

10/2020

FINNISH CENTRE FOR PENSIONS, REPORTS

# SUMMARY

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## Automatic stabilizing mechanism of pensions systems in the Netherlands, Japan, Canada, Sweden and Germany

In Finland, the life expectancy coefficient and the old-age retirement age that is linked to life expectancy adjust the financing balance of the earnings-related pension system to changes in life expectancy. However, the current automatic mechanism does not react to changes in fertility, demography or national economy. In the current situation and from a generational point of view, the risks are more strongly allocated to the working-age population.

The notable decline in fertility in Finland in the last decade has increased the need to explore whether, in case of an unfavourable development, automatic stabilizing mechanisms that could stabilize the demographic and economic risks more evenly than at present could be found. Examples of different stabilizing mechanisms can be found in other countries. More extensively than the current Finnish model, they can identify demographic and economic changes and divide the risks more evenly between generations.

In traditional defined-benefit (DB) pension schemes, the financers (employers and workers) carry the risks relating to economic and demographic development. As a rule, the automatic stabilizing mechanisms transfer these risks to retirement, either to current or future pension recipients. In practice, the automatic stabilizing mechanism means that pension indexing reacts to changing circumstances.

In this report, we present current models of automatic stabilizing mechanisms used to strengthen the stabilising of pension system financing in Canada, Germany, Japan, the Netherlands and Sweden. As a rule, these countries face the same challenges relating to pension financing as does Finland. The population is ageing as life expectancy extends and fertility is below the level for demographic renewal. The low interest rates also apply to all countries.

Our report shows that, although the aims of the pension systems and the pressures caused by the demographic and economic development are similar in many ways in the countries under review, their automatic stabilizing mechanisms differ from each other considerably. Per se, the automatic stabilization mechanisms do not guarantee that the pension system is in a financially sustainable state or even that it would achieve that state in the long run once the mechanism is activated. However, the mechanisms allow for a more even distribution of risks and make the risk distribution more predictable. Nevertheless, as our country comparison shows, political decisions continue to play a central role in the final risk distribution.

The transfer of the risks to pension recipients has probably been taken the furthest in Sweden. In principle, all economic and demographic risks of statutory earnings-related pensions are reflected in the level of current or future pensions. The mechanism allows for a cut in pensions in payment, which has happened. Even in Sweden, the actual risk distribution may deviate from legislative principles. For example, since the cuts have been compensated through taxation, it means that all taxpayers have carried at least some part of the risks.

In Germany, the mechanism takes the demography and the level of pension contributions into account. This way the risks have been transferred to pensions. Nevertheless, the risk distribution between financers and pension recipients is somewhat unclear. This is because certain limits have been determined for both the benefits and the contributions. What has not been determined, however, is what should be done if the limits are not kept. The protective mechanism prevents the nominal cutting of pensions.

The situation in Japan is very similar to that in Germany. The pension contribution is fixed and the protective mechanism prevents the nominal cutting of pensions. In addition, the standard regulations regarding pension indexing have been deviated from on several occasions through political decisions. That is why the automatic macroeconomic indexing mechanism intended for 2004 was not applied until 2015 for the first time.

Of all the countries under review, the Canadian earnings-related pension system is the closest to a traditional DB scheme. For example, there is no life expectancy coefficient that relates to an increasing life expectancy and no adjustment of the retirement age or pensions in payment. As in, for example, Germany, pension benefits and contributions have a target level. An essential difference between these two countries is that Canada has clear regulations on how the risks are to be distributed if the goals appear not to be realised. In this situation, pension indexation would be temporarily frozen and contributions raised. From the point of view of risk distribution, however,

it is essential to notice that the Canadian earnings-related pensions are more modest than the European ones. The goal for wage earners with an average income is a 25-per-cent replacement rate of the average earnings during working life. Due to the low benefit level, the effect of the stabilizing mechanism is restricted when taking into account whole pension provision including occupational and national pensions.

In the earnings-related pensions of the Netherlands, the risks are directed at the pensions. In a fully funded system, the discount rate of the pension providers is a central parameter. A higher discount rate would allow for a raising of the current pensions but, correspondingly, future pensions would come with a greater uncertainty. A weaker solvency leads to index freezing and a very weak solvency may force the pension provider to cut pension accruals and pensions in payment. In practice, because of reduced solvencies, earnings-related pensions have not been index adjusted since 2008. However, national pensions form roughly half of the pension provision and reduce the effect of the stabilizing mechanism in total pension provision.

**The Publication is available only in Finnish:**

Eläkkeiden rahoituksen automaattisista vakautusmekanismeista Alankomaissa, Japanissa, Kanadassa, Ruotsissa ja Saksassa  
Eläketurvakeskuksen raportteja 10/2020

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ISBN 978-951-691-306-6 (PDF)

ISSN 1798-7490 (online)

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