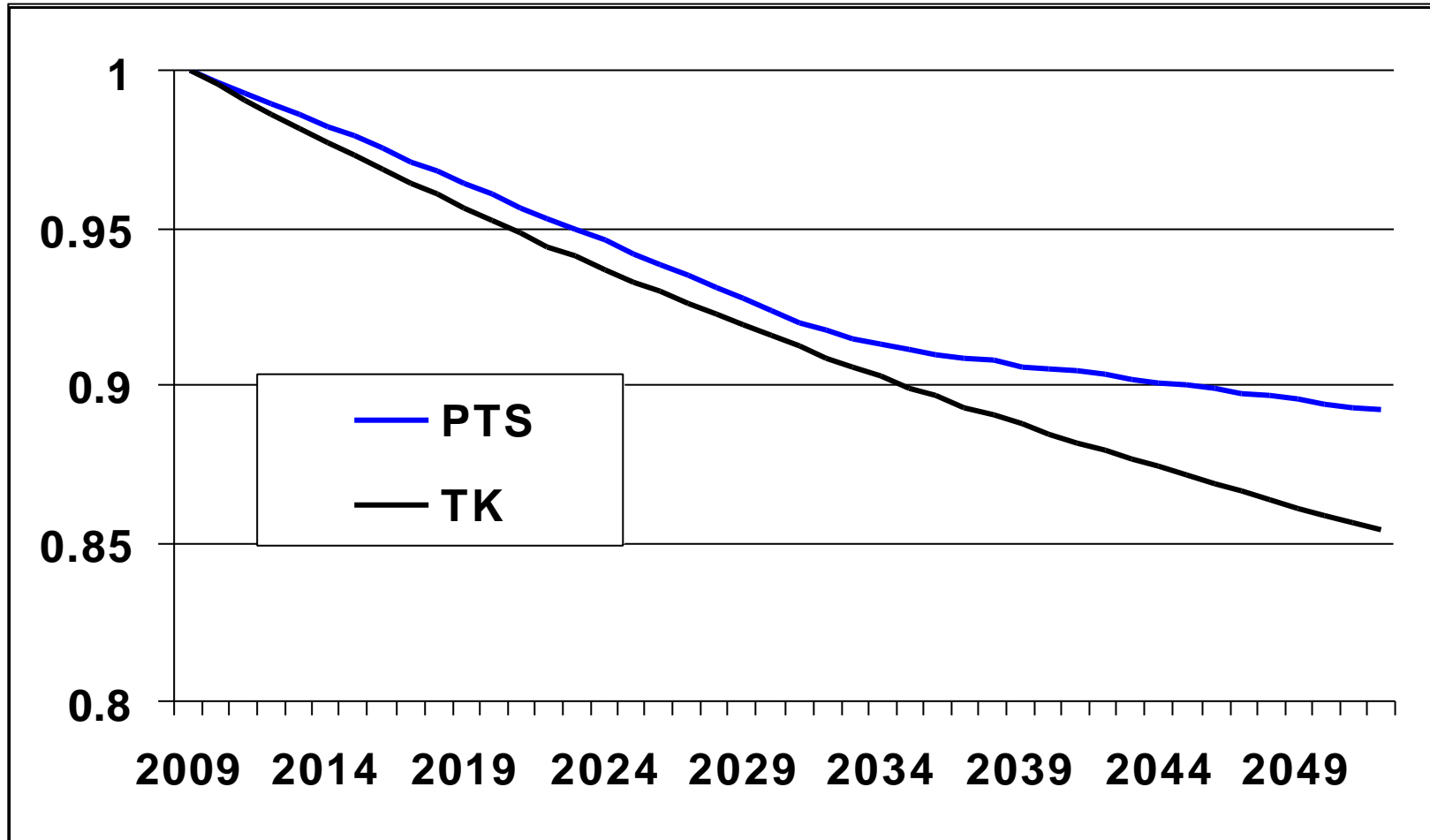
### **(3) Make the system more equitable:**

- (a) base benefits on life-time earnings,
- (b) equalize the minimum age for benefits and contributions,
- (c) abolish the "integration" of pension rights,
- (d) introduce accrual for certain non-working episodes.

## 1a: Increase pre-funding

- Add 7.5% percent of wage sum until 2013
- Current buffer about 120% of wage sum
- Increases reserves from 5 years to 5 years and 4 months
- Costs 0.9 percentage points contribution hike
- Workers will not differentiate between PAYG and funded part
- Lack of occupational (and private) pensions
- Substitution between saving and working longer?
- Portfolio includes domestic and foreign government bonds

# 1b: Linking benefits to longevity



### **Working age:**

- Why not 100% wages?
- Cost cutting?
- Weigh later contributions heavier than earlier ones?

### **Retirement age:**

- Why not choose your own path via annuitization?
- Real/nominal/wage indexed annuities.
- Overannuitize? (Germany)
- Underannuitize? (Great Britain)

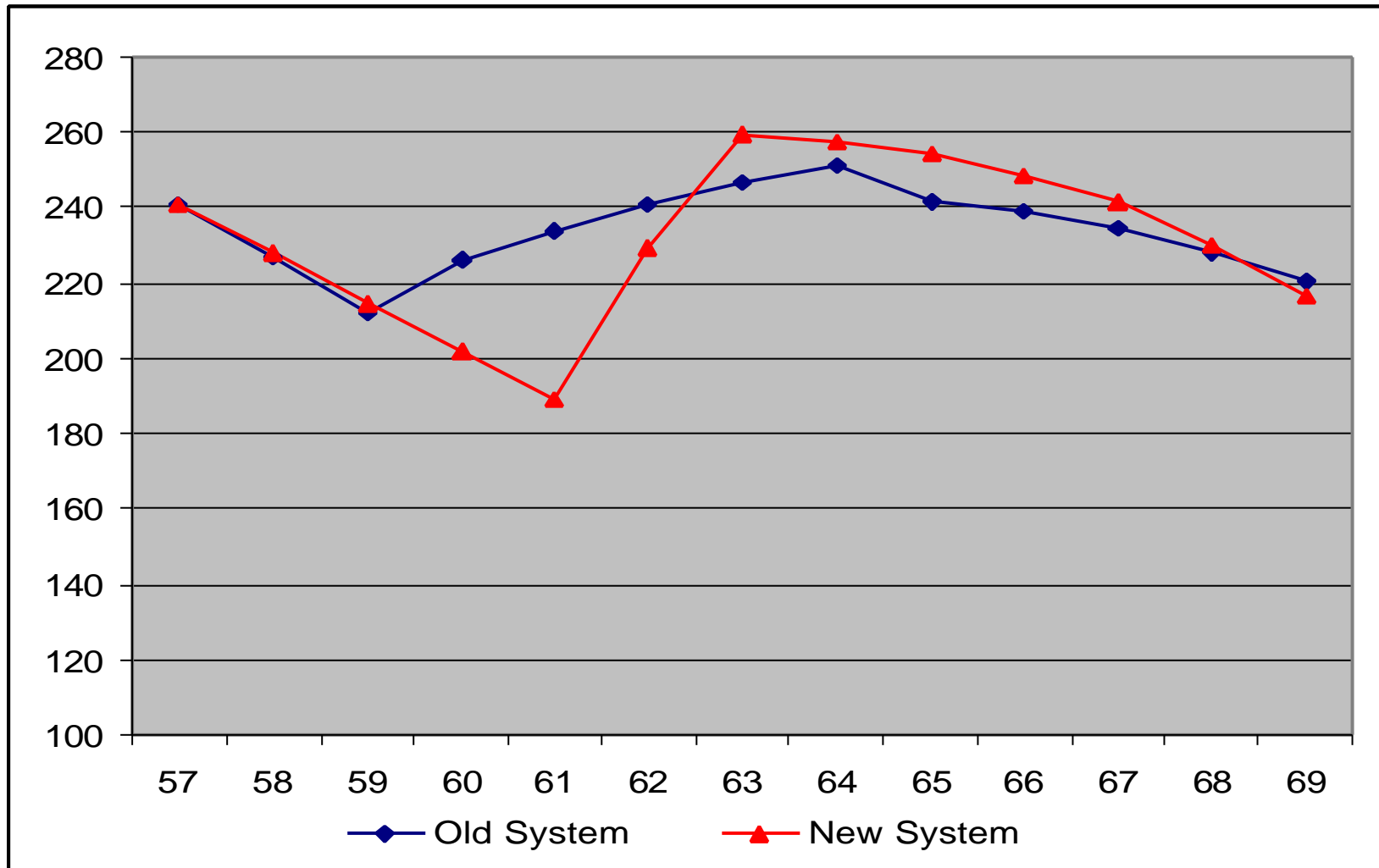
### **Window of retirement (62)63-68:**

- Smart political move
- Complex superimposed and partially redundant mechanisms: accrual, actuarial adjustments, age limits
- No clear signal of “normal retirement age”
- Multitude of pathways: unemployment tunnel, disability due to “social factors”, part-time retirement

### **Does it work?**

- If we have a hard time to understand, what about the people?
- Still kinks and perverse incentives

# Early retirement incentives



Source: Own computations. Normalized for level effects. Discount rate 3 percent.

### **Predicted effects:**

1. Those who want to (or must) retire very early will take the **unemployment tunnel** as early as possible.

Postponing the tunnel entry age by two years is an important step of the 2005 reform.

Lack of any actuarial adjustment pushes to tunnel entrance.

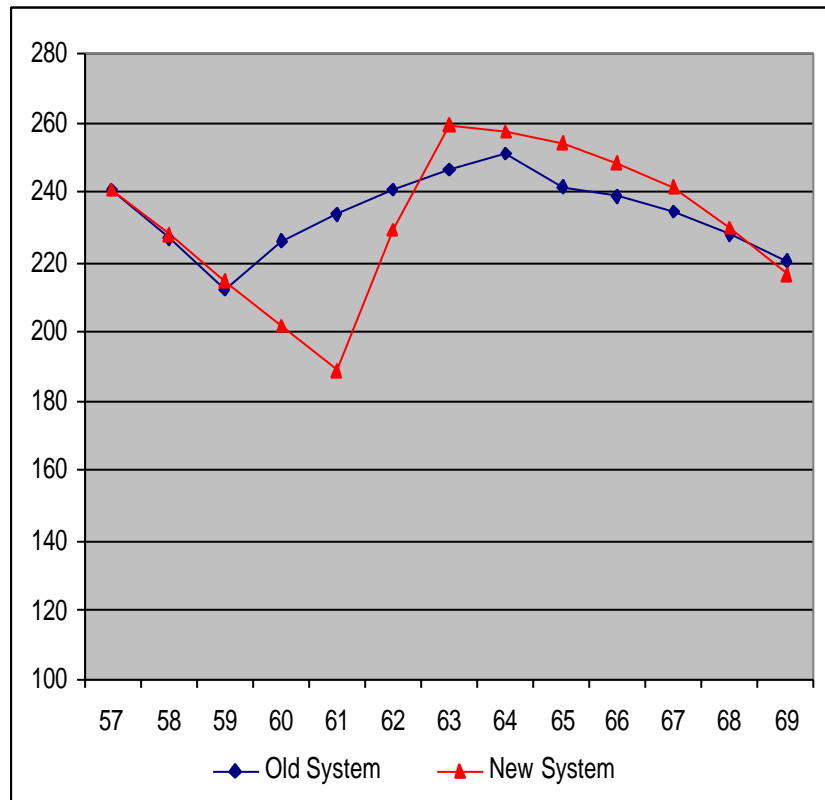
2. **Early retirees** will retire 2-3 years later. This pathway, however, is of little relevance for those who take the unemployment tunnel.

3. For the **later retirees**, the incentives of the reform are perverse: they will now retire about a year earlier.

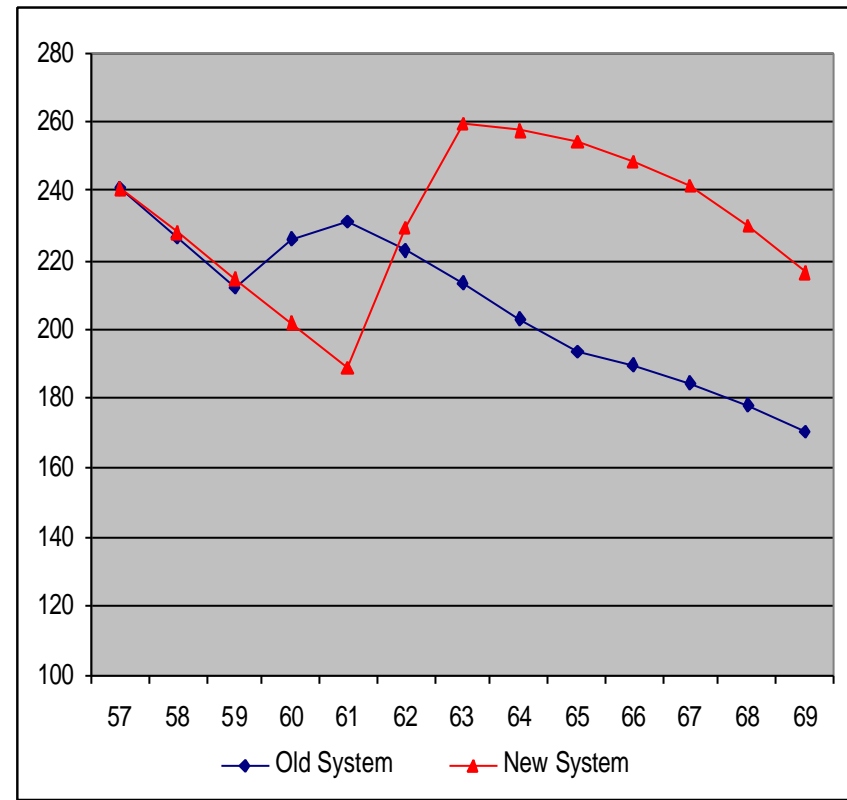
Replacing the actuarial adjustment by a seemingly very high accrual rate does not work correctly. One needs very steep accruals to mimic actuarial adjustments.



## 2c: Abolishing the replacement rate cap



Old System with unlimited replacement rate



Old System with cap at 60% of highest wage

### Considerable substitution among pathways!

- **Part-time pensions:**

- Reduce accrual on earnings gap

- **Disability pensions:**

- Abolish individual early retirement pension

- What are "social factors"?

- **Unemployment pensions:**

- Abolished, but tunnel still very attractive

### **Basing benefits on life-time earnings:**

- Important step to link benefits to earnings
- Reduces deadweight losses
- Re-adjustment of levels? Cost cuts?
- Makes “integration” unnecessary

### **Minimum age for contributions/accrual:**

- Similar to logical step as above. Costs more!

### **New credits for non-working episodes:**

- Carrots and sticks approach
- Slippery slope: tax financing of old age pensions undoes the virtue of the first two steps

## **Admirable combination of carrots and sticks**

- Made it through the political process!
- Will increase retirement age: finances longevity!
- Longevity factor makes it intergenerationally fairer!
- Closer to an actuarial system: lower deadweight losses!

## **Still some work to be done:**

- **Loopholes** through unemployment tunnel and disability
- Very **complex** and intransparent; redundant instruments
- Some perverse **early retirement incentives** remaining
- New entrants reform: **Long transition** period; cost cutting falls entirely on the two younger generations
- **Contribution rates still very, very large:** harms Finland's position in the competition over jobs
- Need addition to public system: private/occup. pensions