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## Top 3: Pension Systems in Denmark, Finland, and the Netherlands

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# Top 3: Pension Systems in Denmark, Finland, and the Netherlands



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## Abstract

According to the 2018 Mercer Global Pension index, the pension systems of Denmark, Finland and the Netherlands are the best three in the world. This paper seeks to identify the common elements of success of these three pension systems, including the institutional framework within which they operate. We emphasize the collective and compulsory nature of the earnings-related pension schemes and the important role for social partners in all three pension systems. We also discuss what we believe are the most important challenges these systems face.

# Tiivistelmä

## Kolmen kärki: Tanskan, Suomen ja Alankomaiden eläkejärjestelmät

Kansainvälisen eläkeindeksin (2018 Mercer Global Pension index) mukaan maailman kolme parasta eläkejärjestelmää ovat Tanskan, Suomen ja Alankomaiden järjestelmät. Kuvaamme näiden eläkejärjestelmien ja niihin liittyvien instituutioiden keskeisiä yhteisiä piirteitä ja tärkeimpiä eroja. Kaikkien kolmen järjestelmän keskeinen osa on kollektiivinen ja työntekijöiden näkökulmasta yleensä pakollinen ansiosidonnainen eläkevakuutus. Toinen yhteinen piirre on työmarkkinajärjestöjen tärkeä asema järjestelmän kehittämisessä ja ylläpitämisessä. Käsittelemme myös näiden eläkejärjestelmien tulevaisuuden haasteita.

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**Key words:** Pensions, Pension taxation, Fiscal sustainability, Saving, Retirement

**Asiasanat:** Eläkkeet, Eläkkeiden verotus, Julkisen talouden kestävyys, Säästäminen, Eläkkeelle siirtyminen

**JEL:** D58, E21, H55, H68, J11, J26

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## 1 Introduction

The 2018 Mercer pension index, which compares pension systems of 34 countries, ranks the pension systems of Denmark, Finland, and the Netherlands as the top three. While this type of rankings must be taken with more than a grain of salt, we think it is fair to say that these pension systems are indeed quite successful. Other countries may want to look at these countries when contemplating changes in their own pension systems. The theme of this paper is to identify differences and similarities between these three pension systems, including the institutional framework within which they operate. We also discuss what we believe are the most important challenges these pension systems face in the medium-to-long term.

These pension systems display similar strengths in terms of, e.g., coverage, adequacy, fiscal sustainability and cost-efficiency. At the same time, there are important differences between the systems. Denmark and the Netherlands have occupational pension schemes which are (approximately) fully funded and clearly belong to the second pillar of the standard 3-pillar model. The corresponding earnings-related pension scheme in Finland is a universal and only partially funded scheme that is better seen as belonging to the first pillar. The Finnish scheme is also classified as statutory social insurance by the EU Regulation on the coordination of social security systems.

As regards the institutional framework, there is a very important role for social partners in all three pension systems. We will argue that this is one element behind their success. One point is that the political structure involving social partners may have been critically important to get acceptance for policies preparing for future demographic burdens and to protect the pension systems from populist proposals. The role of social partners also creates certain tensions. The fact that participation to the earnings-related pension system is mandatory, even though the decision-makers are not necessarily democratically elected, raises legitimacy issues.

From here the road map is as follows. Section 2 provides a brief overview of the three systems. We focus to some extent on the collective occupational schemes since they are the most distinctive parts of these systems. Section 3 outlines who controls the power to design and run the system and discusses how this may affect the outcomes. Section 4 discusses what we see as the most important current and possible future challenges, including legitimacy concerns and changes in the labour market. Finally, section 5 summarizes and draws out policy lessons.

## 2 Description

### Overall pension systems

The broad structure of the overall pension system is similar in all three countries. The first main element is a basic flat-rate pension scheme that ensures a minimum old-age income for all. This scheme is tax financed, operated on a pay-as-you-go basis, and of the defined benefit type. The basic pension is strongly means tested against earnings-related pensions in Finland, and less so in Denmark.

The second main element is a collective, earnings-related pension system that helps individuals to maintain their living standards after retirement by providing insurance against longevity risk. The earnings-related pensions are financed by pension contributions that are collected from employers and employees and managed in a decentralized manner by pension insurance companies, industry-wide pension funds, and other institutions. Participation to this system is usually mandatory for individual workers and firms. However, in the Netherlands, some firms are not covered by any collective arrangement and choose not to offer a pension contract to all (or part of) their workers.

In addition, individuals may have voluntary private pension insurance. However, since the basic and earnings-related schemes already provide relatively high pensions relative to wages, private third pillar pensions are not very important in these countries.

### Earnings-related private sector pension schemes

A closer look reveals also major differences across these countries, especially regarding the earnings-related pension systems.

In Denmark and the Netherlands, the main element of the earnings-related pension system consists of occupational pension schemes that are set up on a sectoral or industry level. The Danish schemes are fully funded and clearly of the defined contribution type, with investment returns affecting pension wealth at the individual level (see Jensen et al. 2019 for a detailed discussion of the Danish occupational pension scheme). The Dutch schemes are also in principle fully funded and closer to defined contribution than defined benefit. However, the system allows some funding deficits to be carried forward so that future generations help absorb current deficits. Therefore, they are currently often phrased as collective defined

contribution schemes. In the standard 3-pillar system, both the Danish and the Dutch occupational pensions clearly belong to the second pillar.

In contrast to the Danish and Dutch occupational schemes, the Finnish earnings-related pension system covers all paid work with the benefit rules being the same for all workers. The scheme is of the defined benefit type in that in case of a funding deficit the default option is to increase contribution rates. Related to this, the system is only partially funded, with about one third of the benefits financed via funding. Therefore, the Finnish system allows for large transfers across generations, unlike the Danish and Dutch system (see Lassila 2018 for a detailed analysis). Moreover, the different private institutions, including pension insurance companies that run the system, are mutually responsible for their liabilities. Because of these features, the Finnish earnings-related pension system is best seen as being part of the statutory social security system, and belonging to the first pillar, even though it is also managed by private institutions.

### Strengths

The three overall pension systems display similar strengths. First, their coverage is very good. The basic pension covers essentially all individuals living permanently in these countries and the earnings-related or occupational pensions cover at least a very large majority of workers.

Table 1: Gross and net replacement rates, 2017

		DK	FI	NL	OECD average*
50% of average income	Gross	123.4	56.6	98.1	64.6
	Net	110.3	66.9	105.1	73.2
Average income	Gross	86.4	56.6	96.9	52.9
	Net	80.2	65.0	100.6	62.9
150% of average income	Gross	79.5	56.6	96.5	48.4
	Net	76.2	65.1	100.2	58.9

Source: OECD (2017), \* Figure for males. For females, the figure is similar.

Second, replacement rates are relatively high. Table 1 lists gross and net (after tax) replacement rates for the three countries and the OECD average. It does so for an average income earner, a person with half of average income and one with one and a half average income. The replacement rates are calculated for fictive persons who start their careers 2016 at age 20 and work without interruptions until their estimated future retirement age which are 74 years in Denmark, 68 years in Finland, and 71 years in the Netherlands.

In all three countries, the figures for the average income earner are higher than for the OECD average, and especially so in Denmark and the Netherlands. For the latter two countries, both gross and net replacement rates are also much higher than the OECD average for the other two income groups, although this reflects also the fact that the assumed retirement ages are very high. The total costs of pension provision is high in these countries, but compared to the replacement rates, the ratio of paid lifetime benefits and contributions is high because of the large funds saved previously.

In the table, the gross replacement rates are independent of the income level in Finland. This is because the basic pension is strongly means-tested against earnings-related pensions and therefore not available for most individuals with a long working career. The replacement rate is higher for individuals with a relatively short working career. In the Netherlands, the basic pensions are not means-tested at all whereas in the Denmark the means test does not yet apply fully at the lower income level considered here.

Third, while the taxes and pension contributions needed to finance the overall pension systems are substantial, the fact that the funded or partly funded parts of the system are largely run at the sectoral level, rather than at the firm level, helps to limit costs related to administration and investments, and to share risks across individuals. According to the OECD (2017), operating costs of private (or privately managed) pension plans were 0.2%, 0.5%, and 0.1% of assets in Denmark, Finland and the Netherlands, respectively. At the same time, the fact that the main elements of the overall pension system are mandatory from the point of view of individuals, helps to avoid problems related to adverse selection.

Fourth, the funds accumulated in the earnings related or occupational pension schemes improve the fiscal sustainability of the earnings-related pension systems and help to mitigate the impact of population aging on public finances. At the end of 2016, aggregate assets of all collective pension schemes were more than 200 % of GDP in Denmark and the Netherlands and almost 100 % of GDP in Finland. Related to this, the three countries have a similar fiscal framework

where pension benefits are subject to income taxation while pension contributions are not. This means that the tax revenues created by the pension system are backloaded and increase with population aging.

Fifth, all three countries have also recently increased eligibility ages for pension benefits following the increase in longevity to limit the costs while maintaining relatively high replacement rates. Perhaps even more importantly, the three countries established automatic linkers between the pension eligibility age and life expectancy. This ensures sustainability of public finances will continue to drive economic policies without the political costs of frequent discussions about policy reform. In Denmark and the Netherlands, the automatic link is used in first pillar pensions, in Finland both in the first and second pillar pensions.

### **3 Controllability: more by social partners, less by the government**

The occupational pension systems in Denmark and the Netherlands, and the corresponding earnings-related pension system in Finland, were all in practice established by the representatives of employers and employees – the so-called ‘social partners’. Benefit rules and policies concerning the earnings-related pensions are in practice also decided by them. In Denmark and the Netherlands, the employer and employee organizations apparently could in principle also agree on terminating the occupational systems. In contrast, the Finnish earnings-related system is governed by the Employees pension act, and thus the existence of the system is in the hands of the parliament. This distinction is interesting but hardly important, since social partners as well as the government are involved in discussions about reforming any of the three systems.

On both the employer and the employee sides, social partners are a group of organizations that operate on many levels, are partially overlapping, and may have diffuse views on pension issues. In Finland, e.g., pension policies are mostly made by central organizations of both trade unions and employer organizations. In Denmark and the Netherlands the occupational pension systems are more decentralized and individual trade unions and industry-wide employer federations have a somewhat bigger role.

Social partners have an advantage over politicians concerning the controllability of occupational pensions: they can concentrate on controlling a rather limited system. Politicians have a broader duty when considering old-age living conditions. When considering pensions,

they also need to consider issues like old-age care, housing arrangement, and income distribution.

When deciding on pension issues, the social partners cannot ignore the political system and the government. In Finland, changes in the rules of earnings-related pensions must be included in the pension law, but the parliament have rarely done any major changes to what the social partners have agreed. But there is communication between the social partners and the government when pension reforms are planned, and in the latest reform (2017) also cooperation; the main motivation of the reform was to make working lives longer to improve especially the finances of the state and the municipalities, although pension finances are also expected to improve. In the Netherlands, the government has traditionally included social partners in decision-making, probably to avoid social unrest or to prevent social partners from taking actions that counteract government decisions. Trade unions, employers' associations and the government are currently discussing the proposals that the government made October 2017 and that it elaborated February 2019 as part of a long-term debate on pension reform. In Denmark, consensus is also seen as important. Successive cabinets have actively proposed reforms to the pension system, especially concerning the low incentives to save for retirement caused by means-testing in public benefits.

### **Does it make a difference?**

The key role of social partners gives some strengths to the occupational systems. Almost by definition, they are insulated to some degree from the risks that come from the political system and public finances. There are two main risks, the first concerning benefits and earliest eligibility ages and the second the controllability of funds.

The politicians might want to please older voters, including those already retired and those near retirement. This may lead to generous benefit levels and indexation rules, and various routes to early retirement. Social partners as decision-makers represent more the current working-age population than current retirees. This may result in outcomes that are financially sounder.

A crucial issue for all fully or partially funded systems is who decides the use of funds. Ambachtsheer (2013) summarizes research results as showing that organizational autonomy and alignment of interests do matter, and that good governance does matter. Building on these “lead to a series of sensible investment beliefs to guide investment decisions, and an organization design capable of effectively implementing those decisions. Scale plays an important role in organization design, as it permits the acquisition of the resources required to

do the job well, while at the same time keeping unit costs low. Finally, attracting and retaining the right people inside the organization requires being able to pay competitively for the requisite skills and experience” (Ambachtsheer 2013, p.44). Who bears the risk if any institution or company providing the occupational pensions goes bust? In Finland this happened to pension company called Kansa in 1994. Because all earnings-related pension providers are mutually responsible in Finland, the losses were covered by raising the contribution rate of all participants. In Denmark and in the Netherlands, in contrast, the participants in the scheme provided by the institution in question would bear the consequences. Finally, the government, parliament and political parties always have important potential influence on occupational pension systems. Taxation of benefits and tax deduction of contributions are concrete examples. To illustrate, in 2015 the Netherlands reduced the subsidies that are associated with the EET principle by limiting this principle to income up to EUR 100.000. The reverse is also true: financial security in old age is always a responsibility of the political system. Thus, if privately managed pension systems are properly funded and financially sound, the fiscal sustainability of the public sector probably looks better in international rankings, even if there is no formal link between the systems. In the EU’s fiscal rules, the Finnish earnings-related system is classified as being part of the public sector, while the Danish and the Dutch occupational pensions are not. This is in line with our view that the Finnish system is best understood as belonging to the first pillar, whereas the Danish and Dutch system belong to the second pillar.

## 4 Challenges

### Legitimacy

Many of the strengths of the pensions systems in the three countries relate to the fact that they are compulsory for individual workers and employers. Compulsion is needed to ensure comprehensive coverage and limit adverse selection. It may also be justified on paternalistic arguments; understanding the need for pension saving and longevity insurance is not straightforward to everyone.

However, the compulsory nature of the earnings-related pension systems also raises legitimacy issues, given that they are largely controlled by the social partners rather than the parliament or other democratically elected decision makers. The declining degree of unionization in all

three countries may further undermine the perceived legitimacy of these systems, or at least their current decision-making processes. There is also a risk that at some point the interests of the main trade unions will conflict with each other, making it harder for them to coordinate pension policies. For instance, unions representing open sector workers may weigh the costs of pensions more than unions whose members are less exposed to international competition. This is a mirror image of the system being isolated from political risks.

### **Flexibility**

Another flip side of compulsion is that the pension systems may restrict individual choices too much. Some degree of flexibility is useful.

All three systems provide some freedom of choice. For instance, they all provide some flexibility regarding the withdrawal age and allow for withdrawing benefits while still at work. In Denmark, individuals may also choose to take part of the occupational pension benefits as a lump sum payment (and about half of pension fund members use that option). In the Netherlands, the retirement phase can be split in two sub phases, so that the pension benefit can be up to a factor 100:75 higher during the first phase than during the second phase. Lump sum payments are not allowed in the Netherlands but are currently being debated.

The key question, however, is whether the consumption and savings patterns induced by the pension system make sense for the individual. The focus should be on the possibility of being able to shift consumption possibilities over the life cycle. This includes allowing individuals *not* to save - or even take out loans - during certain periods, while at other times, saving up or paying off loans when it makes more sense.

The problem is that pension savings are not a liquid part of the financial system. On the contrary, individuals have very limited access to their pension savings or accrued pension rights. For many people, liquidity constraints are particularly binding during the period in which they establish a family, have expenses for children and want to enter the housing market. Younger people often find themselves in a situation where their terms of employment force them to pay into a pension scheme while they simultaneously choose to take out large loans (e.g., when entering the housing market) and/or pay interest rates and instalments on existing debts (e.g., paying back student loans.) A relevant question to ask is whether the mandatory pension saving for younger people would be better spent avoiding debt, or reducing other debts, which may have a higher interest rate than the yield they can get from their pension savings.

With this background, it would be worth considering introducing a more flexible system that allows for an age-related saving profile. One way of doing this would be to allow young individuals to postpone paying contributions and then increase the contribution rate over time.<sup>1</sup>

In this way, younger households would be allowed to retain a larger proportion of their monthly income - and in return they would save more at a later stage in life when other expenses have been reduced or paid off. However, a reformed system with age-specific contribution rates must be carefully prepared in order not to end up throwing the baby out with the bath water - old-age income must be secured, adverse selection must be kept limited and the financial sustainability of the system must not be endangered. But when the system is in good condition and sound, as it in the three countries considered, such amendments can be considered.

#### **Labour market changes**

An often-expressed concern is that workers' position in the labour market is becoming more precarious with more workers nowadays having temporary contracts or part-time jobs or being self-employed. The earnings-related or occupational pensions in these countries usually cover also temporary and part-time jobs. An increasing share of self-employed workers is a more serious concern because the Dutch and Danish occupational schemes often do not cover them. While the share of self-employed workers is rather low and has decreased over the last decade in Denmark, this is especially troubling for the Netherlands. The Dutch share of self-employed workers has gradually increased since 2007 and reached 16.7% in 2017, which lies above the EU average of 15.5% (OECD, 2018). In Finland, the earnings-related system in principle covers also the self-employed workers. However, self-employed workers and entrepreneurs often evade contributions by under-reporting their income. Labour market changes may thus effectively diminish the coverage of the earnings-related pension systems in all three countries.

A related issue is that workers may have to need to change occupation more often than before. Ideally, pension systems should not hinder worker reallocation across sectors or industries. The Finnish pension system is already perfectly compatible with this principle, as the earnings-related system covers workers in all sectors and industries and pensions accrued from different employment contracts are integrated with the same benefit rules. In contrast, in Denmark and especially in the Netherlands, a job change may sometimes affect individuals' pension plans.

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<sup>1</sup> Arguably, this would be easier to implement in the second-pillar schemes in Denmark and the Netherlands, than in the first pillar system Finland.

## 5 Conclusions

The main elements of the top 3 pension systems of Denmark, Finland and the Netherlands are similar. They all have a tax financed basic pension providing a minimum old-age income for all. On top of that, they have fully or partially funded earnings-related pension systems that are financed by separate pension contributions. These systems are mandatory from the point of view of individual workers and employers, which helps increasing coverage, sharing risks and reducing administrative costs. The earnings-related pension systems are nevertheless managed in a decentralized manner by private insurance companies and other institutions.

Interestingly, the role of the so-called ‘social partners’ – the representatives of employers and employees - is very important in all three countries. Indeed, the current earnings-related pension schemes were in practice established by them. This may have been critical to gain support for policies that ensure both high replacement rates and fiscal sustainability.

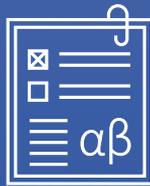
On the other hand, the fact that participation is mandatory for individuals, even though the decision-makers are not necessarily democratically elected, raises legitimacy issues, especially if the decline in unionization continues. Another concern is that the mandatory pension systems may restrict individual choices too much. While it may seem sensible to force people to save for retirement, this sometimes induces the same people to become indebted. It might be worthwhile to consider the possibility of making the earnings-related pension schemes somewhat more flexible e.g. by allowing young workers to postpone paying contributions.

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