Commentary

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Social Security Reform? Bad Lessons from Sweden

A Guest Editorial by JAN HAGBERG and ELLIS WOHLNER

As various reform proposals are considered for the US social security system, policymakers would do well to note the lessons to be learned from Sweden. The reform debate usually begins with well-known demographic facts—i.e., that people are living longer, birth rates are low, and the ratio of retirees to workers is increasing.

Rarely though, are the reasons discussed for having social security pension systems. The strongest motives lie in the very words, "social security". "Social" implies a social purpose and that the system is for a whole population; "security" implies some basic level of protection and that covered individuals can feel secure about actually receiving what is promised from the system. Also implicit is that society as a whole benefits by helping retirees secure a decent standard of living while reducing the burden on younger generations and/or government of supporting senior citizens.

Powerful economic interests see a vast market and profit potential if social security can be even partially privatized. Even in a country like Sweden, with a long tradition of extensive social benefits, these economic interests have been able to make unfortunate inroads. What lessons can be learned from Sweden?

From 1960 until recently, Sweden had a national social security pension system based on *defined benefits (individuals know what benefit is coming)*, that provided retirees at age 65, having at least 30 years of eligible work experience, with indexed pensions averaging 60-65% of pre-retirement earnings. The system was financed on a pay-as-you-go basis, with tax revenues from the current workers contributing to the pensions of the retired. Substantial buffer funds—invested primarily in Swedish government bonds—minimized the effects of variations in contributions, investment returns and benefits.

The system was widely accepted and easy to understand, future pension benefits were predictable and senior citizens' purchasing power was maintained. It was simple to operate, with administrative costs at only 0.5% of total benefits.

Changing demographics and a national economic crisis in the late 1980´s paved the way for drastic changes—agreed on, without public debate, behind closed doors—beginning from 2001. The existing system could have been modified by, for example, upping the retirement age and/or raising the number of years of work required and/or lowering benefit levels. Instead, the formerly self-evident social goal of maintaining the living standard of the *elderly* was abandoned for the new goal of achieving automatic, long-term financial stability of the *system*. The new system is based on *defined contributions (individuals have no idea what benefit is coming)* and on lifetime earnings, and is financed by a levy of 18.5% on wages. 16% is allocated to a completely new kind of pay-as-you-go pension where an "automatic balancing mechanism", without new political decisions, transfers all financial disturbances into reduced pensions. 2.5% is placed in a "premium reserve pension" (*private account*) that each covered person must invest in mutual funds.

General benefit levels have been significantly lowered, future benefits are impossible to forecast, and administrative costs have *quadrupled*—mostly because of the mutual fund part—to 2.0% of total benefits. (If real investment return is 3% per annum, the amount accumulated after 30 years of regular annual savings will be *22% lower* if the cost factor is 2.0% instead of 0.5%.)

Future pensioners are confronted with the hopeless task of choosing up to 5 mutual funds for their private accounts out of 650 funds offered by 75 financial institutions including, banks, insurance companies and mutual fund operators. Premium pension credits of those who do not actively choose—*over 90% of all new participants*—are placed in a state-operated fund established specifically for that purpose. Everyone in the new system is forced to speculate in mutual funds and results in the first years have been disastrous.

From March 2000 until March 2003, the Swedish stock market declined by 68%. As of 31st January 2004, 84% of all accounts had lost money, despite the upturn in the market since March 2003. Defenders of the new system say that the stock market always rises again. That might be the case, but it is not at all sure. And it is unfair to transfer all risks onto the retirees, as is now done both in the pay-as-you-go system and in the private account system. *This is, in fact, a betrayal of the basic idea of Social Security!*

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For more information about the Swedish pension reform, see an earlier Hagberg/Wohlner article at: http://www.nnn.se/n-model/pensions.htm

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