Features of the Swedish pension reform

Joakim Palme

Introduction

The common massive expansion of pension entitlements among the most advanced industrial nations should not conceal the large variation in how pension systems have been designed. The political motives behind the pension reforms have differed, and so have the social policy goals (Myles 1984, Esping-Andersen 1990, Kohl 1988). The priority given to the different goals has also varied among countries and shifted over time (Palme 1990). This has resulted in different institutional set-ups and created specific legacies. Historically, Japan and Sweden have followed different paths in the development of public pension systems. When, at the turn of the 21st century, the question of pension reform had again become high on the agenda, not only among the most developed countries but all over the world, these institutional set-ups provided specific frameworks for the debates and policy initiatives. Again, Japan and Sweden appear to have responded to these challenges in different ways. This paper examines the Swedish case.

Pension reforms in mature welfare states are reactions to the problems and achievements of the existing systems of old age security, as well as to the different interests generated by them. This is also true for the Swedish pension reform. In June 1994, the Swedish Parliament took a decision about guidelines for pension reform and four years later, the implementation of the actual legislation started. In November 2001, the first benefits generated under the new systems were paid out. The new legislation is reshaping all parts of the pension system. It is introducing the so-called 'notional defined contribution accounts' as the first-tier, a new way of guaranteeing basic security for elderly people, and funded defined contribution accounts with private fund managers within the public framework. The reform has provoked considerable interest in the international community of pension scholars and policy makers. This is due to the radical and innovative character of the reform.

There are a number of reasons why the Swedish pension reform is interesting to people beyond the country's own borders. The current understanding of social policy change during the crisis of mature welfare states has been largely informed by studies of the conservative retrenchment of liberal welfare states (for example, Pierson 1994). The Swedish welfare state is different, and so is the politics of the pension reform. Even if there are elements of privatization, the reform does not represent a clear-cut retrenchment of public commitments. Instead it can be seen as a response to the fundamental criticisms of modern welfare states for eroding incentive structures and lacking cost control, a response that tries to deal with these issues within a, basically, public framework. It is also an interesting test case for studying how welfare state institutions serve as a basis for interest formation and coalition building, as well as for creating their own legacies. Moreover, the boundaries between public and private are reaffirmed, generating a special interest.

The Swedish pension reform is claimed to be a solution to the demographic, financial and political pressures on old age security. The reform has also influenced reforms in other countries, such as Latvia and Poland (Fox and Palmer 1999). Whether there is scope for further diffusion of the logic of the Swedish reform remains an open question. However, it is important to recognise that the reform has also provoked considerable confusion as well as some criticism. Obviously, many commentators have difficulties in understanding the technical aspects as well as the social policy content of the reform, while others are just critical of the design of the reformed system. This suggests that descriptive accounts of the reform are warranted. In addition, the reforms have implications for the public-private mix and for the wider political economy of the welfare states that, so far, have not been discussed very much.

The paper addresses, firstly, the historical legacy behind the reform, then the three components of it are described from the benefit side, including the funded component and its organization. The different forms of funding and the debates about them, as well as ongoing reform work, are briefly discussed in the following section. The paper concludes with a discussion of the politics behind the reform and the political economy of the Swedish pension system in the wake of the reform.

1. The historical legacy and the reform process

Even if the Swedish pension reform is radical in many respects, the legacy of the pension history of the 20th century was also evident. Arguably, it is necessary to consider the historical development, not only to understand why the reform happened but also why it was designed in such a way.

The first public pension reform, beyond systems designed for specific groups like military officers and civil servants, can be dated back to 1913. The first-tier of the system was a universal and compulsory fully funded contributory plan that would eventually pay benefits for those who contributed. The reform also included means-tested, so-called 'supplementary,' benefits that were targeted at low income pensioners (Elmér 1960). Another deviation from a strictly universal model was that it did not include state employees, who instead continued to have separate programs.

It turned out that the funded benefits never became very big and that the means-tested supplements became of much greater importance. This was a result, not only of the modest size of the premiums and of the failure of the funded benefits to keep pace with inflation, but also of a gradual, more generous application of means-testing. Thus, in the early 1930s, a large majority of those above statutory pension age actually received some sort of public pension (Palme 1990).

The truly universal system, giving equal benefits to all persons above pension age, was established only after the Second World War, when means-testing was completely abolished by the legislation of a universal 'People's Pension' in 1946 (Elmér 1960). The entire population was not only integrated in the same system of social protection, but also provided with equal benefits. The growing importance of occupational plans among white-collar employees in the private sector (besides the existing programs for public employees) became part of the platform for policy making in the post-war era. It also raised the issue of earnings-related benefits for blue-collar workers in the private sector. Thus, the situation was similar to the British one after the war, to what Richard Titmuss (1955) labelled 'two nations of welfare' and the solution he saw was compulsory earnings-related pensions.

Whereas the 'People's Pension' reform received unanimous support in parliament (Elmér 1960), the next step in the formation of the public pension system was accompanied by the most acute political conflicts in Swedish post-war political history (Heclo 1974). It was implemented only after a referendum that divided political life into different camps, and in parliament it passed with the smallest possible margin. The result was the ATP plan that was enacted in 1959. In 1960, the population of the working age started to earn entitlements to supplementary earnings-related benefits on top of their universal benefits (FP). Whereas the FP was financed out of the general revenue, the ATP was entirely financed by employer contributions, originally with the same ceiling applicable to both contributions and benefit purposes. Well above 90 percent of the labour force had earnings below that ceiling.

The ATP program was designed according to the 'pay-as-you-go' (PAYG) and defined benefit principles. A benefit formula was applied in which 30 years gave the right to full benefits based on the 15 best years of earnings. The target level was set at 60 percent of past earnings. Past contributions as well as outgoing pensions were indexed to the development of a consumer price based index—the so-called base amount. The same index was used for the FP benefits. As the ATP benefits began to be paid out, they triggered compensatory demands for higher benefits to those with only FP benefits. Following the Norwegian example, special graduated supplements (PT) were introduced for those with no or very low ATP benefits (but with no other income testing). These supplements were graduated in relation to a fixed target level. This, in fact, made small ATP entitlements worthless, which is something we will return to in the context of the recent pension reform.

In some respects, the data from the 1980s show a remarkable performance of the Swedish pension system. Not only had the ATP reform trebled the replacement rate of the public pension of a retiring worker in the 1980s compared to the situation in 1960, but the basic benefits had also almost doubled in relation to average earnings (Palme 1990). In terms of poverty and inequality, only the Finnish and Norwegian systems, with similar designs, appeared to match the Swedish system in terms of reducing inequality among the elderly (Korpi and Palme 1998). If expenditure levels of the 1980s are standardised by the relative size of the elderly population, the levels appear modest by comparison.

Why was a system with such a good track record so radically reformed? The need for change had become obvious, despite the good social policy performance. To explain the nature of the change is more complicated. The urgency of changes in the existing system had actually been recognised in the early 1980s and resulted in the formation of a parliamentary pension commission that was appointed in 1984. There were two outcomes of that commission. One outcome was very concrete; widows' pensions were to be phased out and replaced by time limited survivors benefits for both men and women. This was a reflection in the fact that the dual earner model had gained an almost universal foothold in Swedish society, but it also represented a reduced public commitment. The other outcome was more indirect in terms of changing policy and consisted of a comprehensive report into the status of the pension system (Reports of the Government Commissions (SOU) 1990:76).

The old age pension part of the system was under-funded and, given the increased demographic pressure that could easily be projected, these problems were going to be aggravated. The system was kept going by the interests from the buffer funds. However, the funds would have to be substantially reduced or even emptied to keep the system going, unless benefits were reduced or contributions increased. It had become clear that the price indexing of the system meant that the system was unstable in not only financial terms, but also when it came to the social policy goals. Financial instability was evident in the forecasts from the National Social Insurance Board. If growth was going to be low or zero, contribution rates would have to be increased to match the entitlements to such an extent that it would be unbearable for the population of working age.

The system of indexing that guided the Swedish social insurance system for decades has been admired for its simplicity and transparency. However, the ceiling for benefits purposes had been set at 7.5 of the so-called 'base amounts' (used for the price-indexing of the social insurance system) in 1960, and with real wage growth this meant that more and more people had earnings above that ceiling. This process was slowed down by the fact that wage distribution had become more compressed during the 1960s and 1970s and real wages fell in the early 1980s. Towards the end of the 1980s, it was nevertheless evident that the gradual transformation of the entire earnings-related component of the pension system into a basic security flat rate program could be rapid if nothing was done. The price indexing of the basic benefits FP and PT had also resulted in frequent adjustments of the percentage of PT, but left it subject to the discretionary decisions of parliament.

In this context, problems with prevailing inequities should be added. The primary focus in the debate had been directed towards the benefit formula, where the 30 out of 15 rules penalised those with a long working career and flat earnings profile over the life-cycle, a typical trajectory of low income persons. Less attention was given to the fact that the gradual increase of PT meant that the past (employer) contributions of those with very low ATP, in fact, became worthless.

Thus, the pension system was not reformed, because it had failed to deliver either basic pensions or income security to the retired population. It was reformed because it was tied to the development of prices and not the underlying real economy, which meant that the system was unstable from both a financial and social policy perspective (SOU 1994:20). These instabilities in combination with the fact that the Centre/Right opposition challenged the Social Democrats on the pension issue meant that the political stability of the system had been shaken. To understand the nature of the actual reform and the process that led to this outcome requires a more extensive analysis than can be offered within the context of the present paper.

2. The three components of the reform: IP, GP and FFP

The Swedish reform is fundamental when it comes to the policy instruments. It is reshaping both the income and basic security components of the system, as well as the role and forms of pre-funding. Since it has no predecessor elsewhere in the world, it is necessary to describe the basic elements, as well as its implications for the public-private boundaries, in order to understand it. Since the reform has both micro- and macro-economic implications, this is vital for understanding the implications for the economy at large. In short, the reform, firstly, is replacing the old earnings-related defined benefit system with a defined contribution system where basically 18.5 percent of earnings are the financial basis of the old age pension system; 16 percent will go into notional accounts (NDC) and form the basis of the income pension (IP) and 2.5 percent will go into fully funded individual accounts (FDC) and generate fully funded benefits (FFP). Both kinds of accounts are converted into annuities at the date of retirement, albeit these annuities have different forms. Secondly, basic security is ensured by a universal guarantee pension that replaces the old combination of FP and PT. The size of this guarantee is graduated in relation to the two contributory public retirement benefits (NDC and FDC). We will start the description with the income pension since it forms the first-tier of the reformed system, continue with the guarantee pension, and conclude with the description of the fully funded component.

IP- Income pension according to the Notional Defined Contribution Principle

When it comes to the basis for determining the size of benefits, the reform introduces a number of changes. One fundamental change is that the earnings-related component becomes the first-tier. Another fundamental change is that the benefit formula is to follow the principle of defined contributions. Here, it is important to recognise that the total size of the contributions (18.5 percent) has been determined with the underlying ambition of maintaining the replacement levels of the old system. The assumption is a contribution record of 40 years, same life expectancy as in 1994 and a 2 percent annual growth in average income. In expenditure terms, the reform implied an increase of expenditures roughly equal to a scenario where the ceiling of the old system would be indexed to earnings. It is important to note that this implies an increase in expenditure compared to unchanged rules. The concept of a notional account means that the PAYG character of the system is retained in this part and the size of the contributions going to the notional account was defined at a level high enough to cover the earned entitlements in the old system.

The reform introduces a new logic for determining the size of benefits. The principle is that all contributions are accumulated and attributed a rate of return, which is equal to the growth in average annual pensionable income of all insured persons. Even if there is no fixed retirement age in the new system, the pension cannot be drawn before the age of 61 and there is no legal right for employees to continue their employment beyond the age of 67. The withdrawal is flexible, not only beyond the age of 67 but also in terms of percentage. It can be drawn at 25, 50, 75 or 100 percent. The accumulated notional wealth and the life expectancy of the cohort determine the size of the pension (but it is life-long for each individual). The annuity from this part of the system is calculated at an interest rate of 1.6 percent. This interest rate has been imputed in the conversion of the accumulated notional wealth in order to get a more even income during retirement. There is a transitional period, which means that persons born in 1954 and later will have their pensions fully calculated according to the new benefit formula. Pensions of persons born from 1938 to 1953 will be determined according to a mix of old and new rules. The cost of administration has been calculated to 0.7 percent of contributions or 0.02 percent of notional capital.

In practice, the system is much more complicated, which has to do with the fact that there might be changes in employment and earnings, which means that the accumulation of pension entitlement in this notional system is not matched by future contributions. This is handled by the buffer fund of the notional system and the application of the automatic balancing mechanism. With the buffer funds it is also possible to handle demographic and economic shocks to the system, at least when it comes to the financial stability of the system and generational equity (Settergren and Mikula 2001).

The design of the benefit formula follows the principle of making lifetime earnings the basis for determining the size of the future pension. A strong motive here is to provide a good incentive structure to increase labour supply. An important feature of the reformed system is that it attempts to make all kinds of redistribution that occurs within the system explicit and motivated by social policy considerations. Thus, earnings not only give future entitlements to income pension but also to a number of other incomes, such as social insurance benefits. Credits are given for having small children, engaging in tertiary education and doing national service. Child rearing is a special motive for giving pension entitlements besides income and earnings. There are three different ways of calculating additional entitlements on top or in addition to the entitlements generated by the parental leave benefits. The most favourable way of calculating these entitlements is applied automatically. Common to all three mechanisms is that the credits only apply until the youngest child is four years old. In addition, military service and tertiary education can give additional pension credits. Since the incomes associated with these activities tend to be low, this will also be the case with the additional pension credits.

The old benefit formula had some implicit redistributive elements in it. It allowed those who stayed outside the labour market and/or worked part-time for some time to still earn a decent public pension because of the 30/15 rules. This was something that particularly benefited the large number of women who had interrupted work records and/or part time jobs for long periods of time. For persons who had experienced extended periods of unemployment or sickness, the old system also gave some leeway. At the same time, the old formula delivered a fair amount of unintended redistribution in favour of those who had chosen to work less for their own welfare. In this context, there is also a social class dimension in the sense that white-collar employees benefited from the old 15 best years formula with their rather steep earnings profile over their career. Blue-collar workers will get a better deal with the new formula with their flat earnings profile.

GP - Guaranteed pension

The strongest element of redistribution of the reformed system is associated with the provisions for low-income pensioners. As indicated above, the old mechanism of providing basic pensions were the universal pension (FP) and the graduated supplement (PT), which is now replaced by the guaranteed pension (GP). The GP is co-ordinated with the IP. This means that only those who lack an IP will get a GP at the maximum rate. Those who have an IP below the guaranteed level will get a supplement of GP. Hence, a difference compared to the old system is that those who have earned entitlements to IP will get a slightly higher total public pension (sum of GP and IP) than those with only a GP. This is an application of a Finnish innovation when it comes to co-ordinating basic pension and other benefits (Kangas and Palme 1991).

The universality of the basic provisions is important when it comes to the classical social policy goal of combating poverty. It is also of vital importance in terms of the public and private boundaries of old age security and the interplay between these two spheres. The reformed public system is insulated from what happens with private provisions since the GP is only co-ordinated with IP (including the funded component) and not with private pensions, whether occupational or individual. In principle, this is not new. However, in one respect, related to the tax system, the universality has been strengthened. This means that private pension savings will not have any effect on present and future public pension benefits. As will be argued below, this is important in the sense that it strengthens the motives for private savings without reducing public commitments. This diverges from what happens elsewhere in the world in terms of strengthening the means-testing of basic provisions.

The reformed system is, hence, primarily an income-related system based on contributions. Most people will have contributory benefits because most people have been employed. For those who have only earned small contributory benefits, there will be a supplement. So even if they have not reached the guaranteed level on the basis of their past contributions, they will get some credit for past contributions and get a higher total pension (unless incomes have been particularly small).

FFP - Fully funded individual accounts within a public framework

This part of the reform is the clearest example of the changing boundaries of public and private in the system of old age security. It opens up the possibility of private fund managers handling individual contributors within a public framework, where public authorities both collect contributions and pay out the pensions. Moreover, it introduces individual risk taking within social insurance, where programs are usually designed for collective risk sharing. As indicated above, the size of the total contribution rate to the new system was guided by an ambition to secure the same benefit levels as in the old system, and the size of the notional accounts were determined by the explicit goal of maintaining earned entitlements. This left 2.5 percent for a pre-funded element. The design is an outcome of a political compromise, where the Centre/Right accepted a higher contribution rate than required by the past commitments, only if an individual solution was found with regard to the funded component.

The contributions to the Swedish system are compulsory. They are collected jointly with the other contributions by the National Tax Board (RSV). Until the final assessment of a person's taxable income is made, the National Debt Office (Riksgäldskontoret) manages the funds. Then the money is transferred to the Premium Pension Authority (PPM). The PPM manages the individual accounts of all contributors to the system. In 2000, this number was more than 4 million and it is expected to rise to 6 million in the foreseeable future. Each individual can choose a maximum of five different fund-managers for their accumulated funds, and fund-managers can be switched each day of the working week without cost. The PPM aggregates all individual choices every day and trades them with the fund managers. This means that savers are anonymous to the fund managers. The accumulated funds of the individual are equal to the contributions and annual return on investment (plus inheritance gains and minus administrative costs). Funds can be withdrawn from the system starting at the age of 61, but can be postponed as long as the contributor wishes. The withdrawal is always in the form of an annuity—fixed interest or variable—that is provided by PPM. The proportion of the funds that is withdrawn is flexible (25, 50, 75 or 100 percent of funds). The administration cost of the system is about 0.4 percent, whereof the PPM share is about 0.3 percent of the assets. To this, an average of about 0.7 percent of administrative costs of the fund managers should be added (Palme and Sundén 2004).

3. Pension funds in the new system: Buffer (AP) funds and PPM funds

The funding issue has been the subject of heated debate ever since the AP funds were established in connection with the implementation of the ATP program in 1960. It is not the funding as such which has been the big controversy, but rather the public control over it. In the 1950s, the political Centre/Right had proposed fully funded individual solutions outside public control. The funding issue also became important because the size of the funds became very large, even by international standards. As the ATP program started to mature in the 1980s, the size of funds equalled five to six times the yearly expenditures of the supplementary earnings-related benefits. In all these respects, the issue of funding emerged as critical in the reform process in the 1990s. Worries about the savings rate of the increased public commitment to old age security, and a need to create buffers to smooth the effects of demographic changes, show that the macroeconomic concerns were important motives in the early history of public pension funds in Sweden. They continue to be so (Government Report 2001/02:180).

There were clear restrictions regarding the investment of the three AP funds from the beginning. The funds were mostly placed in Swedish—mainly government—bonds and used for investment in the housing sector. However, the importance of investments in the stock market grew, especially with the establishment of the fourth and fifth AP funds in 1974 and 1988, respectively. In 1996, a sixth fund was set up and directed towards emerging business, particularly small- and medium-size firms. This supply of investment capital has been considered as important from time to time. This was, for example, the case when the third AP fund got its new and more liberal instructions. It coincided with a downward pressure of the prices on the Stockholm Stock Exchange and was therefore welcomed by the private sector. However, the proposal by the Social Democratic Party at the time of the 1991 election, to liberalise the investment restrictions on the public pension funds and thus allow a larger share of assets in stocks and a larger share in individual companies, was heavily criticised by the political Centre/Right.

A central feature of the pension reform is that it separates old age pensions from the invalidity (or as they used to be called 'early retirement') pensions, thus creating separate systems for managing the risks of ill health and old age. One aspect is important to point out in relation to the issue of funding: a major achievement of the pension reform was to solve the long-term under-financing of the old age pension system, partly by fixing contribution rates and linking entitlements strictly to contributions, and partly by increasing contribution rates. The task of the AP funds in the new context of old-age pensions is to work as buffers, i.e. short-term shocks of an economic or demographic nature should not immediately translate into lower pensions.

The original AP funds should not, however, be seen to be designed exclusively for coping with old age pensions. Rather, their purpose was to cover for fluctuations in both invalidity and old age, and it therefore seemed reasonable to use part of the funding to strengthening the general revenue since the expenditure on invalidity pension now became a responsibility for the general revenue. The size of the sum to be transferred to the general revenue has been subject to discussion and some controversy. It is hardly surprising that the view of the Ministry of Finance was that as much as possible should be transferred. For those who defended the old-age pension system and the reform of it, the obvious restriction here was that there was a clear need for a buffer fund if the automatic balancing mechanism was not to kick in. It was decided that in the first round, 200 billion SEK were to be transferred to the general revenue and that a check should be made in 2004, and then it should be decided if more money could be transferred. In the summer of 2004, this issue became a political controversy and views between the Minister of Finance and the cross-party group responsible for implementing the reform were openly divergent. However, after negations there was, in the end, no transfer of money from the AP funds to the general revenue.

In the future, the size of the AP funds is intended to vary and be dependent on, among other things, demographic development. The fact that the size of the pension funds will decline from time to time is not really a new feature since they were originally designed as buffer funds. By international comparison they are not likely to be small in the future either, but relative to the individually linked funds and to private pension funds they will lose in relative importance quite considerably. It should also be emphasised that the size of the AP funds are dependent on several factors, but that there is a so-called (negative) 'automatic balancing mechanism,' which kicks in if the funds become too small. Such a situation might, for example, appear if the employment rate develops in an unfavourable way. (It has to do with the fact that the notional accounts are indexed with the average pensionable income and not the pensionable income sum.)

It is also here that the last component of the pension reform comes in. It is an automatic mechanism, which is intended to handle a situation where the AP funds have grown unnecessarily large. If the size of the funds is considered unnecessarily large, a situation with a *distributable surplus* would appear. The proposal of the investigator (SOU 2004:105) is based on the principle that a release of a distributable surplus should not more than marginally increase the probability of negative automatic balancing. This led the investigation to propose that automatic distribution of the surplus should only be made when the balance ratio (total assets/total liabilities) reaches above 1.1000. The various analyses and simulations done by the investigation suggest that this is a reasonable level. The surplus will be distributed in the form of increased pension benefits and pension credits on the notional accounts.

The PPM system is likely to generate assets of more than 700 billion SEK. It represents a form of integration of public pension funds that is important to recognise, not only because it represents something new in Sweden but also because it is a break from the patterns established elsewhere. Views diverge, not surprisingly, about the merits of the new system. Whereas trade union leaders and people from industry have claimed that the new openness is diverting Swedish capital and is therefore lowering investment in Sweden with implications for employment growth; the same critique has been directed to the AP funds because of their large foreign investments. Others claim that the new order is necessary, as any other directives would not only make the job of the AP funds difficult but also make the pensions lower than they would otherwise be.

A common feature of all pension funds is that during the first years of the 21st century they suffered extensively from the very poor returns on the international stock markets since 2000. This has actually led to a decline of the nominal value of these investments, and it is likely to have contributed to the low level of interest among the population in becoming active in this market. This is evident in the PPM system. Whereas more than 70 percent made active choices in the first round in the year 2000, only 9 percent of the newcomers (mainly young persons) in 2003 made active choices (Press-release PPM 2004-05-07).

Although the PPM system was criticized from within the labour movement and the trade unions, that part of the critique had not been very vocal once the compromise was struck. It should also be pointed out that several unions have struck collective bargaining agreements with very similar solutions. Instead, it is issues raised by economists that have been more prominent in the debate. Among Swedish economists, M. Palme and A. Sundén (2004) have presented the most elaborate analysis. Their conclusions can briefly be summarised as follows: The very large number of funds, well over 600, is pacifying rather than stimulating rational choices and that, in addition, individuals do not necessarily want to choose their own placement strategy. Another important observation is that it has been observed that individuals tend to invest too much of their assets in their own country or in a company that they work in—what is usually labelled as 'home bias.' Diversifying your risks, not placing the pension capital in the same sectors as the human capital, would be more rational. What has also been pointed out is that individuals should decide the proportion of stocks in their total pension package, but that this is an area where individuals typically make mistakes. Here a basic feature is that individuals take a decision once and do not make changes, even if changes are motivated by the aging of the individual (see below), or by new information about the stock market.

Even if the 'great compromise' that is embedded in the pension reform is more or less sacred, it would be premature to rule out change. Given the fact that the Social Democratic Government has appointed an investigator to examine the present rules, this has opened up a possibility for a first change in the system. According to the directives (terms of reference) of the investigator (Dir 2004:77), the review is supposed to address the following issues: Firstly, identify problems in relation to the support of the choice of an individual, both in terms of improved information and guidance. Secondly, analyse to what extent improved information and guidance can improve results and reduce risks in terms of poor returns. Thirdly, consider the design of the system in terms of the extent and composition of the supply of funds, and suggest motions that can improve the choice situation of individuals and thus reduce the risk of poor returns. Fourthly, consider and propose changes in connection to when the individuals make the transition of assets into annuities. Lastly, evaluate the costs of the system in terms of fees to the fund managers and to assess the consequences of the proposed changes for the total administrative costs of the system. The final report of this investigation is due October 31st 2005.

4. The public-private mix and interplay

It can be argued that the pension reform has changed the public-private boundaries and interplay in several ways. The clearest example of the changing boundaries is how the funds of the fully funded component of the public system are managed. Not only do private fund managers manage the pension contributions, but there is also an open registration procedure and free choice for the contributors. This should, however, not be confused with an entire privatisation of pension provision. There are a number of important differences that deserve to be emphasised in this context. First of all, the system is entirely anonymous since the fund managers do not know the identity of those who have chosen their fund. Secondly, the payments from the fully funded component are public in the sense that PPM pays the annuities to the contributors, even if this part is also subject to choice in terms of the start date, duration, amount (in percentage) and form of benefit. It is also important to point out that contributions are compulsory and not voluntary, as is usually the case with private pensions. Moreover, there is a default fund with public management of the funds for those who do not actively choose a private fund manager. Depending on how meaningful contributors find it to be active in choosing a private fund manager, this fund has the potential to be of great importance.

The private-public interplay is, however, changing in other ways too. Are they crowding each other out or are they mutually reinforcing? Historically, the ATP reform was perceived as a threat in the sense that it provided income security for fairly large segments of the labour force that otherwise would have saved in private pension plans. Yet, the private occupational program continued to expand and was also redesigned to be better co-ordinated with public provision. It appears that the existence of public provision reduced short-sightedness among the population, and made other supplementary private solutions appear affordable.

The relative importance of private pension has been on the increase for over two decades. This shows very clearly when we compare expenditure levels for social insurance with those for occupational and private individual insurance for the 1990s. Even if the expenditure on old age pensions increased in real terms in the public systems, the growth was higher in both absolute and relative terms in the private sphere (Grip 2001).

Turning to the coverage of the various kinds of provisions, it should be emphasised that comprehensive statistics do not exist. Figures have been estimated, using direct information from the various authorities, except for the labour force data from Statistics Sweden. The estimates give the following picture for 2000: the statutory schemes covered virtually 100 percent of the labour force and more than 80 percent of the population of working age (20-64). The occupational plans covered more than 90 percent and 75 percent of the labour force and the population of working age, respectively. The number of contributors to private individual plans equalled about one third of the population of working age (direct information from insurance companies).

The design of pension reform has consequences for the co-ordination with private sector benefits. It is difficult, or at least potentially very expensive, to run defined benefit plans on top of public defined contribution plans. The pressure on (and desire of) employers to get a grip on costs has pushed development in the occupational pension sector in the same direction. The defined contribution plans offer a solution. Here, it is interesting to note that today the occupational plans include redistribution, for example, by giving credits during periods of parental leave, showing that these sorts of elements can also be a part of private pensions. It should be emphasised that the collective plans in the public sector have moved towards more secure funding since 1998. The move towards more funding and an increased reliance on the DC principle started with the reform of the blue-collar workers' scheme in the private sector, which is converting the plans to individual defined contribution. It continued with a reform of the municipality sector with a new agreement in 1998, and further developed with a new agreement for a funded component for state employees in 2002, which was implemented in 2003. Negotiations have been progressing in the fourth and last area, the so-called ITP plan for private white-collar workers where the plans are fully funded, but where employers are pushing for a change towards defined contributions. In all areas changes have been made, following an EU directive, to include employees with temporary contracts in order to improve coverage. The coverage has also been improved by lowering the age for earning entitlements in the occupational plans.

When we assess the incentive structure in the wake of the pension reform, an important aspect is that the system is insulated in relation to private pensions. The universal guarantee is not affected by income other than contributory public pensions. This gives good incentives for private savings. In many countries, the minimum guarantees might actually be higher than the contributory benefits, which provide very poor incentives for people to take part in the public system. A means-tested minimum provides a disincentive for savings, because people who have saved will not get the basic pension.

The concern about labour supply, and ultimately about economic growth, and the role of private pension plans as a pull factor has manifested itself in different ways. One example is the appointment of a special review investigation by the Government (Dir 2004:99). The mission of the investigator is not to examine the private pension plans as such, but rather the tax treatment of contributions, funds and pension benefits. The task of the investigator is to put forward further proposals that should promote labour supply and growth. In this context, the Government wants to simplify and neutralise the taxation of the various pension systems. The importance of the EU context is also present in the terms of reference for the investigation. Here, the importance of increased labour mobility and the potential erosion of the tax base should be given due attention by the investigator. The background to these directives is also to be found in the tax subsidies that are currently applied to both occupational and private individual plans. The subsidies are most important when it comes to the lower taxation of the returns on capital. The final report is due to be delivered by November 1st 2006.

5. Discussion: The political economy of pension reform

The reform has been successful in putting the system on financially stable ground, in both the long- and short-term. The system is actually stable, irrespective of demographic and economic developments. In this respect, the nation-based welfare state appears to be on safer ground than it was before the reform. Will the reform increase the legitimacy of the welfare state? This question is, of course, more open than that of financial stability. One problem is related to the fixed contribution rate that is, in effect, shifting the financial risk onto the retired population (Pedersen et al. 2001). The question is whether pension levels will be seen as offering a decent living to retired people, even if longevity increases substantially.

The individual risk-taking in the FDC part of the reform is another aspect that limits the risk sharing introduced by the reform. Whether this will contribute to the erosion of solidarity that typically underpins the welfare state remains an open question. This is also the case with the exit option in the funded component of the reformed system. Potentially, if solutions outside the typical boundaries of the national welfare states appear attractive to a majority of the population, this might increase political demands for moving further in the same direction in pensions and in other areas of social policy.

All social policy programs affect the interests and the formation of coalitions (Korpi 1980). This implies that changes in social policy programs have the potential for changing the formation of interests and coalitions, and here the pension reform raises several issues. The first is the separation of the financing of old age and invalidity pensions. This is problematic from a distributional point of view. The financial base for the invalidity pension (which primarily goes to low income people) is thinner in terms of forming risk coalitions. The pension reform solves the problems of financing the old age pension part of the system, while it leaves the invalidity pensions to be financed out of general revenue. Secondly, the shift in terms of making the income pension the first-tier of the system reflects changes in the employment structure, including increased female participation in the labour force. It is also a way of dealing with the equity and incentive problems inherent in the old benefit formula and of the co-ordination of basic and earnings-related benefits. These changes may enhance the legitimacy of the system, and the wage indexing of the ceiling guarantees a continued broad base of commitment to the system. The fact that the basic provisions are supplementary forms means a second-tier might narrow the level of commitment to this benefit. Universality is retained, but the changes may have implications for the extent to which the Swedish people are prepared to subscribe to the system. As discussed above, the indexing to prices of the universal guarantee is also likely to create tensions. Furthermore, those living on other benefits will get pension credits on their notional accounts, which in turn means that there will be very few with only the guaranteed level.

No other part of the welfare state is likely to have as great a degree of inertia as old age pensions: the contributory systems build up entitlements over long periods of time, and young and old are involved at the same time. This means that it is difficult, but—as the Swedish pension reform shows—not impossible to change existing institutions. There is, hence, no determinism in institutions. Even if the design of institutions is important for how interests are organized and make some scenarios more likely than others, it is still the case that the future of specific institutions lies in the hands of people who are free to choose. Moreover, every kind of change may trigger different kinds of mobilization with different consequences for the viability of the institutions themselves. The conclusion is that the Swedish pension reform, like all pension reforms, represents both continuity and change. The reason for continuity, when there is a change in the overriding purpose of a reform, lies in the fact that the state also has to deal with both those who have already retired and those who have earned entitlements in the existing systems. The Swedish reform also represents continuity in that it maintains the social policy goals of basic security, income security and redistribution, although the means have been changed dramatically. The drama is not about the level of benefits, but how the different parts of the system are co-ordinated and how redistribution is achieved.

The history of pension reform has often involved conflict, but also coalition-building and emerging consensuses (e.g., Baldwin 1990, Salminen 1993). The conflicts and coalitions have been manifested in the pension systems in various ways, and they are part of the institutional legacy of each system. It appears to be a reasonable hypothesis that the effects of institutions, their legacies, stem from different sources. One direct effect is that each kind of model has its own technical logic in the sense that once it has been implemented, it appears to restrict the kind of reforms that may be implemented subsequently. In this respect, the Swedish pension reform represents an important break with 'path dependency.' Another effect is more indirect and it relates to the kind of coalitions that stood behind the reform and what kind of interests it organises. Once implemented, the institutions have also started to work as mechanisms for interest formation, independently of the conditions that created them, giving an additional dimension to the notions of institutional inertia and path dependency. For the political actors, the range of possible reforms is simply restricted by these factors—along with the real, or imagined, constraints imposed by 'the economy,' where the notion of 'globalisation' appears to play an increasingly important role. This kind of path dependency has proved to be much stronger in Sweden.

In the reform of the systems of social protection, there is another immanent dilemma concerning the sustainability of the public pension systems. On the one hand, the aim with these institutions is that they, in principle, should not be changed. Instead they should ideally be robust enough to 'survive' changing economic conjunctures, and, thus, to contribute to the 'predictability' of important conditions for different actors, not least on the labour market. On the other hand, if needs and constraints change to such an extent that the institutions no longer serve their primary purposes well, then this is, of course, a good enough reason for reforming them.

Finally, it appears warranted to make a remark about what pension systems can and cannot do. Experience demonstrates that a public pension system can be very efficient in eradicating poverty among the elderly. It can also be a very efficient means of securing sufficient income for those who retire from the workforce. However, pension systems alone cannot solve the problems of employment, savings or the situation of elderly workers. In designing the public system in a reasonable way, in taking incentive problems into consideration, both when it comes to labour-force participation and when it comes to savings, social policy making can assist in trying to achieve the goals. Yet, all these measures will not help us if we do not succeed in securing a macroeconomic policy framework that is more employment-oriented than we now witness in many places, including Sweden. Also, problems and challenges may sometimes appear insurmountable; but that something is difficult does not make it impossible. It would, on the other hand, be misleading to believe that anything goes. Omission to correct mistakes and mismanagement, or to adapt the systems to changing needs and demands, will make the programs undesired and unsustainable. An important lesson, drawn from Lawrence Thompson's (1998) thought provoking book on pension reform: there is freedom of choice. If we want to, and if we take wise decisions, we can make public pension systems efficient with regard to both social and economic considerations.

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Joakim Palme
(Stockholm University Swedish Institute for Social Research and Institute for Futures Studies)