Pros and cons of the Swedish pension system in an international perspective: Adjusting the system but keeping the faith

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1 Background issues
2 Next steps: Policy design
3 Next steps: Process
1 Background issues
Theoretical lesson: The simple model is not enough

• The simple model (well-informed consumer, rational behaviour, etc.) is a useful starting benchmark but a bad basis for policy design

• What is needed is second-best analysis
  • Imperfect information (the economics of information, Nobel Prize 2001)
  • Non-rational behaviour (behavioural economics, Nobel Prize 2002, 2017)
  • Incomplete markets, incomplete contracts (Nobel Prize 2016)
  • Distortionary taxation (necessary to finance government redistribution; addressed in the literature on optimal taxation, Nobel Prize 1996)
Policy lessons

• A holistic view: pension systems comprise different elements, e.g. inkomstpension, guarantee pension, premium pension, occupational pensions, which should be considered as a whole

• A long-run view

• Automatic adjustment where plausible

• But also a mechanism for periodic discretionary adjustment, *inter alia* to address
  - Design problems as they emerge, e.g. the operation of the brake, exposed by the economic crisis
  - Changing social circumstances and values, e.g. registered partners, same-sex marriage
Lessons from Sweden for other countries

• Good initial design
• Ability to take a long-run view (Pensions Group)
• Capacity for thoughtful consideration of reform
• A system in good shape but needing some adjustments
2 Next steps: Policy design

• Adequate pensions: Pension age
• Adequate pensions: Contribution rates
• Occupational pensions
• The premium pension
2.1 Adequate pensions: Pension age

• My 2013 report criticised the way the inkomstpension adjusts to rising life expectancy
  • Not only a lower inkomstpension at earliest pension age as life expectancy rises
  • But also, earliest pension age should rise over time, linked in some sensible way to life-expectancy

• In a DB plan failure to raise pension age can cause problems of sustainability

• With DC/NDC the issue is not primarily sustainability but the adequacy of benefits
What other countries do:
Proposed retirement ages in 2050


Under 65  Sweden, Norway
65-66    Estonia, Bulgaria, Austria, Latvia, Lithuania, Luxembourg, Malta, Romania, Slovenia, Hungary, Switzerland, Poland
66-67    Belgium, Spain, Croatia, France, Germany, Slovakia
67-68    Finland, Czech Republic
68-69    Cyprus, Ireland, Great Britain, Portugal
69-70    Italy
70-71    Greece, Iceland
71-72    Netherlands
72-      Denmark

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2.2 Adequate pensions: Contribution rates

- Illustrates need for a holistic approach
- In a DC or NDC plan with a brake, the level of benefits is constrained by the level of contributions
- A lower contribution rate increases the risk that
  - The balancing mechanism will reduce inkomstpension benefits
  - As a result, more people will qualify for the guarantee pension
- Underlying issues
  - The overall adequacy of benefits
  - The balance of costs between workers (inkomstpension) and taxpayers (guarantee pension)
  - The incentive effects on work of a greater role for the guarantee pension
- Further considerations
  - Raising contribution rates affects benefits for everyone
  - Raising pension age affects benefits only for those who would previously have started benefit at age 61
2.3 Occupational pensions

• Again, need for a holistic approach
• Desirable for the rules for occupational pensions to be thought about alongside those of the state system to avoid unhelpful incentives, e.g. ‘spikes’ that give excessive incentives to retire at a particular age
2.4 The premium pension

• The approach
  • The following discussion is not based on ideology, but on what works
  • Why does Sweden have a national health service but not a national food service?
2.2.1 The problem

• Can’t
• Won’t
• An impossible problem
Can’t

Lessons from information economics

– In many areas of social policy the model of the well-informed consumer does not hold

– In the context of pensions
  • A survey, 50% of Americans did not know the difference between a stock and a bond
  • Most people do not understand the need to shift from equities to bonds as they age if they hold an individual account
  • Few people realise the significance of administrative charges for pensions

• In Sweden, a worker faces 830 pension providers

• Even if all information is given in a standard format, the volume is too great for good decision making

• Not a problem that can be solved by improving financial literacy

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Financial literacy goes only so far


- Lusardi and Mitchell’s ‘Big Three’ questions
  - You have $100 in bank account paying 2% interest/year. How much would you have after 5 years: less than $102? equal to $102? more than $102? don’t know?
  - Suppose interest rate on your bank account is 1% a year and inflation is 2% a year. After one year could you buy: more than today? same as today? less than today?
  - True or false? Using $100 to buy shares in a single company usually provides a safer return than buying $100 in a wide range of shares)

- In Sweden (among the best globally) 71% are financially literate; but even in Sweden, that means that nearly 30% lack financial literacy
Won’t

• It gets worse: not only people who can’t, but also:
• People who can but don’t: behaviour by a financially knowledgeable person given time/energy/attention constraints
• Note that managing a pension is a continuing process over the whole of working life, not an event like buying a car
An impossible problem

- Imagine a person aged 25 with graduate training in finance. His/her optimal savings pattern in a voluntary setting will depend on
  - Future needs
  - Future earnings
  - Future asset returns
  - Annuity prices at the time of retirement
  - Future inflation
- All these involve substantial uncertainties
2.2.2 What policy directions

- As mentioned in my 2013 report, the economic case for choice from 830 funds is weak
- Peter Diamond and I recently submitted evidence to an Australian inquiry on the design of default pensions, drawing on lessons from behavioural economics and the experience of the US Thrift Savings Plan, UK NEST and the default in Sweden
- Points to a simpler system in which choice from a large number of funds is very much a minority option
  - ‘Marks and Spencer’ pensions (good quality-mass produced suits) for most people
  - ‘Saville Row’ pensions (exquisite, very expensive tailor-made suits) for people with the money and the interest for more active approach
- Much of what we propose for Australia draws on some of what Sweden already does
The right approach

- People who wish to make choices about pensions and retirement should generally have room to do so
- But
  - Some people will not make choices
  - Choice can be costly, and
  - Some people may make bad choices
- Thus, the fundamental point:
  The pension system should work well for people who make no choice – and making no choice should be an acceptable option

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Recommendations to Australian inquiry: Accumulation

- A single default design, the same age-varying portfolio for all workers who make no choice, or who explicitly choose to be in the default
- A simple choice architecture within the default: US Thrift Savings Plan has 5 funds, so does UK NEST
- One account per person to avoid ‘lost accounts’ and reduce administrative costs
- A single clearing house to collect contributions and distribute them to providers, as in Sweden
- A single record keeper, as for the Premium Pension
Implications: Premium Pension

• The premium pension already has much of this design, but it is useful to think about its choice architecture.

• Since the premium pension is part of the mandatory system, the state should establish the choice architecture, e.g. government should establish risk levels because taxpayers face the downside via the guarantee pension.

• Pilot study (2017) recommends
  • A well-designed default, together with
  • A small number of curated funds, and
  • Access to a larger range of funds, but with choice subject to regulation for reasons of efficiency and quality assurance.

• The pilot study reaches the same conclusions as our Australian evidence for the same reasons. The two documents were finalised within a week of each other without either having knowledge of the other.
Why a regulated platform

• Pharmaceutical drugs
  • Regulated for quality for well-understood reasons
  • If there are many similar branded drugs, many systems encourage generic versions and/or competition to be a preferred provider

• Pensions
  • Analogously pensions need oversight by an independent entity that does not itself provide a product
  • Australia and Chile have moved over time to an increasingly regulated and controlled environment

• NEST in the UK has taken the process to its logical conclusion
  • Explicitly based on the findings of behavioural economics
  • Default is target date funds with 3 phases: foundation phase; growth phase; consolidation phase
  • Curated choice: higher risk, lower risk, Sharia and ethical
How much should choice within the Premium Pension be constrained?

• If the premium pension followed the NEST approach, there would be only one provider (AP7)
• The pilot study is less radical: like NEST it includes
  • The default, together with
  • Curated choice from a small number of funds
• But it also includes wider choice for people who want to make a more active choice
• However, regulation is essential
  • To avoid inefficient duplication
  • To protect workers from making bad choices
  • To protect taxpayers, who have to pick up the pieces if excessively high-risk products work badly
• Note that what is being discussed is the mandatory system; voluntary plans can offer wider choice
Implications: Occupational pensions

• Also useful to consider extending some of the Australia recommendations to occupational pensions, e.g. to make sure that a mobile worker does not have multiple pension accounts
3 Next steps: Process
What has gone well

- Sweden has a good pension system
- Some marginal adjustments are desirable, but the system as a whole is in pretty good shape, so radical reform would be a major mistake
The way ahead

• Automatic adjustment is useful in many circumstances

• But (reprise) all pension systems need a mechanism for periodic discretionary adjustment, *inter alia* to address

  • Design problems as they emerge, e.g. the operation of the brake, exposed by the economic crisis

  • Changing social circumstances and values, e.g. registered partners, same-sex marriage
Adjusting the system while supporting the strategy

• The division of labour
  – The role of the Pensions Group should be to set strategy
  – The role of the pensions administration should be to
    • Implement the strategy
    • Make necessary adjustments to the way the strategy is implemented, perhaps in consultation with the Pensions Group, but without the Pensions Group having to agree every detail
• The last point is important to allow necessary adaptation, e.g. to tighten regulations for the Premium Pension quickly if there is evidence of fraud
• The 1998 design was avant garde, but risks falling behind. Its great strength has been stability, but stability should not become stasis
• UK (frequent, politically-motivated reform) is one corner solution; Sweden (no reform) should not be the other
References


*Pilot study of possible structural changes for a more secure and more efficient premium pension system* (2017),