
The Swedish pension reform: Well conceived, badly implemented

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These are the slides that follow:

1. *Well conceived, badly implemented*

-With a few contrasting example, good-bad. And why this happened

2 *The old system*

3 The old Pension system, an overview

-The elements of the old system and its financing.

4 The old PAYGO system

- How a PAYGO pension is established and develops

5 Problems in the old PAYGO system (qualification periods)

6 Problems in the old PAYGO system (the ceiling)

7 Problems in the old PAYGO system (Replacement rate)

8 Problems in the old system (Costs)

9 "Problems" became problems due to lack of action from politicians

10 *The new system*

- Here under a reference for further reading about the old and the new systems can be found.

11 The new Swedish public pensions system

- The elements of the new system and its financing. Comprehensive transitional arrangements.

12 So far: "A well conceived pension system"

- Details about the various elements.

13 Strengths in the new PAYGO system as originally enacted

14 New risks followed, but, in spite of this, the new system was recommended for its strengths

15 Politicians called for further changes; a PAYGO system that could "stand unchanged until next Ice Age"

- An automatic balancing mechanism (ABM) was introduced and the system was named Notional Defined Contribution (NDC).

- Here under a reference for further reading about the ABM can be found

16 The final result (1): the pensions system

- An automatic system left alone by politicians

17 The final result (2): Pension politics and praise from financial institutions

18 The final result (3): But there were also solemn warnings

12 How the system has performed

- 20 **Minimum guarantee (1) is indexed to cost of living not to wages. Development 1998-2013**
- 21 **Minimum guarantee (2)**
- 22 **First year's pension (1)**
- Pension Age, needed for "a certain pension level". Today it is close to 68 years.
- 23 **First year's pension (2)**
- Replacement rate has dropped
- 24 **First year's pension (3)**
- Individuals left alone to judge pension age, social protection systems and employment opportunities
- 25 **First year's pension (4)**
- What about persons with problems? Strenuous work, health problems, too old.
- 26 **Pensions in payment (1)**
- Diagram illustrating the development of a pension over 20 years
- 27 **Pensions in payment (2) The ABM transfers all risks for financial problems to the pensioner**
- 28 **2022: The system collapsed**

29 Now, what can be done?

- 30 **First step in an analyse: Why a public involvement?**
- 31 **To sum up (1)**
- We remember the good features of the system but have to summarise that politicians over the years have left behind the basic request for a public pension system, i.e. to implement and preserve a fair balance between pension age, pensions and contributions.
- Therefor, the work must begin all over again
- 32 **To sum up (2)**
- Politicians must meet the challenge
- First step is to open up for change in contributions
- 33 **Many countries offer good examples, without a total automation and without leaving all social policy responsibility aside**
- Sweden did took an early step to cure the problems with traditional defined benefit systems. But went too far.
- Now there are many good examples around in the world.
- Here under are references for further reading about good examples. They are strongly recommended!

34 A way forward (1)

- Evaluate every five years broadly the systems performance
- Introduce an alternative to the ABM
- Inform the public much more nuanced than today

35 A way forward (2)

- Seek a close cooperation with the labour market parties in monitoring the pension systems

36 A first step in the structural reform is to consider the reference period

37 A word to upcoming actuaries

- Distance yourself from all sorts of external pressure. You are the expert, you shall tell the truth, nothing else.

Well conceived, badly implemented

The new system is

- Financially stable - but without regard for social outcome
- Work longer, yes - but where are the employment opportunities?
- And what about those who can not work?

How this happened

- Everything was gradually made automatic, steered by formulas.
- Concept of a political responsibility to strike a fair balance between pensions, pension age and contributions vanished

This is what it is all about

In the following we will discuss: **Old system** design and problems (2-9), **New system**, design (10-16), international reactions (17-18), performance and problems (19-28),

And recommendations: **What can be done?**(19-37)

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1

The old system

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The old Pension system, an overview

BENEFITS to retired, disabled, survivors

- A flat-rate basic pension to all
- An earnings related PAYGO scheme
 - plus **cash supplements**, over the years gradually increased, to those with no or only a small PAYGO pension
- A means tested housing supplement
- Other, additional, benefits

FINANCED by

- PAYGO pensions: **contributions** on employer's **total** wage bill
- Other benefits: combination of contributions and general revenue

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The old PAYGO system

- **A full earnings-related pension** at 65 years
 - Subject to min. **30 years** of registered earned income,
 - Income registered between a **base amount** and a **ceiling**, both **indexed to increase in cost of living**
 - Pension based on average earnings, (indexed to cost of living) over the **fifteen “best years”**
- First years pension was **60% of average best years**.
- **Pensions** in payment indexed according to **increase in cost of living**

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Problems in the old PAYGO system

1. Too short qualification periods
 - 30/15 already in the 60's were considered very short
 - And from the very beginning intended soon to be extended
2. The design of the earnings ceiling
3. Replacement rates became dependent on growth in wages
4. Financial performance out of touch with development in external factors

A few details follow

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Problems in the old PAYGO system (the ceiling)

- When enacted the **ceiling** for earnings taken into account for earnings related pensions **covered nearly all earnings**. By **1994** the ceiling due to wage growth was **reduced to 60 %** of it's former real value.
 - Excluded more and more earnings
 - With continued growth the whole system would gradually transform into a **flat rate basic pension**.

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Problems in the old PAYGO system (Replacement rate)

Replacement rate as a function of growth in real wage for a person.
(The 15 last years were the best)

With growth in a person's real wage, the outcome ended up far below expectations

<i>Rate of growth in a person's real wage</i>	0 %	1%	2%	3%
Pension as percentage of the last year's salary	60%	55%	51%	47%
Pension as percentage of the average earnings, indexed to cost of living over the 15 last years	60%	60%	60%	60%

Over the calculation period the persons earnings were below the earnings ceiling

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Problems in the old system (Costs)

Old-age, disability and survivors' pension costs as proportion of total wage sum

<i>Rate of growth of real wages sum</i>	0 %	1%	2%	3%
1990, cost as percentage of wage sum:	22.5	22.5	22.5	22.5
2005, cost as percentage of wage sum	34.3	29.1	25.7	26.9
2025, cost as percentage of wage sum	49.2	33.6	23.8	17.4

- **Revenues** are dependent on **total wages**, both when paid as contributions and as taxes,
- **Pensions** are dependent on **prices** and legal provisions;
- **Cost driving forces**: Increased life expectancy, baby boom generation, i.e. **more and more pensioners**.
- **Cost reducing effect**: Contributions and taxes follow real wage growth, benefits are capped based on figures only following prices.

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”Problems” became problems due to lack of action from politicians

1. **The ”problems” becomes real problems only when politicians do not intervene** in order to adapt the system to changed external conditions.
2. **Sweden** as many other countries **did not manage** to do this
3. **Economists and financial institutions**, such as the World Bank, the International Monetary Fund and others **claimed that politicians could not handle these systems**
 - Estelle James *Averting the old age crises* symbolises
 - ”Individual accounts”, defined contribution systems recommended
 - Chile hailed as a good model
 - ”Paradigm shift” was called for, i.e. make pension systems independent of external conditions
4. **At last, but too late, ISSA and ILO reacted.**

In fact, these four observations call for a lecture of its own!

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The new system

For more about the old system and its problems and the rules in the new system see

https://www.ilo.org/secsoc/information-resources/publications-and-tools/Discussionpapers/WCMS_207699/lang--en/index.htm

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The new Swedish public pensions system

(in addition 80 to 90 % of wage earners have around 4-6% contributions set aside for occupational pensions)

Parts

- 1) Minimum Guarantees - tax financed
- 2) Earnings-related pension –around 85% of all earners total income, **financed by contributions**, split between workers and employers, with two sub schemes,
 - one PAYGO,
 - one individual account

Transitional arrangements preserved pensions rights

- A **big pension fund** available to secure pension rights registered in the old system
- Pension rights earned in **old system combines with rights credited in new system**, affecting first years PAYGO pension up until 2019
- Final distribution between sub schemes for first years pension **only 2040**
- Pensions in payment under new rules already from 2001

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So far: “A well conceived pension system”

Minimum guarantees

- **Guarantee level** of public pension, indexed to **cost of living**.
 - So, if left without adaptation, successively reduced compared to wages
- Means tested housing supplement,
 - discretionary adapted to housing costs

PAYGO 16%

- first year pension depends on
 - “Pension rights” of 16% of earnings over the individual’s lifetime and on social security benefits, benefits for childcare and military service, all uprated by average wage growth
 - “inherited rights” and deduction for administrative costs
 - age of retirement, life expectancy
 - **a factor to make first years’ pension significantly higher** than with a straight wage indexation of pension in payment, this is called **“advance payment”**
- pension in payment depends on:
 - Index: average wages **minus** 1,6%, the 1,6% to **compensate for “advance payment”**

Individual Account 2,5%

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Strengths in the new PAYGO system as originally enacted were:

1. **Benefits based on an extended reference period**
 - offers incentives to increase working life, even if it is not extended to the whole working career.
2. **Benefits dependent on wages, not prices**
 - risk of an imbalance between benefits and contributions diminishes
3. **Benefits linked to changes in life expectancy**
 - The realism in “pension promises”, improved

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New risks followed, but, in spite of this, the new system was recommended for its strengths

- Risks needed to be followed up
 - A **successive reduction of the minimum pension** as compared to earnings in the face of economic growth
 - The full working career as a base for the earnings-related pension career means that **pensions become heavily dependant on external factors outside the pension system.**
 - This **calls for regular scrutiny** and, if needed, adaptations. Of the system itself and/or of the dependence on external factors.
 - **Scrutinizing reform was only natural – and there was nothing to prevent it**

Michael Cichon leading expert with ILO, pointed to useful elements that could make necessary changes *easier to explain to the general public.*

(Old wine in new bottles? ISSA Review Nr 4, 1999)

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Politicians called for further changes, requesting a PAYGO system that could “stand unchanged up until next Ice Age”

- Initial financial forecasts for the new system indicated that it **would function with stable contributions** for the future
 - This belief **soon proved incorrect**
- A special feature, the Automatic Balancing Mechanism (**ABM**) was **introduced** and enacted 2002.
 - ABM **automatically reduces pensions in payment** as long as the long-range financial stability seemed threatened
- A **Swedish expert** named this system *Notional Defined Contribution (NDC)*
 - Defining it as: **designed so that the contribution rate will be maintained into the future** (Takayama 2003 p 245)

For an analyses of ABM see a report to a PBSS seminar, Edinburgh 2011 pp 22-30 in http://www.actuaries.org/PBSS/Colloquia/Edinburgh/Presentations/A04_Automatic_balancing_mechanism_and_Social_Security_PAPER.pdf

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The final result (1): the pensions system

1. A PAYGO scheme enacted 1998 , transferred 2002 by **ABM into a truly contribution defined** model, where;
 - **Life-time earnings** becomes the basis for the level of retirement pension, hence
 - A ‘**full pension**’ and a ‘**normal pension age**’ becomes irrelevant
 - **Increased life expectancy** becomes a factor in the calculation of pensions, thereby **steadily raising the age** when a person can retire with an ‘adequate pension’;
 2. A *funded pension component* alongside the PAYGO part
 3. A *successive phasing out of the minimum pension*
- Following this design politicians decided that the **pension system could be left alone** without any attendance. **And, in fact, so it has been for nearly 25 years**
 - **Pension policy was reduced to guarding a system and the unity of political parties**

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The final result (2): Pension politics and praise from financial institutions

- A **broad political consensus** behind this far-reaching reform;
- A policy that **contribution rate** to the public earnings related pension system should be **unchanged for ever**. **No tax subsidies** should be allowed. **This is the cornerstone of the new system**
- **People seemed to be indifferent** to what happened
- Sweden's reputation as an advanced welfare state makes it **useful for politicians elsewhere** to refer to their reform proposals as following the Swedish model.
- No wonder that Finance Ministers around the world as well as representatives of the World Bank sees this as the ultimate solution: **No political quarrel. Contributions can not ever be increased**

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The final result (3): But there were also solemn warnings

- **Michael Cichon**, observed in 1999 with positive comments the new Swedish pension system. Now, in 2005 he warned for the Swedish Automatic Balancing Mechanism. To his mind ***“it symbolizes a fundamental shift away from a solidarity-based way of coping with emerging new demographic, economic, social and resulting financial burdens to an individualistic approach.”*** (See <https://www.nft.nu/sites/default/files/2005210.pdf>)
- **Krzysztof Hagemejer** leading expert with the ILO later wrote ***“What we thus need is not to keep politicians away from pensions- that is not only unrealistic but also undesirable; pension policy is part of overall social policy”***. (Lessons from Pension Reforms, in a World Bank publication 2012)
- **And yes, all this has happened. External conditions**, including other social security systems changed, in some respects dramatically.
 - Pension politicians did not even observe the changes
 - Or, if observed, they were met with only talk and good wishes, but **no action**

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How the system has performed

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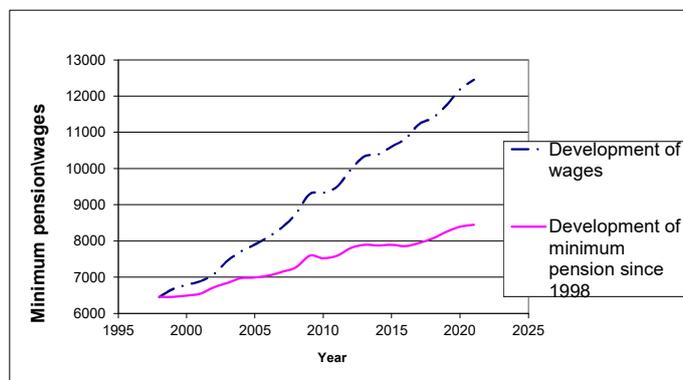
19

Minimum guarantee (1) is indexed to cost of living not to wages. Comparison of development 1998-2013

Minimum guarantee

- is meant to follow cost of living even in the long run.
- transfers poverty risks to the individual
- but means-tested housing supplement increased.

1 USD=10,5 SEK

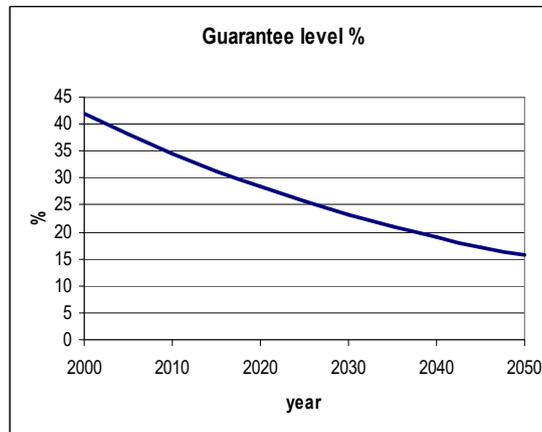


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Minimum guarantee (2)

- in 1998 still **some guarantee** supplement could be granted as long as the earnings-related pension **not exceeded 45%** of the ceiling for pension rights
- After 35 years, that relation will have been halved
- (The Pensions authority, OECD and others object. But politicians persisted)



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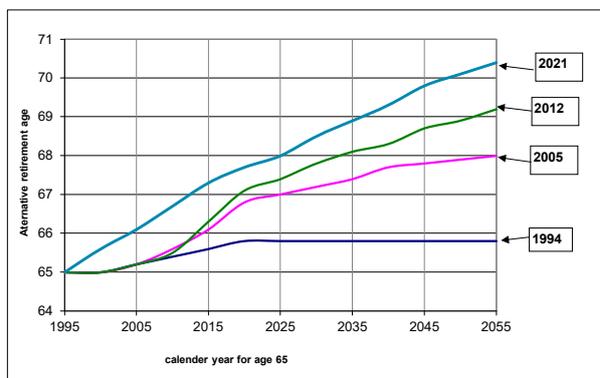
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First year's pension (1)

Pension Age in the future, needed for "a certain pension level"

- No statutory pension age
- Now left with this →
- What pension age shall the individual plan for?
- Many (most) still aim at **65!**

"pension age" indicated 1994, 2005, 2012 and 2021



First year's pension is unavoidably dependent on age of retirement and remaining life expectancy at retirement

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First year's pension (2)

- **First years pension as** compared to final salary over the last 20 years have **dropped** from around 60% to 50%
 - average pension age have not increased much above 65 years,
 - despite formula calling for an increased pension age
- **Leaving those behind** who have not wanted/been able to adjust to the new pension system

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First year's pension (3)

Individuals face

- 1) consequences of **demographic change** and demographic projections
 - complicated and difficult to understand
- 2) development of **employment opportunities**, own and for all workers
 - For healthy but old people
 - For the young ones
- 3) How **social protection systems works**
 - especially for unemployment, sickness, disability
 - employment protection rules

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First years pension(4)

What about persons with problems?

- For older workers
 - The social security **safety net ends at 65** in spite of gradually higher age for a decent pension
 - Many are **forced to go on early pension** arrangement
 - At last in 2023, the age limit goes up to 66. Twenty years too late. And it needs to be near 68 years!
- For **younger** people
 - Without being established on the labor market no unemployment benefits,
 - **no pension points for those years**
- For people in **strenuous occupations**
 - There are **no special arrangements** for such occupations.
- For people in poor health
 - 65 is up to 2022 age limit for the social security safety net
 - **criteria for such benefits more restrictive** than when the reform was launched

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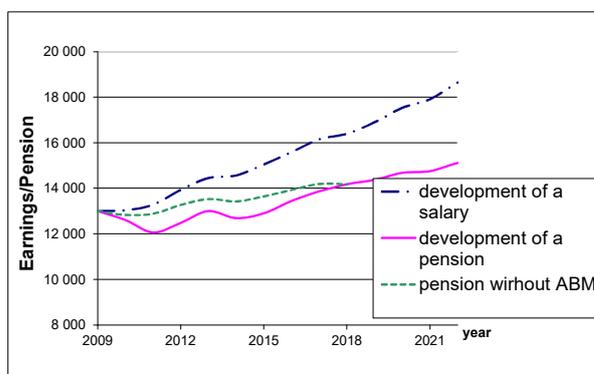
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Pensions in payment (1)

Reasons

- Pension follows wages -good
- Index is wage growth minus 1,6%
 - problematic
- Automatic Balancing Mechanism (ABM)
 - affects only pension in payment, not accumulated pension rights
 - Unfair!

The diagram illustrates how indexation in the new PAYGO scheme functions



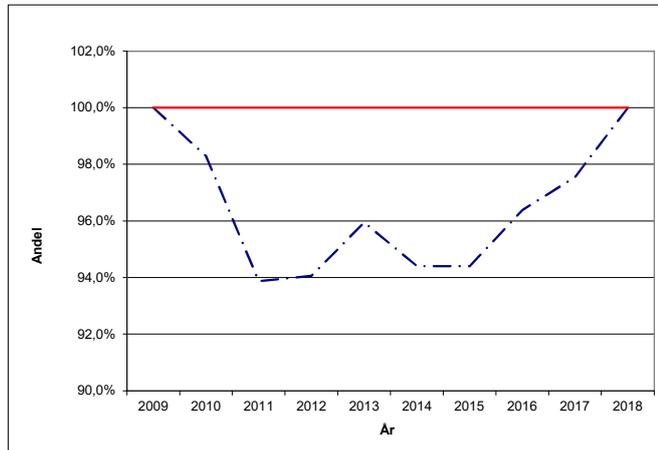
1 USD=10,5 SEK

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Pensions in payment (2) The ABM transfers all risks for financial problems to the individual pensioner

Pension as part, (blue curve) of what it should have been without ABM



This mechanism was said to be needed only in extreme circumstances!

Now, it was activated in spite of a blooming economy

Most probably, it will come back again!

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2022: The system collapsed

- “**income pension supplement**”, added to PAYGO pensions
 - for a limited group, financed over the state budget
- **minimum pension** raised substantially in 2022
 - total net pension, including housing benefit, **now around the average pension**
 - enacted for the sole purpose **to make a certain person Prime Minister**
- **Resulting in:**
 - Earnings related pensions does not follow life earnings anymore
 - Tax subsidies are introduced in the earnings related pension system
 - Minimum pension does not follow only development of cost of living anymore

Only the idea of a never changed contribution remains!

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Now, what can be done?

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First step in an analyses: Why a public involvement?

The answer depends on knowledge as well as values

- Poverty relief
- Support to retain living standard
- Myopic behavior, i.e. individuals have difficulties in planning for a distant future

If the system does not meet objectives in these dimensions,

- **change the system and/or the environment!**
- **Or give up the objectives**

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To sum up (1)

- The request to **work more and up to a higher** age for a decent pension is a realistic approach
- A **financially stable** earnings-related pension system is important
- But the Swedish system, left alone with the Automatic Balancing Mechanism, **has transferred too much risk** onto the individual. It does not offer
 - neither adequate pensions,
 - nor social justice,
 - nor transparency.
- So it **must be revised** observing
 - **a fair balance between contributions, pension amounts and pension age can not be handled by formulas**
 - **other welfare systems as well as labor market influence** the outcome of a pension system. (To some extent this has been observed. But no action!)

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To sum up (2)

- **Avoid any attempt to relief politicians** of responsibility, for the simple reason that this is not possible
- So, **avoid the pledge to hold contributions fixed** forever
 - “the Notional Defined Contribution (NDC) principle” makes it impossible to adjust contributions,
 - and the consequences have been shown in the preceding slides

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Many countries offer good examples

Without a total automation and without leaving over all social policy responsibility aside

- Examples worth studying are Germany, Canada, Japan, Finland and Norway.
- **Norway** uses the same formula to establish a earnings-related public pension as in Sweden. **But:**
 - No automatic balancing mechanism is introduced. **The state takes full responsibility** for financing
 - **A commission** evaluated the outcome of the system **after less than 10 years**
- **Canada** is a good example on how to **guarantee financial stability**. When the government actuary has warned against instability a two step process begins:
 - First, politicians have a certain time to solve the problem
 - If not, the stability is restored by raising contributions to meet half the need and freezing benefits for a three year period

Further information see pp 18-22 and 33-36 in the above mentioned Edinburgh paper. Today's situation can be studied in the OECD biannual report "Pensions at a Glance", <https://www.oecd.org/publications/oecd-pensions-at-a-glance-19991363.htm>

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A way forward (1)

- Establish a **five-year period** as a basis for a political review,
 - of the balance in the system itself and its dependence on all external factors
 - **charge the government** to suggest changes needed.
- Establish a **renewed automatic formula of the Canadian or German** type, that kicks in if the politicians fail to respond to financial needs,
- **Inform individuals**
 - of forecasts of possible pension levels in the future,
 - but with **much clearer description about the uncertainties**, both when it comes to external development and individual work pattern

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A way forward (2)

- By making the changes enumerated on the preceding slide **politicians become responsible once again**
- **Consider Hagemayer's article 2012:** *"A key prerequisite for further reform need to be to ensure through Democratic mechanisms the full participation of each group of stakeholders – workers, employers together with the government, in establishing relevant standards and in creating and maintaining permanent structures through which pension systems may be monitored, verified and adjusted in a responsible way"*
- **Or, at least, establish an independent body** with the responsibility to every five years produce and report data for evaluating how the pension system fulfil its task
- Following this, time has come **for structural reform** of the system

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A first step in the structural reform is to consider the reference period

- Lifetime earnings call for incorporation of the whole Social Security system in the evaluation of the pension system
- As a contrast, **limited reference period** makes it possible to leave individual periods of unemployment, ill health etc out of the analyses of the pension system
- Much of the **Swedish problems** originate from the fact that **this weakness of the lifetime perspective has not been observed.**

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A word to upcoming actuaries

- Be aware that a social security scheme is a combination of:
 1. technicalities
 2. politics
 3. traditions
 4. values
 5. economics
 6. external pressure, such as international organizations and the like
- **Actuarial experts must hold all these aspects clearly in mind and must not be influenced by political wishes**