

Finnish Centre for Pensions

How to make pension systems more robust?

Adjusting pensions to counter ageing

Increasing life expectancy is a financial challenge for pension systems. In DB pension schemes, the pension promise is often based on the notion of a monthly pension. The problem with DB schemes when people live longer is that pension expenditure grows.

There is a limit to how much contributions can be raised. To avoid an undesired financial burden, Finland has introduced two automatic adjustment mechanisms. They reflect different concerns.

Experience from pension level adjustment

Firstly, Finland introduced the life expectancy coefficient (LEC) in 2005. LEC is based on thinking earned pension rights in terms of pension capital, not in terms of monthly pensions. When you work, you earn a right to pension capital, which is paid out as an annuity. If you live longer, LEC decreases your monthly pension in order to make up for the extra months that you will spend in retirement. LEC gives also a financial incentive; one can avoid decreases in one's monthly pension by postponing retirement.

As LEC reacts to changes in longevity, it will help achieve financial sustainability in the long run. But it has turned out to be ineffective as an incentive to postpone retirement, at least so far.

Firstly, while the overall development in pension expenditures as a share of GDP between now and 2060 looks rather stable (thanks to LEC and other reforms), the cost increase in the Finnish pension system will be felt between now and 2030, largely caused by different-sized age cohorts. The LEC effect, in contrast, will increase year-by-year, raising the question of right timing.

Secondly, LEC is an economic incentive that affects the monthly pension at an individual level but leaves the retirement decision to the individual. Finland has a flexible retirement age (63-68 years), but the majority of people prefer to retire as soon as they are allowed to do so.

To help solve these issues, further reforms have been implemented from 2017. The aim is to raise the effective retirement age by three

years by 2025 (compared to 2009) and to contribute to reducing the sustainability gap in public finances by 25 per cent.

Raising the retirement age

In Finland, the effects of further adjustments were considered beforehand against employment and unemployment but also disability, as not all are capable to work until a higher retirement age. Effects on pension finances and government finances had to be assessed. Also, the effects of adjustments to pension levels, as well as gender, socioeconomic and intergenerational fairness were addressed.

At the end, the decision-makers in Finland chose to increase the retirement age with three months per cohort per year over the next eight years. That way, the minimum retirement age will eventually be 65 years (and upper limit 70).

However, although this adjustment is likely to meet the retirement target set for 2025, the increase in the retirement age was deemed insufficient for the other goal for reducing the sustainability gap. That is why an automatic retirement age adjustment after 2025 was also agreed on in the 2017 pension reform.

After 2025, a new automatic adjustment mechanism links the retirement age to longevity in a way that is to keep the ratio of years spent in working life over the life course stable.

A blend of two mechanisms

As a result, Finland will have two automatic adjustment mechanisms: the pension level and the retirement age adjustment. These two mechanisms will work together with a greater emphasis on the retirement age adjustment and a lesser emphasis on the pension level adjustment.

In practice this means, firstly, that people have to retire later, and secondly, in case they retire at the earliest possible time, their pension will be reduced. They cannot avoid this reduction mechanism, but they can compensate for it by continuing to work until the target retirement age that is calculated separately for each cohort. ■



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