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# Changes in the Swedish pension regime in the mid-1990s

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## **Changes in the Swedish pension regime in the mid-1990s**

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Paris April 23<sup>rd</sup>, 1997

### **0. Introduction**

In my paper I will present a broad overview of the Swedish pension system mix as well as a discussion of the major changes in the principles and institutional logic of the system that have occurred during the last few years. I will end by discussing the social meaning and consequences of the shifts and changes going on in the Swedish pension system.

What does the Swedish pension regime taken as a whole look like? The Swedish pension system has for a long period been built around three different building blocks. The first, basic system is the tax-financed, public pension system. The second system is the earnings related secondary public pension system. The third tier is the occupational pensions systems. To this we can add the private pension industry with the tax-subsidized individual pension insurance.

In line with the theme of this seminar I will focus on those changes that illustrate the shift from defined benefits to defined contributions as well as the increasing importance of funded pension schemes.

### **1. The structure of people pension scheme today**

The basic, peoples' pension is the state-organised and tax-financed pension system directed to Swedish citizens and/or those that have been living in Sweden for a minimum of three years. This pension system constitutes the basic foundation for supporting the elderly in Sweden. Its main, rights-based principle

goes back to the mid-1940s. The pension benefits of this system are regulated by a cost-of-living-index. All citizens are entitled to this pension. Over 80% of all those receiving a pension in Sweden today will also have pensions from the public earnings-related pensions system.

Those that do not have any or just a low supplementary pension will get an additional *pension benefit*. The effective minimum amount is about 50.000 a year, i.e. 4000 SEK a month for a single person. The additional benefit accounts for about 15.000 a year. All extra pension incomes are fully deducted from the pension supplement, i.e. there is a strong marginal effect for those with rather low pensions.

## **2. The public secondary pension system: income-related system**

About 60% of all public pension benefits paid to Swedish retired persons flow from the earnings-related labour market pension system (ATP). The peoples pensions represent about 40 %. The publicly organized supplementary system, the ATP (the general supplementary pension system) grew out the economic and political considerations in the late 1950's and started to function in 1960. It served as a model and reference case for the pension reforms that came in Norway and Finland at a later stage.

The contributions to this system have been paid by the employers, today amounting to 13% of the wage sum. The individual contribution is a further one percent of the income. Full benefits presuppose a contribution period of 30 years. The level of benefits is determined by the earnings during the 15 best years.

Over the years contributions from the employers have accumulated into large funds. In 1995 the ATP funds had a value of 573 billions SEK. This fund equals 5 years of pension benefits. The fund is still growing, but the yearly contributions do not cover the pensions benefits paid out each year. In 1995 the contributions represented 70 % of the benefits paid out. The large dividends from the existing funds still led to a net increase in the value of the ATP funds.

The ATP funds were from the beginning planned to be transitory. They have

served the purpose of counteracting a drop in savings as well as balancing the expected rise in expenditures when the system reached maturity.

The pension benefits are pegged to the consumer price index and the ATP system is a defined benefits system.

### **3. The new unified public pension system in Sweden**

The structure of the public pension system changed radically in the mid-1990s. This transformation was supported by a broad political coalition, including the Conservative, liberal, centre and Social democratic parties. (The Green party and the Left Party were not included.)

The main feature of the new public pension system is that *pension benefits in Sweden in principle will be based on the total life incomes of the individuals*. The guaranteed basic level of income for the 65+ is redefined into a residual system. This guarantees a minimum of pension benefits on broadly the same level as today. The phasing out rules for this guarantee pension will not be 100% (as it is for the additional pension benefit of today) but 75%.

The new system is constructed to be financially stable and robust. It is based on contributions, reaching 16% of the incomes. The pension benefits from this new system will be linked not to a consumer price index but to a growth index. The new pension scheme will be phased in over a period of 20 years.

There is still discussion how much that should be paid in the form of employer contributions and how much that each individual should pay as an national insurance fee. What has been decided is that 2% of the contributions to the pension system shall be directed to personal pension accounts. Individuals are expected to choose an insurance company or pension fund to administer their personal account.

For the purposes and theme of this seminar I will emphasize these aspects:

- The decreasing importance of the defined benefits aspect,
- The increasingly tight link between a person's life earnings and the pension

benefit level

- The expanded role for individual pension fund accounts and the institutional links to the private pension industry that this implies
- The *overall level of pension benefits will decrease for many groups and categories*, e.g. those with short or irregular work careers. This aspect of the new pension system will increase the role of the occupational as well as the private pension schemes. These effects have already been noted by the pension industry, when marketing private pension insurance.

#### **4. The structure and changes in the major occupational pension schemes**

The third layer in the Swedish pension regime consists of the employer or employer/employee-run occupational pension schemes. These pension systems, their administration, funds as well as benefits are part of the wage and salary agreements between employers and employees.

In Sweden these systems fulfil a couple of different functions in relation to the public pension systems:

- They add a further 10% of income compensation to the pension recipients.
- They add substantial amounts of pension benefits for those in the higher income brackets that are not been covered by the public earnings-related system (ATP)
- They take into account the latter part of work life career to higher degree than the ATP scheme, basing the benefits on the earnings in the latter years of the work career.

There are four major schemes, representing the social and institutional cleavages in Sweden. There are two major systems in the private and two in the public sphere.

##### *4.1. Occupational pension schemes in the public sector*

The oldest, institutionally simplest and most generous system is that which covers the employees of the state. This system has the following characteristics:

- Pensions are paid from the state's current income, i.e. pensions are non-funded
- The pension benefits are basically determined by the income of in the last years

- And the pension benefit is defined as a specific percentage of the income in the last years of employment. The state pension system fills the gap that the levels 1 and 2 leaves for obtaining this defined benefit

The major part of public employment today however falls within local government (local authorities as well as counties). (For non-Scandinavians it may be worth pointing out that health care is the responsibility of counties). Traditionally local government has financed pensions from their current income. This system is somewhat less generous than that of the State. Negotiations are going on between the unions in the local government sector and the Association of Local Authorities and Association of the Counties regarding the future character of this pension system.

Among the larger cities and other local authorities there is tendency to reserve some money today for future pension costs, in the form of internal pension funds. The counties want a system of “virtual”, not real funds. Future pension benefits are to be calculated within the counties themselves and technically reserved

The pension debt for the local authorities is calculated to 110 billion. SEK while the pension debt of the counties is 70 billion SEK. These pension debts are not funded. The increasing pensions costs in the rather near future is a reason for cutting expenditures of local government.

In the public sector the pension systems include all employees, manual workers as well as white collar groups and management. In the private sector, however, we find a major difference between the occupational pension schemes for workers and white collar employees.

#### *4.2 Occupational pensions scheme for white collar employees in the private sector*

The pension system for white collar employees in the private sector is a funded system which at the same time operates with defined benefits, based on the earnings in the last years of the work career. The major part of contributions from the employers goes to finance the defined benefits:

- A 10 percent extra pension income for those who have pensions below the upper limits of the ATP public superannuation scheme
- For the higher income groups this system offer substantial benefits; employees having incomes over 270.000 SEK up to 750.000 will get about 65 % in pension.

This occupational pension scheme can be administered and funded in two different ways. The *majority* of the white collar employees are having their pension organised through an employer/employee-administered pension fund. But many of the larger Swedish firms keep the pension contributions as working capital within the firms; these large amounts are earmarked, monitored and re-insured in a specific pension institute. Here there is a parallel to what is developing within the local government sector, cf. above.

The funds run by the employer/employee co-sponsored pension scheme are quite large, up to 400 billion (SEK), all included. This large system is also now changing into a defined contributions scheme over time.

A further, recently introduced part of the white collar employee pension scheme has another character, explicitly based on the defined contributions model. Financed by a contribution of 2% of the salary, each employee may choose which pension fund or insurance company that they entrust the administration of “their” fund. This part of scheme is the model along which one of the new elements of the new public pension system will be organized. It is also the model for a part of the reorganised scheme for the manual workers.

#### *4.3 Occupational pensions for Manual Workers in the Private*

The occupational pension scheme for the manual workers has recently been reorganised. From now on it will be organised as a fully funded scheme, with rapidly growing funds. The larger part of this pension scheme will be based the “guaranteed growth” in the level of benefits. Another part of the scheme is based on the defined contributions model. Each worker is expected to choose an insurance company or pension fund to administer “his/her” account.

In 1996 the funds within the manual workers occupational pensions scheme

(STP) reached 115 billion, According to sources in the Swedish TUC the funds in the occupational pension scheme for workers will grow and reach 300-400 billion in 10-15 years. Of the yearly contributions 2-3 billion a year (based on a contribution of 2 % of the wage sum) are going to the individually managed pension accounts.

Thus, the two major occupational schemes in the private sector are based on pension funds - in fact very large and important funds.

### *5. The private pension industry*

Finally we should mention the role and importance of the “privata pensions industry”. This industry plays a role corresponding to the occupational pension schemes for the self-employed as well as for employers, by organising pension insurances that add pension benefits over and above the public systems. This is especially important for those with high incomes.

However, many citizens, esp. those in higher income groups have private pension insurances, on top of the public and occupational systems. The premiums are tax deductible to a certain degree, i.e. we have an example of the fiscal welfare system.

### **6. Concluding comments**

During a short period in the mid-1990s the Swedish pension regime has changed dramatically in its basic principles and institutional structure, even though the actual pension benefits that are being paid have as yet only been modified slightly.

- a) There is a shift from the defined benefit to either the defined contribution or the guaranteed growth model in determining the benefit level. (Cf. the new public pension scheme, and some of the larger occupational pension schemes)
- b) The link between the total lifetime earnings and the level of pension benefits in old age has become more direct. This means that there is less of redistribution within the pension schemes. This feature is being argued by economists and

politicians as having beneficial effects for the “incentive structure”.

c) There is an increasing emphasis on the personal pension account where the individuals will have to think about investment decision influencing the value of their future pensions. This is seen as an educational - some would even say ideological - device, forcing or making it possible for all with an income from their work to cast themselves in the role of an investment fund manager for part of their own pensions. This new institutional embedding of the pension system differs from the perspective that have shaped the traditional view of pensions and social security as based on citizenship rights and as being part of policies aiming at nation building or social integration.

The effects of this change of perspective will take time to materialize in a country such as Sweden. New pension systems, based on the individual responsibility as well as an insurance-based system of the defined contributions type, but with no tax-financed guarantee pension at the bottom, are now being introduced in some of the post-communist countries.

There are interesting but controversial arguments among influential economists on the reshaping of pension and social security systems, not least within the World Bank (cf. *Averting the Old Age Crisis* 1994). As social scientists doing research in social policy and social security we need to discuss the wider social impact, when the logic of pension systems shift from the perspective of social and national integration to a “pure pension market” logic.