Incentives for a prolonged working life: increasing accrual rates with age

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Background

There are many reasons why we seek policies that lengthen the working lives. The need to improve public finances is the most important. More years in employment generate higher tax revenues and reduce the need for means-tested income transfers. Compared to cuts in social security or increases in taxes, it is a more efficient and fair way to solve the fiscal problems related to ageing populations. It also provides higher incomes for pensioners and thereby reduces the risk of old-age poverty.

Before going into the details of the Finnish pension policy, it might be useful to remind you of the historical reasons why pension systems in general have mandatory retirement ages. One of them is to shelter myopic people from retiring too early and getting low pensions. Another is to enable an employer to get rid of employees who are no longer interested in performing their tasks. The much used example is university professors. Third reason for a mandatory retirement age is to control pension expenditure. This is especially needed when pensions are not automatically adjusted with respect to the age of retirement.

Pension reform of 2005

Next I'll present the main elements of the Finnish pension system focusing on features that are aimed at lengthening working lives. The major pension reform of 2005 changed the rules in many ways:

- The calculation period of pensionable wages was extended from the four last years in each contract to lifetime earnings.
- Accrual of old age pensions starts from age 18 years instead of age 23.
- Earned pension rights are more tightly indexed to wages.
  => Earnings received when young increase pensions more than before.

- The accrual rate is 1.9 % of wages per year (instead of 1.5 %) in ages 53-62.
- Introduction of the flexible retirement age between 63-67 years.
- A super-accrual rate of 4.5 % per year is earned between ages 63-67 if working continues and pensions are not drawn.
  => Earnings received when old increase pensions more than before.

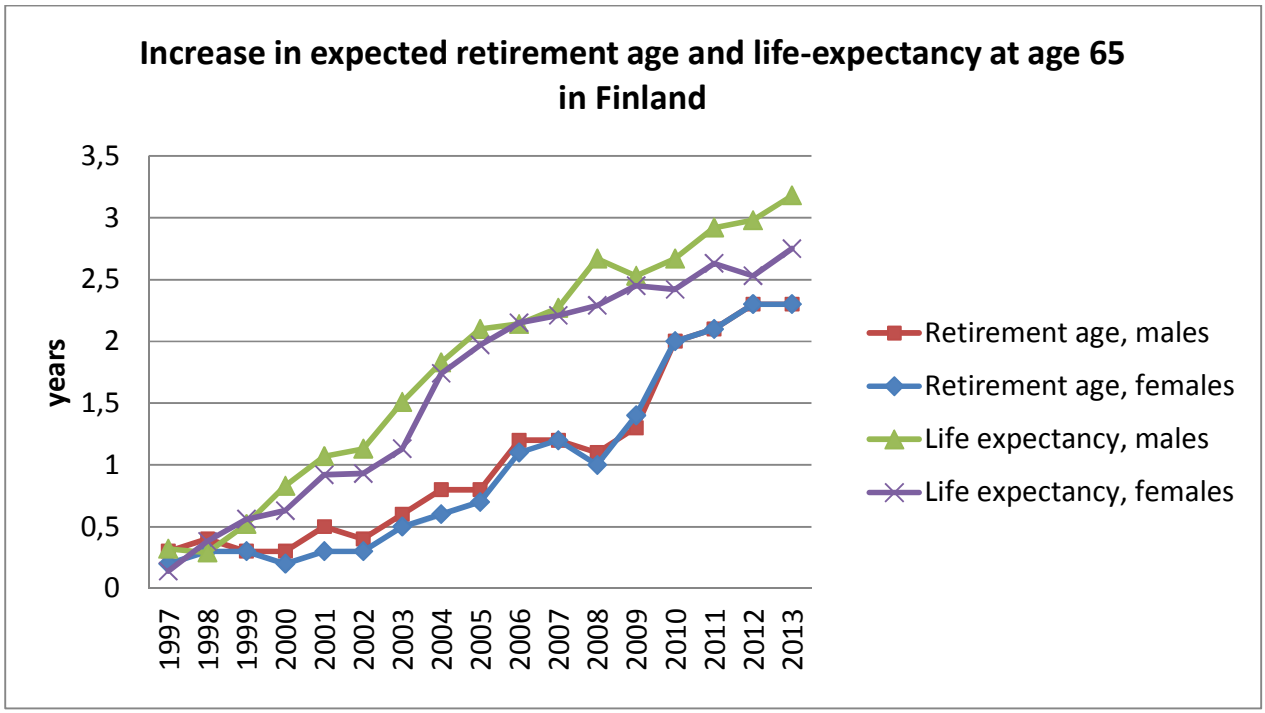
- If a pension is drawn in ages 63-67 while still working, yearly accrual falls to the normal 1.5 % per year.
  => Super-accrual compensates for the postponed drawing of the pension.
  => Benefits of postponing can be reached only by working longer.

- Several early retirement routes in ages 60-62 were abolished or the conditions tightened.
  => Reduced access to and rewards for early retirement.

- Introduction of longevity adjustment of pensions. The idea is to divide the earned pension rights with life expectancy at age 62.
  => If the retirement is not postponed when life expectancy increases, the monthly pensions will fall.

The public relations departments of the pension funds emphasized the need for working longer (longevity adjustment of pensions) and the benefits of doing so (the super-accrual rate). Not much attention was paid to the possibility of drawing a pension at the same time as working after age 62.

The actual retirement age did increase rather strongly. But the increase in the employment rates took place mostly between ages 60-62 due to the abolishment of early retirement routes, which was implemented gradually between the years 2005-2011. There has been a much smaller increase in employment rates during the flexible retirement age years from 63 to 67.



What we learn from this Figure is that before the pension reform of 2005 the trends in life expectancy and retirement ages were diverging. The reform improved the situation, but we expect that the increase in the average retirement age will slow down again. This actually is the main motivation for the next reform. If the trends in life expectancy and retirement age started to diverge again, both the fiscal and the social sustainability of the pension system would weaken.

Proposal for pension reform of 2017

There were two main goals in the reform proposal accepted by the labour market organizations in September. The expected retirement age should increase by 1.6 years by 2025 and the sustainability gap of public finances should decrease by 1 per cent of GPD. The main elements were as follows.

- The lowest eligibility age for old age pensions will increase gradually from 63 in 2016 to 65 in 2025. It will be linked to life expectancy in 2030 so that the ratio of working years and retirement years will be fixed to the situation prevailed in the year 2025. The upper age limit of the flexible retirement age follows the changes in the lower age limit.
    - ⇨ *The age limits increase first rather rapidly (3 months/year) and after 2030 the increase is expected to slow down to 1-2 months per year.*

- Higher accruals will be abolished so that the annual pension accrual rate of individuals of all ages will be 1.5 per cent of the wages. The accrual will start from age 17.
    - ⇨ *Lower accrual during late working years*

- Employees' pension contribution will no longer be deducted from the pensionable wage.
    - ⇨ *Higher accrual in all ages.*

- If an employee does not draw the old-age pension when reaching the earliest eligibility age for old-age pension, the accrued pension will be adjusted with a monthly increment for deferred retirement. This increment is 0.4 % of the accrued pension per month.
    - ⇨ *Reduces incentives to continue working, since the increment is no longer related to working.*

- The life expectancy coefficient will be mitigated (adjusted with respect to the eligibility age).
    - ⇨ *Higher pensions. This adjustment is aimed to avoid a double cut in pensions first due to a higher retirement age and then with the life expectancy adjustment.*

- The introduction of a partial early old age pension. The lowest eligibility age is 61 until 2025, when it will be raised to 62. After 2030 it will be adjusted to increases in life expectancy. Drawing early pensions reduces the old age pensions in an actuarial way (0.4 % per month).
    - ⇨ *Less generous than the current partial pension system.*
    - ⇨ *Not related to working.*

- Introduction of years-of-service pension. The criteria for access are as follows. Minimum age of 63 years, working life spanning 38 years and physically or mentally demanding work.
    - ⇨ *Not expected to be important because of tight interpretation of the stressfulness criteria.*

A note on politics:

In both reform negotiations (2005 and 2017) the final disagreement was between labour unions representing blue collar and white collar workers. The former emphasized that earnings received when young should increase pensions and there should be early retirement possibilities. The latter were in favour of rewarding long careers with high accruals. In the 2005 reform the white collars could negotiate the introduction of age-dependent accrual rates. In the 2017 reform it was fiercely defended by them, but being in minority, they lost the battle. From 2017 the accrual is higher, but not dependent on age.

Discussion

What have we learned from these reforms and the related studies?

1. The most effective method to reach longer working lives is to increase the eligibility age for old age pensions and restrict the possibilities for the use of early retirement routes. This has been confirmed by many studies.
2. A recent study shows that increasing the eligibility age for old-age pension is not particularly problematic from a distributional perspective because it does not weaken the position of those who are disabled or unemployed.
3. It is unclear how much the higher accrual rates of the current Finnish system have influenced the retirement decisions. It looks like the effect has been rather small. This is understandable because the super-accrual is conditioned not only on working longer but also on the deferred drawing of a pension.
4. People opting for early retirement use the routes out of employment that are most generous. In the case of Finland we have still the system of additional days of unemployment security. An unemployed person can get earnings-related benefits from age 60 to 65. The use of this route is expected to increase when the eligibility ages for pensions are increased. It may endanger the achievement of the fiscal sustainability goal of the 2017 reform.

Some related studies:

Andersen, T.M., N. Määttänen and T. Valkonen (2014): Pension reforms: Longevity and retirement. In Valkonen, T. and V. Vihriälä (eds.): The Nordic model – challenged but capable of reform. TemaNord 2014:531/ETLA B262. Nordic Council of Ministers 2014. http://www.etla.fi/julkaisut/nordic-model-challenged-capable-reform-2/

Barr, N. (2013): The pension system in Finland: Adequacy, sustainability and system design. Finnish Centre for Pensions. http://www.etk.fi/en/gateway/PTARGS_0_2712_459_770_3439_43/http%3B/content.etk.fi%3B7087/publishedcontent/publish/etkfi/en/julkaisut/research_publications/other_publications/the_pension_system_in_finland_adequacy__sustainability_and_system_design_7.pdf

Lassila J. and T. Valkonen (2007): The Finnish Pension Reform of 2005. Geneva Papers on Risk and Insurance – Issues and Practice, Vol. 32, pp. 75-94.

Lassila J., N. Määttänen and T. Valkonen (2014): Linking retirement age to life expectancy: what happens to working lives and income distribution? Finnish Centre for Pensions, Reports 02/2014, ETLA B 260. http://www.etla.fi/julkaisut/linking-retirement-age-life-expectancy-working-lives-income-distribution-2/