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# EXECUTIVE SUMMARY

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## Employer liability in disability pension costs

Prolonging working careers has been a debated topic in Finland for a long time. The discussion has covered prolonging working life in its initial, final and mid-stages. Disability is the principal cause of an early exit from working life. Up to 2004, it was more common to retire on disability pension than to retire directly on old-age pension. Since then, the situation has improved as a growing number of people retire directly on old-age pension, while an increasingly smaller number of people exit working life via disability pension. Nevertheless, disability pension remains the most common form of early retirement and is thus in a crucial position when it comes to prolonging careers at the end of working life.

In this report, we examine employers' disability pension contributions under a former excess model and current experience rating model. Since the birth of the former Employees' Pensions Act (TEL), big employers have been liable to cover, partially or in full, the disability pension costs of their employees. In the excess model, an employer above a certain size threshold had to pay an excess to the pension provider in the year in which a disability pension was granted to its employee. This model was considered to function well, but as the international accounting standards (IFRS) came into force in the early 2000s, the structure of disability contributions had to be amended. As a result, the excess model was replaced in 2006 by a model of experience rating (or a contribution category model).

Although the underlying principle of employer liability has transferred to the new model in the sense that a company's disability contribution depends on the costs of disability pensions awarded to its employees, the structure of the current model differs significantly from that of the previous one. In the excess model, an employer was charged a portion of the realised costs of its employees' disability pensions in addition to a flat-rate contribution. The size of the excess was proportional to the size of the company. In the experience rating model, on

the other hand, the disability pension costs of a company's employees affect the calculation of the company's risk level. The company's risk level affects the company's annual disability pension contribution with a lag of two to three years. The weight of the risk level in the calculation of the disability pension contribution is proportional to the size of the company. Thus, the intention is not to charge the employer for direct costs of a certain pension but to determine an employer's disability contribution according to the company's risk level.

Another central difference between the two models is how the disability costs are allocated over time. In the excess model, the cost was realised already in the year in which the pension was granted, while in the experience rating model, the cost is realised two to three years after the year in which the pension was granted. In other words, in the excess model, the cost effect occurred quickly and all at once, while it is spread over two years in the experience rating model. Due to the time delay, the company can forecast the effect.

We use data from Finnish registers to analyse employers' disability contributions under the former excess model and the current experience rating model. Our analysis reveals the differences between the structures of the models and the incentives they generate. The average disability contribution of big companies seems to grow when transferring from the excess model to the experience rating model. However, the growth is mainly moderate. The average annual disability contribution was EUR 150,000 in the excess model. For more than half of the sample companies, the contributions during the 10-year review period grew by less than 4 per cent when the model was changed. However, there is deviation between the companies; for some of them, the contributions doubled. This might entail additional costs to the value of millions of euros over a period of ten years. Only few companies experienced a decrease in their contribution level as a result of the change of model.

One of the purposes of the excess and the experience rating models is to encourage companies to pay attention to the prevention of disability cases. In the excess model, it was straightforward to calculate the cost of a new disability pension, whereas in the experience rating model, the effect of an individual disability pension on the employer's contribution varies a great deal. Depending on the counterfactual risk level of the employer, a new pension may or may not cause the company to rise to a higher contribution category. Thus, one disability pension may have either no or a very large cost effect. Among the sample companies, the average cost saving of one prevented pension is EUR 20,000 in the excess model and EUR 26,000 in the experience rating model. A quarter of the companies subject to experience rating did not generate any cost saving since the company remained in the same contribution category. Therefore, the economic incentive to prevent entries into disability pension (the effect of an individual disability pension on the disability contribution) is not as pronounced under experience rating as it was in the former excess model. In addition, the cost-based incentive of medium-sized companies is minor in both the excess and the experience rating model. On the other hand, many employers have found the incentives to be clearer in the experience rating model since the information regarding the company's disability risk is captured by a single figure, i.e. the contribution category, which allows for comparisons with other companies.

There are also other, indirect changes to incentives between the models. For example, the effect of certain pension types on disability contributions was changed at the same time. Previously, all pension types based on disability led to an excess to be paid by the employer.

In the experience rating model, cash rehabilitation benefits have been excluded from the determination of a company's risk level. In other words, only permanent disability pensions have an effect on risk level determination and ensuing contributions. Moreover, partial disability pensions have a smaller impact on the employer's cost in the current model than in the excess model. This is so because a company's risk level is not affected by a person transferring from a partial disability pension to a full disability pension at a later stage. This new regulation emanates partly from the requirements of the IFRS standards and partly from the aim to encourage employers to keep their employees with work limitations part-time employed. However, it is not clear whether employers react to this type of incentive in the desired manner or whether they aim at using the regulations as a channel to by-pass costs.

The structure of the new experience rating model is quite complex. For this reason, the financial incentives of the model may remain weaker than in the former excess model. On the other hand, employers have paid attention to the scale of comparison offered by the contribution categories. The opportunity to compare one's own disability risk level to the average risk of companies may encourage employers to aim for a lower risk level, i.e. to prevent their own employees from retiring on a disability pension. It is impossible to say in advance how significant the financial incentives created by the new experience rating model are in practice, and how they compare to those of the excess model. Therefore we estimated the effects of the incentives of the two models on the inflow into disability benefits.

The excess model's dependency on the size of the company was adjusted in 1996 and again in 2000. These adjustments offer an opportunity to examine how the risk of disability costs affected morbidity and disability risks. According to our results, the employer liabilities in the excess model reduced the likelihood of an employee of a big employer drawing sickness allowance. In other words, the risk of disability costs due to the excess seems to have encouraged big employers to invest in the prevention of disability cases. The risk of disability costs also reduced the likelihood for employees transferring from sickness allowance to disability pension. The possibility to avoid the excess probably motivated big employers to keep employees with limited work capacity at work.

The coming into force of the Employees Pensions Act (TyEL) in 2007 offers an opportunity to assess how companies that were never directly liable for the disability pension cost of their own employees reacted to the introduction of the experience-rated contributions. The excess model was never applied to employees working under the Temporary Employees' Pensions Act (LEL) or the Pensions Act for Performing Artists and Certain Groups of Employees (TaEL) but their employers paid flat-rate disability contributions. As the former LEL and TaEL sectors were transferred under TyEL, a large number of companies and employees transferred from flat-rate contributions to experience-rated contributions, albeit gradually within complex transition provisions. We assessed the effect of experience rating by comparing the inflow into disability pensions in the former LEL sector prior to and after TyEL coming into force. If the incentives of experience rating were effective, the number of new disability benefit recipients from big companies should have declined along with the introduction of TyEL. However, we found no clear empirical evidence of such effects.

From the viewpoint of incentives, experience rating appears to be less efficient than the excess model was. However, this interpretation should be taken with some caution. It is possible

that the incentive effects become apparent only after a longer period of time when companies learn how the complex model operates and when, during the transition period, they gradually experience the real cost effect of their disability risk level.

The effect of employer liabilities may also vary by sector, so the results cannot necessarily be generalised to all sectors. The former LEL sector covered persons in short-term employment, such as construction workers. Due to the short employment relationships, employers may have both weaker incentives and opportunities to take care of individual employees' well-being and health. Short employment relationships may also offer employers better chances to avoid cost liabilities. These factors may have diluted the effect of experience rating among former LEL employers.

In addition, the former LEL sector has traditionally had a higher average disability risk than the former TEL sector, at least partly because of the sector's higher physical work strain (and perhaps also due to a lack of costs relating to the excess). Hence, employers' possibilities to affect the disability inflow in the former LEL sector may be more limited in general than in many other sectors.

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