

The spoken work counts!

The Swedish Pension Reform - Some Lessons

Presentation by **Mr Bo Könberg** (Lib.), former Minister for Health and Social Security in Sweden, at Hitotsubashi Winter Workshop on Pensions, Tokyo, January 10-11, 2002

Ladies and gentlemen,

Pensions and pension systems are controversial in most countries – at least if there is talk of changing them. In few countries have they been as controversial as in Sweden. Admittedly, the Swedish basic national pension was introduced without political controversy just before World War I. But controversy raged in connection with the introduction of the national supplementary pension scheme 40 years ago.

In 1957, after several years of investigations and political discussions, a referendum was held on the supplementary pension scheme; there were three alternatives, and none of them was backed by a majority of the electorate. The year after, the first extra general election ever was held in Sweden and the pension question split the coalition between the Social Democratic Party and the Centre Party. The year after that the proposal put forward by the Social Democrats and the Communists in the referendum was adopted with the smallest possible margin and with the help of a Liberal abstention.

The supplementary pension scheme (the so-called ATP) was introduced in 1960. Ever since the introduction of the basic pension the age of retirement was 67, and this was not changed until the mid-1970s. With the occasional exception, pensions did not rank high on

the political agenda in the next few decades. One reason was that the non-socialist parties, having burnt their fingers on the supplementary pension issue, were reluctant to challenge the system that was subsequently introduced. Another reason was the general feeling that pension systems are not something that should be changed in a hurry. To active members of the Social Democratic Party, the supplementary pension scheme was the 'jewel in the crown' of the welfare society created by their party and the pension showdown was something to talk about around their campfires.

So much for the famous Swedish tradition of consensus decisions!

Several times since the agreement about the new pension system was reached I have been asked to talk about how to reform a pension system and about the lessons that can be learned from the Swedish experience. Every time I have felt a reluctance about doing it. This is not because I don't like talking about pensions and the Swedish Pension Reform, but because I am genuinely uncertain about what one country can learn from another country's decision-making process.

This is because of the great variation between countries when it comes to the political tradition of decision-making, the size of the parties, the nature of the differences between the parties, the strength of management and labour, the extent to which management and labour have any significant practical responsibility for the system and so on.

As regards the content of reforms I think we have much more to learn from each other, and of course I hope that there is something in the Swedish Pension Reform that may be useful when reforms are discussed in other countries.

Given my views about what you can and cannot learn from other people's mistakes and successes, I will now talk both about how we carried out the Swedish reform and what principles are underlying it.

Let me first finish off my résumé of the history of our pension reform.

The national supplementary pension scheme was, with a few initial exceptions, compulsory. It was a pay-as-you-go system. However, the pension funds which were created were rather large for a PAYG-system. The scheme was introduced in such a way as to allow the older members of the workforce to enter the system quite fast although they had not paid contributions for any length of time.

The system was financed by payroll taxes. To start with, contributions were payable in relation to earnings higher than the basic pension and up to a level that today would be the equivalent of a monthly salary of 2,400 dollars. Later, contributions were paid as a percentage of total income, even if this exceeded that limit.

The pension rights earned were proportionate to the contributions paid in up to the ceiling, apart from the fact that the qualifying period was only 30 years and the size of the pension was calculated on the basis of the 15 years with the highest earnings. A simpler way to put this is that 30 years' earnings were sufficient to receive a full supplementary pension, which meant that contributions paid for years that employees worked more than 30 years did not increase their pensions. The persons insured received no information about the status of their pension rights.

From the start the link between contributions and benefits was not very strong. And almost all the changes that were made during the first 20-30 years had the effect of further weakening this link. For example, a supplement was introduced for those who only received the basic pension and this was gradually increased until it represented as much as 50 per cent of the basic pension. This was set off in its entirety against any supplementary pension rights earned, which naturally meant that for people with low pensions the supplementary pension was considered worthless up to an amount equivalent to the supplement. The rather generous means-tested housing supplement for old-age pensioners was also gradually increased, with much the same effect.

The retirement age was lowered to 65. Nevertheless, the number of early retirees doubled between 1970 and 1990. And as I mentioned

before, contributions also became payable on income which did not earn any pension rights.

The supplementary pension scheme was designed at the end of the 1950s. The annual rate of growth during the previous decade was three to four per cent per year. It was therefore understandable – although not excusable – that the calculations for the scheme basically assumed high future growth. Naturally, those who designed the scheme were aware that an unusually large number of children were born in Sweden, as in many other industrial countries, at the end of the war – the ‘baby boomers’. But they would start to draw their pensions 50 years after the introduction of the new scheme. Life expectancy was increasing, it is true, but the rate of increase was fairly modest. Nobody predicted the rapid growth in life expectancy that has occurred in the last two decades.

In the early 1980s Sweden ran into severe economic problems, partly as a result of the two oil price shocks. Unemployment was unusually high. The Swedish currency was devalued in one of these years by 25 per cent. Many people became concerned about the financial sustainability of the pension scheme in the long run.

An official commission of inquiry was set up. (During the latter half of the commission’s mandate I was the Liberal representative on it.) Its main result was an agreement to very slowly phase out the system of widow’s pensions. Apart from that, the Pensions Commission was unable during its six years to agree on any major changes, although many useful analyses were carried out. These analyses indicated that something needed to be done.

One reason – perhaps the most important one – why agreement was not reached on any other major changes was undoubtedly the fact that after a few years the recession gave way to an economic upswing that was followed by a boom lasting several years, with a very low unemployment rate. The vague feeling that something should be done before the big generation that was born in the middle of the forties retired around 2010 evaporated. The Commission’s final report,

including its analyses, was circulated during a very long review process that drew out past the election in the early autumn of 1991.

The result of the election was that Sweden got a new government consisting of the country's four non-socialist parties. I was appointed Minister for Health and Social Security. One of the new government's ambitions was to reform the pension system and to seek to do so in a spirit of political consensus, i.e. at least together with the large Social Democratic Party.

There were considerable differences between the political parties even in the new non-socialist government. The supplementary pension scheme was a pet Social Democratic project, and the party was strongly opposed to premium pensions. The largest non-socialist party, the Moderate Party, wanted to reduce the scope of the mandatory pension system and to introduce a premium pension component. The Centre Party had long advocated a system with guaranteed basic security, which meant substantially raising the level of the basic pension, but they also wanted a premium pension component. The Christian Democrats wanted to raise the basic pension and to have a premium pension component. My own party, the Liberal Party, wanted to strengthen the link between contributions and benefits, and it also wanted a premium pension component.

Terms of reference were quickly drafted for a commission of inquiry – in practice a working and negotiating group – the Working Group on Pensions. The seven parties that were then represented in Parliament were invited to take part in this work. Nine politicians from the seven parties met for the first time in the Working Group shortly before Christmas.

A very unusual feature for a Swedish commission of inquiry was the fact that it was chaired by the responsible minister. The other parties in government also appointed high-ranking politicians to the Group. The large opposition party, the Social Democrats, had two representatives. One of these was the outgoing Minister for Social Affairs and the other the outgoing Under-Secretary of State. The former is once again the minister responsible for pensions. The latter

replaced me as Minister and is since several years Director of our National Social Insurance Board. Some of the country's leading pension experts were employed by the Working Group.

Another unusual feature was that neither the employers' nor the employees' organizations nor organizations representing old-age pensioners were included in the group. This naturally gave rise to protests.

I organized the inquiry on the basis of my personal experience of several years of political activity, both at the regional level in the county of Stockholm and as participant in several official inquiries and negotiating assignments, including an inquiry on freedoms and rights, negotiations on a the traffic system in Greater Stockholm, negotiations on care of the elderly and the National Pensions Commission.

The lessons I learned from these experiences were:

- the importance of having a very clear direction,
- the importance of high-level participants,
- the importance of great intellectual openness between the participants,
- the importance of having a limited number of people in the room and, perhaps the most important of all,
- the importance of not having anyone in the room who is there just to watch the negotiators.

It may be mentioned that, as is usually the case in Sweden, a large number of representatives of trade unions, employers' organizations and old-age pensioners' organizations had served on the previous pensions commission. Obviously, the task of these representatives was to present the views of their organizations and keep track of any agreements that might emerge between the representatives of the political parties. And, where such agreements conflicted with the views or interests of their own organization, to oppose them, both in and outside the meeting room.

Instead, the new Working Group on Pensions invited representatives of the various organizations to special meetings to present their views.

I mentioned that there should be a clear direction. I purposely use the word direction rather than objective to indicate a somewhat less ambitious approach than that suggested by the word objective.

To get down to specifics, the concise terms of reference for the Working Group on Pensions contained very few items. These items had deliberately been chosen as being of interest to several members of the new government and also because they partly coincided with ideas set forth in the last budget statement of the outgoing government. They were mainly about making the pension system more sustainable and strengthening the link between contributions and benefits, thus reducing tax wedges and encouraging people to save more.

The question of premium pensions was not raised at this stage, since it was seen as a difficult hurdle that would have to be negotiated if and when an agreement was in sight.

One of my personal aims, apart from making sure that the system was sufficiently robust in economic and political terms to withstand the anticipated strains, was to strengthen the link between contributions and benefits as far as possible. I had for many years been convinced that the 30-year qualifying period and calculation of the pension on the basis of the 15 years of highest earnings not only created substantial tax wedges but were also wrong from the point of view of income distribution.

The previous Pensions Commission had considered increasing the qualifying period to 40 years and taking the 20 years of highest earnings into account, but it was forced to withdraw these proposals in the face of criticism from groups which thought they might lose by such changes, in particular white-collar workers' organizations. The main argument used by these organizations was, incidentally, that such a change would be unfavourable to women.

My inclination was thus to try to forge a much stronger link between contributions and benefits, leaving the negotiating situation to determine how much progress could be made in this direction. On the face of it, a classic example of reformism. In the event, however, I decided that it was worthwhile trying to gain acceptance for the most radical principle rather than trying to build a consensus on a limited increase - say from 15 to 25 and from 30 to 35 years. The reason for this was that I felt that it might in fact be easier to sell a new principle – ‘every penny counts’ – than to propose small changes which would allow the losers to fight each change without having to produce any arguments on matters of principle. Today I believe that some Social Democrats had arrived at a similar conclusion at the same time as me.

In the Working Group we decided together not for the first few months to represent and argue the convictions of our parties but to listen and talk to several of the country’s leading pension experts. Only after this preliminary phase did the real discussions between the representatives of the various parties begin in earnest.

After quite a short time we agreed, when discussing the rules on the earning of pension rights, surprisingly enough to apply the principle that every crown should count. Reasons would have to be given for any departure from this rule, and reasons would also have to be given for any modifications on the grounds of income distribution policy.

Thus, with very little struggle, the principle of lifelong earnings was born. Later this principle came to be known in English as the Notional Defined Contribution (NDC).

Our draft proposal of the summer of 1992 was probably the first time the principle was presented in a political document. The idea had been proposed by some Swedish economists in 1990 and 1991. The structure of some of the negotiated pension schemes that were set up in France after the war is said to have some similarities, although I very much doubt that any of the Swedish experts and politicians in the Working Group was aware of that.

In the international debate during the last years the idea of having an unfunded system based on the principle that “every penny counts” have been considered as a completely new idea. Maybe it was. But I can say that we in the Working Group did not feel it so extremely innovative as it is nowadays sometimes described. The idea sometimes seems to be easier to describe to the general public than to pension experts.

A part of implementing the principle of life income was changing the system of a basic pension for all, that was introduced in 1913, to a system of guarantee pension. The new principle meant that the majority should earn their pension rights and thereby diminish the tax wedges.

Apart from the basic principle, the draft was characterized by:

- a system that was linked to the economy,
- transitional rules covering three cohorts (born before 1938, between 1938 and 1953, and after 1953),
- differences of opinion on the funded component, and
- differences of opinion on the payment of contributions on earnings that do not earn pension rights (the ‘benefit ceiling’).

The draft was presented at a very well-attended press seminar a few weeks before the Swedish currency came under pressure and was later allowed to float. For several months, under the pressure of the economic crisis, the main protagonists had little time – and perhaps little mental energy – for the pension reform.

To the surprise of almost everyone, an agreement was reached in January 1994 between the four parties of the Government and the Social Democratic Party, which together represented about 85 per cent of Parliament, on a thoroughgoing pension reform, indeed much more thoroughgoing than very few had predicted.

Its main elements were:

- the lifelong earnings principle and pension rights, inter alia, for parents who stay at home to care for small children,
- contributions of 18.5 per cent of wages,

- pensions (and the benefit ceiling) linked to wages instead of prices,
- pensions linked to life expectancy (up to the date of retirement),
- a minimum guaranteed pension instead of the basic pension,
- a premium pension component, which in the agreement was fixed at two per cent,
- a fifty per cent reduction of contributions above the benefit ceiling,
- pensions could be drawn on a flexible basis from the age of 61,
- the raising in law of the right to work from 65 to 67 years,
- annual information to all wage-earners on their pension rights, including a forecast,
- annual pensions fixed with reference to remaining life expectancy, plus an imputed real rate of return of 1.6 per cent, and
- step-by-step implementation over three cohorts.

The level of contributions was a result of compromise. The Moderate Party wanted a lower level and the Social Democrats a higher level. The agreement means that a change to another level will require a new agreement between the five parties. Most parties seem to think that the level will not be changed. If the level is to be changed, it will only concern the new pension rights. Such a decision will also require some changes in the balancing mechanism.

After a rather short review process Parliament adopted the bill at the beginning of the summer, a few months before the elections in September which returned the Social Democrats to power. Before the elections an Implementation Group was set up by the five parties that were responsible for the reform for the task of implementing and sustaining the reform. The chairperson was to be the minister responsible for social security. This was the first time in Sweden that such an arrangement was made in connection with an agreement across party lines.

During the years that have passed since the agreement of 1994, all the details and changes in the system have been implemented in agreement. The group has not always been in complete harmony, but agreement has been reached and, with one or two exceptions, the reform is now complete.

The premium pension component has been raised to 2.5 per cent of earnings. The design has later been imitated by some of the largest negotiated pension schemes. Over 90 per cent of Swedish wage-earners are covered by such schemes. Both private sector employees and local government employees can now invest about 3.5 per cent of their pay in mutual funds, which means that about 6 per cent of their earnings are invested in such funds. This group represents about two million members of the workforce of some 4.5 million.

A significant innovation compared with the 1994 reform is the automatic balancing mechanism, which acts as a brake or accelerator depending on the circumstances. The reason for introducing this mechanism is that, although the system was designed in accordance with actuarial principles, it was in certain respects probably - almost certainly - more generous than a strict actuarial system. For one thing, the previous supplementary pension scheme was not immediately replaced by the new system but as mentioned only on a step-by-step basis. Second, changes in life expectancy are not taken into account after a person has retired. Third, pensions and pension rights are adjusted upwards to keep pace with changes in per capita wages rather than with changes in the total wage sum.

As a result of these three factors, the new system will lose some of its stability, that is if life expectancy continues to increase and per capita wage growth is faster than total wage growth.

The purpose of the balancing mechanism is as follows. Where the ratio between assets and liabilities/pension rights – a ‘critical value’ that should ideally be 1.00 – develops in a way that is unfavourable for the system, normal indexation is suspended until the balance between assets and liabilities – the ‘normal’ level – is restored. On the other hand, where the critical value is very positive, another mechanism will increase pensions and pension rights more rapidly than the normal indexation based on per capita wage growth. The design of this mechanism is planned to be finalized by 2004.

At present, the assets consist of the year’s contribution revenue (about SEK 145 billion) multiplied by the average length of time the

contributions remain in the system (about 32.5 years), added to the existing funds (about SEK 525 billion), or about SEK 5.250 billion altogether. Current liabilities are estimated at just over SEK 5,000 billion. Calculations made in November last year are more positive than was thought earlier, indicating a value of 1.03 for next year. The main alternative at present indicate that the value during the period up to the year 2050 will not fall under 1.00. In that case the “brake” will not be necessary.

Almost the only part of the reform that is not yet complete is the 50 per cent reduction of contributions above the benefit ceiling by means of contribution switching or tax switching. The pension contribution paid by employees, which under the agreed system is to be half of 18.5 per cent (which amounts in practice to about 8.5 per cent of the employee’s wages) is currently 7.0 per cent. Prior to 1993 employees paid no individual pension contributions.

The four most unusual features of the new pension system are probably:

- the strict application of the lifelong earnings principle,
- the link to pay and life expectancy,
- the premium pension component, and
- the automatic balancing mechanism.

The first three were approved by Parliament from the start, in the summer of 1994, and the last was approved last spring. The lifelong earnings principle was originally controversial, but many opponents were won over by the force of the logic behind it. Furthermore, the Working Group managed to demonstrate that this principle, together with eligibility for pension rights for childcare years, did not mean that women’s pensions were lower in relation to men than in the previous system.

This was a surprise to many people. The main explanation is that what women gained from the short 30-year qualifying period under the previous system was offset by the built-in advantage that men have on account of the calculation of the pension on the basis of the 15 years of highest earnings, since men’s pay still tends to rise more sharply

than women's. We therefore made sure that the pension rights earned for childcare years meant that the new system, despite its stricter rules, did not penalize women in comparison with the previous system.

Another factor that helped us was the fact that the Swedish Confederation for Employees with University Education was basically in favour of the lifelong earnings principle, which its chief economist had advocated as early as 1990. As a result, few protests were heard from graduate employees.

The confederation of whitecollar employees, however, was very critical and would probably have preferred to continue with the previous qualifying rules, but it devoted more and more of its energy to ensuring that pension rights were earned for higher education. Such rights were indeed provided, although only to a limited extent.

The situation in the largest trade union organization, the Swedish Trade Union Confederation which organizes bluecollar workers, was more complicated. Its largest affiliated federation, the Swedish Municipal Workers' Union, sympathized with the proposed reforms. The Union has a large majority of female members and is by far the largest Swedish organization for women. An important reason for its position was probably its realization that low-paid women as a group benefit from a good mandatory pension system and their acceptance of the analysis that the 30-year rule, not to mention the 15-year rule, was not to the advantage of the majority of its members.

Some of the affiliated federations were very critical, particularly the ones that organize industrial workers. The reason for this was apparently that their members hitherto often had been unable to work past the age of 55-60 and would not therefore be favoured by a system that focuses strongly on the number of years spent at work. There was also concern about a risk for less generous rules for early retirement. Perhaps this was the real cause of their dissatisfaction, since the then existing supplementary pension scheme did not pay out old-age pensions before the age of 60 either. Pensions were then adjusted strictly in accordance with actuarial rules, which meant that the annual

pension for a person who retired at the age of 60 instead of 65 then was 30 per cent lower for the rest of his life. The new rules are similar.

Given the differences of opinion in the Swedish Trade Union Confederation, the organization was obviously not in a position to vigorously attack the new system.

The employers were generally in favour of the new system, in particular its basic principles. They criticized the fact that contributions were still payable on earnings that did not generate pension rights and that wage indexation instead of price indexation of pension rights could prove costly for the system.

Apart from this criticism from employers, however, the change from price indexation to wage indexation was probably the feature that aroused least criticism. The adjustment for life expectancy did not give rise to many objections either.

But the premium pension did give rise to serious conflicts. There was strong opposition among many Social Democrats to this idea. Despite the fact that the party leadership under the previous – and future – prime minister approved the agreement at the start of 1994, serious attempts were made internally for several years to persuade the party to tear up the agreement with the non-socialists and instead implement minor reforms together with other parties, the Left Party in particular. These attempts failed, however, although they considerably delayed the implementation.

Finally, there has been some criticism of the proposed automatic balancing mechanism. This comes mainly from some of the influential old-age pensioners' organizations, which regard it as a way of undermining pensions without politicians having to take responsibility for it. In the public debate, and also at a hearing in Parliament last spring, they have refused, however, to answer the question whether they would prefer to replace the balancing mechanism by indexation to the total wage sum and link not only future pensions, but also ongoing pension payments, to changes in life expectancy. The proposal has also been criticized on the grounds that it only contains

draft legislation on the negative aspect of balancing, while the rules on 'acceleration' will only be presented in three years or so.

While we are on the subject of the balancing mechanism, I must admit that we in the Implementation Group could have explained it better. We should have made it clear that it is an alternative to other changes in the rules and that retaining the agreed rules and introducing the balancing mechanism will in all probability result in higher pension levels than if the rules were changed without applying the mechanism. Nor have we succeeded in making it clear that the alternative we propose probably ensures greater equity between the generations than the use of a total wage growth index. Despite these shortcomings in our presentation of the proposals, Parliament has recently adopted them.

As I have already mentioned, the balancing mechanism was not a part of the agreement of 1994. In my opinion it is a very valuable contribution to the reform – and to the international debate on pensions.

I am often asked what the greatest threat to the pension reform was. There have been many threats to the reform since we prepared it at the end of 1991. One serious threat was – I believe – that the original agreement was reached less than eight months before the 1994 election at a time when the Social Democratic opposition had had very high ratings in the polls for over a year. There must therefore have been a great temptation not to conclude an agreement with the arch enemy that would lead to radical changes in the Social Democrat welfare state and instead wait until they were in power again. But the leadership resisted this temptation.

The most serious threat was probably during a few years in the mid-1990s, when there existed a tacit unholy alliance between Social Democrat activists who thought that pensions would be too low and experts at the Ministry of Finance, who thought that pensions would be too high. This threat was averted too.

As regards income-related pensions, there are great similarities between the Swedish reform and one of the three pension reforms decided in Italy in the 1990s – the Dini reforms of 1995. Two differences are that the changeover to the new system in Italy will be much slower and changes in life expectancy will not be taken into account annually but only after discussions once every 10 years. The similarities also include the idea of adding in the imputed real growth rate during retirement when the annual pension is first calculated.

The Swedish reform has influenced reforms of pension systems in other countries. This is perhaps most apparent in the case of Latvia in 1995 and in Poland in 1997, but some other countries in Central and Eastern Europe have also been influenced. The most obvious difference between the Swedish reform and reforms in Latvia and Poland is the difference in the premium pension component. It is much larger in the systems adopted in Latvia and Poland.

One reason for this is that there was a much greater need of funding in the Latvian and Polish pay-as-you-go systems than in the Swedish national supplementary pension scheme, which still had substantial assets thanks to the large volume of earned pension rights that had not yet been paid out.

In the first half of my talk I commented on some important features of our reform process. I also mentioned that I am uncertain as to how much a country can learn from reform processes in other countries. To dwell for a moment on this rather destructive aspect, I would like to mention that I am convinced that we were lucky, not least as regards the parties' choices of representatives on the Working Group on Pensions. Myself excluded of course.

The people who concluded the agreement proved to be exceptionally well-suited in seeking and finding a broad consensus, despite the fact that the differences in opinions between them were even greater than those between their parties. Once the agreement was concluded they have defended the reform through thick and thin. So one of my recommendations is - have luck!

To sum up, perhaps the most important thing for a successful pension reform is that it helps as far as possible to create social positive incentives. This is because pensions play such a large part in all modern economies.

If you think that work should be encouraged and that tax wedges weaken the will to work, you must try to reduce the wedges. And it is then not a good idea to punish those who work for many years and reward those who have a short working career. If you believe that people's decisions are based on knowledge about the economic consequences of early and late retirement, you should make sure that they are given the necessary information in good time before retirement. If you think that prosperity is created by private enterprise, you should make sure that a majority of the people have an immediate interest in successful companies. If you believe that social cohesion is good for the country, you should choose a form of indexation that follows wage trends.

What we do with our pensions is very important, but what they do to us is even more important!