

EXECUTIVE SUMMARY

Arto Laesvuori, Ismo Risku, Juha Knuuti,
Sari Keski-Heikkilä and Hannu Uusitalo

Indexation of earnings-related pensions from the Employees’ Pensions Act (TEL) to the Employees Pensions Act (TyEL)

From the viewpoint of pension provision indexation is an important issue. If pensions were not index-linked, already an annual inflation of two per cent would eat up 40 per cent of the purchasing power of the pension in 25 years.

The history of the indexation of earnings-related pensions can be summarised as follows:

	Adjusting earnings to the level of the year of retirement	Index adjustment of pensions in payment
1962–76	Earnings level index	Earnings level index
1977–95	fifty-fifty index: the weighting of the change in earnings level in the index is 50 per cent and that of the change in price level 50 per cent	fifty-fifty index
1996–2004	fifty-fifty index	bent index in relation to age: pensions of persons aged under 65 with the fifty-fifty index, adjustment of the pensions of persons who have reached the age of 65 with the TEL index for persons of retirement age, where the weighting of the change in earnings level is 20 per cent and that of the change in prices 80 per cent
2005–	wage coefficient: the weighting of the change in earnings level is 80 per cent and that of the change in prices 20 per cent	earnings-related pension index: the weighting of the change in earnings level is 20 per cent and that of the change in prices 80 per cent

The index adjustments of earnings-related pensions and residence-based national pensions are unequivocally laid down by law and under the provisions they are not discretionary. The national pension index is determined on the basis of the changes in the consumer price level. In addition, overall general increases to the national pensions have been made through separate decisions. The earnings-related pension index and the wage coefficient are, for their part, determined on the basis of the changes in consumer prices and the earnings level. When calculating the pension indices the indicators used for the price and earnings levels are the official indices calculated by Statistics Finland.

A comparison of the indexation of statutory pensions in 31 countries indicates considerable variation between the countries. The general trend seems to be a weakening of indexation. However, all the countries have some kind of adjustment procedures for at least some part of pension provision, which strive to give protection at least for inflation. The Finnish earnings-related pension index and wage coefficient may be considered as taking a position roughly midway on the variation range.

In 1995–2008 there was a lively debate on indexation in Parliament. In 1995–2008 the Members of the Finnish Parliament introduced a total of 95 motions, written questions or corresponding motions regarding the indexation of pensions. The number of signatories totalled nearly 700. The motions requested an index that better than the earnings-related pension index would follow the growth in earnings level, for instance a return to the fifty-fifty index. There was doubt about the ability of the consumer price index to measure the change in pensioners' cost of living and changes were demanded to the contents of the index.

The same topics have also been visible in the public debate. The discussion in the media can be summarised as criticism of the earnings-related pension index and suggestions of a return to the fifty-fifty index, or at least in that direction. Other less visible topics have concerned the lag of the earnings-related pension index and the question of how well the consumer price index measures changes in pensioners' cost of consumption.

There are good reasons to base the consumer price index on a real, observed consumption structure. In the long term the effects of excluding a commodity or group of commodities (e.g. alcohol, fuels) are quite small, since the prices of the commodities develop at a different pace at different times. Another suggestion in relation to indices has been that the price development used as the basis for adjustment of pensions should be based on pensioners' consumption, not the consumption of the population as a whole. This viewpoint can be considered well-founded. Assessed on the basis of past development, a switch to an index based on pensioners' own consumption would in the long term be cost neutral, however. From the pension recipient's viewpoint the change may have the advantage that the index would provide a more fair compensation than the current procedure, for instance, for exceptional price occurrences. In practice there are no information basis and system to construct an index for pensioners, however.

In the parliamentary and public debate the lag of the pension indices has been considered a problem. For instance, the 2008 adjustment was under-dimensioned in relation to the inflation of that year. This was compensated in the pensions at the beginning of 2009, when the adjustment of the earnings-related pensions was affected by both the high inflation in 2008 and the considerable wage increases. In the long term nothing is excluded from the index adjustments of pensions due to the lag, but the lag may cause problems for persons with small pensions, if the increase in price and earnings levels is accelerating. The lag in the pension indices cannot be shortened, however, if the indices are to be based on the realised development. One alternative is to include in the index a projection of the future price and wage development or base it entirely on a projected development. This would, however, weaken the transparency and clarity of index adjustments.

One reason stated at the time for the switch from the fifty-fifty index to the bent index was, among others, that consumption surveys indicated that the person's age affected consumption needs. This still holds true: the consumption of old-age pensioners is more strongly focused on so-called necessities and a larger proportion of the income is saved as compared to people of working age. On the other hand, pensioners' saving rate decreased between 2001 and 2006, whereas the saving rate of people of working age increased. The financial problems experienced by pensioners increased in 2003–2006, whereas they decreased among the population as a whole.

The public debate on indexation can be summarised in the question of whether the pension index should follow the development in earnings level with a higher weighting than currently. A switch to the fifty-fifty index would increase pension levels and earnings-related pension expenditure. The annual index increase would rise by a good half a percentage point, if the real growth in earnings level is of the same size as in the past. For some years the effects of the change in indexation rule on pension expenditure would not yet be significant. After several years increases of half a percentage point would, however, cumulate. When the typical time in retirement is approximately 24 years, a change in the index would raise the level of the earnings-related pension by about six per cent on average.

In relation to the wage sum the pension expenditure would increase by two percentage points. In 2007 the need to increase the TyEL contribution was estimated at four percentage points. A switch to the fifty-fifty index would mean that the TyEL contribution should be increased from the current level of about 21 per cent to 27 per cent.

The generational effects of the change would be problematic. The oldest persons receiving the smallest pensions who were born at the beginning of the 1920s and earlier would not have time to gain from the change. A switch to the fifty-fifty index would increase the pension incomes of the cohorts born at the end of the 1940s and later. The increase in the pension contribution due to the index change would not have time to concern them. However, the significance of a gradually increasing contribution becomes considerable. All cohorts born

before the 1980s would receive more income following the index change than they would have to pay contributions, but for the cohorts born after the beginning of the 1980s the net effect of the index change would be negative, i.e. the increase in contribution would be larger than the gain from a more favourable index.

In principle it would of course be possible to return to the adjustment method of the initial years of the scheme, namely adjust pensions in payment by, for instance, an earnings level index. If pension expenditure is not to be increased at the same time, it would require, however, considerable reduction in the current initial amount of the pension, for instance, by reducing the accrual rates. The generational effects would also be negative, and in practice the implementation of such a change would only be possible over a very long transition period. In principle it would also be possible to determine the accrual rates so that the initial pension is considerably higher than at present, but correspondingly the indexation during the time in retirement is significantly weakened. In the 2005 pension reform a solution was sought in between the extremes by improving the indexation for the earnings during the working career and weakening the indexation of pensions in payment for pension recipients aged under 65. The reduction was, however, compensated by the lump-sum increase payable to disability pensions after five years of payment.

A possible index change, for instance, a return to the fifty-fifty index in the index adjustment of pensions, would also not solve the income problems of pensioners, which, according to an assessment of the Finnish pension scheme made by the EU, concern especially older women due to the low pension level.

The Publication is available only in Finnish:

Työeläkkeiden indeksisuoja TEL:stä TyEL:iin. Eläketurvakeskuksen raportteja 2009:1.

More information:

Arto Laesvuori

E-mail: arto.laesvuori@etk.fi

Telephone: +358 10 751 2149

Ordering of publications:

aineistotilaukset@etk.fi

ISSN 1236-5948

ISBN 978-951-691-110-9 (PDF)

ISBN 978-951-691-109-3 (printed book)