

Lessons from Sweden

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This presentation

- In this presentation, I will:
 - Provide an overview of the Swedish retirement income system
 - Discuss lessons for the US

Background

- In Sweden, as in many countries, the payroll tax rate has reached the level where it cannot be raised further because of political considerations.
- Also in Sweden, as in many countries, the old-age dependency ratio is increasing due to increasing life expectancy and low fertility rates.

The System's Constraints

- Like many countries, Sweden relies largely on pay-as-you-go financing.
- Thus, there are 3 constraints
 - Fixed tax rate
 - Increasing old-age dependency rate
 - Pay-as-you-go financing.

Implications

- With these 3 constraints, the generosity of benefits must fall over time.
- That can occur as a falling replacement rate with a fixed retirement age.
- Alternatively, the early retirement age can be raised over time, with benefits not increased for the increase in the early retirement age.

Sweden's choice

- Sweden has chosen to fix the early retirement age at 61 and to have a slowly falling replacement rate, achieved in part by the life expectancy indexing of benefits.
- In the long run, it may decide at some point to offset the decline in the replacement rate by raising the early retirement age.

Sweden -- Description

- A PAYG NDC system – 16% of payroll
- A mandatory IA system – 2.5% of payroll
- Widespread pension coverage through collective bargaining – 3.5% - 4.5% of payroll. Less than 10% of workforce not covered.
- TOTAL contribution at least 22%

NDC

- A Notional Defined Contribution system is a relatively new innovation.
- It is a pay-as-you-go system where each participant's benefit is defined in terms of an individual account, to which contributions and investment earnings are credited.

Features

- Life-expectancy indexing of benefits at retirement age
- Adjustment of benefits in payment for level of productivity growth
- Less than full price indexing of benefits if real wage growth less than 1.6 percent per year

Redistribution

- This system was adopted in 2000.
- It was adopted in part to correct adverse income redistribution in the old system.
- Because benefits were based on the highest 15 years of work, high-achieving white collar workers, with rapidly rising incomes, got a better deal than blue collar workers, whose wages rise less rapidly.

NDC Benefits

- In a NDC system, like an individual account or DC system, every year's earnings are counted in determining the ultimate benefit level.
- In addition, early years are relatively more important, which tends to favor lower-wage workers.

The Reform Process

- The Swedish reform evolved over a process lasting about 7 years.
- The winners in the reform were workers with low and moderate incomes, and young workers, who were assured that the total payroll tax rate would not rise above 18.5%.

Auto Adjustment

- A major new trend starting this century has been for countries to adopt auto adjustment mechanisms to maintain social security.
- Sweden has been a leader in this area.

Indexing

- Life-expectancy adjustment of benefits is natural in an NDC system, and all those countries have adopted it in some form
- Technically, the adjustment can easily be adopted in a traditional PAYG system, and a couple of countries have done so.

Life expectancy indexing

- With life-expectancy indexing of benefits, benefits at retirement are adjusted downward for each new birth cohort reaching retirement to adjust for the increase in life expectancy.

Insolvency

- Auto adjustment tied to insolvency in countries also having life expectancy indexing – Sweden
- Auto adjustment tied to insolvency in countries without life expectancy indexing – Germany, Japan, Canada

System stability

- Because of life-expectancy indexing of initial benefits, and productivity growth affecting price indexing of benefits, expected that further adjustments will be needed infrequently

Commentary

- Solvency indexing adjustment entirely on benefits in payment and benefits accrual, the payroll tax rate is fixed
- Normally, the rate of per capita wage growth is used as the rate of interest accrual credited to the workers' account balances.
- Total wage growth would be a better measure for maintaining solvency

Indexing

- Life-expectancy indexing would reduce political risk
- If established in the US, would maintain solvency for more than 50 years
- It has been established by 8 countries in recent years

Framing

- Sweden traditionally has had employer-provided defined benefit plans.
- Following the conversion to its individual account premium pension system, employers converted the DB plans to DC plans. This move is opposite of what economists would predict based on diversification.

Conclusions

- Sweden finances its retirement income system with contributions of at least 22% of payroll.
- Sweden finances its social security with contributions of 18.5% of payroll.
- Sweden has determined that it will not raise its payroll tax rate further.

Conclusions (2)

- Sweden has been a leader in automatic adjustment mechanisms for social security.
- Sweden uses life expectancy indexing for its NDC benefits.
- Sweden has an automatic adjustment mechanism tied to insolvency.

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Retirement Age Signaling

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What is signaling?

- Behavioral economics has shown that the framing of information can send a message apart from the economic incentives.
- Thus, government policies can affect the behavior of workers through both economic incentives and signaling.

This presentation

- In this presentation, I am going to discuss what signaling is and how it may affect retirement age.

Explicit and implicit signals

- The government can send explicit signals through policy statements, or more subtly, and possibly even being unaware, through indirect statements implying approval.
- An example of indirect signaling would be highlighting the retirement at age 62 of the first baby boomer to receive Social Security benefits.

The decision to retire

- For some workers, the decision to retire is determined by ill health or loss of a job.
- For most workers, the decision to retire represents a choice.
- But how do workers decide what is the best age to retire? The decision may be affected by social norms, and those social norms may be affected by the government.

Signaling and retirement

- It can be difficult for a person or for policy makers to decide what is the “right” age to retire.
- Aspects of government retirement income policy or statements may affect the decision to retire by sending a signal as to a government endorsement of a particular age.

Signaling and the ERA

- The ERA is the Early Retirement Age – the earliest age at which workers can receive social security benefits.
- As well as incentives that are often associated with the ERA, the ERA may send a signal as to that being the appropriate age, or the appropriate minimum age, at which to retire.

Social norms

- In sociological terms, the ERA establishes a social norm that age 62 is an appropriate age at which to retire.
- This view is supported by econometric studies that indicate that more people retire at age 62 than appears to be explained by the financial incentives within the Social Security system.

Signaling and the NRA

- The NRA is the Normal Retirement Age. Similarly to the ERA, the NRA may send a signal as to the appropriate age to retire.
- The NRA in the US currently is age 66, but by 2022 it will reach age 67 for people reaching the ERA of 62 that year.

The ideal retirement age

- The NRA is sometimes referred to as the full retirement age.
- However, workers can raise their benefits if they postpone receipt to age 70.
- Social Security could send a signal by calling age 70 the full retirement age, or perhaps calling it the ideal retirement age.

Signaling and different groups

- The signaling effect of the ERA and NRA may affect different groups of workers differently.
- The ERA may affect workers considering a relatively early retirement age.
- The NRA may affect workers considering a relatively late retirement age.

Direct Signaling

- Governments may also signal directly.
- They signal directly when they adopt a policy that states that they wish people to postpone retirement past a certain age.

Governments and Direct Signaling

- While the US government has not adopted a policy to encourage workers to retire later, some European countries have specifically stated such a policy, with targets for increased labor force participation at older ages.

Changing the retirement environment

- Governments can change the retirement environment by discouraging age discrimination and by making mandatory retirement illegal.
- Promoting lifelong learning can be a way of encouraging workers to postpone retirement.
- All these policies may have a signaling effect as to the desirability of postponing retirement, as well as a direct effect facilitating such a change.

Variation in the ERA and NRA

- The NRA is being increased over time in the US, but the ERA has been fixed at age 62 since the early 1960s.
- Thus, it is not possible to directly assess the effect of changes in the ERA in the US

International variation in the ERA

- The ERA varies considerably across countries:
- Canada – 60
- Sweden – 61
- US -- 62
- UK -- 65 for men, currently 60 for women
- Iceland, Norway -- 67

Effect of Variation in ERA

- Does the variation in the ERA cause variations in the retirement age across countries?

Correlation

- There is a general correlation between the ERA and retirement ages, with countries that have low ERAs tending to have relatively low retirement ages, and the reverse for countries with high ERAs.
- For example, retirement ages are relatively low in France and relatively high in Ireland.
- However, men in the UK retire on average at age 63, which is the same for men in the US.

Causation

- It is more difficult to determine whether this represents causation because of the issue of endogeneity.

Signaling vs Endogeneity

- Endogeneity refers to the issue of what causes what.
- For example, does Iceland have an ERA of age 67 to send a signal to workers from the government
- Or does it reflect the collective views of workers as to the appropriate age at which to retire? Thus, perhaps it represents a signal from workers collectively, through the political system, to the government.

Pathways

- An alternative hypothesis is that workers have a desired age or age range for retirement and if that is not possible through social security because of a high ERA, they will pressure the government to create alternative pathways.

Disability and unemployment

- In some countries, such as the Netherlands, many people retire early by taking disability.
- In other countries, extended unemployment benefits provide a pathway to early retirement.

Conclusions

- A number of factors enter into a worker's decision as to when to retire, including the incentives of government programs and the worker's level of lifetime wealth.
- Signaling by the government may be one of the factors.
- The government may provide implicit or explicit validation of some ages as being suitable for retirement.

Policy Implications

- Governments should consider the explicit and implicit signals they provide as to the retirement age.
- Simple and “costless” changes can involve what different retirement ages are called.
- In addition, the government can send out explicit messages concerning the advantages of postponing retirement.