

The Market for Social Insecurity

*A shady pension reform entices economic elites
and clouds the future of Sweden's elderly*

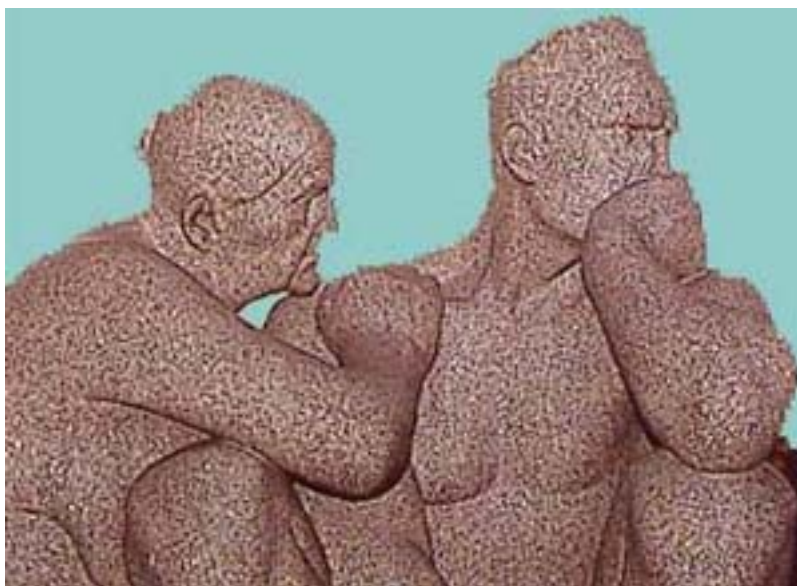
Jan Hagberg & Ellis Wohlner

An efficient national pension system that has helped to make Swedish old folks among the most economically secure in the world has now been replaced by a costly, elaborate construction which is almost certain to make the retirement years of future generations less secure.

The pension reform that went into effect in 2001 has been presented as a necessary response to the "welfare paradox" that confronts virtually all developed countries. The paradox is that a steadily shrinking work force, working fewer hours, must support a steadily expanding population of retirees.

This is a trend that has caused widespread and frequently exaggerated alarm over the solvency of national pension schemes. The Social Security system of the United States, for example, has in recent years come under intensifying attack from those who claim, mainly on the basis of dubious assumptions, that it is on the verge of bankruptcy.

The Swedish pension reform has therefore attracted considerable attention abroad, since it is said to provide a solution to the threat of fiscal insolvency posed by the welfare paradox and other factors. Ironically, the enthusiasm appears to be greatest among interests which in the past have frequently heaped scorn on Sweden for its general-welfare system. These include the enemies of Social Security in the United States, and the international business press (see for example,



"Pensions: Time to Grow Up", in *The Economist*, 16-22 February 2002). Approval by such interests should signal a warning to those who are devoted to the traditional Swedish model of general welfare and social solidarity.

It turns out that there are, indeed, several reasons to be concerned about the likely effects of the recent reform on the well-being of Sweden's senior citizens. Among other things, the new system will almost certainly result in reduced pensions for a large majority of citizens, and promote social injustice by yielding varying retirement incomes for individuals in similar circumstances. It also implies an enormous transfer of economic

power from society as a whole to special interests, and stimulates the flow of capital out of the country.

The problems and deficiencies of the new pension system become evident when compared with its abandoned predecessor.

The old system

The old pension system, which went into effect in 1960, consisted of two components: a universal basic pension (“FP”) to anyone who had resided in Sweden for a total of at least three years; and a supplementary pension (“ATP”) based on the number of years worked and the amount of earned income. Both components were keyed to the Standard Income Unit (SIU)*, and were automatically adjusted for changes in the Consumer Price Index.

With this two-part system, those who retired at age 65 with at least 30 years of eligible work experience received pensions averaging 60-65 percent of pre-retirement earnings. (Most people also had a collectively negotiated supplement, adding roughly ten percent.) This was among the highest pension levels in the world, and greatly improved the standard of living among the Swedish elderly.

The system was financed on a pay-as-you-go basis, with tax revenues from the current work force contributing to the pensions of the retired. Substantial buffer funds were established to minimize the effects of variations in contributions, investment returns and benefits. The funds were invested primarily in Swedish government bonds and grew steadily to the equivalent of ca. four years’ total pension benefits. The size of the buffer funds was reviewed every fifth year. In addition to their function in the pension system, they provided a source of investment capital for the entire economy that was especially

*Standard Income Unit (SIU) is an accounting device used in the calculation of social benefits, income levels, tax tables, etc. Roughly 85 percent of the labour force have incomes less than 7.5 SIUs. The value of an SIU in 2002 is set at SEK 37,900 (roughly US\$3,800 at the end of May 2002).

SECURE RETIREMENT

An adequate national pension system based on principles of social justice would include the following elements:

- Genuine social security that ensures a decent standard of living for all
- Universality, i.e. including the entire population
- Guaranteed minimum benefit
- Financial stability
- Moderate relationship to pre-retirement earnings
- Generally perceived as fair
- Easy to understand
- Predictable benefits
- Low administration costs
- Low vulnerability to market fluctuations.

Note: Terms such as “decent . . . relationship . . . viable . . . fair . . . easy”, etc., are relative, and can only be understood in comparison with other alternatives.

valuable during economic downturns. These funds grew in real terms from 1960 to the mid-1990s, when the revised pension system was agreed upon, amounting at that time to some 700 billion kronor. This contradicts the frequently made assertion that the old system was running out of money.

There were several clear advantages with the old system. It was easy for most citizens to understand, future pension benefits were predictable, and the purchasing power of the elderly was maintained. It was also comparatively simple and inexpensive to operate: The cost of administration was only about 0.5 percent of total benefits.

Given these advantages and the relatively comfortable pensions it provided, the old system enjoyed wide acceptance among the general public. But due to such factors as the welfare paradox noted above, concern began to mount during the 1980s that benefits would

eventually outstrip revenues. Critics pointed to a number of perceived shortcomings, including the following:

- The system was “unfunded”*
- Benefits were not linked to real economic growth or demographic changes.
- The system was financially “unstable” (whatever that means)
- The relationship between the individual’s contributions and benefits was not strong enough.
- Political support for the system was unstable, it having been approved in parliament by a margin of just one vote.

Of course, there were conflicting views about the urgency and the relative importance of these deficiencies. But there was general agreement that something would have to be done in order to prevent the system from collapsing.

The obvious solution was to make adjustments to the existing system, and pension experts recommended three, in particular:

- indexing benefits to real economic growth instead of consumer prices
- raising the normal retirement age.
- providing for a reduction in benefit levels in response to demographic changes, if and when it actually became necessary

Modifications of this sort were entirely feasible. But that option was ignored in favour of the very different thing which is now being cited by fiscal conservatives as the very model of a modern pension system.

The new system

The primary goal of the pension reform is to achieve automatic, long-term financial stability. The self-evident social goal of a pension system, i.e. to maintain the living standards of the elderly, is no longer self-evident. That is a secondary concern of the new system, which will almost certainly result in reduced living standards for the majority of pensioners. Certain subgroups, such as young people who are late in entering the labour market and middle-aged women, are likely to be especially disappointed upon retirement.

*It is very doubtful whether any national pension system can be “funded”. See page 4.

The new system is based on lifetime earnings and is financed by a levy of 18.5 percent on wages. Sixteen percent is allocated to a “pay-as-you-go pension” and 2.5 percent is placed in a “premium reserve pension” which is required to be invested in mutual funds.

According to its authors, the reform has resulted in a stable system which automatically adjusts to changing demographic trends. They also claim that the system is linked to national economic performance, particularly with regard to the 2.5 percent of earned income that is required to be invested in mutual funds. Future pensioners are confronted with a choice of nearly 700 funds offered by some seventy financial institutions including banks, insurance companies and mutual-fund operators. Up to five funds may be selected at any given time, and cost-free transfers are permitted on a daily basis. The pension credits of those who do not make any active choice are placed in a state-operated fund established specifically for that purpose.

Serious problems

Exactly what all this means for the pensions of the future is a mystery to which no one appears to have a satisfactory answer. But it is already apparent that the new system is burdened with a number of serious problems.

For one thing, it is vastly more complex and difficult to understand than its predecessor. It is also much more costly to administer: A special national agency had to be established just to handle the traffic in mutual funds. One indication of the system’s complexity is that its introduction was delayed by several years due to difficulties in developing an adequate computer system. Whether that problem has been solved remains to be seen, but large sums of tax money have already been expended for that purpose.

One thing that no computer system will ever be able to do is to predict future retirement benefits. Although the amounts of contributions are clearly defined, the benefits to be paid are not. This is due especially to fluctuations in the value of the mutual funds in which citizens are required to invest. Those who choose more wisely or more luckily will receive higher pensions than those whose choices are not so fortunate— even if their circumstances are identical.

Thus far, the vast majority of those involved have been losers. Since the funds are tied to the

(continued on page 5)

Funded“ vs. “Unfunded“ Programmes

In his prize-winning essay, “Paygo Funding and Intergenerational Equity”, Prof. Robert L. Brown makes a strong case for the pay-as-you-go principle in financing national pension systems. He argues that a fully-funded pension scheme is no more financially secure than a paygo scheme. Both depend on the ability of the economy to create and transfer wealth. For a pension system, the funding mechanism is irrelevant.

In his essay, Brown quotes from *The Economics of the Welfare State* by Nicholas Barr: “The widely held (but false) view that funded schemes are inherently ‘safer’ than paygo is an example of the fallacy of composition*. For individuals, the economic function of a pension scheme is to transfer consumption over time. But, ruling out the case where current output is stored in holes in people’s gardens, this is not possible for society as a whole; the consumption of pensioners as a group is produced by the next generation of workers.

“From an aggregate viewpoint, the economic function of pension schemes is to divide total production between workers and pensioners, i.e. to reduce the consumption of workers so that sufficient output remains for pensioners. Once this point is understood it becomes clear why paygo and funded schemes, which are both simply ways of dividing output between workers and pensioners, should not fare very differently in the face of demographic change.”

Another interesting angle is provided in the essay, “Can the Latin American Experience Teach Us Something about Privatised Pensions with Individual Accounts?”, published in early 2002 by Dr. Tapen Sinha, who writes:

“In economic terms, there is no fundamental difference between a tax transfer pay-as-you-go social security scheme and a bond transfer, pay-as-you-go social security scheme. In a bond-transfer scheme, the bond issue posits an illusion of asset-creation. But, the sole purpose of the bonds is to engineer a transfer payment to the retirees. In a practical sense, benefits of the current retirees come from the contributions of current workers.

*The fallacy of composition is to assume that, if something is true for an individual, it must also be true for an aggregate of individuals. For instance: If I stand on my seat in the theatre I will get a better view; but if everybody does the same, nobody will have a better view.

“To understand the equivalence, it is important to remember that a government bond is simply a promise by the government to make a payment in the future. A government promise to make a payment, to pay off a bond is not fundamentally different from a government promise to make a payment for social security benefits.

“If the government requires you to buy bonds and promises you future payments to retire the bonds, then it is not doing anything essentially different from requiring you to pay taxes and promising you a future transfer payment.”

Sources

Robert L. Brown, Professor of Statistics and Actuarial Science at the University of Waterloo in Canada, has been president of both the Canadian Institute of Actuaries and the Society of Actuaries. In 1994, he won the third SCOR International Actuarial Prize for his essay, “Paygo Funding and Intergenerational Equity”, which was published under the same title in the *Transactions of the Society of Actuaries*, Vol. 47, 1995. It is also available on the SOA web site at: www.soa.org/library/tsa/1990-95/TSA95V4722.pdf

The Economics of the Welfare State by Nicholas Barr was published by Stanford University Press in 1987.

Dr. Tapen Sinha is Professor of Risk Management & Insurance at Instituto Tecnológico Autónomo de México, Mexico City, and also a professor at the School of Business, University of Nottingham, England. The essay cited above was presented at a Society of Actuaries conference, and can be found on the SOA web site at: www.soa.org/SECTIONS/RIDFC/CLAETUSAPPWIA.pdf

stock market, the recent crash has resulted in widespread losses, some much greater than others. Once again, people are learning the hard way that the stock market can go down as well as up.

Defenders of the system have offered reassurance that the stock market will rise again and, with it, the value of market-related funds. What they have not done is to offer any solace to those who have exercised the poor judgement to reach retirement age at a time when the value of their pension funds has declined. They will have to live with the financial consequences of that unfortunate timing for the rest of their lives.

Even if a positive result could be guaranteed (an impossibility, as noted) the question remains as to how many Swedes really want to devote time and effort to figuring out which of nearly 700 mutual funds to invest in. The largest single category (86% in 2002) consists of those who choose not to make any choice; their credits are invested by default in the state-operated fund, which has been one of the less dreadful performers to date.

In general, the system is based on faith in the stock market's ability to generate higher investment returns than the economy as a whole. It is a faith that appears to be highly exaggerated, as indicated by the following summary of the

relevant trends during the 20th century:

"Between 1920-1929, the value of stocks in the United States increased by over 400 percent. Then came the great crash of 1929, followed by a modest recovery until 1936. But from that year until 1949, stock values declined. True, the level in 1949 was twice that of 1920; but that doubling of value happened to be exactly the same amount as the U.S. Gross Domestic Product (GDP) increased during the same period.

"The stock market climbed again during the period from 1950-1960. Then followed fifteen years of slow decline. In 1979, the value of the stock market was twice that of 1950-- which was, again, the same amount that GDP had increased during the same period.

"From 1980 onward, the stock market climbed straight toward heaven for what seemed likely to be all eternity. A sobering decline has since occurred and, if history repeats itself, it is more probable that the stock market will fail to return to its previous heights than that it will experience a new long-term upswing." (Translated from Swedish text of Sten Ljunggren, "Veckans diagram 10" in *Etc.* magazine at: www.etc.se)

The logic of the new pension system also ignores the most fundamental rule for playing the stock market: Never invest more than you can

COMPARISON: OLD VS. NEW PENSION SYSTEM

	Old	New
What is defined	Benefits	Contributions
Predictable benefits	Yes	No
Typical pension as % of earnings	60+%	35-45%
Social security for the individual	High	Low
Ease of understanding	High	Low
Complexity	Low	Very High
Administrative costs	0.5%	Many times higher
Vulnerability to market fluctuations	Low	High
Investments primarily in	Govt. securities	Stock market
Economic power & control	Public	Private
Changes made by	Parliament	Built-in formulas
Public acceptance	High	Low

afford to lose. For the vast majority of future pensioners, that amount is nil.

It should also be noted that not even the “guaranteed portion” of the new pension is guaranteed. It may decline in value, since the formula with which it is calculated is partially based on the performance of the mutual-fund portion.

Transfer of power

In effect, what the new system does is to transfer a large portion of economic power from society as a whole to special interests, including banks, insurance companies, mutual funds and other financial institutions.

Further, and in contrast to the old system, there has been a large transfer of capital out of Sweden as pension funds invest in foreign stocks. This hardly contributes to the stability and de-

velopment of the Swedish economy, to which the entire pension system is supposed to be linked.

For a large majority of citizens, the net result will almost certainly be a lower pension than would have been the case if the old system had simply been adjusted. In addition, there is a serious problem of social justice: Individuals who have worked equally long and hard will receive widely varying pensions, depending on the luck of the mutual-fund draw.

All of this has been justified by the quest for automatic financial stability. But the fact is that all financial systems require adjustments over time. The goal of automatic long-term stability is exceedingly elusive—the pension-planning equivalent of a perpetual-motion machine. The unlikelihood of ever achieving that goal makes the subordination of the system’s social function all the more indefensible.

THE LATE, GREAT INSTITUTION OF THE PUBLIC INQUIRY

A fundamental feature of the Swedish general-welfare society during its formative period was the use of thorough public inquiries, whose history dates back to pre-parliamentary days. Every reform and all proposed legislation was grounded in a lengthy public inquiry, often carried out in stages.

The first stage was often a study of practical matters, followed by a non-partisan parliamentary review, and sometimes concluding with a political commission whose task was to prepare the implementation of the proposed law or reform.

At each stage, great care was taken to solicit comments and suggestions from government agencies with the relevant expertise, political parties and all organizations with an interest in the proposal. The purpose was to ensure that all relevant issues were analysed and discussed from every possible angle prior to final decision. In this way, technical and practical matters were thoroughly illuminated in the political arena, and members of parliament could become well-informed about important matters on which they were to decide.

The ATP reform provides a good example of this procedure. The first public inquiry into pension reform was commissioned by the government in 1935. It was a one-man inquiry by the chief insurance inspector at the time, O.A.

Åkesson, who submitted several proposals in the mid-1950s, which were then discussed with customary thoroughness. This was followed by a political commission, led by government official Per Eckerberg, which presented its recommendations in 1958.

The Eckerberg commission’s most significant contribution was to raise the pension ceiling, which had the effect of greatly expanding the range of eligible workers. This led to strong public support for the ATP system— support that was much broader than suggested by the narrow margin of victory in the referendum that preceded adoption of ATP in 1960.

When Sweden’s economic policy was shifted in a neo-liberal direction during the 1980s, the institution of public inquiries was bypassed. Examples of major decisions that were rushed through without the traditional process of careful review and consideration are the currency deregulation of the mid-1980s and the tax reform of 1990-91. The Social Democratic government’s revolutionary decision to apply for membership in the European Union was presented as a footnote to a budget proposal in 1989. The recent pension reform is yet another case in point.

These and other far-reaching changes have been implemented out of public view by a small coterie of politicians.

In short, the deficiencies of the new national pension system are so profound that the question arises as to why it was ever adopted. The answer is probably to be found in the secretive, undemocratic process by which it was constructed and rushed into law.

As with all fundamental issues in Sweden, the controlling power over pension reform was held by the Social Democratic Party (SDP) which has dominated national politics for more than sixty years. Since the assassination of Olof Palme in 1986, the SDP has undergone a transformation from a grassroots movement serving the interests of lower- and middle-income groups, to an increasingly autocratic apparatus dominated by a political elite (see "The Price of Everything" at www.nnn.se).

That transformation is more or less complete, and the pension reform reflects the autocratic methods that the SDP leadership has now established as praxis.

This can be seen clearly in the fate of the "consultation process" that preceded the adoption of the new pension system. In accordance with SDP tradition, the party faithful were invited to study and debate alternative proposals for pension reform. An overwhelming majority of the 15,000 active members who participated in this process recommended that the old ATP system be retained, adjusted and further developed.

That was not the right answer. So the SDP leadership chose to misinterpret it and, instead, to conduct closed-door negotiations with representatives of four other political parties. The proposal that emerged from this secretive and hasty process—lacking any significant input of available expertise—was submitted for a review that was scandalously brief by Swedish standards: The members of parliament and other interested parties were granted a mere six weeks to study and comment upon an extremely complex technical document of some 1000 pages' length.

Meanwhile, leading lights of the SDP embarked on a public relations campaign to soothe the mounting anxiety and outrage of the party faithful with an account of the proposed new system that was either remarkably misinformed or deliberately misleading.

In the ensuing bewilderment and confusion, the SDP and its centre-right collaborators were able to ram the reform through the parliament with a large majority. It is doubtful that more than a handful of the MPs who gave their consent had any real idea of what they were voting for.

Brave new democracy

That is what democracy looks like in the brave new world of Sweden, for a fundamental issue that will directly affect the lives of every citizen who reaches retirement age in the decades ahead.

It is a style of democracy and an approach to pension reform that corresponds quite well with similar trends in other countries. The Social Security system of the United States, in many ways similar to the abandoned Swedish system, has long been under attack by reactionary forces that have never forgiven Franklin D. Roosevelt for introducing such an element of "socialism" into the American Way of Life.

Wild, undocumented claims of the Social Security system's impending collapse have been a standard feature of U.S. politics for decades, and experiments in other countries are often cited as better alternatives. The market-oriented pension system of dictator Pinochet's Chile was frequently served up as a suitable model—until it sank in the wake of the market crisis that afflicted the Orient in the late 1990s.

A similar campaign was conducted against Sweden's recently abandoned ATP system since its inception in 1960. The difference is that the U.S. Social Security system has, thus far, survived the propaganda assault by powerful special interests.

Now, it is the Swedish model of pension reform that is being touted as the best bet for the future. Some countries of Western Europe and the former Soviet bloc have been so effectively indoctrinated that they have modelled their own pension reforms on the new Swedish model. These include Latvia, Poland, Russia, Croatia and Mongolia—societies that differ in many significant respects from each other and from Sweden.

But they do have one thing in common: The new Swedish pension system is very likely to have very unpleasant consequences for all of them, and especially for their most financially vulnerable citizens.

– 10 June 2002

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See following page for update on developments during the first six years with the new system.

POSTSCRIPT

The first six years with the new Swedish pension system

Evolution of the system: *then vs. now*

- Costs in percent of total benefits: 0.55 % in 1999 vs **2.18 %** in 2006.
- Number of funds: 700 funds (in 2002) vs **780 funds** (in 2006).
- Percentage of new savers actively choosing funds other than the “default” fund: 14.1 % (in 2002) vs **8.0 %** (in 2006).
- Only **2.7 %** of savers changed funds more than once in 2006.
- As foreseen, there is little understanding of the complex new system; a recent public survey reports that only **22 %** of the 5.6 million participants *claim* to understand their individual annual statements.
- Public debate focuses on ways to (1) reduce the number of funds in the system; (2) improve the pedagogics of the individual statements; (3) introduce mandatory “personal economics” courses in the schools, rather than on important basic changes.
- While the “automatic braking mechanism” has not actually hit the system any year, it has been very close to doing so and has only been avoided thanks to a booming economy the past few years; what the reaction will be to reduced pensions when the “brake” inevitably does hit is unknown. The then responsible social insurance minister claimed that the “brake” was a tool for almost unimaginable circumstances, such as a war close to Sweden with large numbers of refugees or an extreme global economic crisis, and was only added for the sake of completeness.
- The new system’s defined contribution nature makes comparisons very difficult, but various studies have confirmed that pension benefits under the new system are gradually reducing relative to the old system; according to the Swedish Social Insurance Agency, a drop of about 10 % in the first 12 years, with further reductions expected.

Impact of the original article

- **Publication** of the article in the **Scandinavian Insurance Quarterly**, December 2002.
- A **public debate** in Sweden in February 2003 between the authors and two principal architects of the new system, one of whom was the former Minister for social insurance.
- **Rebutals** in the **SIQ** in 2003 by the two “architects”.
- Participation by Wohlner in a **Pension Seminar in New York** in June 2003, organized by the Actuarial Society of Greater New York.
- **Support** in the **SIQ** in 2003 for our views by the former Director General of the Swedish National Insurance Board.
- A “guest editorial” (“*Social Security Reform? Bad Lessons from Sweden*”) by Hagberg / Wohlner in May 2004 in **Commentary**, the internationally distributed monthly newsletter of Buffin Partners, a US-based economic investment and actuarial research consultancy firm.
- The “editorial” became part of a study module for the Society of Actuaries examinations.
- **13 more debate articles in SIQ**, from 2004 to the present, by a variety of international experts on pension issues.
- More time is required in order to properly assess impact, but the original article has received attention from many places, contributed to debate and even to questioning of the Swedish “model”. The Swedish reform has been used as a shining example by enemies of Social Security in the United States, and even elsewhere; our critique has provided valuable ammunition to those defending Social Security.

— 27 April 2008

Jan Hagberg and Ellis Wohlner are both retired from senior management positions at large Swedish insurance companies. Both are members of the Swedish Society of Actuaries, where Hagberg has served as Chairman, and the International Actuarial Association. Wohlner is also a member of the (American) Society of Actuaries and the American Academy of Actuaries.