Pensions and Pension Funds in the Making of a Nation-State and a National Economy

The Case of Finland

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Acronyms

GDP	gross domestic product
KVTEL	Pension scheme for the municipal employees
NP-funds	National Pension funds
NPI	National Pension Institution
PAYG	pay-as-you-go
SDP	Social Democratic Party
TEL	pension scheme for employees in the private sector
VEL	pension scheme for state employees

Summary / Résumé / Resumen

Summary

The aim is to study and describe the development of Finnish pension schemes. Special focus is given to the use of pension funds in national policy making. The Finnish case offers useful material for the study of two latent functions of social policy: how to create a unified nation (after a severe civil war) and how to invest pension funds in a way that makes national developmental projects possible.

The paper looks at the first national pension programme of 1937 that was fully funded and accumulated in individual accounts. Those funds were used to provide the country with electricity. The role of employment-related pensions, implemented in 1961, is also considered. The 1961 scheme funds were used to industrialize the country. The municipal pension scheme that was introduced in 1966 and is partially funded, is also of particular interest. The communal pension funds were partly invested in the production of housing, which in turn helped in the transformation from an agrarian to an industrial and urban society. Finally, the paper discusses the present-day situation, where such "national meta-projects" do not seem to be possible any longer. Nowadays capital, including pension capital, is invested according to where the best possible profits can be made without taking in consideration national goals as was previously the case. Here, we come up against a classic collective action problem: pension funds are collected from Finnish employment but they are, to an increasing extent being invested in projects outside the country. This in turn means fewer jobs in the country, which in turn squeezes the base for collecting pension premiums. Thus, the crucial question is whether or not this vicious circle can be broken, and if it can be broken, then how?

The Finnish experience serves as a good example of how social policy has been successfully used as a developmental strategy. In the history of the Finnish pension policy there are a number of issues that may serve as learning strategies for developing countries. First, the initial national pension scheme was introduced in a predominantly agrarian and poor society. Hence the implementation of the scheme, as well as the way in which problems related to the insurance premium collection were solved, may provide useful lessons. Second, social policy programmes may create and fortify solidarity and a sense of belonging among the populace. The way in which social security is constructed has important ramifications for social solidarity. The Finns were successful in this area: they trust each other and their institutions, and Finland is the least corrupt country in the world.

Third, social policy may be used as a device to promote national economic goals; this is given particular attention in this paper. The first national pension scheme of 1937 was based on individual savings accounts. The pension scheme was a kind of obligatory saving, or confiscation of consumption, for investments purposes. To some extent it worked, and national pension funds were used to help the country through the turmoil of the Second World War and the rebuilding of the nation after the war. National pension funds were deliberately used to establish the basic infrastructure of the country. In that sense, the savings-based, totally funded scheme was a success. In the beginning of the 1960s employment-related pensions were legislated. Those pensions were based on partial funding. These employment pension funds, which are now among the highest in the European Union, were invested to accelerate the industrialization of the country and a lion's share of the funds were loaned back to, or invested in, Finnish industry. Thus, where national pension funds were of utmost importance in providing electricity for the country in the 1950s, the employment-related pension funds have helped to establish an industrial society.

The history of Finnish pension policy indicates that it is possible to unify social policy and economic development in such a way that a more or less just and stable society, decent social security and strong economic growth can be achieved simultaneously. These aspects need not be mutually exclusive. In this respect, the Finnish case is a telling example.

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Résumé

Le propos de ce document est d'étudier et de décrire l'évolution des régimes de retraite en Finlande. L'auteur se place en particulier sous l'angle de l'utilisation des fonds de pension dans la politique nationale. Le cas finlandais apporte des éléments utiles à l'étude de deux fonctions latentes de la politique sociale: comment unifier la nation (après une grave guerre civile) et comment investir les fonds de pension de manière à permettre la réalisation de projets nationaux de développement.

L'auteur examine le premier régime national de retraite, par capitalisation, qui, créé en 1937, reposait uniquement sur la constitution de comptes individuels. Ces fonds ont servi à fournir de l'électricité au pays. Il étudie aussi le rôle des pensions liées à l'emploi, introduites en 1961. Les fonds du régime de 1961 ont servi à industrialiser le pays. Institué en 1966, le régime municipal des retraites, par capitalisation partielle, présente aussi un intérêt particulier. Les fonds de pension communaux ont été en partie investis dans la construction de logements, ce qui a aidé le pays à passer d'une économie agricole à une économie industrielle et urbaine. Enfin, il aborde la situation actuelle, dans laquelle de tels "méta-projets nationaux" ne semblent plus possibles. De nos jours, les capitaux, y compris les fonds de pension, sont investis là où la rentabilité semble la meilleure, sans tenir compte des objectifs nationaux comme autrefois. On se heurte là à un problème classique dans les actions collectives: les fonds de pension proviennent du travail accompli en Finlande mais sont de plus en plus investis dans des projets hors du pays, ce qui se traduit par une réduction du nombre des emplois en Finlande et entraîne une contraction de la base sur laquelle sont perçues les primes de l'assurance vieillesse. La question cruciale est donc de savoir si l'on peut sortir de ce cercle vicieux et, si oui, comment?

L'expérience finlandaise est un bon exemple de la façon dont la politique sociale a été utilisée comme stratégie de développement. Il y a, dans l'histoire de la politique finlandaise des retraites, plusieurs aspects qui pourraient être riches d'enseignements pour les pays en développement. Premièrement, le premier régime national de retraite a vu le jour dans une société pauvre et essentiellement agricole. Il y aurait des leçons utiles à tirer de la mise en œuvre du système, ainsi que de la manière dont les problèmes liés à la perception des primes d'assurance ont été résolus. Deuxièmement, les programmes de politique sociale peuvent créer et renforcer le sentiment de solidarité et d'appartenance de la population. La façon dont se construit la sécurité sociale a une incidence importante sur la solidarité sociale. Les Finlandais ont réussi dans ce domaine: ils se font confiance, mutuellement et à leurs institutions, et la Finlande est le pays le moins corrompu au monde.

Troisièmement, la politique sociale peut servir à promouvoir des objectifs économiques nationaux; l'auteur accorde à cet aspect une attention particulière. Le premier régime national de retraite de 1937 reposait sur des comptes d'épargne individuels. C'était une sorte d'épargne obligatoire ou de confiscation à la consommation, à des fins d'investissement. Ce régime a fonctionné dans une certaine mesure, et les fonds nationaux de pension ont servi à aider le pays à traverser la tourmente de la Deuxième Guerre mondiale et à reconstruire la Nation après la guerre. Les fonds de pension nationaux ont été délibérément utilisés pour doter le pays des infrastructures nécessaires. Dans ce sens, ce régime fondé sur l'épargne et la capitalisation a été un succès. Au début des années 60, une loi a été adoptée pour relier la retraite à l'emploi. Ces retraites reposaient sur une capitalisation partielle. Ces fonds de pension d'employés, qui sont maintenant parmi les plus importants de l'Union européenne, ont été investis pour accélérer l'industrialisation du pays, et la plus grande partie des fonds a été placée, notamment sous forme de prêts, ou investie dans l'industrie finlandaise. Ainsi, si les fonds de pension nationaux ont joué un rôle capital en fournissant de l'électricité au pays dans les années 50, les caisses de retraite des employés ont aidé à le transformer en une société industrielle.

L'histoire de la politique finlandaise des retraites montre qu'il est possible de concilier politique sociale et développement économique de manière à obtenir simultanément une société plus ou moins juste et stable, une sécurité sociale décente et une forte croissance économique. Ces différents aspects ne sont pas forcément incompatibles. Le cas finlandais est révélateur à cet égard.

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Resumen

El presente trabajo tiene por objetivo describir y analizar el desarrollo de los sistemas de pensión en Finlandia. Se presta especial atención al uso de los fondos de pensión en la formulación de las políticas nacionales. El caso finlandés contiene material de utilidad para estudiar dos funciones latentes de la política social: cómo crear una nación unificada (tras una dura guerra civil) y cómo invertir los fondos de pensión de forma que permitan llevar a cabo proyectos nacionales de desarrollo.

En este documento se analiza el primer programa nacional de pensiones, instituido en 1937, que fuera plenamente financiado y acumulado en cuentas individuales. Tales fondos se utilizaron para proveer de electricidad a todo el país. También se analiza el papel del régimen de pensiones vinculadas al empleo, aplicado por primera vez en 1961. Los fondos del plan de 1961 se destinaron a la industrialización del país. También los planes de pensión municipales introducidos en 1966, y cuyo financiamiento es parcial, resultan de especial interés. Los fondos de pensión comunales se invirtieron parcialmente en la producción de viviendas, lo que a su vez contribuyó a la transformación de una sociedad agraria en una sociedad industrial y urbana. Finalmente, se aborda la situación actual, donde ya no parece posible llevar adelante semejantes "megaproyectos nacionales". En la actualidad, el capital, incluido el capital de las pensiones, se invierte donde pueden obtenerse los mejores rendimientos sin tomar en cuenta las metas nacionales, como solía ocurrir en el pasado. Enfrentamos en este caso un problema clásico de acción colectiva: los fondos de pensión se recaudan de empleos finlandeses, pero se invierten, en una proporción creciente, en proyectos ubicados fuera del país. Ello se traduce en menos puestos de trabajo en el país, lo que a su vez reduce la base de la cual se retienen las contribuciones de pensión. Por lo tanto, la pregunta crucial que surge en este caso es la siguiente: ¿Es o no es posible romper este círculo vicioso y, de ser posible, cómo hacerlo?

La experiencia finlandesa sirve de ejemplo de la forma en que la política social se ha utilizado con éxito como estrategia de desarrollo. La historia de la política de pensiones de Finlandia contiene una serie de aspectos que pueden servir como estrategia de aprendizaje para los países en desarrollo. En primer lugar, el sistema nacional de pensiones que se introdujo inicialmente se aplicó en una sociedad predominantemente agraria y pobre. De allí que la ejecución del sistema, así como la forma en que se resolvieron los problemas relacionados con la recaudación de la prima de seguros, pudieran constituir lecciones útiles. En segundo lugar, los programas de política social podrían crear y fortalecer la solidaridad y un sentido de pertenencia o identificación en la población. La forma en que se edifica la previsión social tiene importantes ramificaciones para la solidaridad social. Los finlandeses se desempeñaron exitosamente en esta área: tuvieron confianza en ellos mismos y en sus instituciones, por lo que Finlandia es el país menos corrupto del mundo.

En tercer lugar, la política social puede utilizarse como instrumento de promoción de las metas económicas nacionales; en este documento se presta particular atención a este aspecto. El primer plan nacional de pensiones (1937) se basó en cuentas de ahorros personales. El plan de pensión era una especie de ahorro obligatorio, o confiscación del consumo, para fines de inversión. Hasta cierto punto el sistema funcionó, y los fondos nacionales de pensión se utilizaron para ayudar al país durante los años aciagos de la Segunda Guerra Mundial y la reconstrucción de la

nación durante el período de la posguerra. Los fondos nacionales de pensión se utilizaron deliberadamente para erigir la infraestructura básica del país. En ese sentido, el sistema totalmente financiado basado en los ahorros tuvo un rotundo éxito. A principios de los años 60, se promulgaron leyes relativas a las pensiones vinculadas al empleo. Tales pensiones se basaban en un financiamiento parcial. Estos fondos de pensión de régimen contributivo, que hoy en día se ubican entre los más altos de la Unión Europea, fueron invertidos para acelerar la industrialización del país; la mayor parte de tales fondos se devolvieron en calidad de préstamo para, o fueron invertidos en, la industria finlandesa. Así, mientras los fondos nacionales de pensión fueron de crucial importancia para proveer de electricidad a todo el país en los años 50, los fondos de pensión de régimen contributivo han contribuido a establecer una sociedad industrial.

La historia de la política de pensiones de Finlandia indica que es posible unificar la política social y el desarrollo económico de forma de poder alcanzar simultáneamente una sociedad más o menos justa y estable, una seguridad social decente y un sólido crecimiento económico. Estos aspectos no tienen por qué ser mutuamente excluyentes. El caso finlandés es un claro ejemplo de ello.

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Introduction: "Poor Is the Country and Poor It Will Be"

Finland has traditionally been a highly agrarian and poor Ultima Thulean nation, a nation at the ultimate northern edge of the world. The country, situated around the Artic Circle, did not offer particularly lucrative opportunities for making an easy livelihood. Farmers, who until the 1960s formed the biggest socioeconomic group, had to battle against nature. During the short and not very warm summers, they had to try to gather stores for the long and cold winters. Older Finnish literature tells stories of frost that destroyed seeds and caused hunger, suffering and premature death. At the beginning of the nineteenth century, the Finnish gross domestic product (GDP) per capita was one of the lowest in Europe; at times it was less than half of that of the United Kingdom and the United States (Maddison 1982). "Poor is the country, and poor it will be if you look for gold!" stated the writer of the national anthem that was first presented in 1848. The situation was not helped by the brutal civil war that broke out in 1918 (Alapuro 1988) and the wounds caused by the Second World War (Jussila et al. 1999; Pesonen and Riihinen 2002).

Much has changed since then. At present, Finland lies in tenth place on the Human Development Index, with GDP close to that of the United States and somewhat higher than the United Kingdom (UNDP 2002). Finland is classified as one of the leading telecommunication countries with the most widespread mobile telephone and Internet networks. It ranks, along with Denmark, the Netherlands, Sweden and the United States, among the top five countries on the Euro-Creativity Index (Florida and Tingali 2004).[1] According to the World Competitive Index, the leading countries in 2004 were Denmark, Finland, Sweden and the United States.[2] Finland also ranks highest in the Organisation for Economic Co-operation and Development Programme for International Student Assessment achievement survey of the knowledge and skills of 15-year-olds.[3] Considering the dismal starting point and harsh prerequisites, this is not at all a bad record. The million-dollar question is how one of the most backward nations transformed itself into a high-tech society. Of course, there are several competing explanations, each bearing some truth without a single one able to provide a comprehensive explanation.

However, one important aspect for this successful development has been the ability of the state to implement reforms. This capacity, which has been the focus of many welfare state analyses,[4] is the result of interaction between various factors. First and foremost, the state itself must have a structure that facilitates reforms. Unilateral states with ethnically and culturally homogenous populations are easier to manage than federal states with highly diversified populations. The state must also have the bureaucratic ability and power to plan and execute reforms (Heclo 1974; Orloff and Skocpol 1984). Both of these factors were present in Finland.

Even in the early 1500s, the founder of the Swedish kingdom, Gustaf Vasa (1496–1560), paid special attention to the administration of his country in order to keep a record of the Swedish and Finnish population, although mainly for taxation purposes and military conscription. Access to individual citizens—and more importantly, to their income and assets—created a basis for effective taxation, which was a crucial precondition for the independence of the state vis-à-vis other societal actors. As the people were poor, the administrators had to have quite a close relationship with their subordinates in order to accumulate the capital the state needed, since revenues had to consist of small amounts in every location. These small amounts were democratically distributed across the whole of society and, in contrast to many other developing and poor countries, the Finnish state became powerful and independent enough to not be harnessed as merely a vehicle for pursuing specific interests. The state was able to make its own plans and decisions that sought to promote the collective or national good instead of

1 See also www.demos.co.uk/media/creativeeurope_page373.aspx, accessed in June 2005.

2 See www.imd.ch/wcy/ranking/index.cfm, accessed in June 2005.

3 See www.pisa.oecd.org, accessed in June 2005.

4 See Evans et al. (1985); Immergut (1992); Orloff and Skocpol (1984); and Skocpol (1992).

merely promoting group-specific endeavours, which was an important precondition for the rapid industrialization of this poor rural society (Vartiainen 1995).

The early foundation of Finnish statehood and nationhood was inspired by the Hegelian vision of society: in order to promote the well-being of the nation, the state should represent the common will of the people and merge various particularistic group-based needs under the collective goal. In this respect, Finland has some similarities with the so-called developmental states, where the state plays a crucial role in promoting and coordinating private investments and maintaining the overall competitiveness of the country (Kosonen 1987). When it comes to the discussion of whether Finland was a "developmental state" or not, it is sufficient to pinpoint that the state was perhaps more "developmentalist" than "a developmental state". The former means that the state in Finland was actively involved in the country's economic and industrial development and that it had an effective bureaucracy, but given the Finnish pluralistic political structure, the society-state relationship in Finland was qualitatively quite different compared to the genuine "developmental states" such as Japan, the Republic of Korea, Singapore and Taiwan, Province of China.[5]

The strongly collectivist, or nationhood-based thinking, is apparent in the development of Finnish social policy. The starting point, in contrast to the Bismarckian-style workers' insurance, was a people's or national insurance covering the entire population equally. The early programmes were designed to meet the needs of both the rural and urban sections of the population (Kangas and Palme 1992). These flat rate-based, universal national insurance schemes, supplemented later by income-related benefits, came to form the basis for the elimination of poverty.

However, it should be remembered that social policy is much more than just guaranteeing security against various social risks. Social policy creates and fortifies social bonds, and by pooling different groups of people together, it may enhance the creation of trust or "social capital", which is beneficial for economic growth.[6] All international comparisons show that Finland, together with the other Nordic countries, is top of the league in social trust (Mackie 2001), which may be one explanation for the country's highly successful development. People have faith in each other and in the honesty of the public bureaucracy.

Social policy may also be used to accumulate "real" capital, particularly when it comes to pensions. Pension funds are an important source of capital accumulation that can be used for different purposes. A closer inspection of the Finnish case illuminates this point. In the 1950s, the National Pension funds (NP funds) were used to build up the basic national infrastructure, power stations and electric networks, for example, whereas the employment-related pension funds, which began to be accumulated at the beginning of the 1960s, were invested mainly in national industry and provided investment capital for the industrialization of society. The Finnish case provides an excellent example of how it was possible to unify social policy goals with the economic goals of building up modern industrial market economies—and this is precisely the focus of this paper.

The aim is to analyse and describe the development of Finnish pension schemes. Special focus is given to the use of pension funds in national policy making. The Finnish case offers fruitful material to study two latent functions of social policy: (i) how to create a unified nation (after a harsh civil war); and (ii) how to invest pension funds in a way that makes national developmental projects possible. The study concentrates on the first national pension programme of 1937, which was fully funded and accumulated in individual accounts. Those funds were used to provide the country with electricity. The role of employment-related pensions, implemented in 1961, are also assessed. The 1961 scheme funds were used to industrialize the country. The municipal pension scheme that was introduced in 1966 and is

5 For more in-depth discussion on the developmental state, see Woo-Cummings (1999) and Wong (2004a, 2004b).

6 See Fukuyama (1995); Putnam (1993); and Rothstein (2003, 1998).

partially funded is also of particular interest. The communal pension funds were partially invested in the production of housing, which in turn helped the transformation from an agrarian to an industrial and urban society. Finally, the present-day situation, where such "national meta-projects" no longer seem to be possible, are discussed. Nowadays, capital—including pension capital—is invested according to where the highest profits can be made without taking into consideration national goals, as was previously the case. Here, we come up against a classic collective action problem: pension funds are collected from Finnish employment, but they are increasingly being invested in projects outside the country. This in turn means fewer jobs in the country, which in turn squeezes the base for collecting pension premiums. Thus, the crucial question is whether or not this vicious circle can be broken; and if it can be broken, then how?

The Finnish experience serves as a good example of how social policy has been successfully used as a developmental strategy (Mkandawire 2001). In the history of the Finnish pension policy, there are a couple of issues that may serve as learning strategies for developing countries. First, the initial national pension scheme was introduced in predominantly agrarian and poor areas. Hence, the implementation of the scheme, in addition to the way in which problems related to the insurance premium collection were solved, may be something to learn from. Second, social policy programmes may create and fortify solidarity and a sense of belonging among the populace. The way in which social security is constructed has important ramifications for social solidarity (Rothstein 1998, 1989). Institutions, in particular, matter. Apparently, the Finns were successful in this area: they trust each other and their institutions. According to various surveys, Finland is the least corrupt country in the world.[7] Third, social policy may be used as a device to promote national economic goals, which is the main topic of this paper. In this respect, the Finnish case is a telling example, both in a positive and negative sense.

The First National Pension Scheme of 1937: Investments in Basic Infrastructure

In comparison to most other European countries, until the 1960s Finland had an extremely agrarian social structure. This economic backwardness left its traits on Finnish social policy, not least as a result of the strong political impact of the independent peasantry. The farming population was the most populous social class until mid-1960 (Alestalo 1986). The central position of the agrarian movement was also fortified by the civil war of 1918 where the independent peasantry was the nucleus of the victorious White army, which gave political and cultural hegemony to the agrarian vision of society. Correspondingly, the importance of the political left was circumscribed (Jussila et al. 1999; Pesonen and Riihinen 2002).

There were crucial differences in social policy priorities between the working class movement and the agrarians. The former placed workers' insurance with protection against illness and unemployment at the top of their list, while pensions were of secondary importance. The agrarian party was more eager to carry through a pension scheme and demanded that any social insurance programme they supported be universal, thereby opposing Bismarckian-type solutions and only considering schemes that would also provide benefits for the agrarian population (Mannio 1967; Ahtokari 1988). Finnish history lends qualified support to Baldwin (1990), who argues that the universalistic characteristics of the Nordic welfare state were determined by the farmers' narrowly self-interested demands. More clearly than in the other Nordic countries, due to their leading position, Finnish farmers were able to block the implementation of workers' insurance schemes, and the pension issue was brought to the political agenda in the mid-1930s, with coverage expanded to the entire population.

7 See www.globalcorruptionreport.org and www.transparency.org/pressreleases_archive/2004/2004.10.20.cpi.en.html, both accessed in June 2005.

In principle, there were two alternatives: (i) an insurance-based system; and (ii) a premium-financed, tax-based pay-as-you-go (PAYG) scheme. The conservatives, followed by the other bourgeois parties, wanted to have a savings-based and fully funded system. The PAYG system that was favoured by the Social Democratic Party (SDP) was regarded as too expensive by the non-socialists. After heated debates, the parties were finally able to agree on the basic principle of the scheme and carry through the first national pension in 1937. The resulting scheme was a hybrid, so full of compromises that it did not meet all the requirements of any of the parties. Yet, the agrarians were able to get a national, nearly universal system through, and the other bourgeois parties were satisfied with the premium-based and -funded insurance. The socialists managed to include tax-financed pension supplements for people with very low income. The accepted system was universal in the sense that everyone between the age of 18 and 55 was insured. However, the system was not wholly universal—those who were over 55 years of age when the law became effective were totally excluded. In addition, there was a transition period of 10 years when the scheme only accumulated funds and did not pay out any pensions (Niemelä 1994; Häggman 1997).

The programme was genuinely an obligatory savings scheme. Initially, every insured person contributed 1 per cent—which increased to 2 per cent in 1944—of their income and the employer paid half of the fee. For those with no income, the state and municipalities paid a means-tested pension. Every insured person had an individual account with the National Pension Institution (NPI), a semi-public organization that was established to administer the scheme. The NPI occupied a rather independent position, which was regarded as necessary for the administration of the funds. A direct state-run institution was ruled out by the bourgeois parties that were concerned that the state, with the help of the pension funds, would buy up private companies and thereby "socialize" the whole Finnish economy. The aim was to prevent the political misuse of funds.

At the age of 65, people who were covered by the insurance accumulated savings in their accounts could start to receive benefits. The size of the pension was dependent on the capital that was accumulated in the claimants account. This kind of system was based on individual accounts, and individual premiums were difficult to determine and administrate in an agrarian country as Finland was at that time. How was it possible to define pension premiums for peasants partially living in a subsistence economy? In principle, the insured person had to go to the post office to pay the premiums. A special receipt showing that the national pension premium had been paid was given in return, and all receipts had to be carefully preserved for future claims on pensions. In practice, there were variations depending on the labour market status and the place of residence. In bigger towns, employers usually paid all of the premiums for their employees. This happened four times a year. Farmers paid their premiums retroactively based on municipal taxes at the end of each year. According to statistics for 1945, about 60 per cent of the premiums was paid by the employers, about 25 per cent was paid through municipal taxes and about 15 per cent was never paid (Häggman 1997). All in all, the system was regarded as difficult, with many problems associated with the documentation of premiums paid and, consequently, there were numerous complaints.

In 1947, the tax system was totally reformed and instead of retroactive taxation, a prospective taxation was introduced: instead of paying taxes retroactively at the end of the year for the annual income or at periodic intervals, taxes were paid simultaneously with the receipt of income; that is, when employees received their wages or salaries, both state and municipal taxes were automatically deducted from their income. The national pension premiums were made a part of municipal taxes, which simplified the collection of payments and solved the problems associated with collecting the contributions (Häggman 1997).

The political aims of the 1937 scheme were apparent. First, after the Civil War and the right-wing radicalism of the early 1930s, the national insurance tried to unify the nation by placing all citizens under the same insurance. Therefore, the scheme was a universal *national* pension connoting nationhood and universalism. Second, the savings-based insurance accumulated

huge capital stocks. One motivation for such a system was the beneficial consequences for the national economy. In a poor country like Finland, the rate of savings within households was low. The national pension programme presented a good opportunity to save collectively, with individuals surrendering a part of their household consumption for future pension purposes (Niemelä 1994).

According to the original investment rules, loans to the state were not to exceed 10 per cent of all investments. However, the Second World War dramatically changed the situation, and by the end of the war in 1945 the state loans corresponded to almost 70 per cent of all funds (see table 1). Thus, national pension funds helped the country to heal the wounds of the war. After the war, state loans decreased rapidly and the NPI actively and deliberately invested in national infrastructure, especially in power stations and electricity. By 1957, more than half of all investments were targeted toward the development of electricity in power stations and electrical networks. Around 70 per cent of all power stations were de facto financed by the NP funds (Niemelä 1994; Häggman 1997).

Table 1: Investments from the NP funds, 1940–1957 *(per cent)*

Year	State	Municipalities	Industry	Merchant / transport	Power stations	Other
1940	38	15	10	1	7	29
1945	69	9	5	0	9	8
1950	10	11	10	2	57	10
1957	4	11	18	4	59	4

Note: In addition to power stations, some investments in electricity are included under Industry and Other. **Source:** Häggman 1997.

Until 1946, it was also possible to invest NP funds in housing, which was an ongoing problem in Finland. As late as the early 1950s, for instance, many families in Helsinki lived in provisional housing in bomb shelters. However, instead of investing in housing—which was the recommendation of the Ministry of Social Affairs—the NPI decided to follow the recommendations made by the Treasury and concentrate on producing electricity. The country had lost one-third of its power stations in the war, hence the urgent need to replace them. It can be argued that the needs of industry (more electricity) were placed before the needs of the people (more houses) on the list of priorities (Häggman 1997).

All in all, the NP funds formed an important basis for building up the basic infrastructure that later provided a solid foundation for the rapid industrialization of the country. The role of the NP funds was to provide a common good—an infrastructure—that served the interests of the whole nation, including the private economy. However, the private sector was unwilling and unable to carry out the task that was successfully taken on by the NPI—a good example of the "developmental state".

The National Pension Reform of 1956: Universalism at the Cost of Funds

The problems of the strictly premium-based system soon became obvious. There were three main shortcomings. First, in principle, the scheme was universal in its coverage, but due to the long maturation period (40 years), the majority of the elderly were excluded from receiving benefits. By 1950, only one-fifth of the elderly above the normal pension age of 65 years were entitled to national pensions (Kangas and Palme 1992). At the beginning, coverage was very slow in becoming universal. Reformation of the scheme was a question of social justice and safeguarding pensions for all citizens. The second problem was the low level of the benefits. With all available supplements, the full national pension amounted to no more than 15 per cent

of the average industrial wage, which was one of the lowest replacement rates in the Western hemisphere (Kangas and Palme 1992). Thus, reform was needed to increase the level of benefits. The third problem was linked to the funds. After the Second World War, the value of funds was rapidly reduced by postwar inflation and the elderly ran the risk of totally losing their pensions. The funded individual scheme required a stable environment, and when the requirement was not met, the system collapsed and the state had to take over.

The national pension was completely revised in 1957. A coalition cabinet consisting of the SDP and the agrarians agreed on a system whereby the universal basic pension was complemented by income-related pensions for employees. However, in the final vote, the agrarians decided to abandon the income-related part. Previous funds, mainly built up by employee and employer contributions, were distributed on a flat-rate basis to every citizen over 65 years of age. As there was a general strike at the same time that the bill was being discussed in the Parliament, the SDP and trade unions were more occupied with the strike than with pensions (Niemelä 1994). Therefore, the bill was accepted in the form preferred by the agrarians. Later, employee organizations criticized the 1957 law for confiscating the employee's pension funds collected on the basis of the 1937 law and distributing them to the agrarian elderly. This dissatisfaction and mistrust of the agrarians had important ramifications for social democratic and trade union strategies when employment-related pensions were at stake a few years later.

The new National Pension Act of 1956 established universalism, and everyone older than 65 de facto became automatically eligible for a national pension. The pension was divided into two separate parts: (i) a universal basic amount payable unconditionally to everybody over 65 years of age who had resided in the country for five years before their retirement; and (ii) an income-tested supplementary amount that was inversely related to the claimant's total remaining income.

The 1956 scheme abandoned the previous principle of financing and, instead of individual funds and a defined contribution principle, it implemented the PAYG and defined benefit principles. The pension contribution was distributed between the employer (1 per cent of payroll) and the employee (1 per cent of taxable income). By 2005, the contribution rates—including employer's illness insurance fees—were 3 per cent to 6 per cent, depending on the size of the payroll, and 2.5 per cent, respectively.

On one hand, the 1957 Act provided universalism and equality for all citizens, while simplifying the pension system and its administration. On the other hand, the reform nullified the NP funds, and the NPI rapidly lost its importance as a fundraiser for important common efforts such as projects related to the Finnish national economy.

Employment-related pensions in the 1960s: Bonds between social partners

Individual employers did provide some type of pension for their elderly workers as a gesture of gratitude for long and faithful service. Despite the rapid growth of occupational schemes toward the end of the 1950s, the actual coverage of these programmes remained limited. Only about 20 per cent of private sector employees, mainly white-collar workers in big companies, were covered. An additional problem of these occupational schemes was that in most cases they were bound to a specific employer. If a person changed jobs, the right to a pension was lost. Many American enterprises offering company-based health insurance currently face the same situation. Needless to say, this is not good for labour mobility.

In order to guarantee portability and to extend the coverage to include all blue-collar workers, the trade unions—supported by the SDP—insisted on a legislated compulsory scheme. At first, the employers rejected the idea of legislated pensions as a whole, but their attitudes gradually changed when they realized that such reform was inevitable. Additionally, the consultations between Finnish and Swedish employer organizations contributed to this change in attitudes. Swedish employers had lost their fight over pensions just a couple of years earlier. The Finnish

employers concluded that it was better to steer than to be steered. The employers' federation proposed a legislated, but decentralized, scheme with private insurance companies as insurance carriers. The employment-related pension act for private sector employees (TEL) that was accepted in 1961 gave employers many concessions as they were paying the whole insurance premium, which amounted to 5 per cent at the beginning of the 1960s (Salminen 2003, 1987).

For the employees, the most important issue was adequate pension security, and the matter of organizational form was of less importance. Moreover, the trade unions and SDP were sceptical of a publicly administrated system or a scheme based on the NPI: they were afraid that the agrarians would once again be in a position to "confiscate" employees' pension funds if the scheme remained in the domain of the public sector and open to political decision making (Ahtokari 1988).

The employment-related pension scheme for private sector employees was fully legislated and mandatory, but run by private insurance carriers. A special bipartite organization was established in order to coordinate the activities of these private companies. The labour market partners were centrally involved in the administration of the programme. This bipartite system offered employees and employers an institutional opportunity to resist the actions of Parliament should it attempt to radically change the scheme. In a way, markets were used against politics, whereas in the other Nordic countries politics were used against markets (Esping-Andersen 1985). Therefore, the representatives of the trade unions could, in the final instance, accept the pact proposed by the employer federation, the Finnish Employers' Central Organization, rather easily. The former got their statutory pensions fully financed through employer contributions, and the latter got a decentralized system, mainly organized through private pension insurance companies. In Parliament, the agrarians and communists were against the proposals, while the social democrats and the conservatives backed them. The social democratic initiative was finally accepted in 1961 and private sector employees got their TEL scheme. A separate pension scheme was established for employees in the private sector with short-term employment contracts. In 1974, farmers and other self-employed people each acquired their own programmes. Thus, a certain degree of corporatism has influenced the Finnish pension design, where coverage follows sectoral and occupational lines. The target pension level was intended to be 60 per cent of the final wage after 40 years in employment.

The Finnish public sector workers at the state and municipal level had had their own separate pension arrangements for almost a century, and the existing arrangements for these employees were neither financially nor administratively merged with the TEL scheme. Pensions for state employees were somewhat codified and homogenous; however, due to the independence of local administration, there was a plethora of municipal arrangements. The introduction of the TEL system accentuated the need to codify and homogenize the divergent public sector schemes. In the same way that the central organization of trade unions and the SDP feared leaving employment-related pensions in the hands of the public body, the representatives of municipalities rejected the suggestion of joining the TEL system. In agrarian municipalities there was a fear of a social democratic takeover since the SDP had gotten the upper hand in state politics, even though a vast majority of municipalities were dominated by the agrarian/centre party. Thus, they wanted to build up a separate scheme run by representatives of the local authorities. The act for local sector pensions for the municipal employees (KVTEL) that were run by a special insurance body, the Municipal Pension Institution, was accepted in 1964. A separate state pension scheme for state employees (VEL) became effective two years later. In this respect, the Finnish pension design also has some Central European or corporatist traits (Blomster 2004).

Benefits in the public sector have traditionally been somewhat more generous compared to those in the private sector. Both the KVTEL and VEL offered 66 per cent of the final salary after 30 years of employment. Hence, the occupational "bonus" that was built into the legislated schemes for the public sector employees and separate occupational arrangements, common to many other countries, was not developed. The primary function of the Finnish public sector

employees' scheme, however, is to provide income-related pensions in the same way as the TEL programme (Kangas and Palme 1996, 1992). This function became more evident in 1993 when the public sector schemes were homogenized with the TEL pensions and civil servants were deprived of their privileged position. Thus, all employees were guaranteed homogenous benefits regardless of their sector of employment.

The social commitments or bonds that the employment-related pension schemes created in Finland were different from those created by the national pension. The TEL scheme, devised jointly by employer and employee organizations, contributed to the creation of something that has been labelled social corporatism. By pooling their interests in social policy issues, the social partners initiated a tradition of mutual negotiation—a tradition that has lasted to the present.

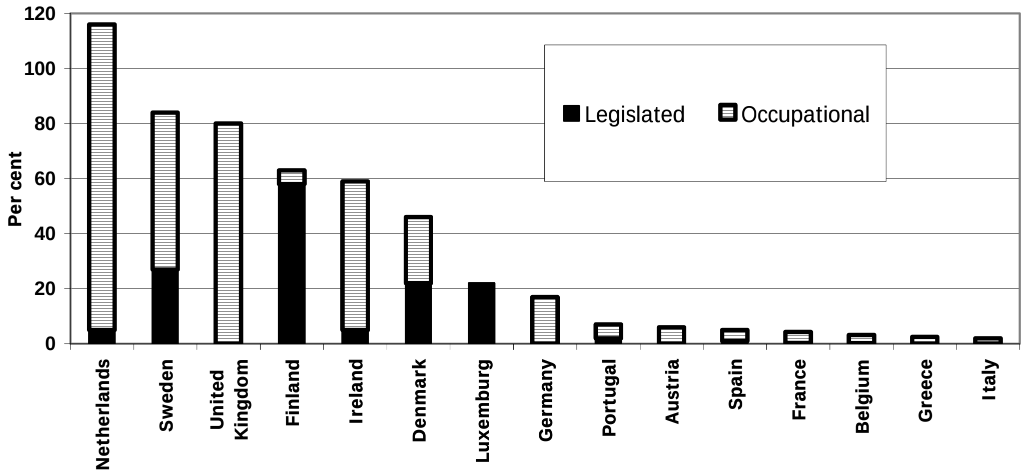
The peculiar political pre-history of the making of the Finnish TEL system had important ramifications for the subsequent administration of pensions. The labour market-based system offered the social partners strong institutional veto points against the political decision making. Only after consent from the labour market partners have the political decision makers been able to change the existing legislation, and only then according to the guidelines agreed by the social partners. This is evident when considering the changes in pension programmes implemented in the 1990s and the early 2000s (Kangas and Palme 2005). In fact, the reformation of the Finnish pension system has many more similarities with the Central European so-called corporatist schemes than with pension systems in the other Nordic countries (Schludi 2001; Lundberg 2003). For example, in Sweden, the 1959 employment-related pensions were organized through a public insurance carrier and consequently the pension reform in the 1990s was a predominantly political process in which social partners played a minor role; whereas in Finland—and in Central Europe—the administration of the pensions was organized through the labour market, and the government had to negotiate with the social partners. Sometimes the politicians expressed their frustration at merely being rubber stamps for pacts decided on by labour market partners. In sum, the very structure of social policy programmes facilitated the creation of strong social bonds and a specific kind of social capital that has conditioned the overall policy-making process in Finland, and which serves as strong evidence that pension programmes exist not only to safeguard the livelihood of the elderly.

Funds: From national projects to foreign profits

The financing of the different pension schemes varied. Both the self-employed schemes are PAYG schemes, and the revenues consist of pension contributions collected from the insured individuals and revenues from the state. The TEL scheme is partly funded and partly PAYG. The funded part aimed to mitigate the undesirable impact caused by changes in the size of successive age cohorts. In pace with the maturation of the scheme, the TEL funds rapidly replaced the decreasing NP funds in the national credit and investments markets. Both of the public sector programmes were initially financed totally on a PAYG basis, but in order to confront the challenges arising from the anticipated demographic changes, a substantial degree of funding was introduced in the municipal KVTEL scheme in 1988 and in the VEL state pension scheme in 1990. At present, the total pension fund—private plus public—constitutes about 70 per cent of GDP, which is one of the highest figures in the European Union, as indicated in figure 1.

In Finland, the legislated pension insurance is responsible for funding. By contrast, in the three countries with the greatest funds—the Netherlands, Sweden and, most notably, the United Kingdom—it is the occupational pensions that are the main source of funds. The same goes for Ireland and, to some extent, Denmark. In international terms, the funds accumulated by the Finnish legislated pensions are relatively large and, needless to say, an important factor in the Finish national economy. Therefore, the investment policy is of the utmost importance not only for safeguarding future pensions, but also in helping the national economy operate smoothly.

Figure 1: The percentage of pension funds in relation to GDP in the European Union, 2002



Source: www.tela.fi, accessed in June 2005.

The opening paragraph in the law that governs investments made by pension insurance companies states that the "funds must be invested profitably and safely". In the beginning, the regulations also stipulated that priority for investment should be given to national projects. Until the 1980s, the vast majority of the investments were indeed directed at Finnish industry. In principle, these investments had two alternative routes. First, according to the TEL rules, it was possible for companies to loan a part of their pension contribution as funding. This was the most frequently used alternative. The second way was for pension insurance companies to make investments. In the 1970s and 1980s, about one-third of all of these investments was directed at industry. In addition to industry, funds were invested in the building sector (about 20 per cent) and real estate (about 15 per cent). The building sector has been an important means of investment for public sector pensions as well. This, in turn, helped to provide housing for those who had to move from the countryside to urban areas. In the municipal scheme, precisely as in the TEL scheme, individual municipalities had the possibility to loan money on reasonable terms from their own centralized municipal pension institutes.

In sum, both the private and public sector employment-related pension funds were more or less deliberately used in national investment projects to promote the national common good. The rapid industrialization that took place in Finland from the 1960s was largely facilitated by employment-related funds, which provided capital for industrial growth.

However, the globalization of economies changed the situation and the underpinning commitment to national projects. In addition, the investment policy adopted by the pension funds became more and more criticized as investments yielded dividends that were very low compared to the alternative options. Toward the end of the 1980s, credit markets were liberalized and pension insurance also had greater freedom to manoeuvre. In addition, in the hope for greater profits, greater risks were tolerated. Foreign investments seemed and still seem to offer larger profits and more lucrative projections. As a consequence, the share of national investments has fallen markedly. In 2000, almost 60 per cent of investments were still made in Finland. By 2004, the share was down to 34 per cent, while a little more—40 per cent—was invested in the Euro zone, and the rest in countries outside Europe.[8]

[8] www.tela.fi, accessed in June 2005.

When it comes to new methods of investment, by 2004 almost half were in bonds (see table 2). The main debtors are the Finnish, French and German states, which have about 90 per cent of all bond investments. The more risky part of the portfolio consists of shares, representing a little more than 30 per cent of the investment portfolio. The shares are exclusively foreign investments and only 30 per cent of the share portfolios are in Finnish companies (see table 3). The rest of the investments are divided between real estate and investment loans (about 10 per cent each).

Table 2: Investment portfolio of the Finnish pension funds, 1997–2004 *(per cent)*

Year	Money market	Bonds	Shares and convertibles	Real estate	Loans to companies	Total
1997	11	42	13	8	26	100
2000	3	47	28	9	13	100
2004	4	48	32	9	7	100

Source: www.tela.fi, accessed in June 2005.

Before allowing the possibility of making foreign investments, there was an active discussion of whether investing Finnish pension money abroad is a "correct" procedure, which concluded that the main task of the pension scheme was to safeguard future pension promises, and as foreign investments appeared to give better dividends they were also regarded as safer investments. In addition, there were arguments that the risk should be divided into different pools: profits in some pools may balance deficits in other pools. As Finnish investors monitor various world indices for investments and the relative weight of the Finnish projects in these investments is marginal, more and more investments are targeted abroad (see table 3).

Table 3: Investment portfolios by investment categories in Finland and abroad, 2000–2004 *($ billion)*

	2000			2004		
	Finland	Abroad	All	Finland	Abroad	All
Money market	2.0	0	2.0	3.6	1.6	5.2
Bonds	15.5	22.1	37.6	6.6	46.4	53.0
Shares and convertibles	11.5	10.5	22.1	9.7	23.6	33.3
Real estates	7.3	0	7.3	9.4	0.2	9.6
Loans	10.2	0	10.2	6.7	0	6.7
Total	**46.5**	**32.6**	**79.2**	**36.0**	**71.8**	**107.8**

Source: www.tela.fi/tela/telabri.nsf/alkusivu?Open, accessed in June 2005.

At present, there are critics who demand the return to the original idea of investment policy, if only partially. Pension contributions are collected from the payroll of Finnish labour, but contributions are increasingly invested abroad. Compared to the previous situation where investments were made to fortify the national infrastructure and the basis for employment, the situation is quite different and will, in the long run, squeeze the basis of domestic employment, which in turn will lead to a squeezing of the basis for pension contributions and problems with the financing of future pensions. There are further demands that a bigger part of the pension funds should be invested in various national research and development projects and the new infrastructure required by the high-tech society.

Discussion: Social and Monetary Capital in the New Situation

The initial point of this paper is that social policy is not only a distributional issue—that is, who gets what and how much—but that it can also be used to build social and physical capital. The history of the Finnish pension insurance was used to demonstrate this. When it comes to institutional set-ups, social policy programmes unify and divide people and social groups. According to Putnam (2000), who makes an important distinction that forms the overarching theme for the idea proposed here, there are two dimensions of social capital: *bridging* or inclusive, and *bonding* or exclusive, social capital (see also Granovetter's (1973) reference to "weak" and "strong" ties; Olson 1982, 1965).

The bridging form of social capital creates broader identities and brings larger sections of society together by unifying them with weak ties, whereas bonding social capital pertains to specific, group-based solidarity. The bonding form of social capital generates strong ties, yet due to its intragroup solidarity, it may create strong out-of-group antagonism. Therefore, there is a danger that the exclusion of social capital will turn out to be antisocial and detrimental for society as a whole. Throughout its history, social policy has had bridging and bonding functions. In some countries, like Finland, the emphasis has been on the bridging side: the basic principle in social policy schemes has been universalism expressed through *people*'s insurance. This is what happened when Finland instituted national pensions: all the people were put together under the same umbrella.

In some other countries—especially central European, Asian and African nations—the schemes have been based on membership of a certain occupational group or category of people. These schemes have relied on bonding social capital and consequently they have created strong intragroup interests. This is evident if we look at the development of the Finnish employment-related pensions at the beginning of the 1960s. By putting social partners together to administrate pensions and pension funds, the schemes gave institutional power resources to social partners that could, to some extent, resist—or, if you like, counter-balance—the political decision-making machinery.

Here, we face a dilemma. How is it possible to find a fruitful balance between bridging and binding social capital? How can we strike a balance between obedience to the state—or society, community or, to put it more generally, "wholeness"—and intragroup loyalty? How is it possible to preserve a sufficient level of group-based social capital—that is, essential for "democracy to work" and for many other good things in society—without sacrificing more general, society-level goals? How can smaller interest groups with their strong bonding social ties be persuaded to make compromises that would cut group-specific benefits (for example, pensions or illness benefits), yet are essential for the maintenance of a collective level of goals (for example, the balance of national economy). In the Finnish case, the balance was in the sheer size of the schemes. The trade unions and employers' organizations knew that they were the big actors and that their decisions inevitably would have national economic consequences. Therefore, they were prepared to act in a reasonable manner and have "wholeness" in mind when "their" pension policy was at stake. From the social capital point of view, the Finnish pension system managed, in its developmental phase, to combine both the bridging and bonding forms of social capital and avoid the problem of special interests being attached to more scattered schemes, which is a problem that many other countries in the developmental phases are futilely wrestling with. This is perhaps the first of five learning points from the Finnish case.

The second point to learn from is related to the history of the first national pension scheme of 1937, which was based on individual savings accounts. The idea was perhaps brilliant: to accumulate investment capital in a country that was so poor that all income was used up by consumption. The pension scheme was a kind of obligatory saving or a confiscation of consumption for investment purposes. To some extent it worked, and the NP funds were used to help the country through the turmoil of the Second World War and the rebuilding of the

nation after the war. These funds were deliberately used to establish the basic infrastructure of the country. In that sense, the savings-based, totally funded scheme was a success.

However, when it came to the other task of the pension scheme—safeguarding a decent livelihood for the elderly—the scheme did not fare that well. There were severe problems, and initially the bookkeeping for individual premiums in a country where a part of the population was still living in a subsistence economy was such an enormous task that it did not quite succeed in the beginning. These administrative problems caused much mistrust. However, after the taxation system was changed and premium collection was merged with taxation, these problems were solved and the legitimacy of the system was regained. In a developmental context, systems like the Finnish 1937 scheme are difficult to administer: the simpler, the better. This is our third learning point and it is exactly what happened with the national pension system of 1956: it simplified the premium collection and benefit calculation. The darker side, however, was that the NP funds were lost and possibilities for "national projects" disappeared.

The long maturation period of the 1937 system caused many problems relating to equality or social justice, which undermined the legitimacy of the scheme. As a result of the maturation period, a great number of the elderly were excluded from the benefits. In addition, as the pension was dependent on individually accumulated capital, no one really knew what the actual size of the pension would amount to. This problem of predictability was not made any easier by postwar inflation that threatened to nullify the entire capital stock accumulated in those individual accounts. This is the fourth learning point: fully funded schemes need stable circumstances to function properly. Under turbulent circumstances, we must always rely on the public hand as the ultimate guarantor. PAYG is always lurking behind even the most decorative premium-based system.

As stated above, the shift to the simpler national pension system eradicated pension funds. The problem was to some extent relieved by the employment-related pension scheme that was based on partial funding. These funds, which are now among the highest in the European Union, were intended to accelerate the industrialization of the country. Therefore, an important part of the funds were loaned back to, or invested in, Finnish industry. Thus, where the NP funds were of the utmost importance in providing electricity for the country, the employment-related pension funds helped to create an industrial society. Against this background, the fifth developmental learning point is that it is in fact possible to unify social policy and economic development in such a way that a more or less just and stable society, decent social security and strong economic growth can be achieved simultaneously. These aspects are by no means mutually exclusive. In fact, this idea was strongly emphasized by social planners in the late 1950s and early 1960s. "In the contemporary society, democracy, social equality and economic growth seem to be interdependent in a fortunate way" as one of the main ideological founders of the Finnish welfare state stated in 1961 (Kettunen 2001:231).

However, as the current situation in Finland displays, there are new problems. We avoided a bear, but met a lion. The basic problem is a classical collective action problem. Pension insurance companies are profit-seeking entities. They try to maximize the dividends on their investments. Presently, the biggest dividends are not in Finland, but are highly scattered globally. Just to give some examples: hourly wage costs in industrial production are about $31 in Germany, $24 in Denmark, Finland and Norway, $21 in Sweden, $17 in the United States and $14 in the United Kingdom. In the Republic of Korea, the costs are about $8, while they are less than $0.30 in China and India (Collier and Dollar 2001). In the era of global production, this situation puts strong pressure not only on Finland, but also on all other high-cost countries since there is a tendency for industrial production to (re)locate in less expensive countries. Consequently, the most lucrative investments are somewhere other than in Finland. And it is here that we face the problem of collective action. From the viewpoint of the common good—national economy/future pensions—it would be advantageous if the funds that are collected from Finnish labour contributed to the expansion of that labour base and, consequently, the base for solid pension finances. However, capital, even pension capital, tends to seek out the

highest short-term profits. In the long run, such a strategy may be detrimental to the maintenance of the national system that created general prerequisites. Of course, if such a boom in global investment leads to acceleration in the developmental processes in less developed countries, this will possibly forge a more balanced situation between the formerly rich and formerly poor countries, which from a global perspective is a most welcome process. Here, the Robin Hood principle (transfers from those who have to those who have not) is more justified than the older Mathew principle (transfers from those who have to those who have).

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