Executive summary

This report evaluates the design of the pension system in Sweden in parallel with the reports listed in Box 1, the main focus being the public pension system. After introductory discussion (section 1), section 2 summarises the analytical approach. Subsequent sections assess the system: objectives (section 3), adequacy (section 4), the role of choice (section 5), labour markets (section 6), risk sharing (section 7) and sustainability (section 8). Section 9 briefly discusses disability pensions, and section 10 voluntary pensions. Section 11 considers the way pensions policy is formulated and offers some broad conclusions.

The primary objective of a pension system is to provide income security in old age. That objective has at least four elements: consumption smoothing, insurance, poverty relief and redistribution. The reforms of the 1990s contributed to the achievement of those objectives, commanded consensus and survived the stress test of the economic crisis. Thus discussion of improvements can be reflective rather than crisis management. In the light of that broad conclusion, much of this report sets out areas for discussion and possible directions of change rather than specific recommendations.

Strengths and weaknesses

The strengths of the system can be summarised as follows.

- Consensual: the system involves most of the interested parties and is run consensually.
- Unified: the national system is unified; occupational pensions allow variation with industry needs, though with issues of how well they integrate with the national system.
- Adequacy: the system scores well for most people.

- Fiscal sustainability is built into the strategic design of the system.
- Coverage is high because (a) the guaranteed pension is based on residence and (b) employment rates are high for both men and women.
- The system is well-designed in terms of the retirement decision: benefits adjust actuarially for a delayed start to pension; and the system provides flexible choice about whether initially to draw the whole pension or only part of it. Both aspects should be protected.

Though the system is not in crisis, a number of weaknesses will over time compromise its ability to achieve its objectives.

- Diminishing adequacy is a potential problem for two reasons. First, the notional defined contribution (NDC) design places all adjustment on the benefits side; thus fiscal sustainability of the inkomstpension (section 8) has priority over adequacy. Second, adjustment to rising life expectancy is by reducing pension benefits at the age of retirement. If people continue to retire at broadly the same age as at present, benefits will over time become less adequate. If the guaranteed pension is high enough the system will still provide poverty relief, but over time will provide less and less effective consumption smoothing.
- The design of the brake mechanism means that adjustment (a) may be too sharp and (b) has the unintended effect of benefiting workers at the expense of retirees.
- The indexation of benefits in payment faces retirees with more risk than is optimal.
- Insufficient account of family structure: as discussed in section 4.1.2, the individual basis of pension design is a partial cause of the fact that the incidence of poverty among single pensioners is notably higher than among pensioner couples.
- Excessive choice: workers can choose from nearly 800 mutual funds as part of premium pensions. The analysis in section 5 suggests that that amount of choice is inefficiently large.
- Occupational pensions can create impediments to labour mobility and later and more flexible retirement.

Strategic issues

MAINTAIN THE CONSENSUAL APPROACH. A central purpose of pension systems is as a long-run institution to allow people to plan over their life course. Long-run stability is therefore important: policy should avoid shocks to the system, particularly for pensioners and workers close to retirement. Thus the principal recommendation is to preserve the consensual way that pensions policy has been managed. Since the pension system is not in crisis, it is better to reform somewhat more slowly on the basis of wide and continuing consensus than reform sooner if that would risk destabilising long-run political support for the system.

More specifically, the Pensions Group is an institution that works and should be preserved. A number of questions arise:

- The Green Party was too small to be represented in Parliament and was thus not included when the original reforms were being discussed. Should the Green Party be added to the Group?
- Should the Pensions Group be extended beyond the political parties, e.g. to include representatives of workers and employers?
- Should there be a periodic review of membership?

OBJECTIVES OF THE SYSTEM. Discussion of the objectives of the system and the relative weights that should be accorded to each (section 3) are part of the process of building and preserving consensus. Discussion should include the founding principles (section 3.2.1).

- Principle 1: The Life Income Principle: the central idea is that every krona of contribution for every person should count the same.
- Principle 2: Automatic adjustment to economic fluctuations.
- Principle 3: Automatic adjustment to changes in life expectancy.
- Principle 4: A guaranteed pension.
- Principle 5: A part of the system that is fully funded and provides individual choice.

These principles have fundamental implications which emerge throughout the report.

- Principles 1 and 2 together embody a self-imposed constraint that the costs of adjustment fall on current contributors and pensioners. At least three aspects merit discussion.

  Since benefits are strictly related to contributions, the arrangement by implication gives fiscal sustainability priority over adequacy.

  There are other definitions of fairness. The two principles imply that cohorts who live through good times (i.e. with rapid earnings growth, and hence a higher notional interest rate) will have higher pensions relative to their previous earnings than those who live through bad times. Thus each cohort is treated as a separate entity, and each receives the pension to which it is entitled on the basis of the rate of return to its notional capital. This is one definition of fairness, but not the only one.

  Strict adherence to the two principles deliberately leaves no room for government discretion. The claimed benefit is potential protection against government failure, but at a cost of forgoing the potential benefits of wider risk sharing across cohorts discussed in sections 7.4 and 7.5. Another way of thinking about intergenerational adjustment is as combining consumption smoothing with some insurance against adverse economic outcomes. From that perspective an element of intergenerational adjustment can be thought of as an efficiency device.
- Principle 3 raises similar issues: a system that is regarded as fair in a static context (e.g. with a constant age profile), will face shocks. Demographic change affects output; the costs of lower output have to fall somewhere. Thus intergenerational fairness is part of the picture but so is risk sharing. A separate issue (discussed below) is how the principle is implemented: should adjustment be only by reducing monthly benefits via the longevity coefficient, or should it also include an increase in the earliest eligibility age?
- Principle 4, again, could be implemented in different ways: via a pensions test, or as a citizen's pension based only on age and residence, discussed in section 4.1.

- Principle 5 raises the question (discussed below) of how much reliance on rational behaviour makes sense in the context of pensions.

The system was set up against the backdrop of acute economic crisis, hence primarily to ensure sustainability. The resulting choices in 1998[1] may have been right given the political economy of the time, but may or may not be optimal in political-economy terms today.

HOW MUCH RISK-SHARING? As discussed in section 7, principles 1 and 2 have major implications for risk sharing.

- Optimal risk-sharing should take account of age. Many pension systems, including the system in Sweden, offer greater protection to people with smaller pensions; the argument here is that, in addition, the extent of protection against risk should rise with age. Adjustment should avoid sudden large shocks, particularly for pensioners and workers near retirement, since the welfare loss from a given adjustment will be larger for an older person since an older person has less time to adjust. Adjustment to pension systems should take account of age-related differences in the ability to accommodate shocks, with implications, for example, for the way benefits in payment are indexed (discussed below).
- Risk sharing across cohorts: as discussed above, principles 1 and 2 together imply that each cohort is self-financing. Thus a cohort which goes through bad times will receive a smaller pension than an otherwise-identical cohort who lives in better times. That design forgoes options for intergenerational risk sharing, discussed in sections 7.4 and 7.5, and raises the question of whether intergenerational risk sharing via the guaranteed pension is sufficient, or whether there should be at least some risk sharing as regards consumption smoothing.
- The default fund invests heavily in equities for workers under 55. Is age 55 too high for this purpose?
- Should the choice of unit-linked insurance be limited to people with higher pension entitlements?

[1] The principles of the reforms, including some legislation, were agreed by Parliament in 1994; the main legislation was passed in 1998. This report uses the term '1998 reforms' as a convenient shorthand.

- As discussed in section 10, the combined contribution to the premium pension and most occupational pensions is 7 per cent. Does the move towards defined-contributions for younger workers in occupational pensions imply that the system faces individuals with excessive risk?

HOW MUCH RELIANCE ON RATIONALITY? The model of choice and competition underpinning principle 5 – a model that works well in many areas – is the wrong model for pensions.

- The inkomstpension: the arguments in section 5.2.1 lend support to two aspects of limited choice in the inkomstpension: the system is mandatory; thus workers do not have the choice to decide how much to save; and workers have no choice of pension provider. These elements should be protected from naïve arguments that increased choice necessarily increases welfare. On the other hand, the inkomstpension relies on workers to respond rationally by working longer as life expectancy increases. As discussed below, uncritical reliance on rational behaviour can be misplaced.
- Premium pensions: choice is inefficiently large, as shown by the high fraction of people in the default fund. Even for someone with the necessary knowledge, the gain from choosing more effectively in any particular month is small, whereas the transactions costs in terms of time are significant; thus even a knowledgeable person may not review his or her choices sufficiently often. In addition, pension products are complex, creating both information problems and behavioural issues such as procrastination and immobilisation, discussed in section 5.1. Section 5.2 considers ways of designing fully-funded defined-contribution pensions in ways that avoid the problems of excessive choice and the associated high costs of administration.
- Should the extent of choice increase with the size of the person's premium pension accumulation, i.e. should choice outside the default fund be open only to individuals whose accumulation exceeds a given size?

Policy directions

ADJUSTING FOR CHANGES IN LIFE EXPECTANCY (section 7.3). Adjusting pensions to rising life expectancy requires reducing benefits at each age of withdrawal from the labour force. In principle this can be done by focussing on:

- The level of the pension, by reducing monthly benefits at the earliest eligibility age (i.e. the minimum age at which a person can draw pension); or
- The age at which pension is first payable, by gradually increasing the earliest eligibility age, with no compensating increase (or a less-than-actuarial increase) in pension; or
- A combination.

Reducing the level of monthly benefits actuarially to reflect longer life is the current system in Sweden. However, lessons from behavioural economics call into question uncritical adherence to the assumption of rationality. There is good evidence internationally that many people retire as soon as they are allowed to do so, whether or not that is in their own long-run best interests or those of their dependants. In Sweden, though most people retire at 65, an increasing share are drawing benefits at the earliest age of 61.

These arguments suggest that it would be desirable to increase the earliest eligibility age gradually.

- Suppose that policy makers regard it as appropriate that people on average should have a period of retirement that is roughly half of their working life. This could be achieved by raising the earliest eligibility age by two-thirds of any increase in life expectancy. Thus the earliest eligibility age is adjusted to relate the number of expected years receiving benefit to the number of accrual years.
- When considering this approach, it would be desirable to consider simultaneously the earliest eligibility ages for inkomstpension and premium pension (currently 61) and that for the start of guaranteed pension and the end of unemployment benefit and disability pension (currently 65), and also to discuss harmonising retirement ages in occupational pensions with those in the national system.

Thus the system should adjust to rising life expectancy in two ways:

- Applying the longevity coefficient at the age at which a person first takes pension assists sustainability.
- Increasing the earliest eligibility age broadly in line with life expectancy assists adequacy in the face of potential non-rational behaviour.

ADJUSTING FOR A DELAYED START TO PENSION (section 6.2.1). Once the earliest eligibility age has been decided, a separate question is how benefits should adjust where a worker delays taking some or all of his/her pension. As with the option for partial drawdown, Sweden is a praiseworthy outlier internationally, in that adjustment for a delayed start is roughly actuarial and thus creates no strong incentives either for or against continuing work.

LATER RETIREMENT BUT MORE FLEXIBLE RETIREMENT (section 6.2). Pension design should seek to raise the average retirement age to assist sustainability, but to accommodate differences in tastes and constraints across individuals by offering choice over how a person moves from full time work to full retirement.

The need for later retirement is now well understood. However, there is less understanding internationally of the gains from more flexible retirement. Facilitating such choice (section 6.2.3) would be good policy even if there were no concerns about sustainability.

- Sweden is an outlier internationally – and an example for other countries to follow – in allowing partial deferral of pension, i.e. the option to draw 25%, 50% or 75% of a person's pension, while the deferred element continues to grow.
- It would be useful to check that the fixed cost of employing a worker is small, to avoid creating an incentive against part-time employment.
- It would be useful to review employment law with the aim of reducing transactions costs and legal uncertainty where a worker wishes to downshift at his/her existing employer. It would also be useful for employers organisations and trade unions to draw up some sample contracts to illustrate best practice.
- Access to training is central to extending working life.

- Public discussion would be useful (a) on the empirical facts about the productivity of older workers and (b) of the implications for labour law, e.g. whether, and on what basis, less productive workers could be paid less. Again, sample contracts would be useful.
- Policies to change attitudes: gradually increasing the earliest eligibility age is important not only to assist sustainability but because of the signal it gives, which will help to change attitudes.

ADJUSTING THE RELATIVE TREATMENT OF INDIVIDUALS AND FAMILIES.

- About 13 per cent of single pensioners in Sweden were poor in 2009, but only 1.1 per cent of couples. The high incidence of poverty among single pensioners suggests a need to review benefits for that group, including the relative size of the guaranteed pension for single people and couples (section 4.1), and whether it might be desirable to include joint-life annuitisation as an option in the inkomstpension.
- Given the frequency of divorce, there is a good case for giving spouses and registered partners the option of transferring pension balances in the inkomstpension at divorce or retirement (section 4.3).

INDEXING BENEFITS IN PAYMENT.

- The guaranteed benefit is indexed to prices not wages. In the absence of discretionary action, the gap between the guaranteed pension and average earnings will increase. Part of the discussion of objectives should consider whether the guaranteed pension should focus on absolute or relative poverty.
- Inkomstpension in payment is indexed to the notional interest rate minus 1.6 per cent. As discussed in sections 4.2.2 and 7.4.1, this method fails to take account of age in the way risks are shared, and thus exposes pensioners to more risk than is optimal. The method of indexation should be adjusted so that benefits in payment do not face the full risk of year-to-year variation in wages.

THE BRAKE MECHANISM. The design of the brake has two ill-effects.[2] First, it operates sharply: without action by government and parliament, the combination of slow wage growth and a balance ratio below one would have reduced the inkomstpension by 4.6 per cent in 2010. It is a misreading to think of those events as a 'perfect storm' – macroeconomic turbulence will tend to affect both wage growth and the balance ratio, so that the combined effect is no accident. The design of the brake should recognise that the two sets of events are correlated.

A second ill-effect (section 7.4.2) is that the operation of brake and catch-up has unintended distributional effects across cohorts and, within a working cohort, across workers with different age-earnings profiles. Those effects are largely arbitrary. In addition, adjustment tends to benefit younger workers and harm retirees, which is sub-optimal since retirees on average are more risk averse than workers. There is no apparent normative justification for these outcomes.

Section 7.5 discusses possible reform directions, which are summarised in section 7.6. One approach is to continue to impose all adjustment on current participants but to adjust the operation of the brake mechanism to share the costs of adjustment differently. Section 7.5.2 discusses several ways of doing so, perhaps the simplest being to apply the balance ratio only to part of the wage growth rate for the purposes of indexing pensions in payment, thus giving retirees, who are less able to adjust, relatively greater protection than workers.

A more radical approach is to share the costs of adjustment more widely across cohorts by retaining automaticity as the primary form of adjustment, but allowing some relaxation of the strict application of principles 1 and 2. As discussed in section 7.5.3, one way to do so is to slow down the operation of the brake; another is by legislating the timing and construction of an independent periodic review.

Topics for discussion

THE DESIGN OF THE GUARANTEED PENSION (section 6.2.2)

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[2] Both problems were recognised in 1998 but, at the time, were unsolved problems.

- Does the 100 per cent/48 per cent taper of the pensions test in the guaranteed pension cause adverse labour-supply incentives? If so, should the design of the taper be adjusted?
- Should the pensions test for the guaranteed pension be expanded to include occupational pensions?

INVESTMENT DECISIONS. One of the arguments for decentralising investment decisions in the premium pension is to avoid giving a single entity too much market power and to diminish the risk of political interference. The approach in the premium pension is one way to do this, but not the only way; the approach in the US Thrift Savings Plan and recent reforms in the UK is discussed in section 5.2.

DISABILITY PENSIONS (section 9). Suitable jobs are scarce, making it difficult to move the partly-abled into paid work. The issue is important, both because of the cost of benefits and because having a suitable job has the potential to increase a person's welfare considerably.

VOLUNTARY PENSIONS should be kept under review to ensure that (a) there is suitable quality assurance and (b) arrangements keep administrative costs low (section 10). Any tax advantages for voluntary pension saving should be limited; and the earliest age at which a worker can draw pension from a tax-advantaged scheme should be kept under review.