In Finland: Saunas are Hot, Retirement is Cool

By David Lindorff *Thu, Nov 7, 2013*

Finnish people love their saunas and their nation's retirement system, which features a basic tax-funded pension, a compulsory collectively-managed DC plan for private-sector workers, and a government pension for public employees.

Helsinki—Mikko Kautto, impeccable in a blue suit and open-collared shirt, was sitting at a table in the cafeteria of the modern Centre for Pensions building on the outskirts of Finland's capital city, answering questions about the operation of his Nordic country's retirement system.

How, he was asked, does Finland—with its own graying bulge of Baby Boomers, low immigration rate and low birth rate—plan to deal with its version of the impending global retirement crisis?

Kautto (below, right), the director of research at the Centre for Pensions, looked surprised and a bit bemused. "We don't see it as a crisis," he said. "We see it as having a lot of older citizens that we need to make sure have a comfortable retirement, and we have been planning for that for years. It's certainly a challenge, but it's not a crisis."

If Finland finds itself more confident than the U.S. in the face of the Boomer retirement wave, it's not because their demographics are more favorable. More than a quarter of the country's 5.4 million people are already over age 60 and almost five percent are over age 80, compared to 19.1% over age 60 and 3.8% over age 80 in the U.S. Life expectancy at birth in Finland is about 80 years. In the U.S., it's about 79 years.

The difference may simply involve better planning and less-politicized public discourse. The U.S. has historically dealt with its Social Security system on a crisis-by-crisis basis. The crisis du jour stems from the projected exhaustion of the system's so-called Trust Fund. If that fund—which contains special-purpose Treasuries purchased with surplus FICA taxes—zeros out in the mid-2030s (and nothing changes U.S. demographics, such as an influx of hard-working young immigrants), the pay-as-you-go system's ongoing tax revenues are expected to cover only about 75% of future retirees' promised benefits.

In contrast, Finland’s government and its rival political parties, together with workers, employers and retirees, have long collaborated to create a sustainably solvent public retirement system whose payments are intended to replace close to 60% of pre-retirement income (higher for those who are poor or were unemployed for long periods).

“In the early 1990s, Finland began preparing in earnest for the large aging population we saw coming,” Kautto told *RIJ*. National studies showed that most retirees would need about 60% of their final pre-retirement income to maintain their standard of living in retirement, he explained. “Consumption smoothing” became the goal of the program. (Sixty percent replacement is ample in Finland because certain costs are low. Health care, including long-term care, is essentially free, and children who go to college pay no tuition and in fact receive a €450 ($600) monthly stipend for living costs.)

Compulsory defined contribution

Finland has a two-tier publicly-sponsored retirement system. The first tier, known as the National Pension, is designed for non-workers and the working poor and provides a basic means-tested pension, supplemented by a housing allowance. Finland’s parliament, or Eduskunta, sets the benefit level. The benefit is paid to those whose pre-retirement earnings were below €1300 ($1800) per month, beginning at age 65. (It also is paid to the disabled.)

The average National Pension recipient gets about €1800 ($2450) a month, plus the household allowance. A couple would get double that amount. Most workers, however, have incomes that exceed the cutoff for the National Pension. They participate in the second tier pension—a employment-based program in which participation is mandatory.

This second tier pension is funded by compulsory contributions from both workers and employers in the private sector. Instead of contributing to Social Security through a payroll tax (6.2% of pay, or half of the payroll tax) and to individual accounts (via an optional matching contribution), as U.S. employers do, Finnish employers must contribute 17% of payroll to a professionally-managed group insurance contract. Workers contribute an additional 5% to 6% of their pay, for a total of up to 23%. Benefits are based on years worked and worker's required contributions, not on the performance of the fund.

Despite the cap on deferral percentages, there's no limit on the amount of income to which those percentages are applied, so high-earning workers can build up proportionately high benefits. "About a quarter of the revenues paid into the [employment-based] system come from the wealthy," Kautto said, "and about a quarter of the payments go to the wealthy."

The percentage of wage or salary paid by employers and by employees is periodically adjusted by negotiations between the country's unions and a group that represents employers. The adjustment is then ratified by parliament and applied to all workplaces and all employees. Finnish pension benefits are adjusted according to where one lives, Kautto noted, with urban dwellers, whose cost-of-living tends to be higher, receiving bigger checks than those living in small towns or the countryside.

The contributions to the employment-based pension system by workers and employers are invested and managed collectively. The Centre for Pensions manages a fund for public employees. A handful of large private insurance companies contract to manage the private workers' funds and guarantee the future lifetime payout. These insurers are barred from offering other insurance or engaging in speculative ventures, and are overseen by a board that by law includes 50% beneficiary representation.

Both the publicly and privately managed funds buy international stocks bonds and other securities as well as Finnish government and corporate bonds. Only about 20% of the equity investment assets are in domestic equities. Between 2004 and 2013, the total amount invested internationally—primarily in Europe—rose to €105 billion from €50 billion, with about half of that in bonds, a third in equities and the rest in money market funds, real estate, hedge funds and private equity investments..

Envious of Finland

Last year the Centre for Pensions hired Nicholas Barr, a professor of public economics at the London School of Economics, to study of the system's adequacy, sustainability and system design. While giving it high marks, Barr also recommended that the current average retirement age of 61 was too low, given Finns' rising life expectancies.

Barr suggested offering older workers incentives to work longer, to prevent any future pressure to reduce benefits or raise worker and employer payments into the system. (There's already a 4.5% boost in annual benefits for each year offered to workers who delay benefits after 65 until age 68, but he says this should be increased.) Barr also suggested allowing people to draw partial pensions while they continue to work, and then increasing their later pension benefit.

"In a way, I'm very envious of Finland," Barr told RIJ. "We in the UK and in the U.S. come from very adversarial political systems. Finland is a more consensual political culture." Finland has been working for decades to ensure the ability of its system to pay for a wave of elderly retirees, while the US has "created a Social Security crisis for political reasons," he said.

Peter Diamond, an emeritus professor of economics at MIT, who has studied the US Social Security system, agrees. “When Social Security was created, Republicans were heavily opposed,” he told RIJ. “When President Clinton [in 1999] proposed putting some Trust Fund monies into an index fund, [Federal Reserve chairman] Alan Greenspan said it ‘threatened our freedom.’ So whatever we do with Social Security will be the usual compromise between what people want as beneficiaries, and those who are ideologically opposed to the program.”

In 1977, Social Security faced a more imminent crisis than the one we face today. “The Trust Fund was five years away from being depleted,” Diamond said. A few years later, President Reagan signed a bill that significantly raised the FICA tax in steps. Diamond predicts that the current “crisis” will be solved too, “again probably at the last minute.”

In contrast to Finland’s retirement goal of “consumption smoothing” in the transition from work to retirement, America’s Social Security program was never designed to pay for a large portion of Americans’ retirement costs, Stephen C. Goss, chief actuary of the Social Security Administration told *RIJ*. “In the U.S., we’ve always said that Social Security is meant to provide a floor of protection. The usual adage is that it should be only one leg of a three-legged stool, along with company plans and private savings,” he told RIJ.

The typical Social Security benefit, Goss said, replaces only about 30% of pre-retirement income—which doesn’t come close to matching the 80% of more of pre-retirement income that many advisers recommend. For higher-income Americans, the low FICA-limit and the mild progressivity of the benefit calculation tend to hold down replacement rates. For lower-wage workers, their tendency—often due to ill health—to claim at age 62, when annual benefits are lowest, works to minimize their replacement rates.

Much as they relish their steaming saunas (especially when interspersed with a cold shower or, ideally, a bare-skinned leap into an icy lake or snowdrift) Finns seem to like their retirement system. “If you work 35-40 years you can expect to end up with a fairly comfortable retirement,” said Kautto. “We tend to debate reforms of the existing system here, like maybe capping the pensions for the wealthy, which is very controversial. But there’s no talk here of moving to a defined contribution approach.”