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Social Security Smörgåsbord?
Lessons from Sweden's Individual Pension Accounts
R. Kent Weaver

President Bush has proposed adding optional personal accounts as one of the central elements of a major Social Security reform proposal. Although many details remain to be worked out, the proposal would allow individuals who choose to do so to divert part of the money they currently pay in Social Security taxes into individual investment accounts. Individuals would have a choice of fund managers, and the return that they earn from those accounts would then partially determine the Social Security benefit they receive when they retire.

Individual accounts pose a number of important and complex design and implementation issues, including how to lower the cost of administering accounts so that they do not erode the value of pensions that individuals receive when they retire, how many and what kinds of fund choices should be offered, and how to engage workers in choosing funds.

In the late 1990s, Sweden added a mandatory individual accounts tier to its public pension system. This policy brief examines the Swedish experience and lessons it suggests for the United States about the design and implementation challenges of individual accounts.

SWEDEN'S NEW PENSION SYSTEM

Sweden has one of the oldest and most comprehensive public pension systems in the world. But by the 1980s, several problems with the system were becoming evident, including current funding deficits and a very large projected funding shortfall as Sweden's population, which is among the oldest in the world, continued to age.

Between 1991 and 1998, Sweden adopted a new pension system built on three fundamental elements. A new "income pension" is intended to tie pension benefits more closely to contributions made over the entire course of an individual's working life, while lowering the overall cost of the system; it is financed entirely by a 16 percent payroll tax. A "guarantee pension" provides minimum income support for workers with low lifetime earnings. It is

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financed entirely by general government revenues and is income-tested against other public pension income.

The third element is a "premium pension" financed by a 2.5 percent payroll tax. These funds are placed in an individual investment account. Individuals have a wide variety of fund choices. To lower administrative costs, and the administrative burden on employers, collection of premium pension contributions and fund choices are centrally administered by a new government agency, the Premium Pension Authority (Premiepensionsmyndigheten, or PPM). Deposits into pension funds are made only once a year, after complete wage records for a calendar year are available from the state tax authorities. Employees choose up to five funds from a list of funds approved by the PPM. Swedes can change their fund allocations as often as they want without charge, but the system is not designed to facilitate "day trading"—switching funds often takes several days.

The new pension system's planners recognized that many workers might not make an active pension fund choice. They created a Seventh Swedish National Pension Fund to offer a default fund, called the Premium Savings Fund, for those who do not choose a fund or simply prefer to have the government invest for them. Because Sweden's non-social democratic parties wanted to limit the role of the state in the Premium Pension system, special rules were imposed on the default fund:

- Individuals cannot actively opt for the default fund—they can only get in by making no active fund choice;
- The default fund cannot be marketed to potential "customers";
- Individuals who opt out of the default fund are prohibiting from choosing the fund again;
- The fund does not exercise its role as a shareholder when companies bring issues such as re-electing the board of directors to a vote.

SYSTEM ADMINISTRATION AND COSTS

The PPM is administered by just 200 employees. Costs are also kept down through automation, bulk trading of fund switches, and once-a-year transfer of funds into accounts.

In 2004, premium pension account holders paid 0.27 percent—which was automatically deducted from their accounts—to cover the costs of PPM administration, and PPM's goal is to reduce that fee to 0.1 percent within fifteen years. Account holders also pay an annual fee to fund managers, although fund management companies must agree to pay a rebate to PPM of their usual fees. In 2002, individual fund managers charged an average of 0.44 percent in 2002, but charges should fall as the system matures.

Sweden deliberately chose a policy that would allow a broad array of fund choices. In the first round of fund choice in the fall of 2000, individuals had to choose from a staggering array of 465 funds. By 2004, there were 664 funds. Choices

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include a broad array of Swedish equity funds, regional and global equity funds, country equity funds (e.g., Japan, U.K.), funds focused on specific sectors such as technology and communications and pharmaceuticals, "mixed" funds that combine equities and interest bearing-securities, "generation" funds that offer differing mixes of equities and interest-bearing securities depending on years to retirement, and funds concentrated in interest-bearing securities. Within these categories, funds offer a variety of special features, such as active versus index-based management, ethical investment criteria, and more or less aggressive growth strategies.

Given the staggering array of potential choices facing contributors, Sweden's Premium Pension Authority tries to make at least minimal information available about fund choices available to potential contributors. In each round, it has published and sent new entrants to the system a very detailed booklet on how to go about making fund choices, as well as a fund catalogue listing all funds (broken down into categories and subcategories), a brief description of each fund, its total capital, fund management charges, returns for each of the last five years as well as a total five-year return (where applicable), and a measure of fund risk.

CHOICE AND NON-CHOICE

In the initial round of fund choice in 2000, about two-thirds of those eligible to choose funds did so. This fairly high level of participation can be attributed in part to the fact that the amounts of money were relatively large, since four years of accrued contributions (for 1995-1998) were to be placed. Moreover, a substantial media campaign was mounted not only by the PPM, but also by many fund companies, calculating that once individuals had made their choices, they were likely to stick with them.

A recent study by Stefan Engström of the Stockholm School of Economics and Anna Westerberg of the National Social Insurance Board shows that those who had prior experience in financial markets and were married were substantially more likely to make an active choice in the initial 2000 round. Advanced education, higher income, and female gender also made individuals more likely to make an active choice, although less so than the first set of factors. Proximity to retirement (age 58-62) and having been born in a non-Nordic country substantially decreased the odds of active choice—the latter likely related to the fact that many PPM materials were available only in Swedish.

Fund choice fell dramatically in the five following rounds held for recent labor market entrants: fewer than 10 percent of those eligible in each of the last three rounds (2003-2005) chose a fund. There were several reasons for the drop-off in choice. Participants in later rounds were mostly younger workers who had a very long time until retirement and low earnings, all of which limited the perceived importance of fund choice. New entrants after the first round also faced a growing array of fund choices.

These factors alone or together are implausible as sufficient explanations of

the dramatic drop-off in active choice, however, since most young workers made an active choice in the initial 2000 round, and the number of fund options was already large in that year.

Several other factors almost certainly had a greater impact on the drop-off in active choice. One was the absence of a "contagion effect" that was present in the initial round of fund choice, which involved the vast majority of adults in Swedish society under the age of 65, and was widely discussed among families and friends. In addition, while the PPM mounted substantial outreach campaigns in the initial rounds and tried to increase Internet accessibility for making choices, the fund companies, recognizing both the small sums at stake and the very broad field of funds available, did not mount substantial campaigns in later rounds. The media also paid much less attention to pension fund choice in the rounds held after 2000.

The widespread publicity given to the negative returns experienced by most Premium Pension savers—especially those in many of the most popular fund choices—may have diluted enthusiasm for making an active choice. The first round of PPM choice took place near the peak of the run-up in global equities markets. Later rounds have occurred against a backdrop of losses by most PPM account holders.

A final factor that may have contributed to the decline in active choice is the availability of the Premium Savings Fund as a default. It was widely perceived, at least initially, to be a safe as well as low-cost alternative to privately managed funds. Moreover, the default fund has outperformed the weighted average of actively-placed funds in recent years, which may further have increased the attraction of non-choice.

PATTERNS OF CHOICE AND RISK

Given the poor performance of equity funds in the initial two years of the Swedish individual account system, it should not be surprising that there was a shift away from equity among active choosers in the 2003 round. However, this trend among active users has been overwhelmed in its effects by the shift away from active choice toward passive investment in the equities-heavy default fund, which essentially functions as a global equities fund.

A small minority of active choosers do appear to be over-concentrated in high-risk funds with high recent returns, despite the high risk generally associated with such investments. For example, the most commonly chosen fund overall in the initial round was the high-tech Roburs Aktiefond Contura, which had a 534.2 percent return over the past five years (after fund charges), according to the PPM's 2000 catalogue. But the Roburs Contura fund lost 32 percent of its value in 2001. In the 2004 round, the two most frequently chosen funds were Russian equity funds, reflecting very high returns reported for those funds reported in PPM's fund catalogue.

One potential risk that does not seem to have materialized, however, is excessive trading by account holders attempting to

make gains through market timing or who panic in response to short-term market fluctuations. Fewer than 6 percent of all premium pension savers made even a single fund switch in 2004. Moreover, only a little over 600 account holders out of more than 5.3 million were very frequent traders (more than twenty fund switches during the year), while two-thirds of those who switched funds did so only once.

THE DEFAULT FUND

The Premium Savings Fund has said that "People who do not have a fund manager, for whatever reason, should receive the same pension as others—that is our goal." But what does this goal mean in practice? Should a default fund minimize risk, seek growth, or simply keep administrative costs low?

The Seventh AP Fund clearly has placed a high priority on keeping fund management charges low. In 2004, its charges after rebates to the Premium Pension Authority were 0.15 percent of invested funds, compared to an average of 0.60 percent for equity funds in the premium pension system. Administrative costs remain low—the fund has only thirteen employees and contracts out most fund management functions to Swedish and foreign fund management companies, and there is a heavy reliance on index funds.

The experience of the Seventh AP Fund also shows, however, that there is likely to be tension in any default fund between the objective of fund security and high returns. Achieving high returns over the long term requires heavy weighting toward higher-yielding equity investments. The Seventh AP Fund has strongly stressed the objective of higher long-term returns, with a current target portfolio of 10 percent in inflation-indexed securities, 17 percent in Swedish equities, 65 percent in foreign equities, 4 percent in private in equity funds, and 4 percent in hedge funds. In the short term, this strategy has led to high volatility in account values and losses for those who entered in early rounds.

The Swedish experience with the premium pension also suggests that a default fund may become involved in debates over domestic, ethical, and environmental investment practices. Indeed, the Seventh AP Fund took an even more aggressive stand on these issues than the other state pension funds, in part because it is not allowed to vote its shares. It instead decided to disinvest in companies that had been found guilty by impartial tribunals of violating international conventions to which Sweden had adhered, including conventions on human rights, labor, the environment, bribery, and corruption. In 2004, thirty-eight companies were on the investment exclusion list for all or part of the year.

LESSONS FOR THE UNITED STATES

If U.S. policymakers move ahead with President Bush's proposal to establish an individual account system, the Swedish experience offers several lessons on implementation and design.

Centralized Administration

The Swedish model of centralized administration minimizes the additional

> "Should a default fund minimize risk, seek growth, or simply keep administrative costs low?"

paperwork burden for employers, facilitates broad fund choice, and allows the government to negotiate reduced management fees by fund providers. But a centralized administration system is not without problems. Individual pension account holders have a long wait before their accounts are credited for contributions. And Sweden's decision to pass on the start-up costs of the centralized management agency and default fund to contributors, rather than paying them out of the general budget, means that the fixed costs of establishing and operating such a system are borne disproportionately by the initial contributors, because the system has a relatively small number of contributors and small asset base of contributions in its early years.

Should the U.S. government create a new agency to administer individual accounts? Given the relatively limited level of fund-changing activity in Sweden, as well as the need for close integration of account management and reporting functions with the roles performed by the Social Security Administration (SSA) in the United States, it might make more sense to keep management of individual accounts within SSA. But this approach could lead to pressure on local SSA offices to deliver services that they are not set up to deliver (e.g., helping people make fund changes at a time of financial panic) as well as services that it would be inappropriate for them to provide at all (e.g., advice on choice of individual funds).

If account management were retained within SSA, the U.S. government would have to convey to the public a clear message that fund-switching services were only available through other mechanisms and that no advice on choice of individual funds could be provided by SSA. This would require a major—and ongoing—campaign of public information. But some misunderstanding is almost inevitable, and it could be damaging to the agency's image and morale.

Swedish experience also suggests that it takes a long lead time to get a new central administrative organization up and running. The information technology requirements for such a system are especially daunting. Indeed, Sweden's scheme had to be delayed in order to make sure that the technology would work, and the PPM ended up having to pay more than $25 million dollars for a computer system that it never used after cancelling a contract with the system's vendor. Attempting to roll out an individual account system too quickly could cause serious implementation problems and undermine public confidence in the system.

Entry Barriers for Fund Providers

Swedish experience suggests that the number of fund options in an individual account system can be very high—and grow over time—unless there are meaningful entry barriers. The large number of choices in the Swedish system almost certainly discourages active choice by overwhelming potential entrants. A better option for the United States is to offer a much smaller range of "generic" funds—perhaps five to twenty—that offer investors a range of choices: equities versus fixed return investments, for example, or domestic versus international

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exposure. But having a government pension authority choose fund managers raises difficult issues for the body doing the picking, since the fees generated for fund providers will presumably be very large. The federal government's Thrift Savings Plan has managed these issues with little controversy, but the stakes in a society-wide individual account scheme would be much greater.

Limiting Risk

Swedish experience also suggests that some constraints on the content of fund options should be imposed in an individual account system. The ten worst performing funds in the first year of the Swedish premium pension—all stock funds with a technology focus—lost an staggering average of 76.6 percent of their value. While most investors probably did not put all their money into such funds, there were no legal constraints on doing so. Limitations should be imposed on sector-specific as well as country- and region-specific funds.

Engaging Workers in Fund Choice

The Swedish experience with individual accounts highlights the difficulties in engaging young workers in choosing a fund, especially after a first round of choice when media attention is high and virtually the whole labor force is making a choice simultaneously. These problems are likely to be especially severe for workers who are not fluent in English. The government would need to provide multi-lingual materials to boost fund choice among this group.

A Default Fund

The Swedish experience clearly suggests the importance of a default fund for non-choosers if the United States moves to a system of universal rather than optional individual accounts. In the United States, establishing a new government-affiliated management entity for the default fund would be both costly and politically controversial. Contracting out management of a default fund to several different fund management firms by competitive bidding would likely spark less opposition.

At least as important as who administers the default fund is the question of how the default option is designed. The experience of the Swedish Seventh Pension Fund's Premium Savings Fund shows that there are very real trade-offs between long-term growth and protection of investment capital for those who, for whatever reason, abstain from making a fund choice. There is no obvious "correct" answer to the growth-versus-security trade-off, but it is probably best to offer different defaults for younger and older workers, and to progressively move the funds of older "abstaining" workers into more secure investments.

If a government-operated default fund were to be set up as part of an individual account tier in the United States, Swedish experience also suggests that it would not be free of controversies over environmental, ethical, and domestic investment criteria. Of course, such criteria would not necessarily be adopted in a political system that is much more conservative than Sweden's—or there might be pressures for a different set of criteria.

For example, should equity funds exclude companies that manufacturetobacco products, firearms or alcoholic beverages? Companies that employ or contract with

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suppliers using sweatshop labor? Companies that invest in countries with unusually repressive regimes? The experiece of the Swedish default fund shows that individual companies can be excluded with little or no increase in fund management costs—which could make it more difficult to avoid political battles over whether to do so, and what criteria to use inmaking those decisions.

CONCLUSION

The Swedish experience with a system of centrally-administered individual retirement savings accounts suggests that such a system can provide great opportunities to save on administrative costs without restricting fund choice. But it also suggests that allowing open entry of fund managers may overwhelm participants and cause more participants to opt for the default fund where one is offered. Allowing active choice of fund managers will not automatically lead to active choice, especially among new labor market entrants and immigrants. Moreover, those who do choose will not always choose wisely. And how the funds of those who do not make an active choice should be invested is far from self-evident. In the design of individual account systems, as with most other policy sectors, the devil is in the details, and those details require at least as much attention from policymakers as the decision on whether or not to set up a system of individual accounts.

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