Individual Pension Accounts: The Innovative Swedish Reform

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Increasing numbers of countries are using mandatory funded individual accounts to provide retirement. The Chilean system of individual accounts has been studied extensively, and its basic approach has been copied by a number of countries. Sweden has instituted a funded mandatory individual account system that differs considerably from Chile's. It incorporates features that reflect lessons learned from Chile and other countries, particularly ways to reduce the system's administrative costs.

*The mandatory individual account pension system in Sweden is a possible model for U.S. Social Security reform involving individual accounts. This individual account system reflects a desire to increase the amount of pre-funding in the Swedish retirement income system and a movement toward a greater emphasis on the role of the capital market and individualism.*** *Sweden's experience may indicate how an individual account system could be put into place if the U.S. were to adopt one, and how such a system might work, including decisions concerning design and problems that might be encountered.*

I. OVERVIEW OF THE SWEDISH RETIREMENT INCOME SYSTEM

To understand how the individual account system functions in Sweden, it is essential to understand the retirement income system within which it operates. The Swedish retirement income system has two parts. First, public Social Security pensions cover all workers.[1] Second, occupational pensions build on collective bargaining agreements between employers and employees.[2] Approximately 90% of workers are covered by some form of collective pension

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* Public Policy Institute, AARP. The opinions presented here do not represent the position of AARP. Annika Sundén has contributed substantially to this Article. I have also received valuable comments from Estelle James, Kent Weaver, and participants at seminars at AARP, The Ohio State University, the Sixth International Pension Conference in Tokyo, as well as the editors of this Journal.

** Lars Harrysson & Michael O'Brien, Pension Reform in New Zealand and Sweden: A Comparative Analysis of Path Dependent Reform Process, Paper Presented at the Fourth International Research Conference on Social Security, 5–7 (May 2003) (draft available at http://www.issa.int/pdf/anvers03/topic4/2harrysson.pdf).

[1] SOCIAL SECURITY ADMINISTRATION, SOCIAL SECURITY PROGRAMS THROUGHOUT THE WORLD: EUROPE, 2002, at 195 (2002).

[2] Joint Report by the Commission and the Council on Adequate and Sustainable Pensions as Prepared by the European Economic and Social Committee 6527/2, 2003, at 167, *available at* http://europa.eu.int/comm/economy_finance/epc/documents/pension_report_2003.pdf.

plan.[3] In addition, as a safety net for workers without any labor market experience or with low pensions, a means-tested guarantee pension provides a minimum pension. The means test is against income from the mandatory earnings-related pension.

A major reform in 1999 changed the public Social Security system from a traditional defined benefit plan to a hybrid plan with defined benefit and defined contribution features.[4] This plan, called a notional defined contribution plan, is financed on a pay-as-you-go basis.[5] The plan is called notional because each individual's account is a bookkeeping entry rather than an actual funded account. The benefits from the notional account are based on a formula incorporating lifetime earnings and unisex (non-gender-specific) life expectancy at the time of retirement.[6]

The new system also has a funded component in the form of mandatory individual accounts, called the Premium Pension.[7] Thus, Sweden has a mixed retirement income system, combining both a pay-as-you-go plan and a funded plan. Sweden also provides a generous minimum pension that assures a benefit equal to one-third of the average wage for those who have resided in Sweden for forty years.[8] Probably because it is larger and because of its novelty, discussions of the Swedish reform have tended to focus on the notional defined contribution plan;[9] however, the Premium Pension is of more interest with respect to possible reform proposals involving mandatory funded individual accounts in the United States and other countries. For example, the new Russian defined contribution system is based in part on the Swedish system.[10]

This Article focuses on the individual account system. The next section gives an overview, followed by a discussion of the mutual funds that participate in the system, and issues concerning the investments workers choose. The conclusion discusses lessons that can be learned from the Swedish experience.

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[3] *Id.*

[4] Annika Sundén, *How Will Sweden's New Pension System Work?*, ISSUE IN BRIEF No. 3 (Center for Retirement Research at Boston College), Mar. 2000, at 7, *at* http://www.bc.edu/centers/crr/ib_3.shtml.

[5] *Id.* at 7.

[6] Edward Palmer, The Swedish Pension Reform Model: Framework and Issues 5 (June 2000), *available at* http://www.oecd.org/dataoecd/63/51/2638200.pdf.

[7] Sundén, *supra* note 4, at 9.

[8] *See* Palmer, *supra* note 6, at 20.

[9] See, for example, the more extensive treatment of the notional defined contribution plan in Palmer, *supra* note 6.

[10] Daniel Brooksbank, *Fund Manager Prosperity Eyes Russian Mandates*, IPE.COM, *at* http://www.ipe.com/article_default.asp?article=14415 (Mar. 27, 2003).

II. MANDATORY INDIVIDUAL ACCOUNTS: THE PREMIUM PENSION

A. *An Overview*

In 1994, Sweden passed legislation that specified the broad outlines of reform for the new public pension system.[11] In preparation for the new system, the government began collecting contributions for mandatory funded individual accounts in 1995 and held the money in an interest-bearing government account at the National Debt Office.[12] In 1998, the Swedish parliament passed the final pension legislation, which took effect in 1999.[13] Participants began selecting investment options in the Premium Pension in the Fall of 2000,[14] after a one-year postponement due to difficulties in implementing the computer system to manage the new individual accounts.[15] Approximately 4.4 million people participated in the system during this initial period.[16]

As determined by the transition rules, the new system affects all workers born in 1938 or later. Workers born between 1938 and 1953 will receive pensions calculated partly according to the new system and partly on the basis of entitlements in the old system.[17] Workers born in 1954 and later will participate fully in the new system which covers all employed and self-employed residents age sixteen and older.[18]

The mandatory individual accounts only constitute a small portion of the new pension system, being provided on top of a generous benefit provided by the notional defined contribution plan. The total contribution rate (employee plus employer) is 18.5% up to a ceiling of about U.S. $40,000 for each worker.[19] Sixteen percent of earnings is contributed and is credited to a "notional" account and 2.5% of earnings is contributed to the Premium Pension individual account.[20]

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[11] Sundén, *supra* note 4, at 4.

[12] Palmer, *supra* note 6, at 3.

[13] *Id.* at 7, 11.

[14] *Information and News on Your Premium Pension*, PPM NYHETER NO. 3 (PPM, Soderhamn, Sweden), 2001, *available at* http://www.ppm.nu/dbfiles/pdf/377.pdf.

[15] Press Release, PPM, Award in the Arbitration Proceedings Between CSC and PPM (Oct. 3, 2002), *available at* http://www.ppm.nu/dbfiles/pdf/824.pdf. The delay in the development of the computer system ultimately resulted in cancellation of the contract with the computer company developing the software and a lawsuit between the PPM and the computer company concerning the compensation that PPM owed the company. *Id.*

[16] *Information and News on Your Premium Pension*, *supra* note 14.

[17] *Id.*

[18] *Id.*

[19] *Id.* The income that is taxable for the pension includes unemployment benefits, so workers who are unemployed continue to accrue retirement benefits.

[20] *Id.*

The benefits ultimately received from the Premium Pension are based on the contributions to and investment earnings on the account. Because the total contribution of 18.5% is approximately equal to the total contribution rate before the reform,[21] the investment of the Premium Pension in financial markets might be considered a mandatory carve-out from Social Security.

The Premium Pension is administered by a new government agency, the Premium Pension Authority (PPM or *Premipensionsmyndigheten* in Swedish). The PPM acts as a clearinghouse and record keeper for the funded individual account system.[22] This new agency was needed because the individual account system includes "a broad range of new activities that would have been difficult to undertake within the realm of the National Insurance Board."[23] Furthermore, the central agency is expected to help keep administrative costs low because of scale economies in administration.[24]

The Premium Pension places a minimal administrative burden on employers. Contributions are withheld by employers from employees' pay and sent to the National Tax Authority.[25] Swedish employers aggregate the tax and contribution withholdings for their workers and make a single monthly tax and contribution payment to the National Tax Authority.[26]

Because Swedish employers report information on individual worker earnings to the Government only once a year, individual pension rights cannot be established until workers have filed their income taxes and these have been consolidated with employers' reports.[27] Collecting contributions and then posting them to the worker's account takes about two years from the start of the year in which the contributions were made.[28] When individual pension rights have been determined, the tax authorities inform the PPM as to how much should be credited to each worker's account.[29]

Until pension rights have been established, pension contributions are placed on an interim basis in a fund established at the National Debt Office.[30] In 2001,

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[21] U.S. SOCIAL SECURITY ADMINISTRATION, SOCIAL SECURITY PROGRAMS THROUGHOUT THE WORLD (SSA PUBLICATION NO. 13-11805) 337 (Aug. 1999).

[22] TRYGGVI THOR HERBERTSSON ET AL., NORDIC COUNCIL OF MINISTERS, RETIREMENT IN THE NORDIC COUNTRIES: PROSPECTS AND PROPOSALS FOR REFORM 112 box 5 (2000).

[23] Sundén, *supra* note 4, at 9.

[24] *Id.*

[25] Lawrence H. Thompson, *Administering Individual Accounts in Social Security: The Role of Values and Objectives in Shaping Options*, 1 URB. INST. RETIREMENT PROJECT 13–14 (1999), *at* http://www.urban.org/uploadedpdf/retire_1.pdf (Feb. 16, 2004).

[26] *Id.* at 13.

[27] *Id.* at 13–14.

[28] *Id.* at 14.

[29] *Id.*

[30] *Id.*

the rate of return paid on those funds averaged 3.5%,[31] close to that paid on government debt.[32] Because government bonds in Sweden are secure, they provide a guaranteed rate of return for the Premium Pension participants. The system provides no other rate of return guarantees. Thus, the delay in posting workers' contributions to the fund or funds of their choice is roughly equivalent to requiring that at least twelve months of workers' contributions must be held in government bonds.[33]

Workers can challenge the income and contribution statements provided by the tax authorities, and errors inevitably do occur. In December 2001, the tax authorities informed PPM that they had changed income and contribution figures for 50,000 workers.[34] The tax authority had understated the income for 11,000 people, and therefore their pension entitlement. [35] It has not been decided who will make up the shortfall in investment income if the shares that should have been credited have appreciated.[36]

When the tax authority informs the PPM of the amount credited to each worker, individuals select how to invest their annual contributions.[37] Similarly, all new labor market entrants allocate their initial contributions to mutual funds at the same time during the year. They also can elect to place their contributions in their spouse's account instead of their own. This feature allows spouses to choose a form of earnings sharing for determining their household pension benefits.

All the country's contributions for a year, plus the accumulated interest on those contributions, are placed in the mutual funds over a period of four to five days. In the second week of April 2001, the PPM received about SEK 20 billion, [38] (USD 1.9 billion at an exchange rate of 10.44 SEK/USD) which were the contributions from 1999. In the first week of February 2002, the PPM placed approximately SEK 20 billion in the funds in the Swedish Premium Pension System, which was the money for the year 2000.[39] This way all workers are treated equally concerning the timing of the investment of their contributions in the mutual funds. Inter-fund transfers of funds already invested, however, can be

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[31] *Information and News on Your Premium Pension*, *supra* note 14, at 4.

[32] Thompson, *supra* note 25, at 14.

[33] *Id.*

[34] Dickon Reid, *PPM Mis-sells Shares for 11,000 Members*, IPE.COM, *at* http://www.ipe-newsline.com/article.asp?article=12370 (Jan. 7, 2002).

[35] *Id.*

[36] *Id.*

[37] Thompson, *supra* note 25, at 14.

[38] Perttu Jarvenpaa, *Non-switching Swedes Prompt PPM Call Centre Sale*, IPE.COM, Mar. 30, 2001, *at* http://www.ipe-newsline.com/article.asp?article=11129.

[39] Press Release, PPM, 19.6 Billions SEK Will Be Placed the Fourth of February, (Jan. 22, 2002), *available at* http://www.ppm.nu/dbfiles/pdf/639.pdf.

made by workers daily,[40] except during the time annual contributions are being placed, which is a blackout period for inter-fund transfers. At the beginning of the system, the initial investment of funds represented the accumulation of several years of contributions.[41]

The PPM keeps all records of the individual accounts and fund share values.[42] All individual transactions concerning inter-fund transfers are aggregated at the PPM at the end of each day and are then transmitted as a net purchase or redemption to each fund.[43] The PPM matches buy and sell orders internally, limiting its transactions with the fund managers to the net amount of the individual transactions.[44] This procedure limits the transaction costs of the mutual funds.[45]

B. *The Mutual Funds*

An issue in an individual account system's design is the number of choices workers are offered. One view posits that the greater the range and number of choices, the better able workers are to pick a choice that suits their personal situation.[46] An alternative view argues that, beyond a point, more choices raise the likelihood of errors in decision-making by individuals lacking a sophisticated understanding of investments.[47] Swedish policy makers decided to offer a broad range of investment options in the Premium Pension System. Initially, the Premium Pension System offered a choice of 453 mutual funds,[48] but by 2002 that number had risen to 625.[49] These funds are offered by more than eighty mutual fund companies, of which nearly half are managed outside Sweden.

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40 Thompson, *supra* note 25, at 14.

41 Sundén, *supra* note 4, at 9.

42 Thompson, *supra* note 25, at 14.

43 *Id.*

44 *Id.*

45 *Id.*

46 Herbert A. Simon, *Bounded Rationality*, *in* 1 THE NEW PALGROVE: A DICTIONARY OF ECONOMICS 266, 266–67 (John Eatwell et al. eds., 1987).

47 *See generally* Sheena S. Iyengar et al., *How Much is Too Much? Contributions to 401(k) Retirement Plans*, *in* DEVELOPMENTS IN DECISION-MAKING UNDER UNCERTAINTY: IMPLICATIONS FOR PENSIONS (Oliva S. Mitchell & Stephen P. Utkus eds., 2004), *available at* http://prc.wharton.upenn.edu/prc/PRC/WP/WP2003-10.pdf.

48 Press Release, PPM, 453 funds registered with Premium Pension System to Date (Nov. 30, 1999), *available at* http://www.ppm.nu/dbfiles/pdf/355.pdf (Feb. 11, 2004).

49 R. Kent Weaver, Reforming Public Pensions: Lessons from Abroad, Address Before the Fourth Annual Conference of the Retirement Research Consortium 10 (May 30, 2002) (slides available at http://www.bc.edu/centers/crr/fourth_annual.shtml).

The large number of mutual funds raises the question of how the average citizen can be expected to make an informed choice from among 625 different options. This suggests that many participants have picked mutual fund companies with which they were familiar, rather than trying to evaluate the wide variety of choices.

One reason for the policy decision to allow many funds, including international funds, is that the Swedish stock market is small and if only a few domestic funds were available they eventually would dominate the market. Any mutual fund company licensed to do business in Sweden is allowed to participate in the Premium Pension System.[50]

Fund companies that wish to participate must sign a contract with PPM covering the fee structure and reporting requirements. To limit the number of funds, the manager of each fund originally could only register up to fifteen funds.[51] Corporate groups that had several fund management companies could register up to twenty-five funds.[52] These limits were raised to twenty-five funds per company and fifty per related group when two Swedish fund providers merged.[53]

Most of the funds are equity funds; of these, about 10% are index funds, investing in a broad stock market index.[54] There are about seventy bond funds and about eighty generation funds, [55] where the participants' investment mix of stocks and bonds varies over time, the percentage held in bonds increasing as the participant ages. Approximately one quarter of the funds invest primarily in Sweden.[56] Because of the broad range of funds and the lack of political limitations on the choices offered, there is no concern about the government manipulating the investment process or limiting the range of choice of investments on political grounds.

The government has established two funds, both of which are managed by the Seventh AP Fund (AP7), a government organization that, in this context, functions as a fund manager.[57] One of the funds, the Premium Savings Fund, manages the money for those workers who do not choose a fund or funds.[58] This

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[50] Memorandum from the Premium Pension Authority to Potential Fund Managers 2 (Mar. 19, 2002), *available at* http://www.ppm.nu/dbfiles/pdf/776.pdf [hereinafter Memorandum].

[51] PPM, *supra* note 48.

[52] *Id.*

[53] Weaver, *supra* note 40.

[54] PPM, *supra* note 48.

[55] *Id.*

[56] *Id.*

[57] Memorandum, *supra* note 50, at 1.

[58] *Id.*

default fund is by far the most popular fund, having almost three times as many participants as the most popular fund designated by choice.[59] As of April 15, 2002, the default fund held 30% of the assets invested in the Premium Pension System, and roughly 40% of the participants were invested in it.[60]

This fund's investment strategy is to achieve a higher long-run rate of return than the average for the other funds offered through the PPM at an overall risk level that is the lowest possible compatible with the rate of return goal.[61] In 2002, the default fund invested 82% in Swedish and international equities, of which 17% were in Swedish equities and 65% were in foreign equities.[62] Part of the fund is managed actively, while the rest is managed passively, meaning that it is invested in broad indexes.[63] Part of the passive portion of the fund is invested in an indexed bond fund. In 2001, investing in the default fund was the only way for workers to have part of their pension portfolios invested in an indexed bond fund, since none of the separate bond funds in which participants could invest were indexed.

The second government fund is an alternative for workers who want the government to manage their pension accounts. To participate in this fund, workers must specify it. In contrast to the default fund, which must hold a minimum amount in interest-earning assets, this second government fund can invest entirely in equities.

The government funds' investment strategies incorporate environmental and ethical concerns. The funds invest only in companies that adhere to the international conventions on human rights, child labor, environment, and corruption that Sweden has signed on to.[64] These requirements do not apply to non-government managed funds. The government funds currently invest in between 2,000 and 2,500 companies worldwide, and biannually screen all of these companies for adherence to these standards.[65] As of June 2002, nearly thirty companies were violating these conventions, so they were excluded from

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[59] *See* PPM, PLAN STATISTICS (2002), *at* http://www.ppm.nu/dbfiles/xls/736.xls (listing 1,851,551 participants in the default fund and only 677,297 participants in the next most popular fund, Roburs Aktiefond Contura).

[60] *See id.*

[61] The five-year return should be in the top quartile of the returns for all funds.

[62] SJUNDE AP-FONDEN, ANNUAL REPORT 2002, pt. 2, at 4 (2003), *available at* http://www.AP7.se/pdf/Annual_report_2002_2.pdf.

[63] *Id.*

[64] *Id.* (noting that these conventions include the Human Rights Convention, the UN Convention on the Rights of the Child, International Labor Organization conventions, international environmental conventions and conventions against bribery and corruption).

[65] *Id.*

the portfolio.[66] Companies that produce land mines, discriminate against women, and harm the environment have been excluded.[67] While the funds' policy only excludes companies that have violated international conventions, broken laws, or admitted wrongdoing, that group includes some well-known companies, such as Coca-Cola, Exxon Mobil Corp., Liz Claiborne, Inc., and Sears Roebuck & Co.[68]

Mutual fund management companies know the total investment from the Premium Pension System but not the identities of individual investors. Because fund managers do not know the identity of their clients, entry costs to the Swedish market should be reduced for non-Swedish funds. Mutual funds only need to provide investment management services. They do not need to spend money acquiring distribution channels, which precludes the need to hire numerous sales agents and open retail offices.[69]

C. *Fees*

High money management fees and administrative costs can substantially reduce the accumulation of assets in individual accounts.[70] The Premium Pension System charges only a fixed annual fee of 0.3% of the account balance and a money management fee.[71] The 0.3% fee is collected by each fund and transmitted to the Premium Pension Authority for its administrative expenses. Each fund also charges a management fee.[72]

Funds must charge the same money management fees in the Premium Pension System as they charge in private markets. The fund companies' contracts with the PPM stipulate, however, that some of the fee must be rebated to the PPM.[73] The rebate is possible because the PPM performs most of the administrative functions for the accounts, so the administrative cost for the fund

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66 Robert Clow, *Sweden's Socially Responsible Investing Drive*, FIN. TIMES, June 3, 2002, at 23. The effect on returns was very small. Simulations done by the fund indicates that the portfolio excluding the thirty companies had a rate of return that was fiteen basis points lower than the full portfolio.

67 SJUNDE AP-FONDEN, *supra* note 59, pt. 1, at 19–20 (2003), *available at* http://www.AP7.se/pdf/Annual_report_2002_1.pdf.

68 *Id.* Coca-Cola is accused of human rights violations, Exxon is accused of oil leaks from the Exxon Valdez in Alaska, Liz Claiborne is accused of anti-union activities, and Sears is accused of of human rights and labor law violations, according to the annual report of the Premium Savings (AP-7) Fund. *Id.*

69 HERBERTSSON ET AL., *supra* note 22.

70 For an individual paying into the system for forty years, every percentage point of the fee reduces the account balance by 20%.

71 *Information and News on Your Premium Pension*, *supra* note 14.

72 Memorandum, *supra* note 47, at 4.

73 *Id.*

managers is lower in the Premium Pension System than in private financial markets.[74] For example, rather than interacting with numerous individual investors, the funds have a single transaction per day with the PPM.[75]

Regulations on fees were introduced in order to create a system that has a wide range of funds, yet is cost effective. The fee structure is designed in part to discourage participation of funds with high fees.

The fee rebate structure is complex and non-transparent, so many workers may find it difficult to understand. The size of the rebate depends on the fund company's gross fee and the size of PPM's investment in the fund.[76] Funds with high gross fees and large PPM investments pay a higher rebate.[77] Competition across funds is also used as a mechanism to limit the fees charged by different funds, as these fees are listed in a booklet provided to all workers. Some investment funds try to attract participants by advertising low fees.

The PPM passes on to the participants all of the savings from the rebate.[78] The individual participant's rebate consists of two parts: an individual share and a general share. The individual share depends on the fees charged by the funds in which the individual has invested and is given for funds whose usual fee exceeds 0.4%.[79] Once the individual rebates have been distributed, the remaining rebate is distributed equally among all participants based on account size. Because the remaining rebate is tied to the participants' account balances and not to fees paid, it returns a higher percentage of fees to workers choosing low-fee funds.

With this rebate structure, the rebate received by the PPM from funds charging high fees is not entirely returned to the workers who choose those funds. Part of it is distributed across all participants. This fee structure favors low-cost funds; workers choosing those funds receive a larger rebate in comparison to the fees they paid than those workers choosing funds with high fees. Thus, while fee level differences across funds provide incentives for workers to choose low-fee providers, incentives to do so are increased through the structure of rebates. This system leaves workers free to choose high-fee providers if they wish, but encourages workers to choose low-fee providers, such as index funds. The rebate system discourages the participation of high cost funds that invest heavily in advertising.

Mutual fund companies are not permitted to charge flat fees, so that low wage workers with small accounts are not disadvantaged. They also cannot charge fees for switching from one investment fund to another, so that workers

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[74] *Id.*

[75] Palmer, *supra* note 6, at 41.

[76] Memorandum, *supra* note 50, at 4.

[77] *Id.*

[78] *Id.*

[79] The rebate is 25% of the difference between the gross fee and 0.4%.

are not discouraged from switching funds. The mutual fund fee covers all the expenses of the fund except transaction costs arising from the purchase and sale of securities. Those fees are incorporated in the net rate of return the workers receive on their account balances.[80] In 2002, the net fee paid by participants in the default fund was 0.17 percent.[81]

D. *Rates of Return*

Individual account pensions cannot provide better rates of return than are available in the capital markets in which they invest. Because of the decline in world equity markets during the years 2001 to 2003, many of the funds have earned negative rates of return over this period. The total return for the Premium Savings (AP7) Fund, which is the default fund, was -7.4% in 2000, -10.6% in 2001, and -26.7% in 2002.[82] This compared to a total return for the PPM index—the capital-weighted average for all funds within the PPM system that are open for active choice—of -10.6% in 2001 and -33.1% in 2002.[83]

E. *Participant Investment Choice*

The PPM's goal is that as many participants as possible will actively choose their account investments. Nonetheless, a substantial percentage of workers do not actively choose a fund, and their contributions are invested in the default fund.[84] The initial choices in the system were made by participants in the fall of 2000.[85] All participants who wanted to make an active choice were required to submit a form to the PPM. Participants who did not choose or who wanted their funds to be invested in the government default fund did not have to take any action. About two-thirds of participants submitted the form. Women were slightly more likely than men to make a choice, as were high-income participants and participants aged 25 to 55.[86] Investment behavior also varied with level of contributions. Workers with large contributions were less likely to invest in the default funds, while about half of participants with low contributions did invest in the default fund. Because no action was necessary to invest in the default fund, it

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80 *Information and News on Your Premium Pension*, *supra* note 14.

81 Stefan Engstrom & Anna Westerberg, *Which Individuals Make Active Investment Decisions in the New Swedish Pension System?* 2 JOURNAL OF PENSION ECONOMICS AND FINANCE 225, 229 (2003).

82 SJUNDE AP-FONDEN, *supra* note 62, pt. 2, at 5. The figure for 2000 is not available.

83 *Id.*

84 Fennell Betson, *One in Five Swedes Makes Active PPM Choice*, IPE.COM, *at* http://www.ipe.com/article.asp?article=11880 (Sept. 11, 2001).

85 *See infra* note 14 and accompanying text.

86 PPM, *supra* note 15.

is impossible to separate investors in that fund into those that actively decided that they wanted to invest in the default fund and those who ignored the selection process.

In 2001, fewer than one-fifth of the new PPM participants made active investment fund choices.[87] Of the 500,000 new contributors to the system in spring 2001, 325,000 were age 18 to 27.[88] Only 18% of the total chose their funds; the remainder were invested in the default fund.[89]

Survey results indicated some participants may have been confused about the investment process—while 18% of new participants in 2001 actually made a choice, 34% thought they had.[90] Also, a number of workers chose the default because they felt it was safer than other options, which is an inaccurate assessment of its risk.[91] Another survey indicated that the majority of people who made an active choice could not remember which funds they had invested in.[92] Of those who made a choice, 73% could not name all the funds they had invested in and 41% could not name any of them.[93]

One risk is that workers who invest solely in the Swedish economy will be inadequately diversified because of the relatively small size and narrow range of economic activity in the Swedish economy, with its stock market dominated by a few large corporations. The statistics on participants' investments indicate, however, that a majority of workers have some investments outside of Sweden.[94]

Workers can invest in a maximum of five funds.[95] On average, participants invested in 3.4.[96] Because some funds invest in a fairly narrow segment of the stock market, such as high tech, it is possible for participants to invest their entire Premium Pension account so that it is high risk and poorly diversified.

F. *Plan and Investment Information for Participants*

Ensuring that workers receive adequate information is an important aspect of the government's efforts to help participants make well-informed decisions. Providing adequate information is especially important because of the large

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[87] Betson, *supra* note 84.

[88] *Id.*

[89] *Id.*

[90] *Id.*

[91] *Id.*

[92] Perttu Jarvenpaa, *Swedes Fear Pension Loss on Retirement*, IPE.COM, *at* http://www.ipe.com (Apr. 25, 2001).

[93] *Id.*

[94] Weaver, *supra* note 49.

[95] Sundén, *supra* note 4, at 9.

[96] *Information and News on Your Premium Pension*, *supra* note 14.

number of investment options workers face. As part of the implementation of the reform, the National Swedish Social Insurance Board undertook a major campaign to inform and educate people about the new pension system.[97] Information about the Premium Pension was part of this overall campaign.[98] The PPM also provided additional information and materials to participants in connection with the investment selections.[99]

The PPM's goal is to provide information that targets all three groups. For motivated investors it is important to provide detailed information on the various funds, whereas for the second and third groups the PPM concentrates its efforts on raising participants' knowledge and motivation. To this end, the PPM provides basic financial information, such as explanations of the different types of funds and the value of diversification, as well as more in-depth information on the various funds. It provides the following basic information about financial markets: Over the long term stocks have had a higher rate of return than bonds, although there is no guarantee that this will continue to be the case. The value of stock funds varies more over time than does the value of bond funds. Although changes in exchange rates affect the value of funds invested abroad and are a source of risk in international investments, international investments provide greater risk diversification.[100]

At the start of the system, the PPM mailed information to participants. It launched a major advertising campaign that included advertisements in newspapers, brochures, and public service announcements on television and radio. The PPM also organized a series of outreach activities to groups with special needs, for example, individuals with disabilities and immigrants with limited knowledge of the Swedish language.

Before choosing funds, each participant received the funds catalogue, which contains information for each fund about its investments, risk level, past returns (for pre-existing funds), and fees. The same information is also available on the PPM website.[101] All information is provided in Swedish as well as in the most common languages of immigrants.

Managers of funds participating in the system must provide information on fund asset values daily. This information is available to participants through various outlets, including the major daily Swedish newspapers, over the Internet, and at Social Security offices.

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[97] Press Release, PPM, PPM's Information Campaign to be Launched (Aug. 24, 2000), *available at* http:// www.ppm.nu/dbfiles/pdf/408.pdf.

[98] *Id.*

[99] *Id.*

[100] *Information and News on Your Premium Pension*, *supra* note 14.

[101] *See* http://www.ppm.nu.

Individual participants receive a single year-end statement summarizing their investments in the Premium Pension. Individuals can also receive this information over the telephone through an automated service and via the PPM website.[102]

G. *Annuities*

The new pension system allows participants a great deal of flexibility as to when they can start receiving benefits from the Premium Pension. Individuals must file a claim to receive benefits, and they must file a separate claim for the benefit from the notional account plan and for the benefit from the Premium Pension.[103] Individuals can claim benefits from the Premium Pension starting the month they turn 61 or later.[104] In the previous pension system, the earliest age was 60, so the reform establishing the Premium Pension raised the earliest age for Social Security receipt by one year.[105] There is no maximum age by which benefits must be claimed. Benefits can be claimed at the same age as the worker claims benefits from the Social Security notional account plan, or the worker can claim benefits from the Premium Pension separately starting at a different age. Workers can also claim full or partial (one-quarter, one-half, or three-quarters) benefits.[106] They can continue working while they draw benefits, in which case they would continue contributing to the system.[107]

This flexibility as to the timing of benefit receipt is important for reducing the risk associated with the annuitization of benefits.[108] When interest rates are low, the annuity resulting from a given account balance is also relatively low. A worker can begin receiving benefits from the notional account plan, but if the worker believes that interest rates will rise, making it more favorable to annuitize Premium Pension benefits later, the worker can postpone annuitization of the Premium Pension. Once participants have claimed Premium Pension benefits, they can suspend payment of them for a period or change the percentage of a full payment that they receive.[109] Participants could first claim Premium Pension benefits starting in 2001, but because benefits then were small due to the short accumulation period, those benefits were paid only for the month of December.

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[102] Palmer, *supra* note 6, at 38.

[103] DEN ALLMÄNNA PENSIONEN, YOUR WHOLE LIFE COUNTS 15, *available at* http://www.forsakringskassan.se (last visited Feb.12, 2003).

[104] Palmer, *supra* note 6, at 35.

[105] SOCIAL SECURITY ADMINISTRATION, *supra* note 1, at 195.

[106] *Id.* at 36.

[107] Palmer, *supra* note 6.

[108] *Id.* at 35.

[109] *Id.* at 36.

The PPM is the sole provider of annuities for participants in the Premium Pension. This is a unique feature of the Swedish system. It is the only country where the government is the sole provider of annuities for participants in a mandatory individual account system.[110]

Starting from the date when Premium Pension benefits are first claimed, the entire account balance in the Premium Pension must be paid out as an annuity as a survivor benefit, or as both.[111] Lump sum payments of even a portion of the account are not allowed. Participants can choose a fixed or variable annuity.[112] If a fixed annuity is chosen, the PPM guarantees a fixed monthly payment for life. The monthly amount may be increased by a bonus, depending on the PPM's investment experience. The level of the annuity is based on standard insurance practices, with the interest rate used to determine the annuity varying based on market interest rates.[113] Thus, participants bear interest rate risk with respect to their timing as to when they take the annuity. The PPM uses unisex life tables for the claimant's birth cohort.[114] If a worker chooses a variable annuity, the Premium Pension may vary, since the amounts paid out will be affected by the value of the funds.[115] Benefits workers receive from the Premium Pension are taxable under the personal income tax at the same rate as labor earnings.[116]

Participants may voluntarily choose the Premium Pension's survivor benefit.[117] It is available on a separate basis for the pre-retirement and retirement periods.[118] Participants pay the cost of purchasing survivor benefits pre-retirement from the funds in their individual accounts.[119] Thus, it is only available to workers with a sufficient amount in their account to cover the cost of purchasing the option. This option became available starting in 2002.[120] If the participant elects a survivor benefit and then dies before retirement, the benefit pays a fixed amount (without regard to the participant's account balance) for five

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[110] WORLD BANK, *Annuities: Regulating Withdrawals From Individual Pension Accounts*, WORLD BANK PENSION REFORM PRIMER 5 (2000), *at* http://wbln0018.worldbank.org/HDNet/hddocs.nsf/65538a343139acab85256cb70055e6ed/1b9bb079e6b112fa852568900071be6b/$FILE/N%20annuities22000.pdf.

[111] Palmer, *supra* note 6, at 36

[112] *Id.*

[113] *Id.*

[114] *Id.*

[115] *Id.*

[116] *Id.*

[117] Palmer, *supra* note 6, at 36.

[118] *Id.*

[119] *Information and News on Your Premium Pension*, *supra* note 14.

[120] *Id.*

years.[121] Beneficiaries of this benefit include children under age twenty, and a spouse, or a registered partner or cohabitant, including a same-sex partner.[122] If the individual dies after retirement, the survivor benefit will be paid as a life annuity to the surviving spouse, registered partner, person previously married to the deceased, or with whom the deceased had children.

If a participant dies before retirement or dies after retirement and has not elected a survivor benefit, the balance of the participant's account is not distributed to the participant's surviving spouse but is distributed among the accounts of all participants in proportion to account balance, raising their rate of return.[123]

III. POLICY LESSONS FOR THE UNITED STATES

Swedish mandatory individual account pensions are similar in some respects to individual accounts that have been considered for the United States. Therefore, it may be useful to examine what the Swedish experience may suggest were the United States to implement such a policy.

1. A new government agency was established in Sweden because the range of activities required was substantially different from those of its existing Social Security agency.[124] There have been suggestions that the Thrift Savings Board in the United States, which manages the Thrift Savings Plan for federal government workers, might serve as a model for such an agency in the United States. Any such entity would need to coordinate with the Social Security system on a wide range of operational issues.
2. To reduce the administrative burden on employers, employer and employee contributions are collected from employers by the National Tax Authority for both the notional account Social Security program and the funded individual accounts.
3. There is a tradeoff between administrative costs and quick processing of contributions. To reduce administrative costs in Sweden, pension rights are established after the end of the tax year when income tax returns are filed.
4. To reduce administrative expenses, the government maintains all the pension records. Individual mutual funds do not know who their investors are. The mutual funds deal only with the government agency, receiving aggregated contributions from the agency, and making aggregated payments to it.
5. Workers have a choice of more than 500 different mutual funds. Because of the large number of choices, extensive efforts to educate and inform workers about different types of investments are necessary.

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[121] *Id.*

[122] *Id.*

[123] *Id.*

[124] *See infra* note 23 and accompanying text.

6. The Swedish experience suggests that restrictions on entry of mutual funds need to be made to limit their number. This could be done by charging the mutual funds a flat fee for participating.

7. Sweden is able to provide individual accounts at moderate cost, but it does so with extensive government involvement, including the government being the provider of annuities.

8. All the country's contributions for a year, plus the accumulated interest on those contributions, are invested in the mutual funds over a period of four or five days. This procedure would not work in the United States because the large amounts of money involved could not be absorbed into capital markets over such a short period without affecting stock prices.

9. Because many workers choose the default fund by not making an active investment choice, the investment portfolio of the default fund requires careful public policy consideration.

10. Participating mutual funds are not permitted to charge flat administrative fees so as not to disadvantage low wage workers with small accounts.

11. Sweden provides a considerable amount of flexibility as to the ways that retirees can receive benefits from their individual accounts. Individuals are not required to start collecting their individual account benefits at the same age they collect their Social Security benefits. However, the benefits must be received as an annuity, and the government is the sole provider of these annuities.

IV. ASSESSMENT AND CONCLUSIONS

The mandatory individual account pensions in Sweden may provide some indications as to how an individual account system would be put into place if the United States were to adopt such a system. Because the system of funded mandatory individual accounts in Sweden has only operated for a short time, it is too early to assess fully its operation. For example, administrative costs relative to assets under management are expected to fall over time as experience is gained with the system and as assets in the system grow, leading to economies of scale.

In considering applicability to the United States of the Swedish experience, it is important to consider the context within which it operates. First, Sweden is a small country. The same system in a much larger country might encounter problems arising from size that would add to the difficulty of administering it. Placing all contributions to the system for a year in the mutual funds over a several day period may work in a small country like Sweden but would not work for a large country because of the effect it would have on financial markets. A possible solution for this problem is to have the holding account for contributions invest in a weighted average of actual worker selections in order to minimize market disruptions when the money is shifted to the individual accounts.

Second, when considering the risks of the retirement income system for low-income workers, it should be kept in mind that the poverty rate in Sweden is low. The poverty rate for Sweden's elderly was 0.8% in 1995.[125]

Third, the Swedish individual account system operates on top of a very generous base provided by the Social Security notional account system. This base reduces the overall risk level for Swedish workers, and for a given level of risk aversion allows them to be more willing to accept financial market risks. This factor may explain why the Swedish system allows participants to take considerable risks in terms of investing in funds covering limited segments of the financial market and why the default fund is invested heavily in equities.

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[125]Timothy M. Smeeding, Income Maintenance in Old Age: What Can Be Learned from Cross-National Comparisons, Paper Presented at the Third Annual Conference of the Retirement Research Consortium, 11 (May 18, 2001), *available at* http://www.bc.edu/centers/crr/papers/wp_2001-11.pdf.