

Secretary-General
Secrétaire général

AG/2010.121.ma

2 March 2010

Dear Prime Minister,

I have the pleasure to send to you the OECD's assessment of Finland's proposals to lengthen working lives and reform the pension system, as requested in your letter of 3 February 2010.

We find the proposals very promising. The experience of many OECD countries shows, however, that in order to achieve a substantial reduction in the numbers of workers retiring on disability benefits it is necessary to restrict access to such entitlements, along with the longer-term measures to improve working conditions and occupational health proposed by your Working Group on Working Life.

The OECD has also examined Finnish disability policies in detail in the 2009 report *Sickness, Disability and Work: Breaking the Barriers*. We have drawn on this study in our assessment and enclose a copy of the full report for further information. As for the proposals to reform the old-age pension system, our calculations show that abolishing the early retirement option at age 62 and moving the lower bound of the pension age to 65 years would greatly improve the incentives to work longer.

I hope that our comments will be useful for the policy debate and will help Finland to address the challenge of putting retirement policies on a sustainable path for the future.

Our Organisation stands ready to provide further information if needed. Please do not hesitate to contact John Martin, Director of Employment, Labour and Social Affairs (john.martin@oecd.org) for any further queries.

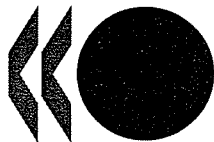
Yours sincerely,



Angel Gurría

H.E. Mr. Matti Vanhanen
Prime Minister
Finland

Cc.- H.E. Mr. Antti Kuosmanen
Head of the Delegation of Finland to the OECD



Secretary-General
Secrétaire général

2 March 2010

Dear Ambassador,

Please find enclosed a letter intended for Mr. Matti Vanhanen, Prime Minister of Finland.

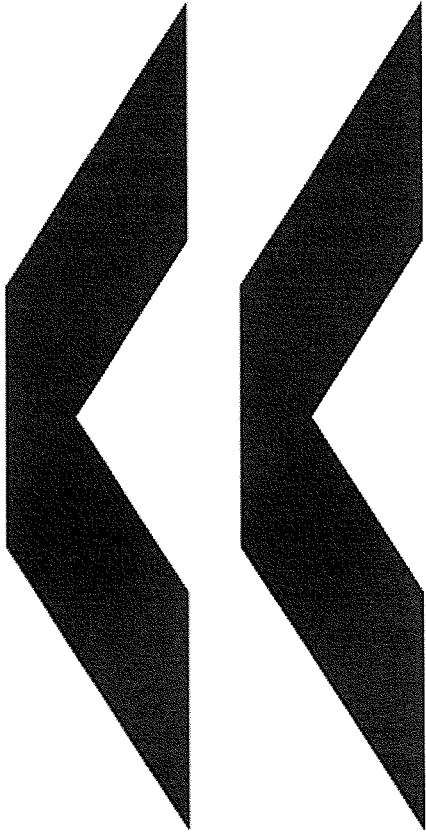
I would be grateful if you could have this letter forwarded to him.

Yours sincerely,



Angel Gurría

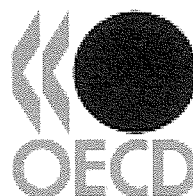
His Excellency
Mr. Antti Kuosmanen
Head of the Delegation of Finland
to the OECD



**Directorate of Employment,
Labour and Social Affairs**

Increasing the effective retirement age in Finland

**REPORT BY THE OECD TO THE
PRIME MINISTER OF FINLAND**



INCREASING THE EFFECTIVE RETIREMENT AGE IN FINLAND

1. Following Prime Minister Vanhanen's request to the OECD to assess the proposals to reform Finland's old-age and disability pension schemes that the working group on working life (the so-called Ahtela group) has put forward recently, we present our assessment of them in this note. The first part of the assessment discusses the proposed measures to increase the working life through strengthened work capacity and wellness at work. The second part focuses on the incentives to retire embedded in the current Finnish pension scheme and examines the impact of closing the early-retirement option at 62 and increasing the lower bound of the retirement-age range from 63 to 65 years. As agreed with the Finnish authorities, no comments will be made on the proposals to reduce youth unemployment and advance the age of first entry into the labour market.

1. Comments on the proposals to reduce disability benefit inflows

2. The following comments are based on documentation provided by the Finnish authorities in February 2010. Our understanding is that additional Working Groups have been created to examine each of the general proposals in more detail and report back by mid-2011. Therefore, our comments are necessarily of a broader nature. They draw heavily on the 2009 OECD review of sickness and disability policies in Finland.

3. The principal idea behind the proposals – that strengthened work capacity and wellness at work throughout the working life is important for staying in work longer – is well taken. Several of the measures aim at a welcome and necessary change in attitudes and mindsets; this is important but – as research and experiences from other countries have shown – not sufficient to achieve the stated objectives.

4. “Soft” measures, such as those proposed will certainly contribute to improving the quality of working life, and of life in general, but alone will not necessarily extend people's working lives. For this to happen, evidence has shown that the incentives for all actors also need to be addressed. At the same time, the implementation and the effectiveness of all measures – and of soft measures in particular – needs to be monitored and evaluated continuously and rigorously. Ideally, this monitoring and evaluation should be done more frequently than at the suggested four-year intervals.

5. The target of reducing disability benefit inflow by half is very ambitious, particularly in view of the persistence of these rates in Finland in the past. Successful reforms in other countries (including e.g. the Netherlands) have shown that such a large decline is possible if starting from a very high initial level, as in Finland. However, nowhere were declines of such magnitude in the rates of new disability beneficiaries achieved without complementary structural reforms affecting incentives for some or all of the key actor, including individuals, employers, benefit system gatekeepers and rehab providers.

6. The measure used to conclude that soft changes aimed at improving wellness at work would reduce disability benefit inflows by half (and thus extend working life by one year) is interesting but unfounded. Inflow rates at the company level, showing that rates of the top half of all companies are 50% lower than for the bottom half are a relevant measure of the benefit inflow risk distribution – and it would

be interesting to compare such an indicator across countries. However, there is no foundation for the assumption that the bottom half could indeed improve to the level of the top half.

7. Some suggested measures seem particularly promising, even though it is difficult to judge their impact on the duration of individual's working lives. Among those are:

- To improve cooperation between the employer, the occupational health care (OHC) specialist, and the employee.
- To strengthen the work participation focus of OHC and to link the level of reimbursement of employers' OHC costs to the capacity-promotion and disability-prevention focus of these services.
- To develop the OHC competence of doctors (both general practitioners and specialists).
- To improve the access to OHC for small businesses and all over the country.
- To monitor and promote health and work capacity of the unemployed.
- To assess residual work capacity of those on long-term sick leave, generally after 90 days and even earlier for those with mental health-related problems.
- To facilitate access to practical tools and advice through a service centre, for employers seeking to improve workplace wellness.

8. It is also important to recognise that the potential benefits of the proposed reforms should be weighed against the fiscal and resource costs of each of the measures.

OECD recommendations to reduce disability pension and lengthen the working life

9. A number of earlier OECD recommendations for Finland, developed in the course of the 2009 Sickness, Disability and Work review, could supplement and reinforce the measures proposed by the Working Group. Among those are the following:

- To improve the cooperation of the many different rehabilitation authorities, including the PES, with earlier, ongoing and clearly-regulated information exchange, to ensure timely intervention; this should also include cooperation with OHC in the preparation of a rehabilitation plan.
- To make the rehabilitation authorities more accountable and to increase the transparency of the rehabilitation system; this will require a single entry point into the system and one authority taking responsibility for a case from the start to the end.
- To introduce mutual responsibilities for clients i.e. to match the existing right to vocational rehabilitation by corresponding participation requirements.
- To streamline the complex and confusing rehabilitation benefit system.
- To improve access of people with reduced work capacity to mainstream PES measures (e.g. long-term sick unemployed, partial disability benefit recipients, denied disability benefit applicants), while also improving monitoring and evaluation of PES programmes.

- To modernise work-capacity assessments, with less focus on medical limitations while also harmonising assessments across the workforce (e.g. abolish the lighter assessment for those aged 60-64 and own-occupation assessment for public sector employees (representing 20% of the workforce)).
- To consider measures also affecting current disability beneficiaries, such as making sure taking up work always pays (e.g. through a gradual phase-out of full and partial disability benefit with increased earnings).

2. Pension incentives to retire in the Finnish old-age pension system

10. There is a large body of international evidence that incentives built into pension systems affect retirement behaviour. Pension incentives to retire are generally measured by the change in “pension wealth” – that is, the lifetime value of pension benefits – that accrues from working an additional year. Gruber and Wise (1998, 1999) suggest that a 1% reduction in the change in pension wealth results in a 0.41% reduction in the probability of working at older ages. OECD analysis (Blondal and Scarpetta, 1999) suggests a smaller value of 0.28% on average for a selected number of member countries.

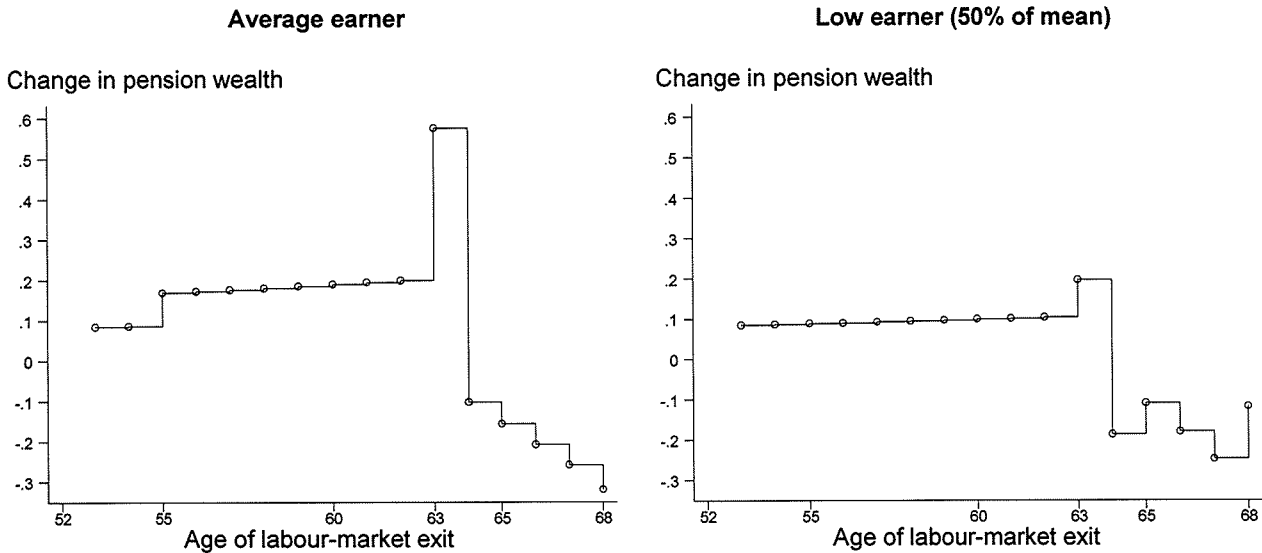
11. Thus, getting retirement incentives “right” has been a central concern of pension reforms in many countries in order to lengthen working lives (for an analysis of OECD pension reforms see OECD, *Pensions at a Glance* 2007 and 2009). Retirement incentives also matter for equity reasons. People who work more and contribute more *should* have higher pensions. Equally, those who are forced to drop out of employment early, perhaps through no fault of their own, need to have a reasonable standard of living in retirement. The aim should be to have a pension system which neither excessively subsidises, nor excessively penalises, early retirement.

12. Of course, retirement incentives are not the only determinant of older workers’ participation in the labour market. Appropriate incentives to keep working longer are rarely a *sufficient* solution to the problem of early retirement, but they are certainly a *necessary* part of the solution. Other measures that address labour force participation of older workers and, in particular, the challenges to the Finnish disability pension scheme, were commented on in the first part of this note.

OECD pension modelling results for Finland

13. The OECD old-age pension models for Finland (not taking into account any use of the unemployment path into retirement) show a strong incentive to remain in work until the lower bound eligibility age for a pension of 63 (Figure 1). At that point, the change in pension wealth – the lifetime value of pension benefits which is the key measure of pension incentives to retire – turns negative. This means that workers face a high implicit tax on staying in the workforce longer. This occurs despite the increase in the pension accrual rate from 1.9% of earnings for each year of contributions between ages 53 and 62 to 4.5% from age 63 onwards, because these increases do not vary between 63 and 67 and they are not high enough to compensate for a) discounting of future benefit payments and b) an increasing death risk at higher ages. This is true for all earnings levels, but especially so for low earners, because of the means-tested benefit, the national pension, which is not reduced for retirement at 63.

Figure 1. Finland: change in gross pension wealth by age

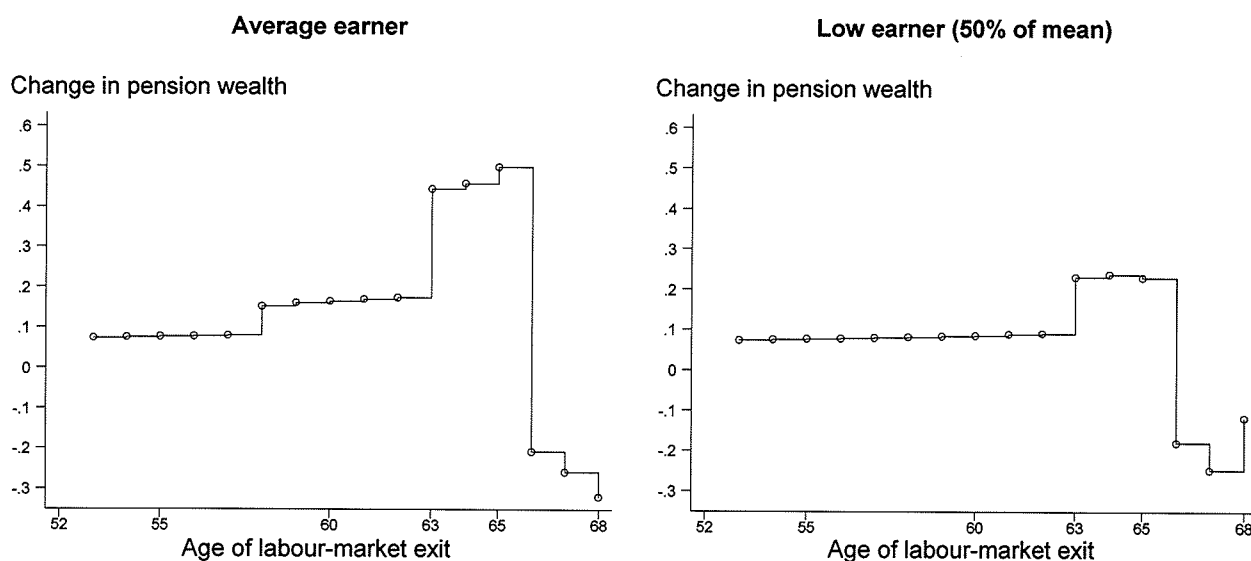


Source : OECD pension models

14. Cross-country analysis shows that both the normal and the earliest pension ages matter in determining when people leave the labour market. Annex Table 1 compares the average effective age of labour-market exit computed from OECD data with normal pension age and the earliest possible pension age. The conditions for early access vary greatly, not only between the different countries but also between the various schemes within one country. Nevertheless, this overview shows that in several OECD countries with earnings-related pension schemes, such as Belgium, Germany, Hungary, Italy, Luxembourg and Spain, the age at which people leave the labour market is very close to the earliest possible retirement age. However, it should be noted that other pathways such as unemployment and disability pensions also play an important role for workers to exit the labour market. The degree of coverage and the level of pensions obviously also affect the retirement decision, especially in countries with universal flat benefits or with immature earnings-related schemes.

15. One of the measures proposed in the current pension reform debate in Finland is the removal of the early retirement option at age 62 in the pension scheme. In addition, it was proposed to raise the lower bound of the old-age pension age range from the current 63 to 65 years. The modelling here assumes that both of these measures are taken simultaneously. As Figure 2 shows, the effect would be an increase in pension wealth for both average and low earners until around age 66, with a steep decline thereafter, especially for average earners, meaning that workers would indeed face a strong incentive to stay in the labour market until the normal pension age.

Figure 2. Change in gross pension wealth by age: removal of early-retirement at 62 years and increase of lower bound of retirement age range to 65 years



16. This result, however, is not surprising given that there is no possibility to access a pension before the regular pension age; leaving the labour market before would mean that the average worker would have to wait in order to draw a pension which, in addition, would be lower than the regular old-age pension due to missing years of contributions. Thus, the impact on the effective retirement age would be large, unless other pathways out of the labour market, such as disability or unemployment pensions, were still left open.

17. Several OECD countries have undertaken pension reforms to encourage longer working lives in recent years. Among them are the Netherlands where early retirement schemes were abolished in 2005 and Belgium, Denmark and Greece where access to early retirement has been restricted. Like Finland, France and the United Kingdom have taken steps to make working longer more attractive by introducing financial incentives to retire later. These reforms are discussed in detail in the 2007 and 2009 editions of the OECD's publication *Pensions at a Glance*.

ANNEX 1: TABLE 1

	Early age	Normal age	Effective age for men (women)		Early age	Normal age	Effective age for men (women)
Australia	60 ⁽¹⁾	65	64.4 (62.2)	Korea	60	65	71.2 (67.9)
Austria	62	65	58.9 (57.9)	Luxembourg	57/60 ⁽¹⁴⁾	65	59.2 (60.3)
Belgium	60 ⁽²⁾	65	59.6 (58.3)	Mexico	60 ⁽¹⁵⁾	65	73.0 (75.0)
Canada	60 ⁽³⁾	65	63.3 (61.9)	Netherlands	..	65	61.6 (61.3)
Czech Republic	60 ⁽⁴⁾	63	62.2 (58.5)	New Zealand	..	65	66.5 (63.9)
Denmark	.. ⁽⁵⁾	67	63.5 (61.3)	Norway	62	67	64.2 (63.2)
Finland	62	6	60.2 (61.0)	Poland	..	m: 65; w: 60	61.4 (57.7)
France	56/55	.. ⁽⁷⁾	58.7 (59.5)	Portugal	55 ⁽¹⁶⁾	65	66.6 (65.5)
Germany	63 ⁽⁸⁾	67	62.1 (61.0)	Slovak Republic	.. ⁽¹⁷⁾	62	59.3 (54.5)
Greece	55 ⁽⁹⁾	65	62.4 (60.9)	Spain	60/61 ⁽¹⁸⁾	65	61.4 (63.1)
Hungary	60 ⁽¹⁰⁾	62	59.7 (58.2)	Sweden	55/61 ⁽¹⁹⁾	20	65.7 (62.9)
Iceland	62 ⁽¹¹⁾	67	68.9 (65.3)	Switzerland	61/63 ⁽²¹⁾	m: 65 (w: 64)	65.2 (64.1)
Ireland	..	65/66 ⁽¹²⁾	65.6 (64.9)	Turkey	..	65	63.5 (64.3)
Italy	61 ⁽¹³⁾	m: 65; w: 60	60.8 (60.8)	United Kingdom	..	65	63.2 (61.9)
Japan	60	65	69.5 (66.5)	United States	62	67	64.6 (63.9)

The average effective retirement age is derived from observed changes in participation rates over a 5-year period (here 2002-2007) for successive cohorts of workers (by 5-year age groups) aged 40 and over.

Source: OECD estimates derived from the European and national labour force surveys.

Notes:

(1) Australia: superannuation guarantee: currently 55 but increasing to 60 by 2025 for men; age pension cannot be withdrawn earlier;

(2) Belgium: since 1.1.2005 the pension can also be claimed at age 60 with 35 years of contributions;

(3) Canada: only the pension from the earning related scheme can be claimed at age 60 while the basic old age security pension is payable at age 65;

(4) Czech Republic: women can claim a pension earlier based on the number of children: at age 62 for 4 and more children, 63 for three children, and 64 for 2 children;

(5) Denmark: the partial early retirement program is being phasing out; a voluntary early retirement program still exists and is linked with the unemployment insurance (it requires to have been members of that fund for at least 25 years within the last 30 and have paid the early retirement contributions during that period and be entitled to the unemployment benefits at the time of the transition in the ER scheme);

(6) Finland: from 2005, the retirement age for the earnings-related old age pension is flexible between the age of 63 and 68, possible to retire early;

(7) France: a full first stage public pension requires 40 years of contributions (to increase to 41 between 2008 and 2012). Full-rate pensions can however be claimed starting at age 60 if the person has contributed for 40(41) years, moreover it can be claimed at age 65 even if the length of the contributory period is less than 41;

(8) Germany: pensionable age, currently equal to 65, is increasing to 67 between 2012 and 2029. People can retire from age 63 with 35 years' contributions and 8 eight years contributions immediately before retirement;

(9) Greece. With a minimum of 15 years contributions

- (10) Hungary: early retirement is possible at age 57 for women. Normal age will reach 65 for men in 2018 and in 2020 for women
- (11) Iceland: It is not possible to claim the basic or targeted pensions before the normal pension age
- (12) Ireland: Normal age to claim the state pension (contributory) is 66, while the age to claim the state pension (transition) is age 65.
- (13) Italy: the minimum age to claim early retirement seniority pension is increasing from 57 to 61 by 2013. Women can leave earlier based on the number of children.
- (14) Luxembourg: It is possible to retire at age 57 with 40 years 'paid contributions and at 60 with 40 years paid or credited contributions;
- (15) Mexico: early retirement is possible upon having contributed for at least 1250 weeks;
- (16) Portugal: Early retirement is also possible with 30 years' contributions;
- (17) Slovak republic; early retirement is possible at any age under conditions (i) of 10 years' contributions; and (ii) the resulting pension is at least equal to, at least, 1.2 times the adult subsistence level;
- (18) Spain: for those entering before 1967 early retirement is possible from age 60; for those entering later, early retirement is possible from age 61 provided they have contributed at least 30 years;
- (19) Sweden: In the new ITP1, pensions may be taken out at age 55. Both the income and premium pensions can be withdrawn at age 61. The income tested guaranteed pension cannot be claimed before age 65;
- (20) Sweden: there is no fixed retirement age in the public pension scheme. While normal age for the income tested guaranteed pension and for the new ITP1 is 65;
- (21) Switzerland: in the occupational scheme it is possible to claim pensions earlier starting at age 61; in the public scheme it is possible from age 63 for men and 62 for women;

ANNEX 2

Finland: Calculation of retirement incentives

The two-tier pension system consists of a basic state pension (national pension), which is income-tested, and a range of statutory earnings-related schemes, with very similar rules for different groups. The schemes for private-sector employees are partially pre-funded while the public-sector schemes are pay-as-you-go financed (with buffer funds to even out future increases in pension contributions). Major pension reform was introduced in Finland in 2005 and all rules presented here take account of these reforms.

Qualifying conditions

The national pension is subject to a residency test (but no contribution requirements), withdrawn against pension income from the earnings-related schemes. The national old-age pension is payable from age 65. The full old-age national pension benefit is payable with 40 years residence as an adult, with *pro-rata* adjustments for shorter periods of residence. It is possible to retire to early old-age national pension between ages of 62 and 65 (Early old-age pension is available from the beginning of the month following one's 62nd birthday).

From 2005 the retirement age of earnings-related old-age pension is flexible between the ages of 63 and 68 (i.e. including the month of the 68th birthday). It is possible to retire to early old-age pension between ages of 62 and 63 and it is possible to take a deferred old-age pension after 68. There are no waiting periods or euro limits to obtain a right to earnings-related pension, even though there are minimum earning levels for pension insurance. Pension accrues only after the age of 18.

Early retirement

Early national old-age pension is available from the beginning of the month following one's 62nd birthday. Its amount is permanently reduced (in comparison with the ordinary old age pension) by 0.4% for each month the pension is to be paid before the normal pensionable age of 65 years. The pension will not rise to its regular level when the recipient reaches the age of 65. These rules operate from 2005.

Early retirement is possible at age 62 under the earnings-related scheme, subject to a 0.6% benefit reduction per month of early retirement until the age of 63. After the age of 63 there is no reduction in pension. However, there is more rapid accrual of earnings-related benefits after this age (see above).

Late retirement

From 2004 the national pension can be deferred after the age of 65 and the pension is then increased by 0.6% for each month by which retirement is postponed.

From 2005 onwards, the increment for late retirement is reduced to 0.4 % for each month (4.8% per year) in the earnings-related scheme after age 68. There is no adjustment between ages 63 and 68 because of the accelerated accrual of pension at those ages.

It is possible to combine receipt of pension and earnings from work. From 2005 after taking the old-age pension, earnings accrue additional pension and the accrual rate is 1.5 % per year until the age of 68.

Pension incentive to retire

The target replacement rate under the earnings-related scheme is quite large, so workers continue to accrue quite sizeable benefits up to the earliest possible pension age of 62. The permanent reduction in

benefits for retiring at 62 rather than 63 is 7.2% per year. This is sufficiently large a cut to ensure that working from 62 to 63 gives a large boost to retirement income. Thereafter, pension wealth falls with each extra year of work by an amount that increases with age. The effect appears to be more pronounced after age 68.

However, it is possible to combine work and pension receipt, which is financially more attractive (before taking account of taxes). Thus, the reductions in pension wealth at these ages can be avoided.

Note that the effect of the income-tested, national pension after age 69 is because the 7.2% annual increment for deferral under this programme means that an average earner would become entitled to a small benefit for working and deferring pension until these very advanced ages. However, as argued in the previous paragraph, this is an unlikely scenario in practice.

Pension incentive to retire: Finland: average earner

retage	penage	totalyrs	grr_1	grr_2	grr_t	dgpw_1	dgpw_2	dgpw_t	gpwret_1	gpwret_2	gpwret_t
55	65	35	0	0.377	0.377	0	0.147	0.147	0	4.421	4.421
56	65	36	0	0.389	0.389	0	0.150	0.150	0	4.684	4.684
57	65	37	0	0.402	0.402	0	0.154	0.154	0	4.962	4.962
58	65	38	0	0.414	0.414	0	0.157	0.157	0	5.254	5.254
59	65	39	0	0.427	0.427	0	0.161	0.161	0	5.564	5.564
60	65	40	0	0.439	0.439	0	0.165	0.165	0	5.891	5.891
61	65	41	0	0.451	0.451	0	0.169	0.169	0	6.238	6.238
62	65	42	0	0.464	0.464	0	0.174	0.174	0	6.606	6.606
63	65	43	0	0.476	0.476	0	0.444	0.444	0	6.998	6.998
64	65	44	0	0.506	0.506	0	0.457	0.457	0	7.690	7.690
65	65	45	0	0.536	0.536	0	0.498	0.498	0	8.428	8.428
66	66	46	0	0.610	0.610	0	-0.208	-0.208	0	9.246	9.246
67	67	47	0	0.642	0.642	0	-0.258	-0.258	0	9.373	9.373
68	68	48	0	0.674	0.674	0	-0.319	-0.319	0	9.464	9.464
69	69	49	0	0.705	0.705	0	-0.364	-0.364	0	9.507	9.507
70	70	50	0	0.736	0.736	0	-0.404	-0.404	0	9.519	9.519

Note: 1 = targeted (national pension); 2 = earnings-related

Notes to table

retage is the age of labour-market exit (ranging from 55 to 70)

penage is the age of eligibility for the pension, conditional on leaving the labour market at *retage*

totalyrs is the total number of years of contributions between entry to the labour market and labour-market exit age (*retage*)

grr is the gross replacement rate, payable from *penage*, conditional on leaving the labour market at *retage*

dgpw is the change in gross pension wealth resulting from working an additional year from the age shown under *retage*

gpwret is the level of gross pension wealth already earned at the age show under *retage*

The Tables are shaded light grey during the window of early retirement (that is, between the earliest pension age and the normal pension age). They are shaded dark grey for normal and late retirement. They are left white at ages when it is not possible to claim the pension.

Where relevant, the replacement rates and changes in pension wealth are shown separately for different components of the system to help isolate the effects of different schemes on the overall retirement incentives. A key is given beneath the Table.

All calculations are carried out using standard OECD assumptions. These include: entry at age 20, 2% real wage growth, 2.5% price inflation, 3.5% real return on defined-contribution pensions, 2% discount rate. Pension wealth is calculated using UN/World Bank projections of mortality rates for 2040.

The analysis covers all mandatory and quasi-mandatory retirement-income programmes. It does not include the effect of credits for periods of unemployment *etc.* on pension benefits.

