



EUROJÄRJESTELMÄ
EUROSYSTEMET

Population ageing in Finland: Consequences and policy actions

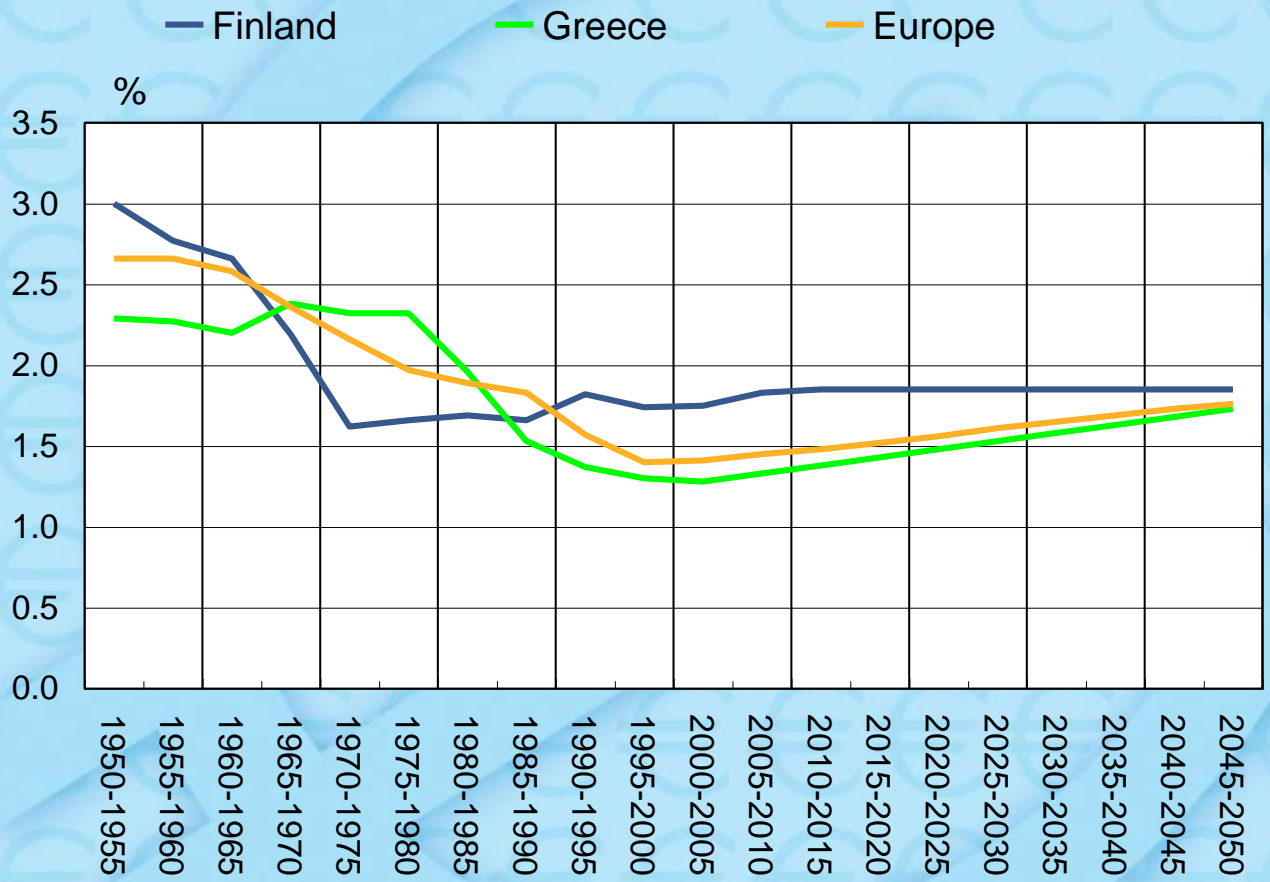
**Erkki Liikanen
Governor
Bank of Finland**

Bank of Greece
17 January 2008

Population ageing in Finland: Consequences and policy actions

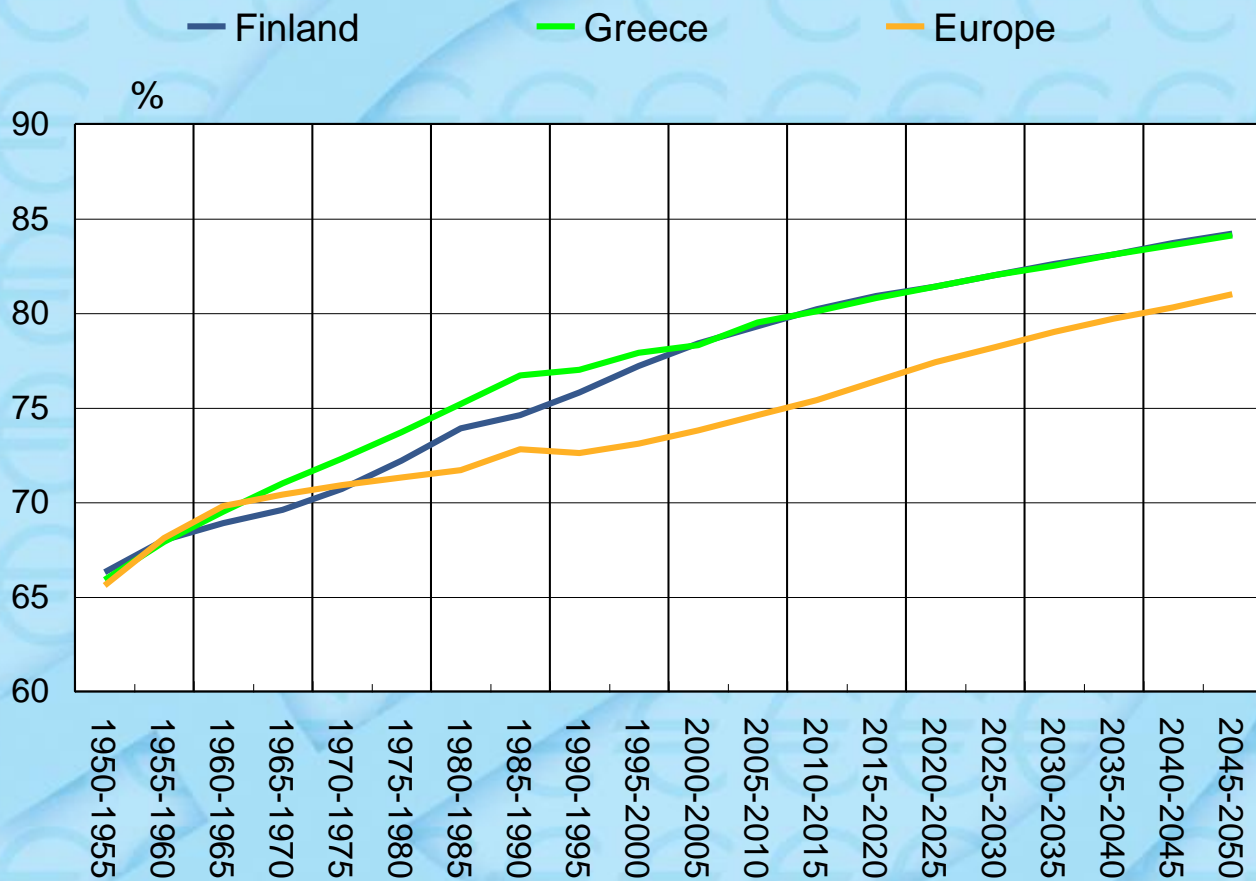
- ◆ Demographic change is a global challenge.
- ◆ In Europe, Finland is the first country to face steep ageing due to large post-war (1945–1949) cohorts.
- ◆ The economic consequences of ageing are fundamental.
- ◆ The 2005 pension reform in Finland was designed to ease ageing pressures on the sustainability of the pension system and labour markets.
- ◆ But challenges still remain.

Total fertility (children per woman)



Source: United Nations.

Life expectancy at birth (years)

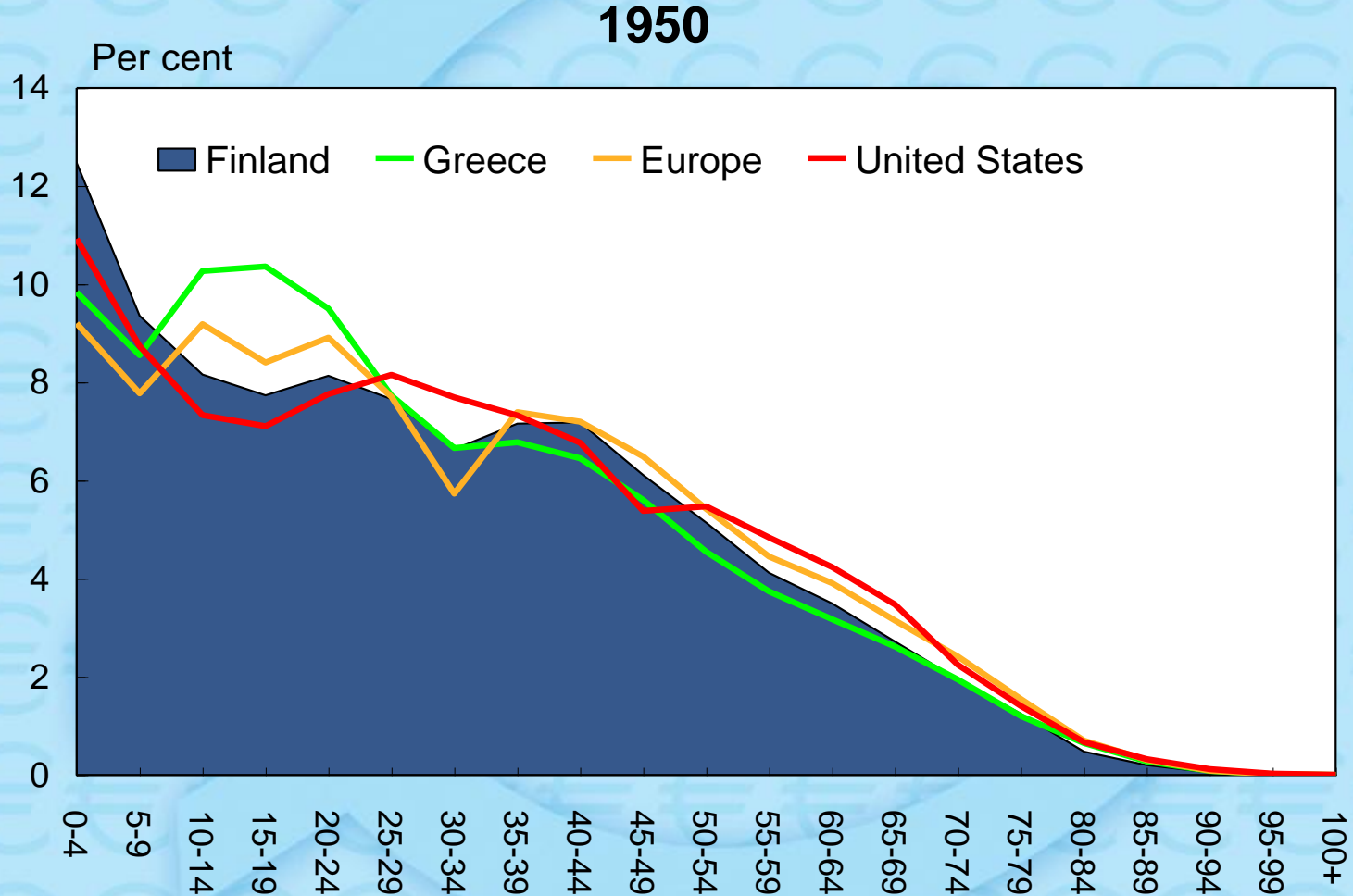


Source: United Nations.

Population is greying faster in Finland than in other Western countries

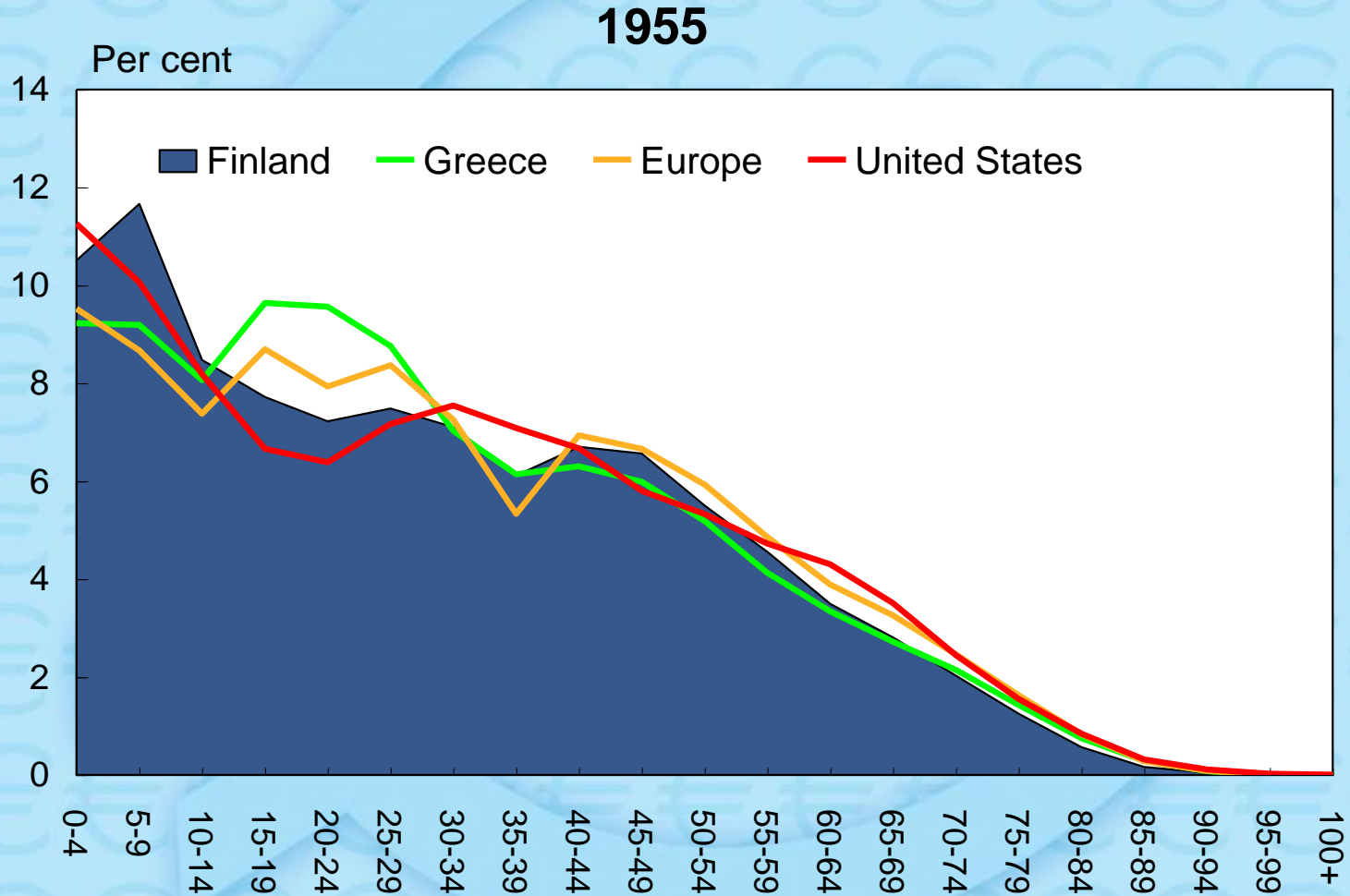
- ◆ Baby-boom (1945–1949) cohorts larger than elsewhere.
 - ◆ But the peak fertility rate was also shorter-lived than in other countries, and soon began to fall.
 - ◆ Life-expectancy has increased rapidly in Finland.
- => An exceptionally large, but also shortlived baby boom together with increased longevity brings the ageing challenge in Europe first to Finland.

Demographic change: Ageing of the baby-boomers



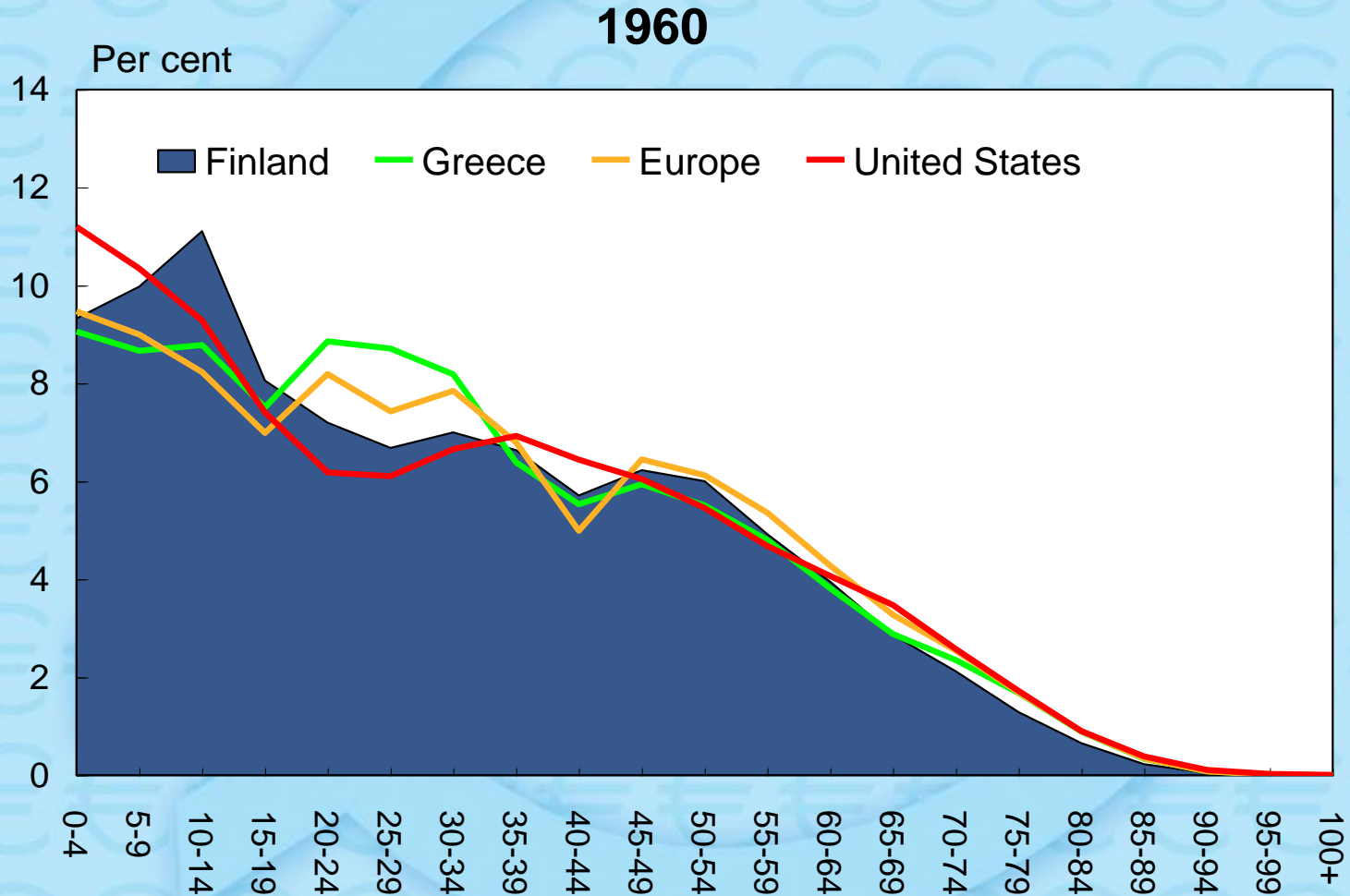
Source: United Nations.

Demographic change: Ageing of the baby-boomers



Source: United Nations.

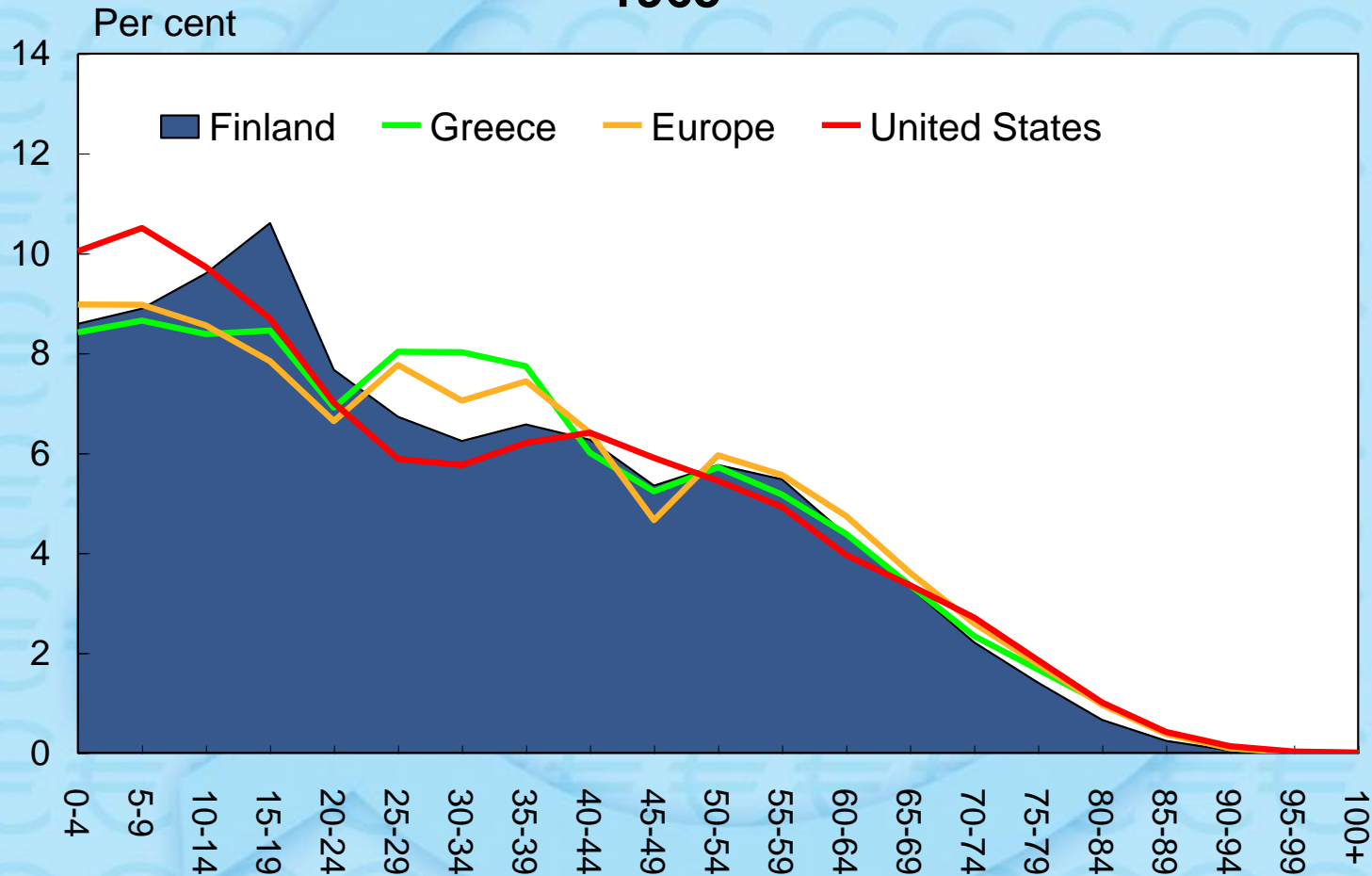
Demographic change: Ageing of the baby-boomers



Source: United Nations.

Demographic change: Ageing of the baby-boomers

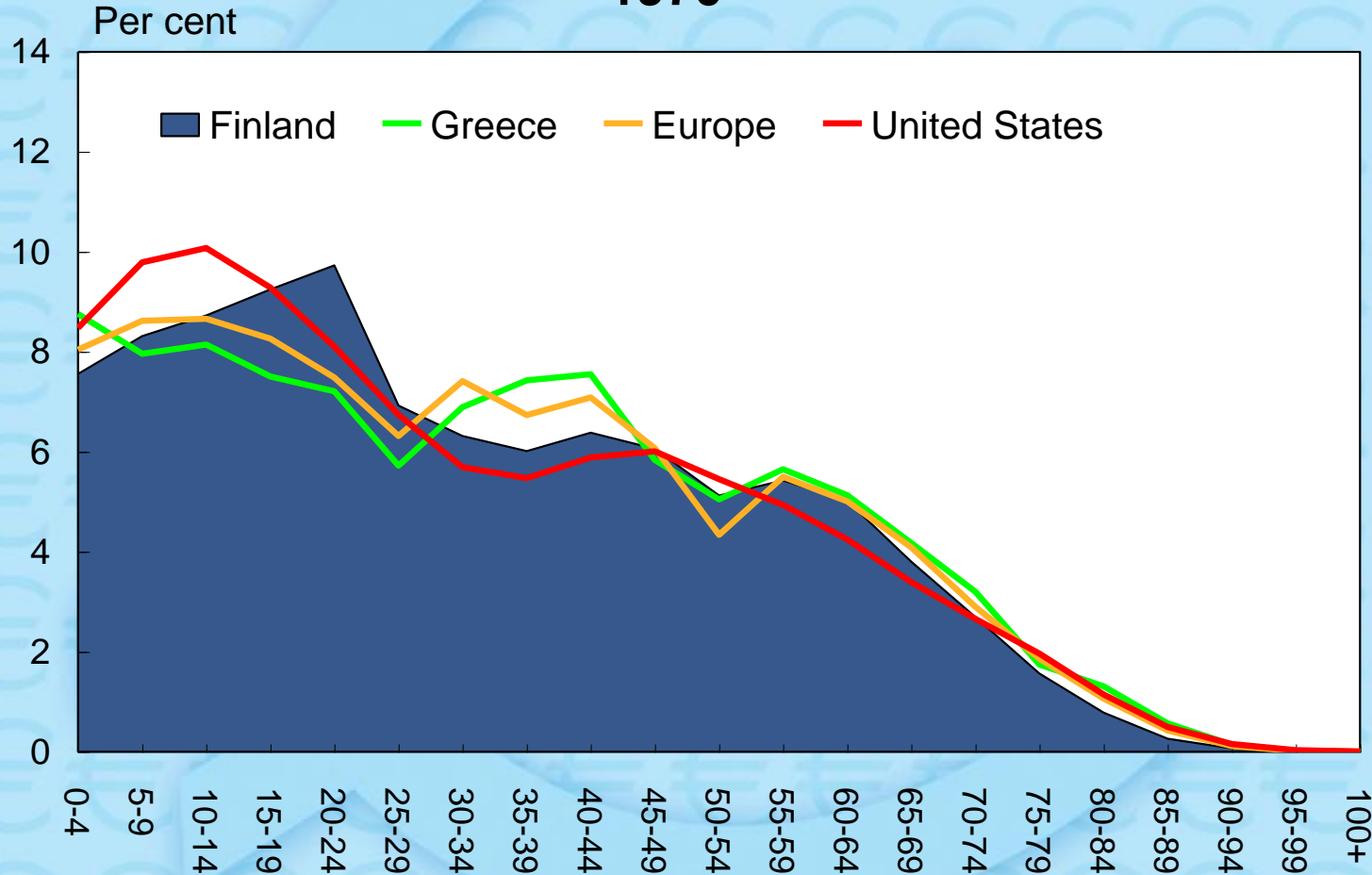
1965



Source: United Nations.

Demographic change: Ageing of the baby-boomers

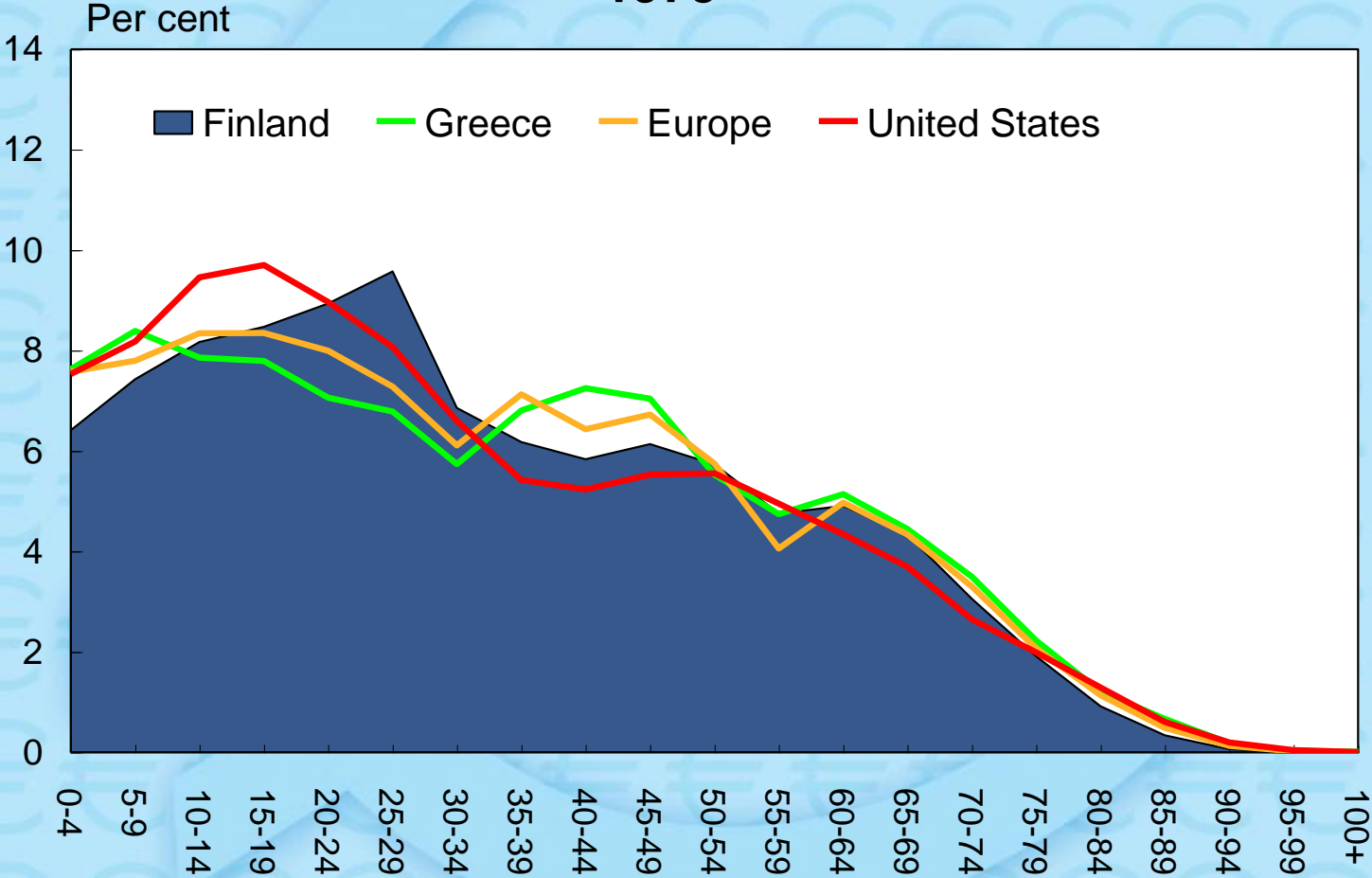
1970



Source: United Nations.

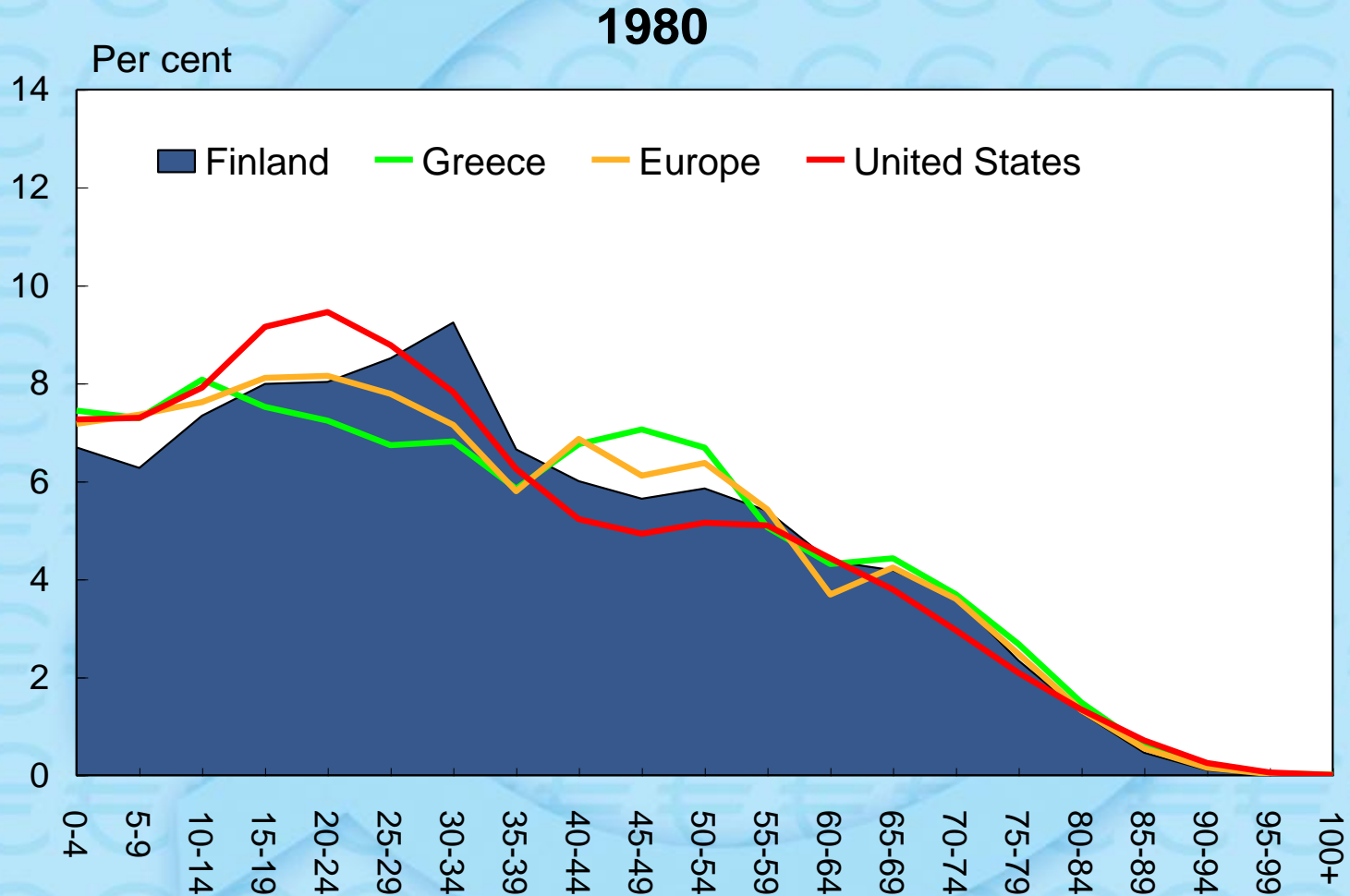
Demographic change: Ageing of the baby-boomers

1975



Source: United Nations.

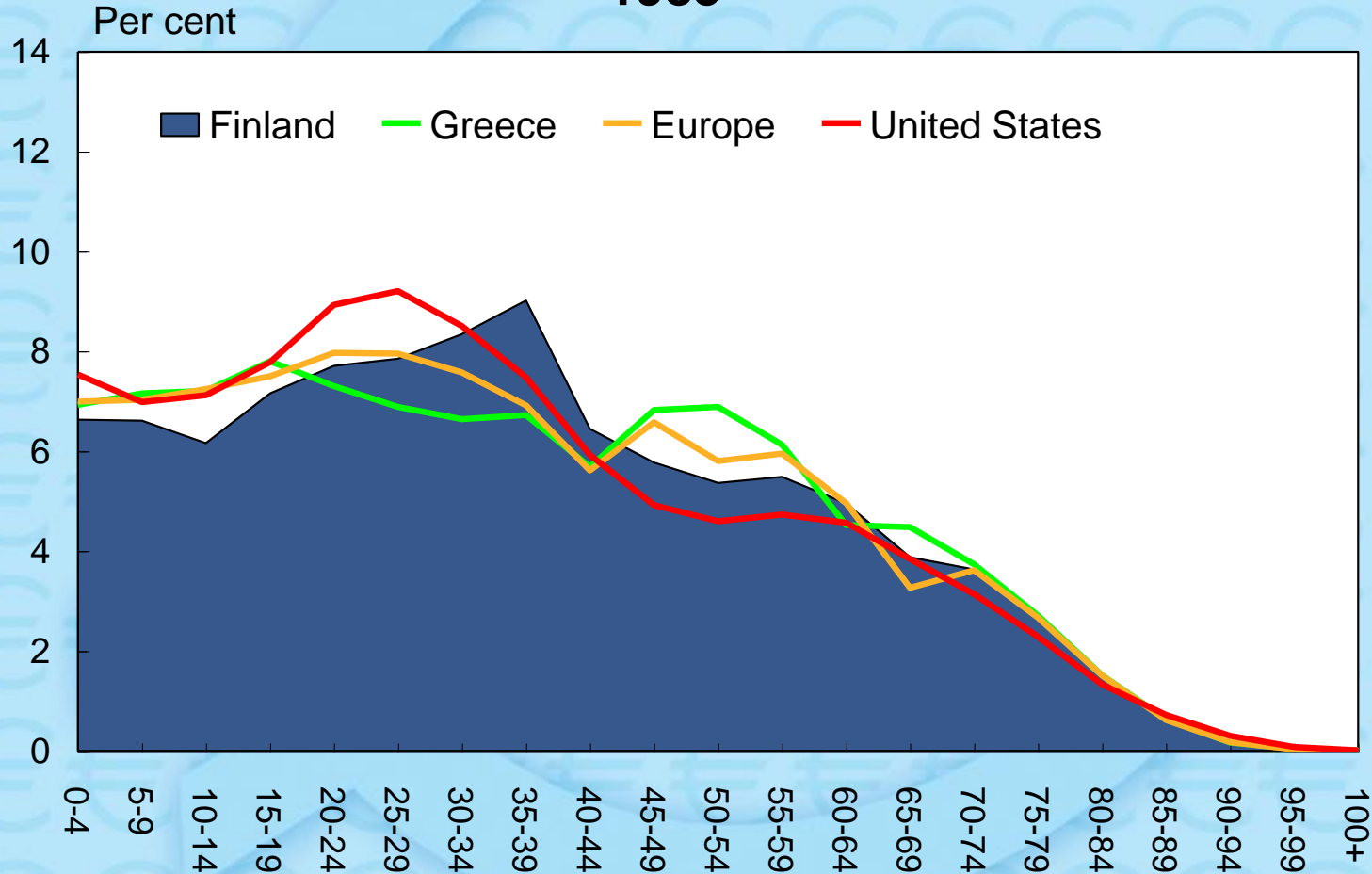
Demographic change: Ageing of the baby-boomers



Source: United Nations.

Demographic change: Ageing of the baby-boomers

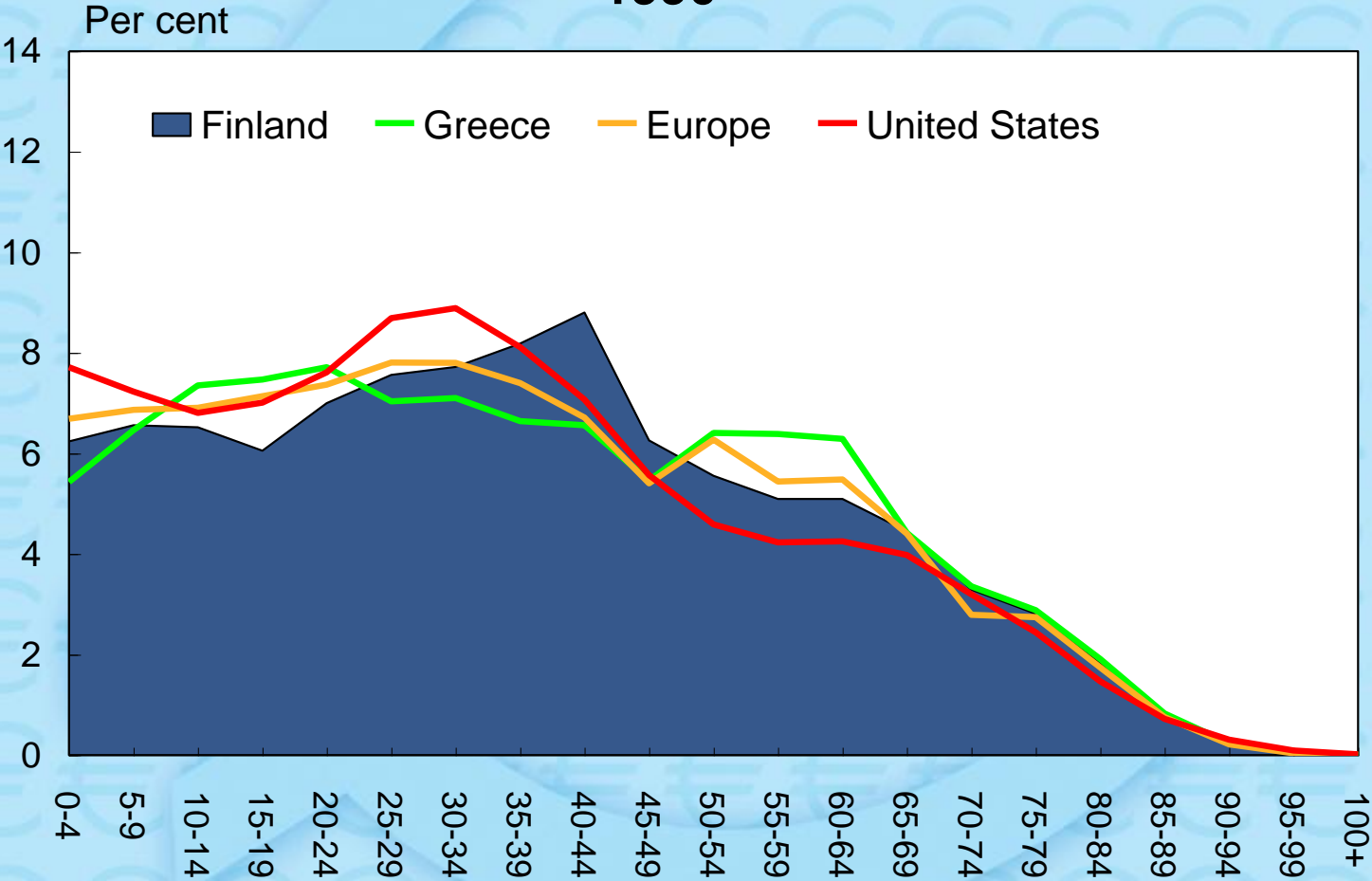
1985



Source: United Nations.

Demographic change: Ageing of the baby-boomers

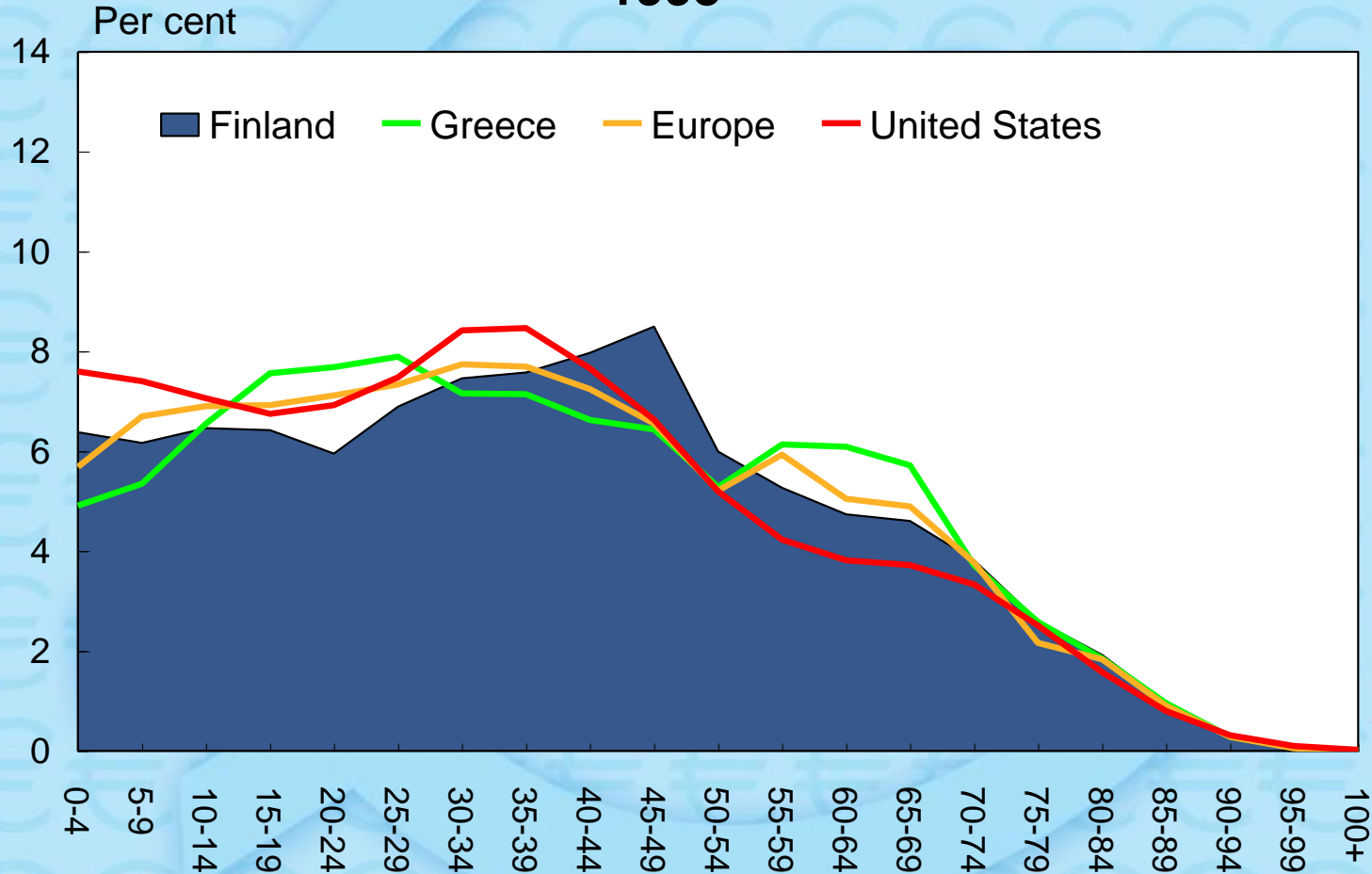
1990



Source: United Nations.

Demographic change: Ageing of the baby-boomers

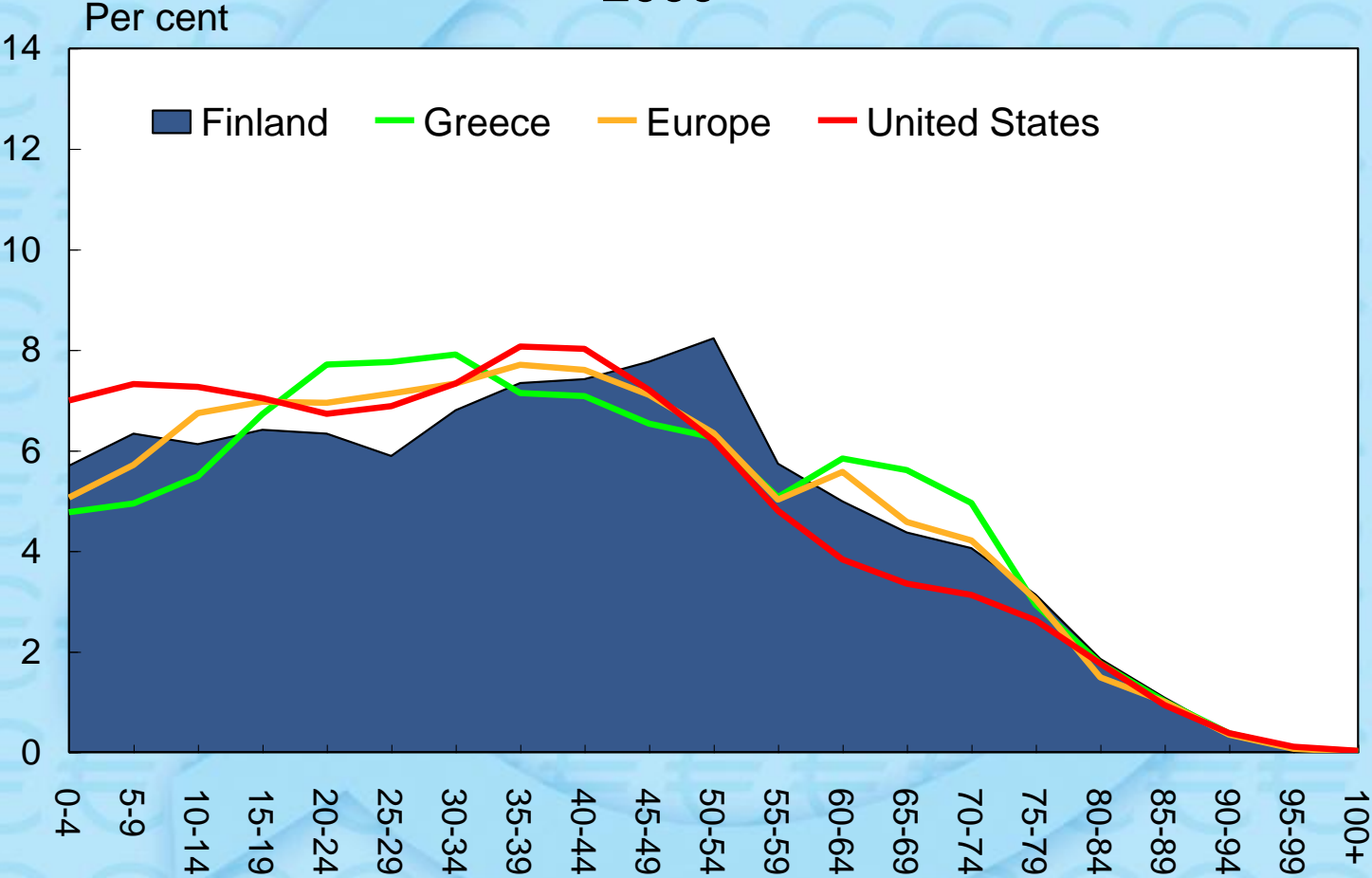
1995



Source: United Nations.

Demographic change: Ageing of the baby-boomers

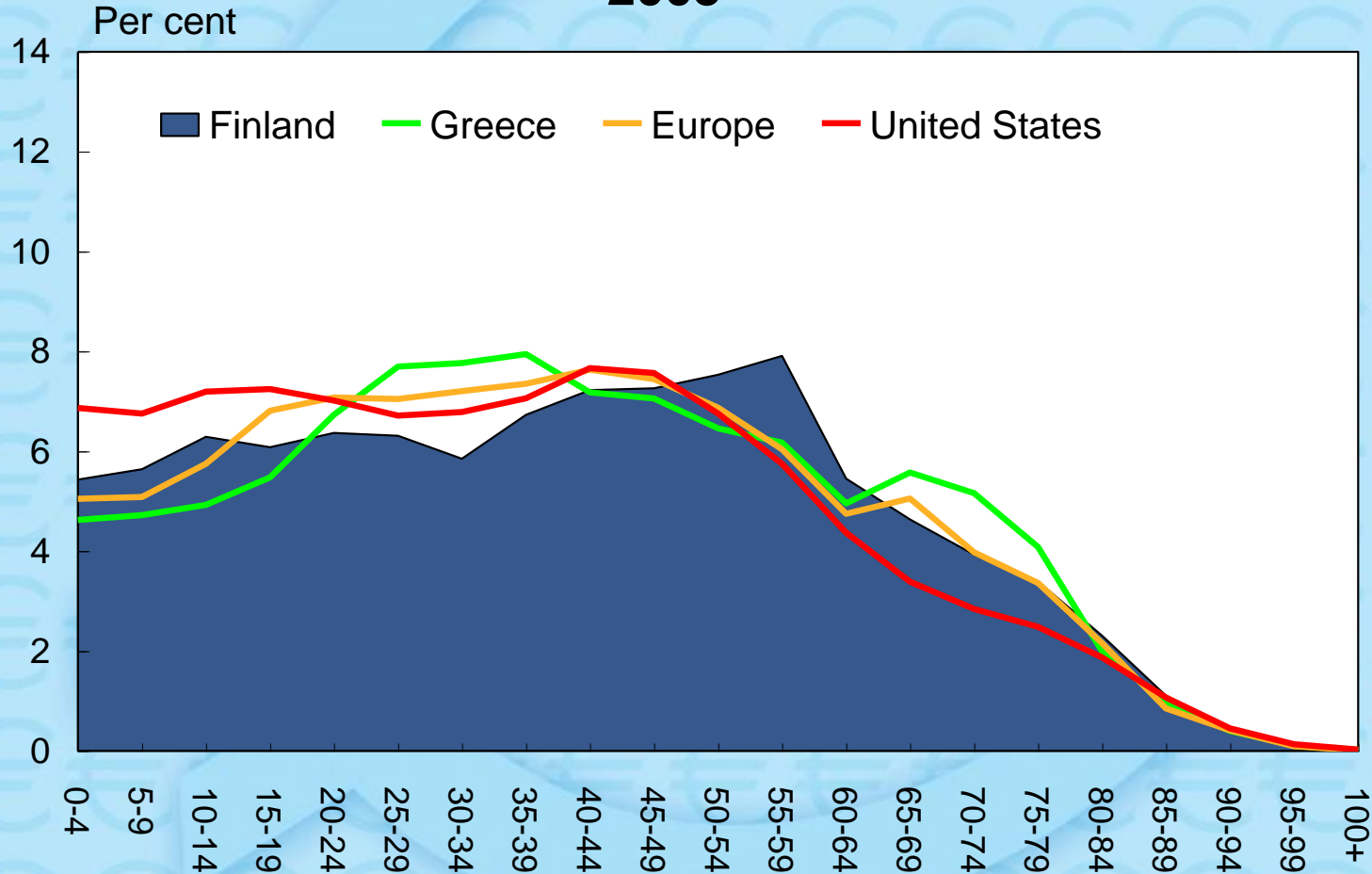
2000



Source: United Nations.

Demographic change: Ageing of the baby-boomers

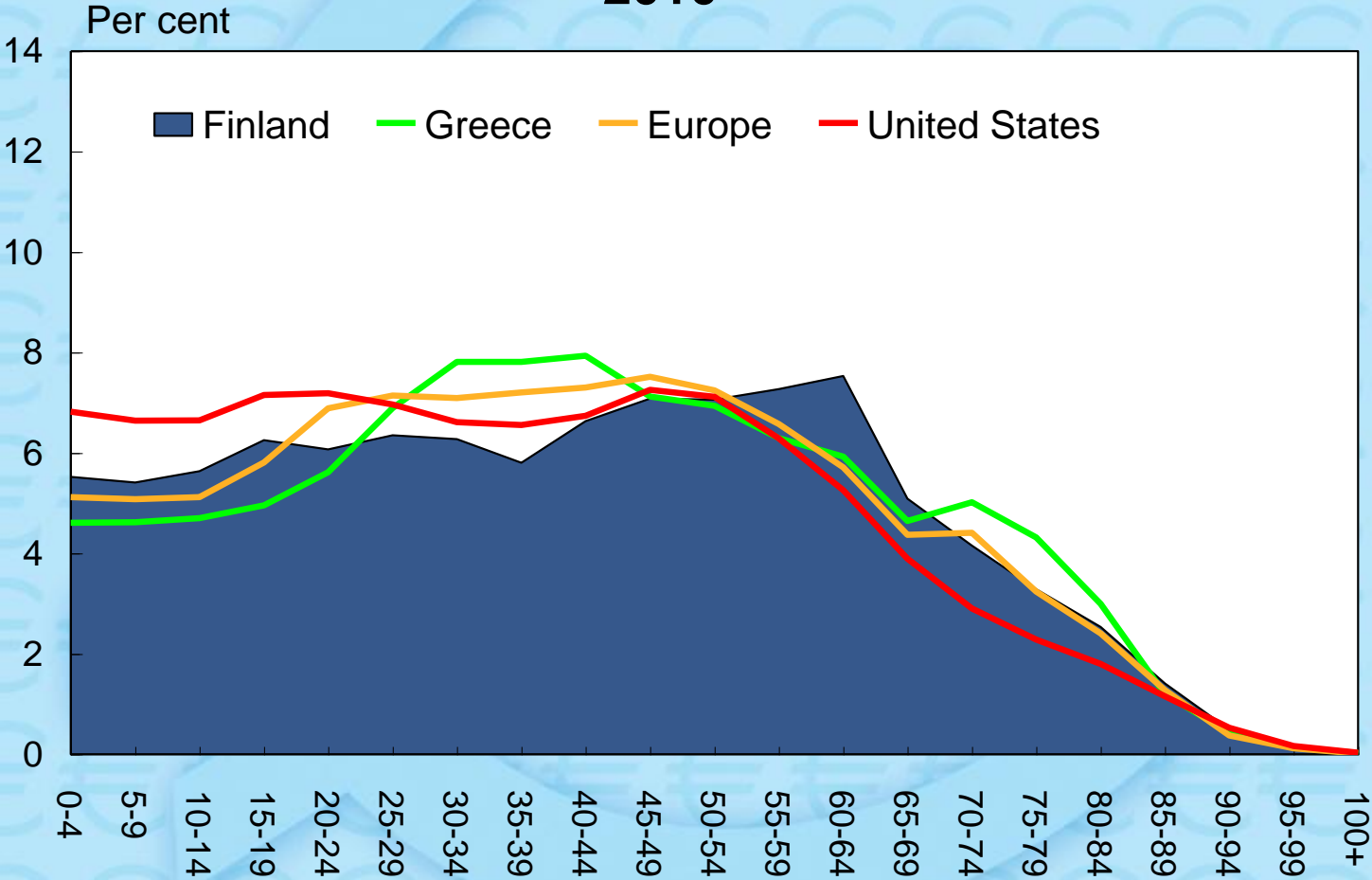
2005



Source: United Nations.

Demographic change: Ageing of the baby-boomers

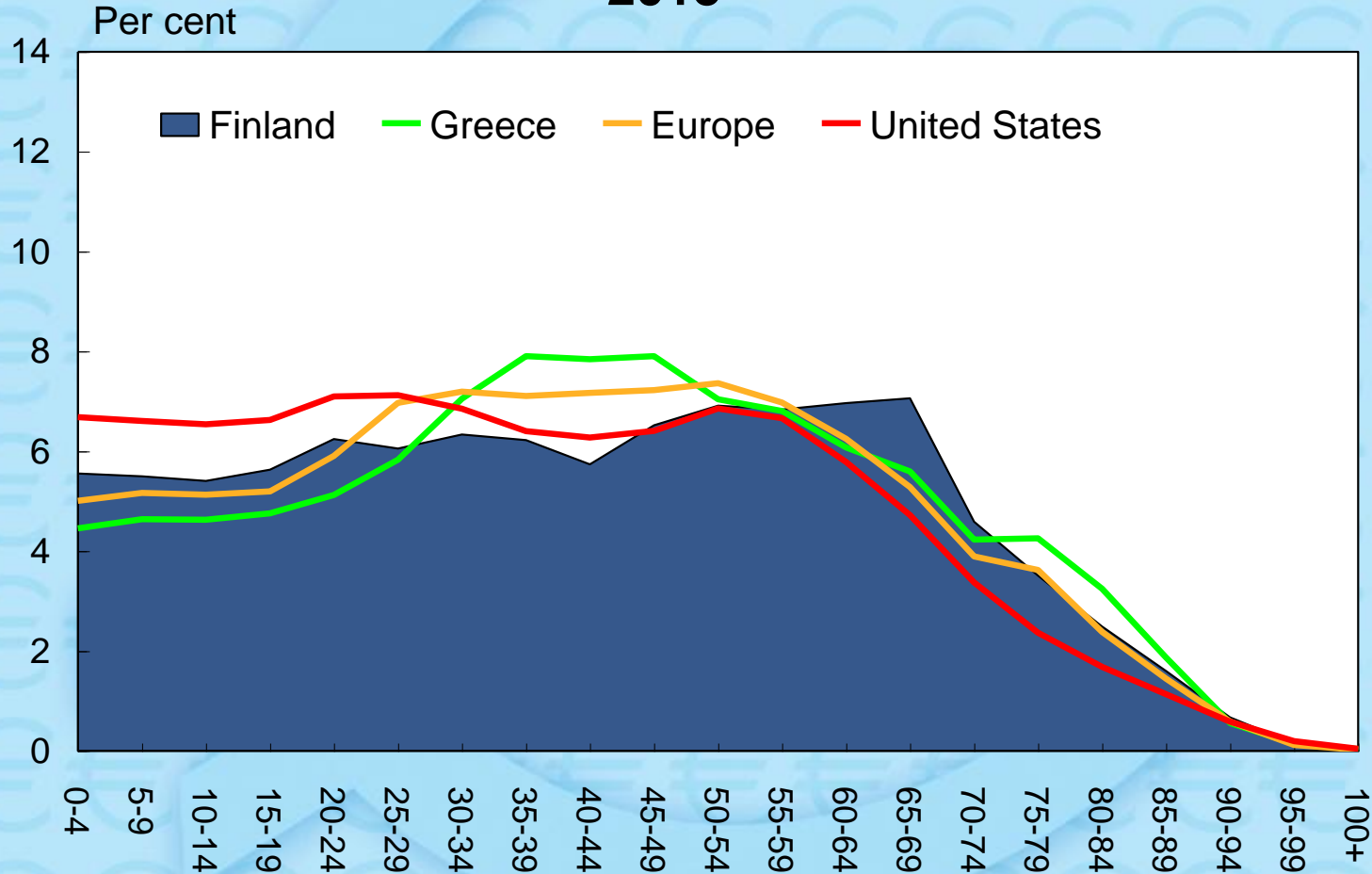
2010



Source: United Nations.

Demographic change: Ageing of the baby-boomers

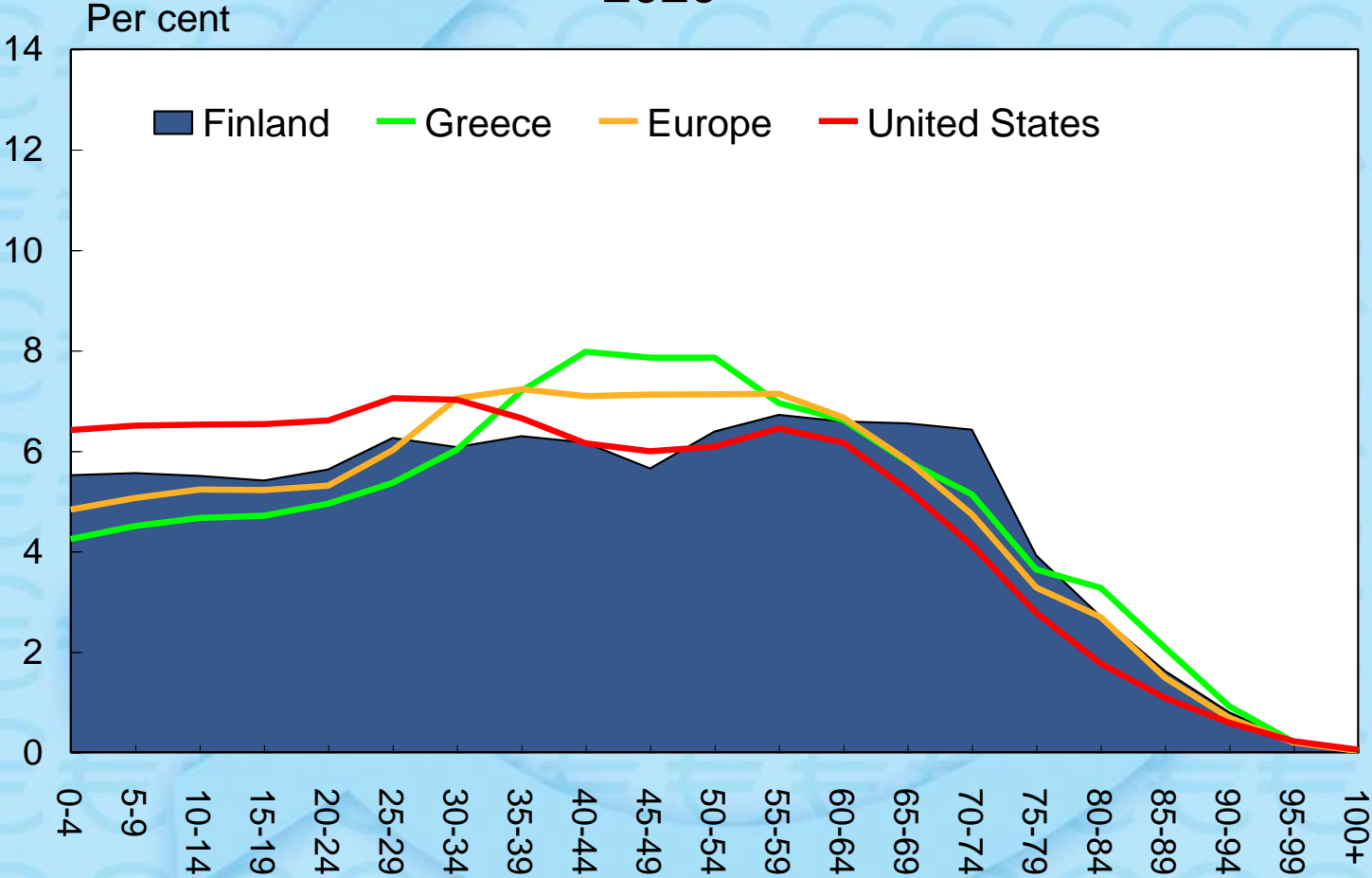
2015



Source: United Nations.

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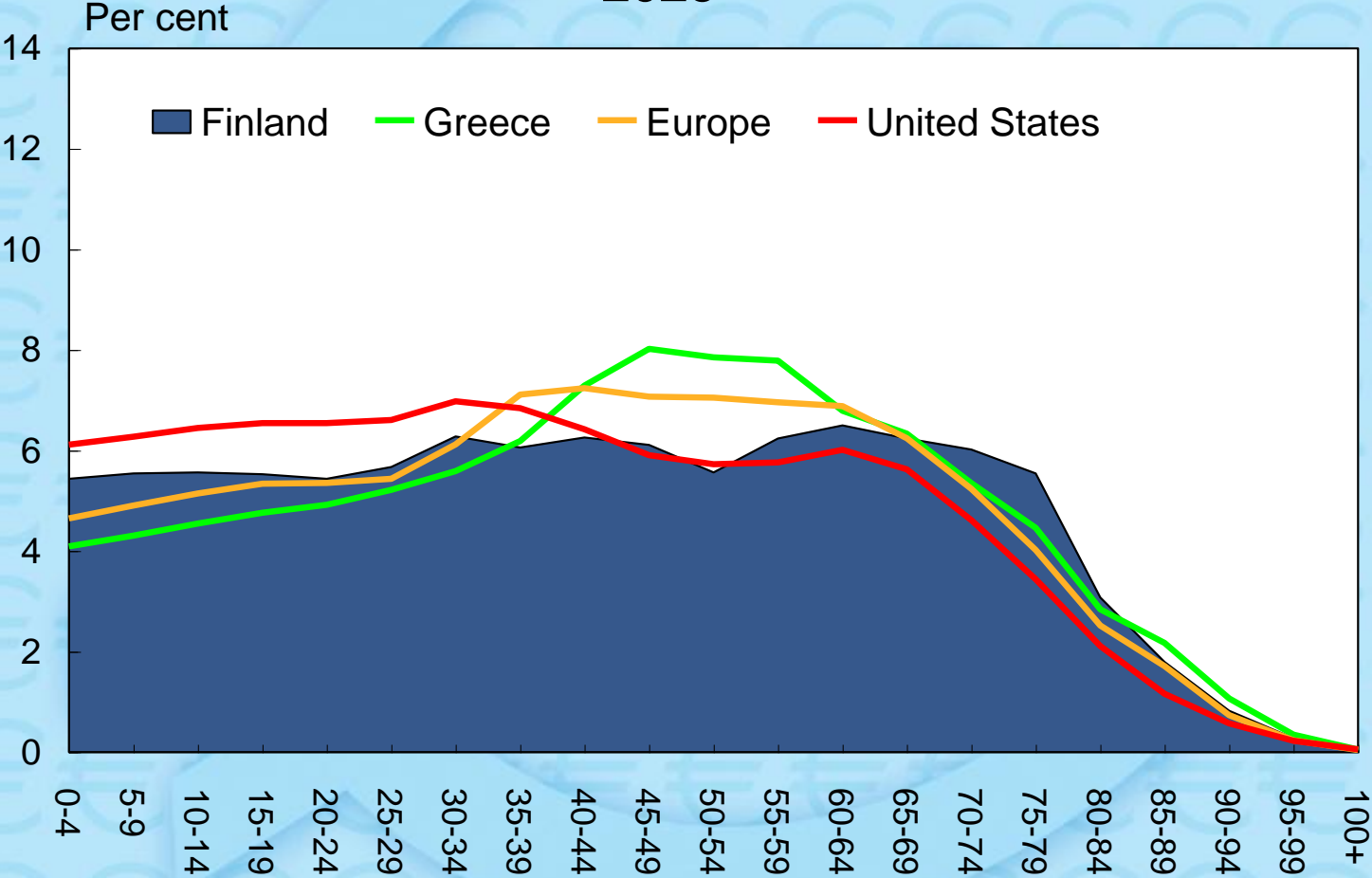
2020



Source: United Nations.

Demographic change: Ageing of the baby-boomers

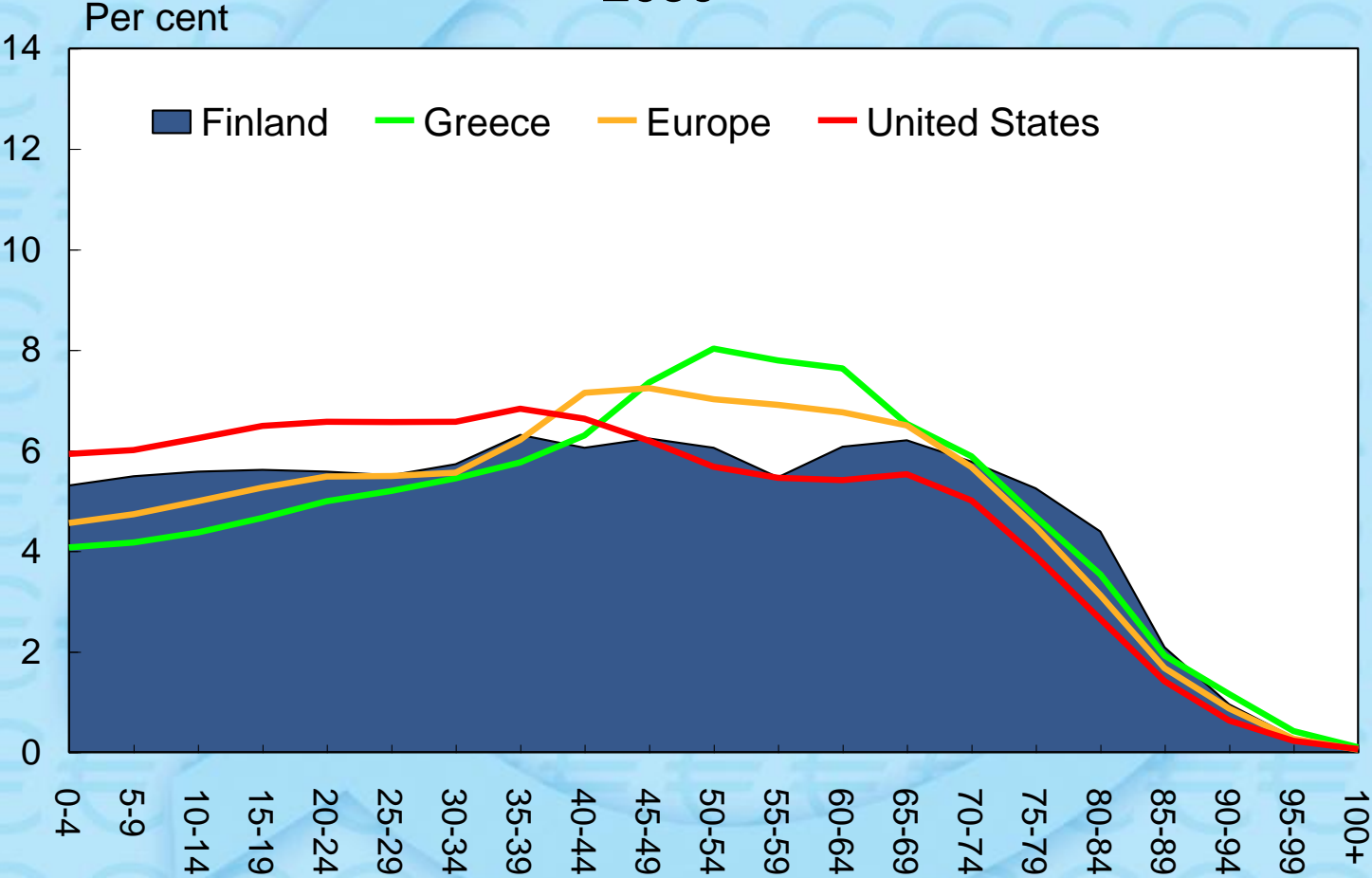
2025



Source: United Nations.

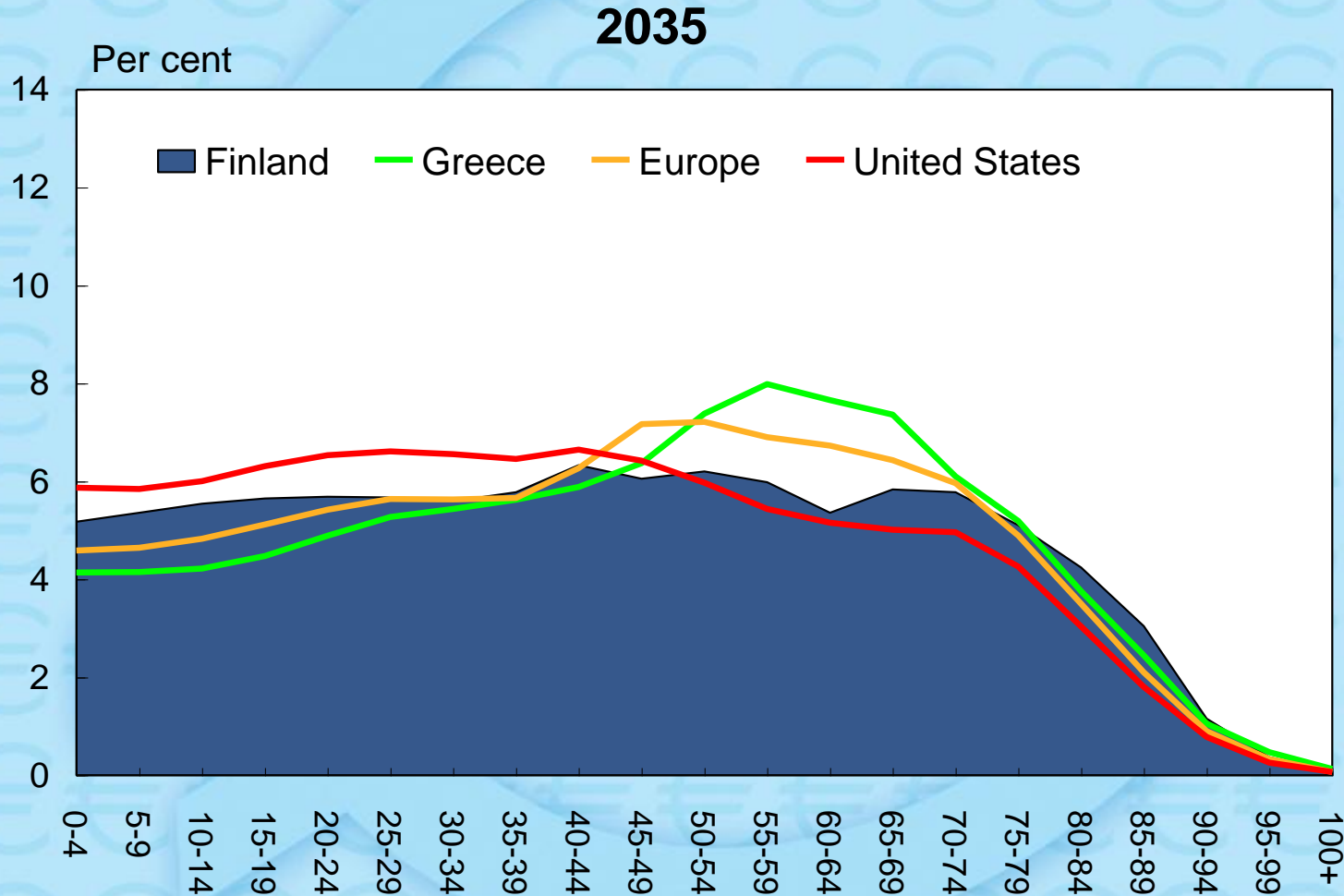
Demographic change: Ageing of the baby-boomers

2030



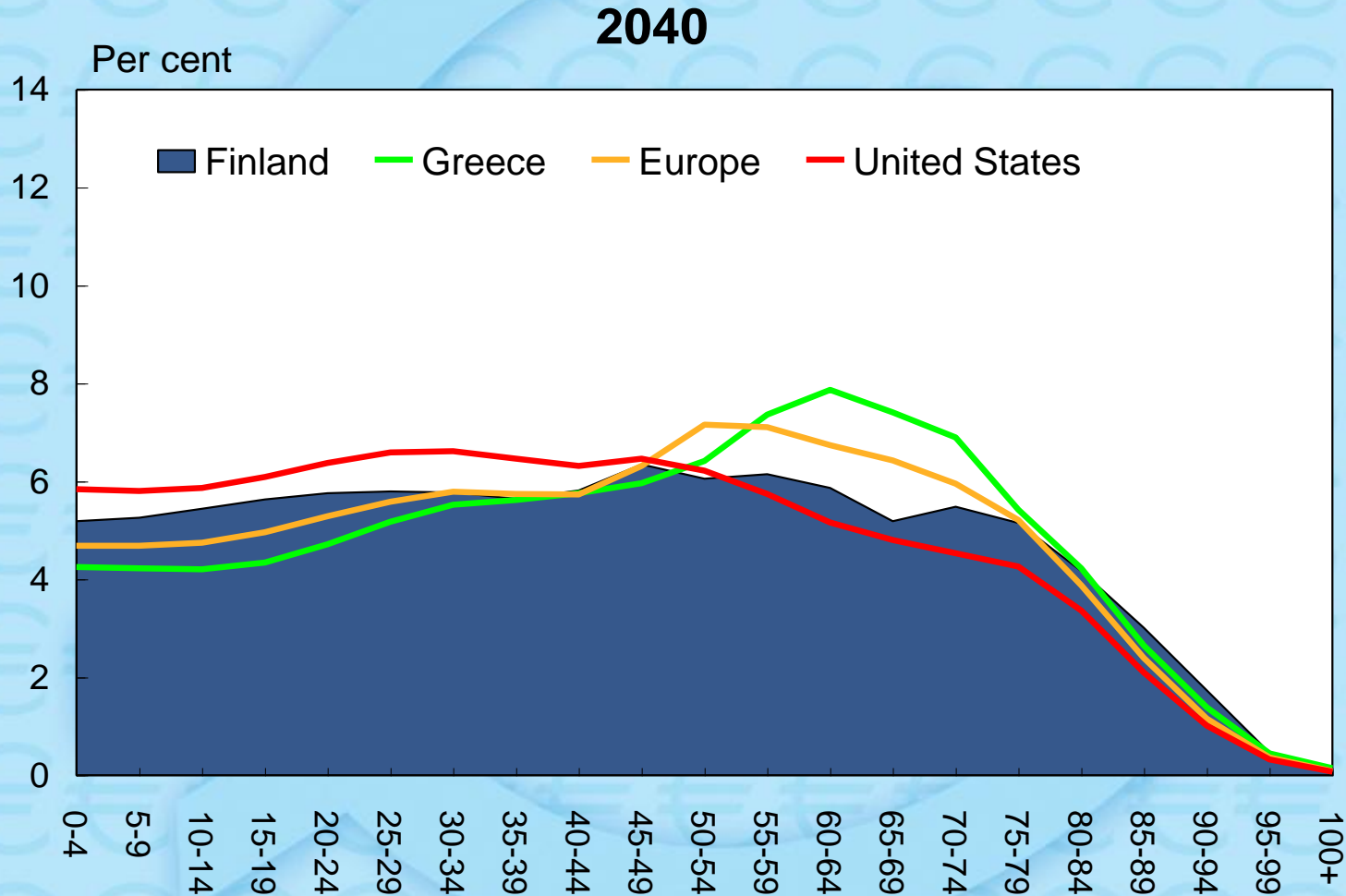
Source: United Nations.

Demographic change: Ageing of the baby-boomers



Source: United Nations.

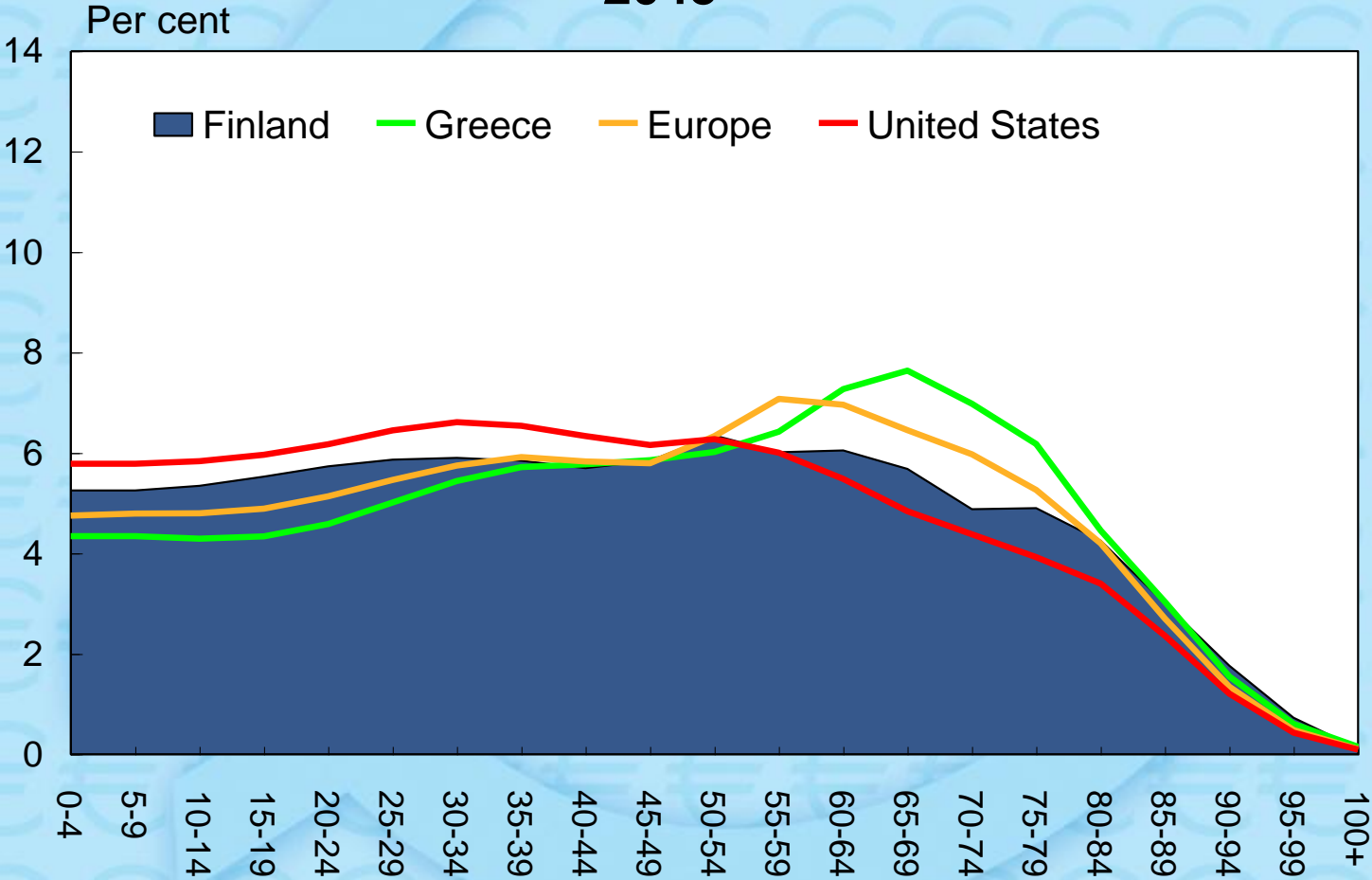
Demographic change: Ageing of the baby-boomers



Source: United Nations.

Demographic change: Ageing of the baby-boomers

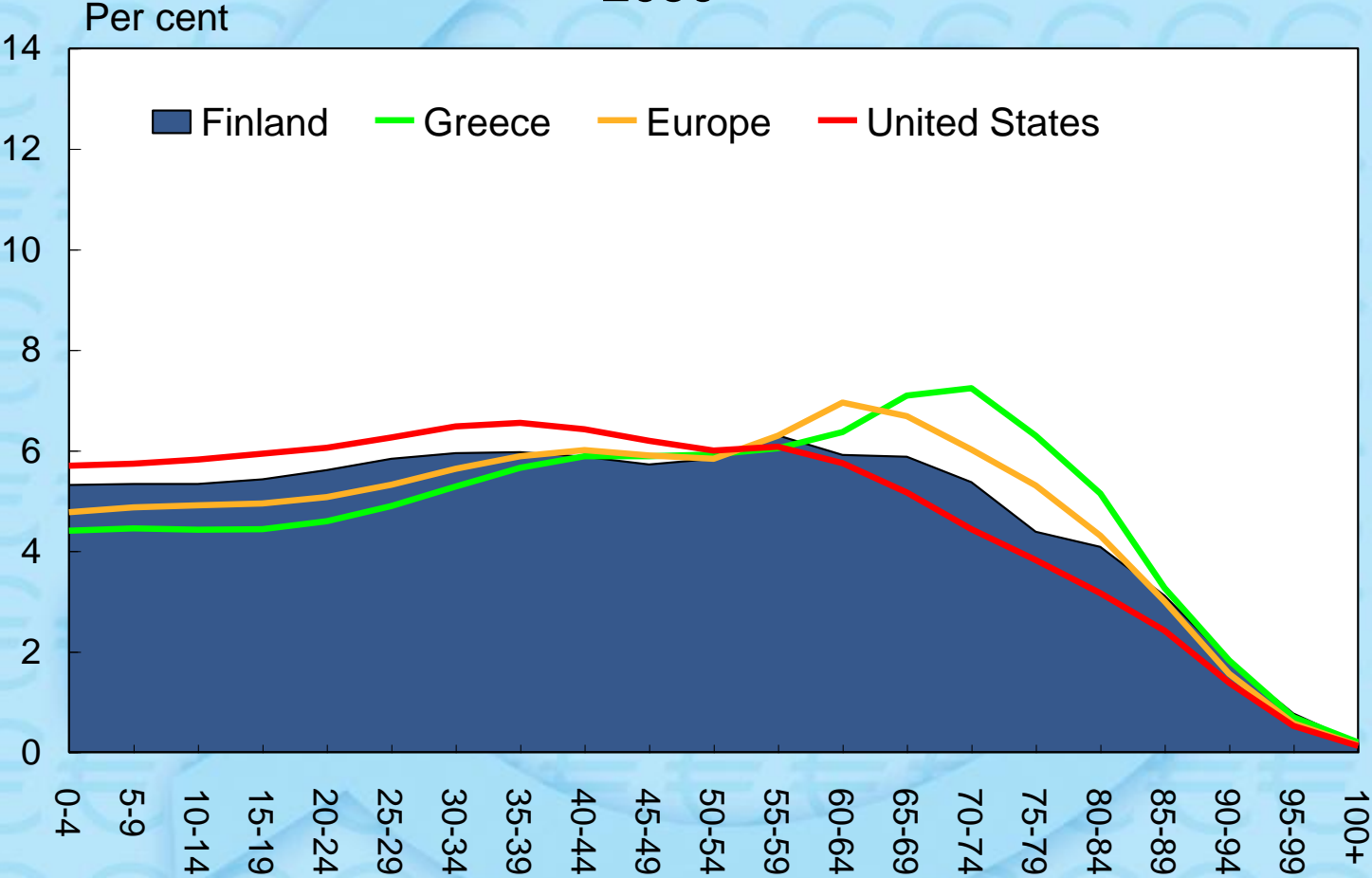
2045



Source: United Nations.

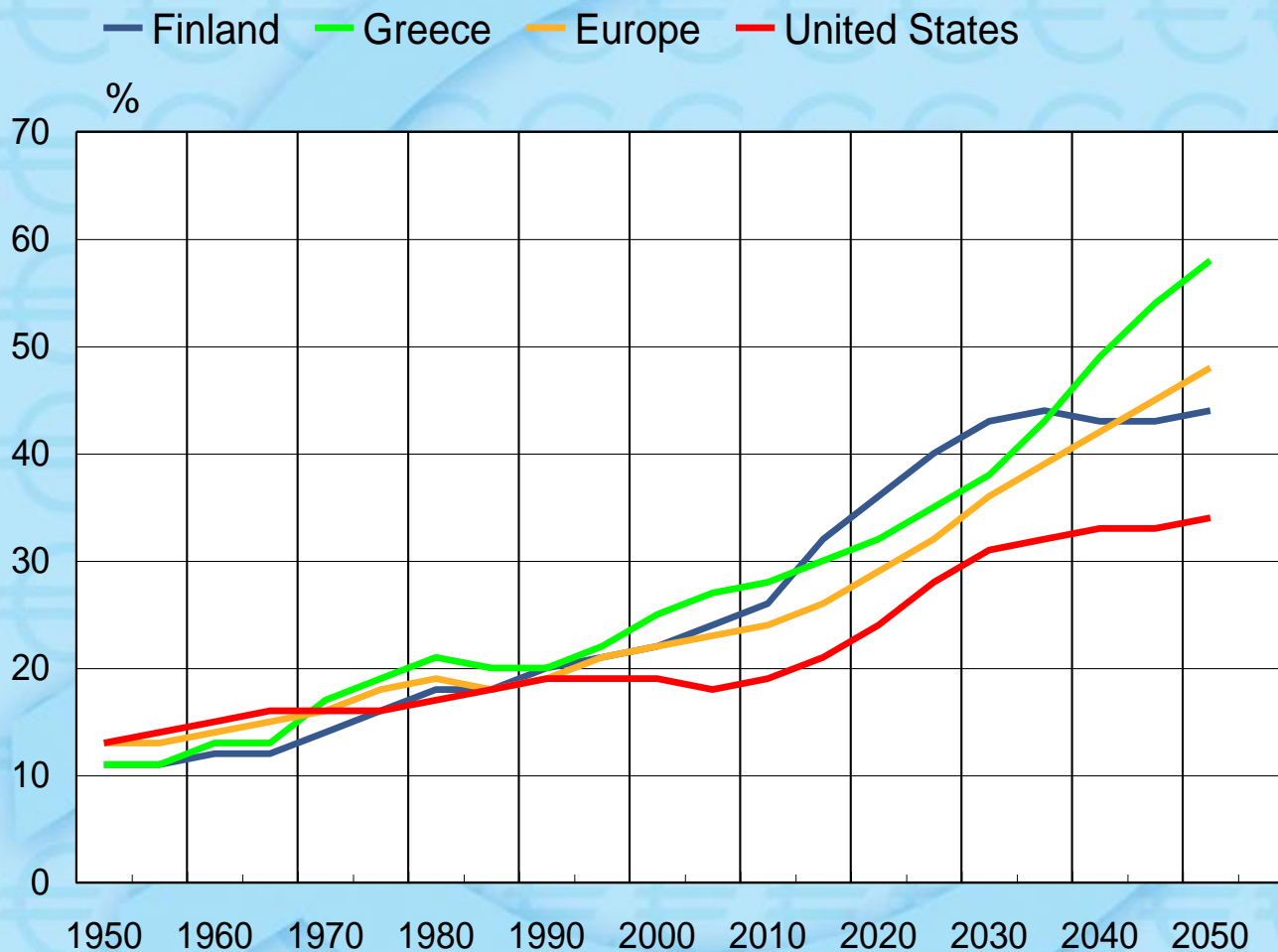
Demographic change: Ageing of the baby-boomers

2050



Source: United Nations.

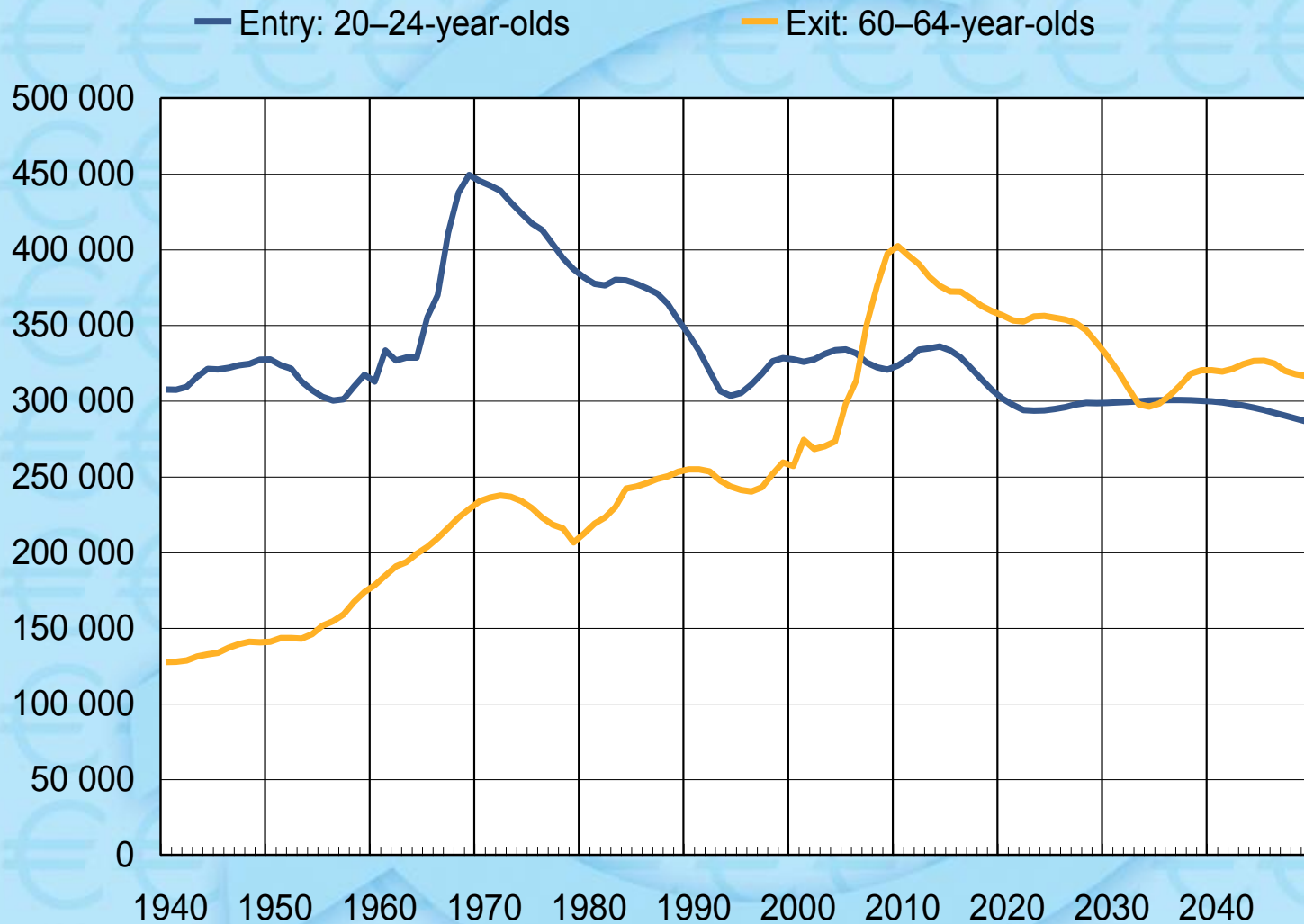
Old-age dependency ratios



The old-age dependency ratio is the ratio of the population aged 65 years or over to the population aged 15–64.

Source: United Nations.

Labour market entry and exit in Finland



Source: Statistics Finland.

Policy challenges

- ◆ Pension schemes under financial stress:
 - **Low fertility rate:** Baby-bust generation not able to finance baby-boom pensions => Need for pre-funding of pensions.
 - **Increasing longevity:** Steady increase in oldest age group => Need to lengthen economically active life span.
- ◆ Labour force starts to shrink
 - **Labour supply decisions** of the baby-boom generation are **critical:** If they do not stay longer at work, labour shortages will be big problem => Urgent need to increase retirement age.
- ◆ Spending on health and long-term care expands
 - **Demand for social and health services increases** dramatically => Need for productivity improvement in public services.

Finnish pension system: main features/1

- ◆ Two statutory pension schemes
 - 1. **National pension scheme** guarantees a minimum pension
 - 2. **Employment-based earnings-related** pension scheme
- ◆ Public pension benefits 11% of GDP in 2006
 - Earnings-related pensions were **9.5%** and national pensions **1.6%** of GDP.
 - National pensions are paid only when earnings-related pensions are very small.
- ◆ Occupational and voluntary pension schemes are negligible

Finnish pension system: main features/2

- ◆ Earnings-related pension scheme is partly funded
 - Pre-funded scheme covers a quarter of pension outlays.
 - The rest is financed through PAYG.
- ◆ Despite pre-funding, earnings-related pension scheme is of defined-benefit type
 - The pre-funding is collective; it has no effect on the size of the pension.
- ◆ Statutory pensions are taxed as earned income
- ◆ Financial position of earnings-related scheme:
 - The system is running a surplus amounting to 2–3% of GDP.
 - **The market value of pension fund assets was 66% of GDP in 2006.**
 - Mandatory pension funds have increasingly diversified their portfolios, also internationally.

The 2005 pension reform was designed to meet the challenges of ageing

- ◆ The main objectives of the reform were:
 - 1) to make the earnings-related pension system financially more sustainable;
 - 2) to increase labour market participation of senior employees; and
 - 3) to make the pension system more equitable and internally consistent.

Key elements of 2005 pension reform were designed to improve sustainability

- ◆ Increase in pre-funding
 - Current mandatory pension funds are large by international standards, but not large enough to smooth the demographic burden in Finland.
 - Funding of the pension schemes must be increased by 7.5% of the wage sum in 2006–2013.
- ◆ Benefits will be linked to life expectancy
 - Life-expectancy coefficient will adjust pensions to the changes in longevity as of 2009.

Key elements of the reform to increase labour market participation of senior employees

- ◆ A flexible retirement age from 63 to 68 has been introduced.
- ◆ Early pension schemes have been closed or tightened, and access to other pathways has been restricted.
- ◆ The accrual rate has been increased for senior employees.
 - For ages 18–52 pension will accrue at a rate of 1.5%, for ages 53–62 at 1.9% and for ages 63–68 at 4.5%.
 - Under the old system there was a standard rate.
- ◆ The cap on the replacement rate has been abolished.

Elements of the pension reform to make the system more equitable and internally consistent

- ◆ Benefits will be based on life-time earnings.
- ◆ Pension indexation rules have been changed.
 - The pension index is a mix: 20% weight for wages and 80% weight for consumer prices.
 - Before, the weights were 50/50 up to age 65, and after that 20/80.

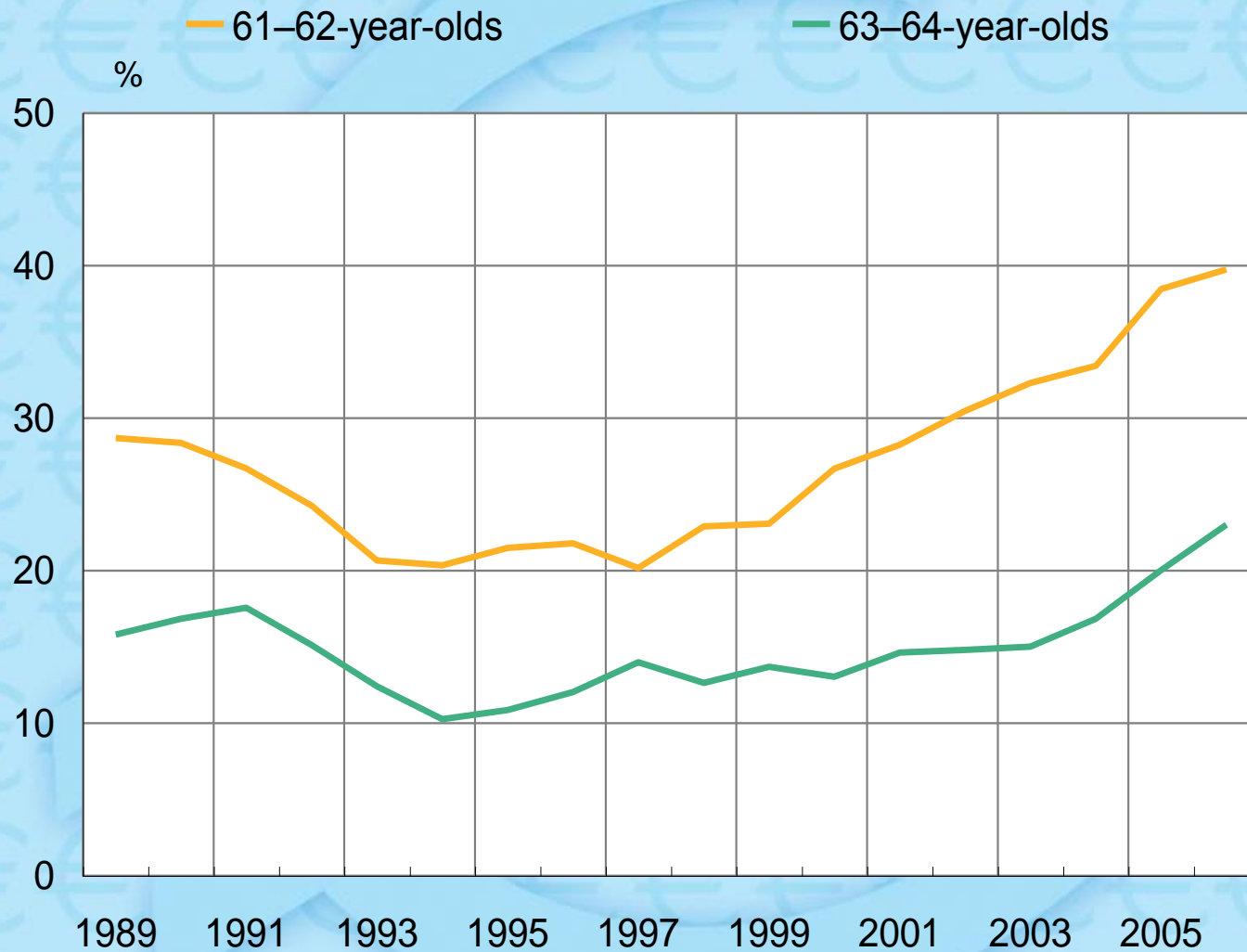
The objectives of the reform

- ◆ The effective pension age is expected to increase by about 3 years, from 60 to 63.
- ◆ The extension of the working careers of older workers is estimated to increase the overall employment rate by $\frac{1}{2}$ -1 percentage point.
- ◆ As a result, the need for an increase in the contribution rate is expected to fall 3-4 percentage points to 25%.



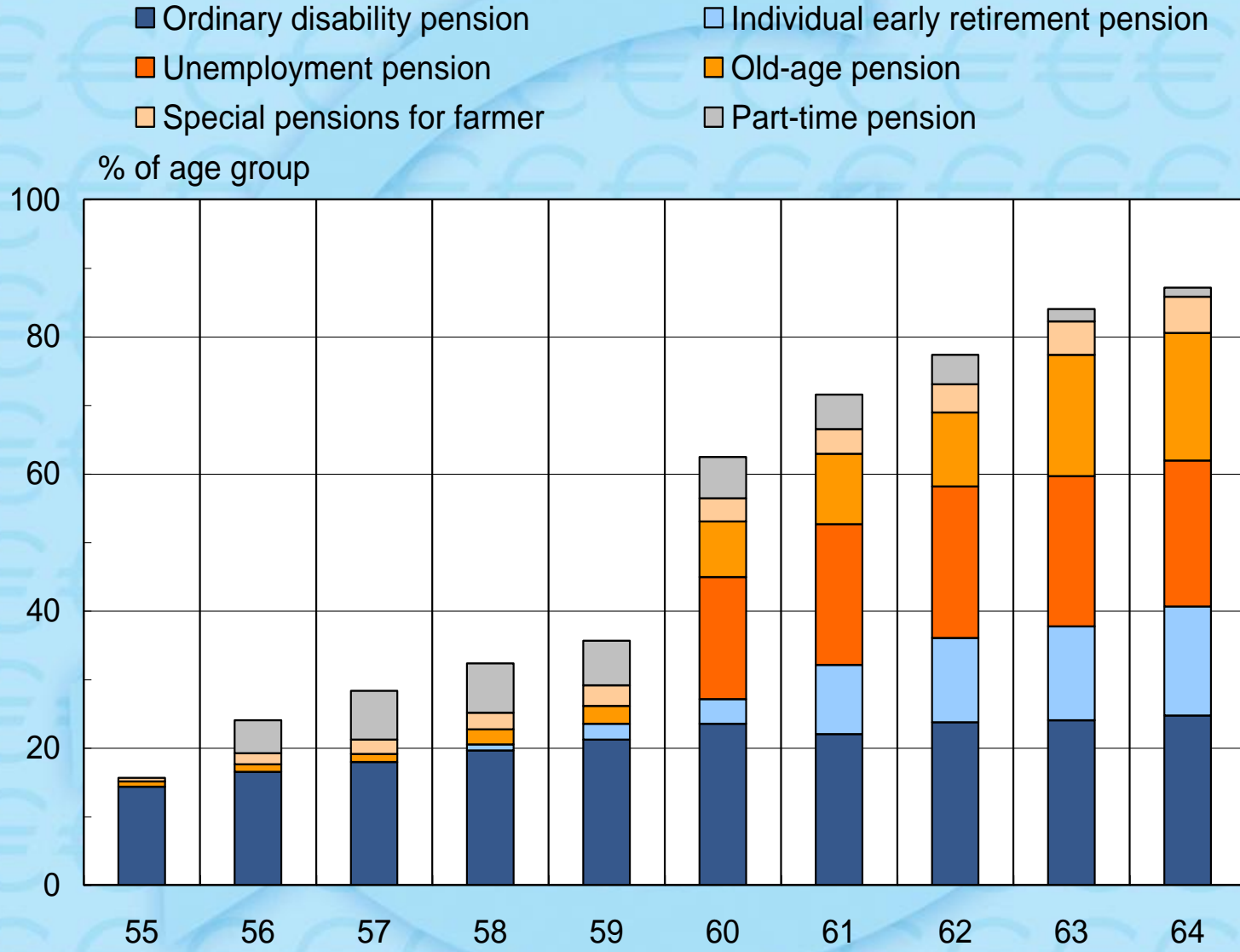
**Has the 2005 pension reform been a success?
What can we see from the latest data?**

Employment rate by age group



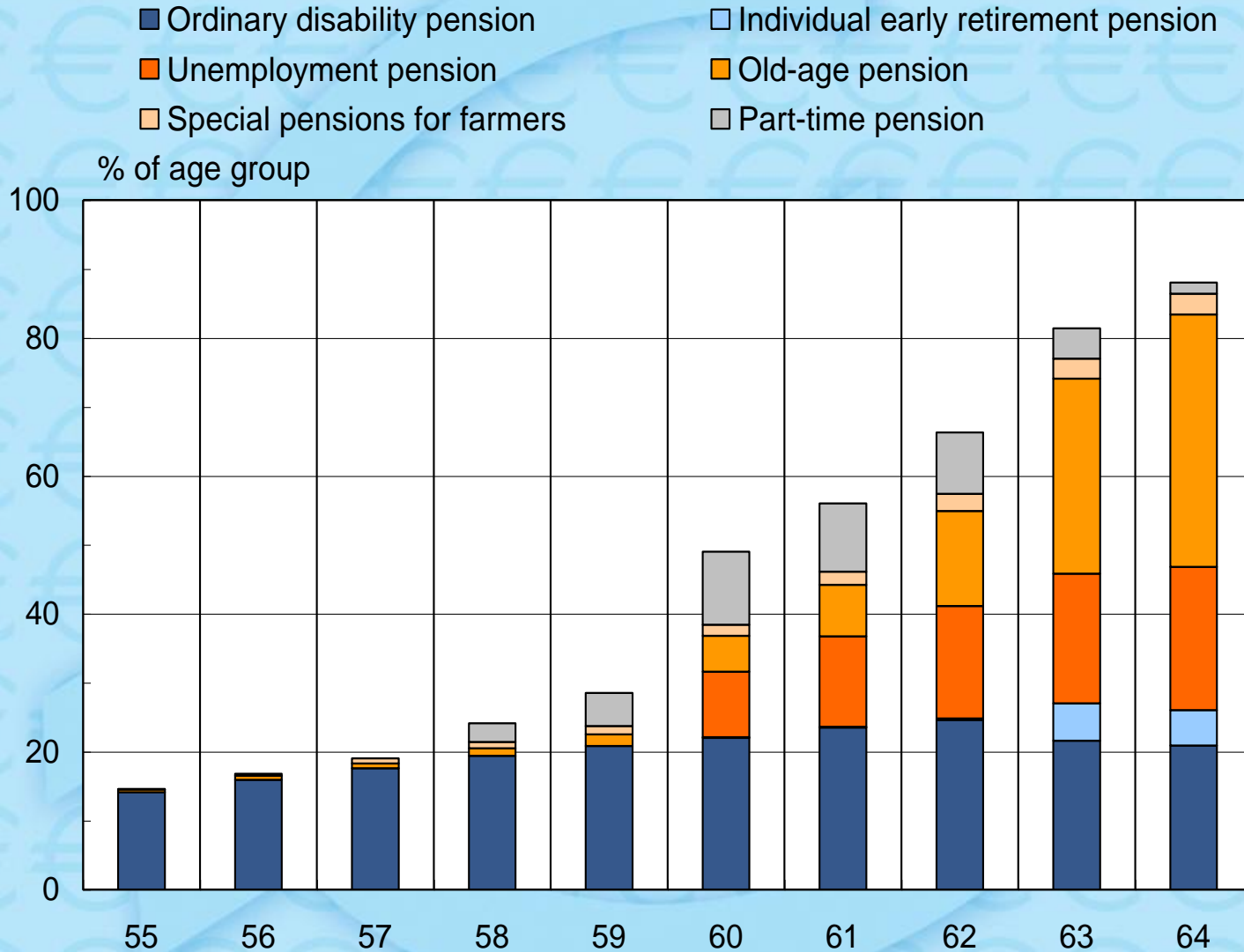
Source: Statistics Finland.

Pension reciprocity among the population aged 55–64, year 2000



Sources: Finnish Centre for Pensions and Social Insurance Institution of Finland.

Pension reciprocity among the population aged 55–64, year 2006



Sources: Finnish Centre for Pensions and Social Insurance Institution of Finland.

Future challenges

- ◆ The pension contribution rate will remain high even if the objectives of the reform are achieved. The reform will not be able to curb the need to raise the contribution rate.
 - Will the contribution rate be too high for competitiveness?
 - Will it cause efficiency losses? (According to a Bank of Finland study, the employment losses caused by contribution hikes could be substantial.)
- ◆ The long transition period protects older workers. Younger generations may challenge it.
 - The reform in unemployment pension schemes and life-expectancy adjustments will be effective only starting from age cohorts 1949 or 1950.
 - The introduction of a life-expectancy coefficient will favour older generations.
- ◆ Lack of transparency may counteract the positive labour supply effects.

Conclusions

- ◆ In Finland, ageing is not an issue of the future, but of today.
- ◆ Policy responses have been a combination of carrots and sticks.
 - Carrots: generous accrual ratio for old workers.
 - Sticks: life-expectancy adjustment in replacement ratio, and less favourable pension indexation.
- ◆ Today, the general view is that pension reform will ease the ageing pressures on the labour market and pension financing. But will it be enough?
- ◆ A huge challenge will be to increase productivity in social and health services.

A supplementary remark on supervision

- ◆ Mandatory pension funds are major actors on the financial markets. They are at present supervised by the insurance supervisor.
- ◆ The Finnish government has decided to merge the banking and insurance supervisors into a single financial supervisory authority.
- ◆ The new authority will start work in 2009. It will be attached to the Bank of Finland.