SWEDEN’S MOVE TO DEFINED CONTRIBUTION PENSIONS

Introduction

In 1994 Sweden converted its defined benefit public pension scheme into a combination of a notional defined contribution (NDC) pay-as-you-go scheme and a financial defined contribution (FDC) scheme. A defined benefit guarantee constitutes the floor of the overall pension system. Reform of the Swedish pension system was driven by several concerns, including the threat of unsustainable cost increases in coming decades, issues of inter- and intra-generational fairness, and a long-standing concern about the effect of tax and benefit rules on the labor force exit of older workers.

The goal of Swedish politicians in setting up the administration of the FDC component of the new public system was to create a system with privately managed individual investment accounts, where the worker makes his or her own investment decisions within a broad spectrum of alternatives.

In *Sweden’s Move to Defined Contribution Pensions*, Edward Palmer, head of the Division of Research and Evaluation of the Swedish Social Insurance Agency and professor of Social Insurance Economics at Uppsala University, discusses in considerable detail the motives for and the design and implementation of the new Swedish pension system.

Findings

Sweden’s new defined contribution schemes—both the NDC and the FDC—are based on fixed contribution rates that are applied to individual earnings. In the NDC pension scheme, contributions go toward paying the benefits of current pensioners, as in any pay-as-you-go plan. In the FDC pension scheme contributions are allocated to individual financial accounts. A main difference between the NDC and FDC schemes is that money transferred to individual FDC accounts is invested in the financial market and represents financial saving.

In the NDC scheme, all participants earn the same rate of return in any given period, which reflects nominal per capita covered wage growth. In the FDC scheme, the financial rate of return is determined by the individual’s own portfolio investment decisions.

Both the FDC and NDC schemes are individual account schemes. Workers pay contributions on their earnings, and the benefits they eventually receive are based solely on their own accounts and their own birth cohort’s life expectancy at the age at which they claim their benefit.

Participants can claim at the same or separate times one-quarter, half, three-quarters, or a full NDC or FDC benefit while continuing to work full or part time or exiting the labor force fully. In principle, workers can combine different percentages of benefits with different percentages of work from age 61. The new system makes gradual exit from the labor force easier. There is no maximum age when a benefit must be claimed.

In the NDC scheme, the retirement benefit takes the form of an annuity based on the retiree’s account balance and the (unisex) life expectancy of the retiree’s birth cohort. In principle, FDC schemes can offer phased withdrawals, lump sums, and annuity products. However, in the Swedish FDC scheme only life annuities are offered.

The contributions of plan participants who do not make an active investment fund choice for their FDC accounts are allocated to a default fund. At the outset, about two-thirds of all participants made an active choice, and one-third ended up in the default fund. In the ensuing years the majority of new participants have not actively chosen funds.

New contributions are credited to individual accounts annually, but there is about an 18 month lag time until the contributions are recorded. During the interim, the contributions of all participants are held at the National Debt Office, where they earn a bond rate of return.

The Swedish model centralized all of the functions of the investment business, except for the asset management function, under the umbrella of a clearinghouse. The goal of this approach was to create cost efficiency while enabling an unlimited number of funds to participate and compete for individual account holder investments.

Conclusion

Summing up, the Swedish pension reform was successful in meeting its objectives. The pay-as-you-go commitment has become financially stable through the introduction of the NDC. The combination of the NDC and FDC schemes has brought financial stability to the overall earnings-related component of the public pension system. As a consequence, the overall system has come much closer to inter- and intra-generational fairness in the sense that the contribution rates paid by successive generations are the same and the value of a krona contributed in a given year by two workers will give the same pension right in the future to both participants, regardless of the shape of their earnings careers or the number of years of participation.

In addition, the transition from defined benefit to defined contribution pensions has not meant the downfall of social policy. Instead, it has led, first, to an increase in the financial transparency of the overall system. Second, non-earnings-related credits are funded in the same period in which they are granted. Third, the system has become neutral in terms of influencing the work and retirement decisions of older workers, at least in the income range above the guaranteed level. Fourth, the FDC scheme creates saving on a yearly basis of about 1 percent of GDP, which, in the absence of offsetting effects, is new net saving. Finally, the overall system, including the occupational supplements that play a central role in Sweden, will yield good pensions in the future for the average employee, and at the same time continue to provide a minimum public guarantee.

This paper is one of several AARP Public Policy Institute reports that examine aspects of social security reform in a number of countries. The other reports deal with voluntary carve-outs in the United Kingdom, recent developments with individual accounts in Chile, Australia’s system of means-tested benefits and mandatory occupational savings schemes, and the financing policies of the Canada Pension Plan and the Quebec Pension Plan.