We evaluate the effect of the 2005 pension reform on retirement, employment and pensions with a life cycle model, which describes labour supply decisions at the individual level. The model includes detailed rules of the Finnish statutory private-sector pension scheme. The model also takes into account income taxation and unemployment insurance.

The model explains the behaviour of individuals solely on the basis of financial incentives. We choose the parameters for the utility function so that with the pre-reform pension rules in force, individuals in the model behave close to the way as people in actual statistical data. We then fix the behavioural parameters, but change the pension rules and observe how the model individuals’ behaviour changes.

Our results show that the pension reform increases the average retirement age in the long run by about eight months. The most common retirement age after the reform is 63 years. At the same time the pension reform increases the employment rate for persons aged 25–68 by one percentage point. Also in the short run, the pension reform affects the retirement age in a rather similar way.

These findings are based on the assumption that the abolishment of the individual early retirement pension increases the number of disability pensions. If this is not the case, the average retirement age increases more – the maximum being eighteen months.
The effect of the pension reform on extending working careers is relies on restricting the access to early retirement – the unemployment pathway to retirement and the early old-age pension. The combined effect of the changes in the incentives – accrual rates, reductions for early retirement and increments for postponed retirement – is small. According to the model, the changes in the incentives more or less cancel out each other.

The pension reform does not, in the long run, really change the average level of the monthly earnings-related pensions. On the basis of the population forecast the life expectancy coefficient will reduce young people’s pensions by about 10 per cent. However, a more generous indexing of pension rights for persons of working age compensates this reduction. Together this indexation and the extension of working careers increase the average pension benefits by approximately as much as the life expectancy coefficient reduces them. However, the reform reduces the amount of pensions young people will receive during their lifetime, since retirement is postponed. The average monthly pension for the middle-aged increases, because the pension reform also postpones their retirement but the life expectancy coefficient reduces their pensions only slightly.

The pension reform does not have a significant effect on the distribution of the total pensions. However, the smallest pensions will increase and the pensions which are close to the average pension will decrease slightly.