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**Accounting for the New Swedish Old-age Pension Scheme:  
A Comment**

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## Accounting for the new Swedish old-age pension scheme. A COMMENT

International Labour Office has always been putting sound financial governance of social security schemes as one of the main prerequisites to ensure that benefits are adequate and sustainable. ILO Convention no 102 on Minimum Standards in Social Security (art. 71 p.3) explicitly requests the governments to monitor closely financial equilibrium of the social security schemes and links this requirement to the overall responsibility of the state for providing benefits at the adequate level:

- *The Member shall accept general responsibility for the due provision of the benefits provided in compliance with this Convention, and shall take all measures required for this purpose. It shall ensure, where appropriate, that the necessary actuarial studies and calculations concerning financial equilibrium are made periodically and, in any event, prior to any change in benefits, the rate of insurance contributions, or the taxes allocated to covering the contingencies in question.*

The Swedish new legislation requires a pre-defined “balance ratio” of the old-age pension system to be calculated annually and links automatically indexation of past contributions (“notional rate of return”) and indexation of benefits to the financial position of the system (as reflected by the “balance ratio” indicator). It certainly strengthens further the long-term financial sustainability of the Swedish old-age pension system. It is also innovative, similarly like the overall NDC design which links automatically benefit accrual rates in the PAYG system to changing life expectancy<sup>1</sup>.

New accounting rules, “balance ratio” indicator linked to this accounting rules and automatic balancing mechanism are advantageous as being simple, more easily understandable to politicians and the general public and as such helpful in improving governance of the Swedish pension system. But is the Swedish approach really “insulating” pension system from the state budget and making it truly sustainable? Does the new accounting approach really fully replace the need for actuarial and other projections using explicit assumptions about future demographic, labour market and economic developments? Finally: is the approach applicable in pension systems designed differently than according to principles of the Notional Defined Contribution?

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<sup>1</sup> For a discussion of relationship between NDC and traditional defined benefit scheme see: Cichon, Michael (1999), Notional defined-contribution schemes: Old wine in new bottles? International Social Security Review 52 (4), pp. 87-105

Accounting approach and balancing mechanism do not cover financial liabilities resulting out of the existing minimum pension guarantee. More often balancing mechanism will be activated; lower will be the pension levels and thus higher costs for public budgets to finance minimum pension guarantee and additional social assistance benefits necessary to keep pensioners out of poverty. Tough eligibility rules in the pension system may lead also to increased expenditure on other social protection schemes (disability benefits, unemployment benefits). Old-age pension schemes are often utilized by workers (and their employers) as vehicles to relatively securely leave labour market in the unfavourable circumstances (like high unemployment, restructuring etc.) Tightening eligibility conditions for retirement (what NDC scheme does) may in some circumstances lead to increases in the number of beneficiaries of other benefit schemes if they are more favourable. Balancing mechanism may thus “insulate” finances of the old-age pension scheme from the budget but not *vice versa*: the overall finances of the whole pension system (and overall system of social protection) may appear to be not financially sustainable and financial sustainability of the NDC pension scheme may appear to be achieved just by pushing the costs of social security outside the pension scheme and increasing the financial burden of other parts of the overall social protection system. This shows that additionally to sound accounting and budgeting of individual schemes one always needs « social budgeting » of the overall social protection system<sup>2</sup>.

There is also a question of balance between financial sustainability and adequacy of the benefit scheme. Benefit adequacy defines “social” sustainability of a social security scheme. Social sustainability means that eligibility conditions and benefit levels are such that social policy objectives of a scheme are effectively achieved. In case of old-age pension system it means providing (agreed as) adequate income after retirement at a reasonable, universally accepted, age. Failing to provide adequate benefit levels usually undermines financial sustainability by weakening incentives to contribute and political (and thus fiscal) support. Financial and social sustainability should thus go hand in hand, together they both make any social protection scheme viable. The Swedish system ensures to a large extent financial sustainability of a scheme but at the cost of benefit adequacy.

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<sup>2</sup>For a discussion of social budgeting concept see: Scholz, Wolfgang; Cichon, Michael; Hagemeyer, Krzysztof, Social Budgeting, Geneva 2000: ILO/ISSA

One should admit that – with respect to balancing financial sustainability and benefit adequacy - design of the new Swedish pension system compares positively to outcomes of similar pension reforms implemented in some other countries of the region. However, if demographic and labour market circumstances will force using balancing mechanism too often and too long, benefit adequacy will be in serious danger and thus also viability of a scheme. Ideally, one would need another balancing mechanism preventing benefit levels to fall below social accepted levels.

Accounting principles of the new Swedish pension system go well beyond pure accounting: many implicit assumptions about the future are involved. These implicit assumptions include those related to unchanged demographic and labour market conditions. One can argue that it is not posing any problem as exercise is repeated every period and thus every period it takes into accounts new current demographic and labour circumstances as reflected by a high quality scheme's data. But while this accounting approach can be seen as a very prudent way to monitor scheme's finances, it does not replace the need for actuarial valuations and actuarial/economic projections. Even if working of the automatic balancing mechanism does not require it, the social policy making does. Policy analyst needs to know how finances of the system will develop depending on different demographic, labour market and economic scenarios and how benefit levels and benefit distribution will develop under these scenarios.

One of the major advantages of the Swedish new pension system is quality of data available to the policy analyst, policy maker, and all those responsible for sound governance of the scheme. Public pension systems (and defined benefit schemes in particular) need extremely prudent actuarial appraisals. However: the data necessary are often not in place.

Actuaries are not prophets but their work still can be trusted when it meets certain standards and is based on sound database. ILO since years, in cooperation with ISSA and International Actuarial Association, aims at developing standards of practice for social

security actuaries covering required knowledge (more than pure actuarial), method and models and reporting standards<sup>3</sup>.

ILO develops sets of tools for sound financial governance (like projection and simulation models, performance indicators), organizes training (like master degree courses developed jointly with universities in Maastricht and Lausanne) and publishes textbooks (like “Quantitative Methods in Social Protection” series). It also develops reporting standards and sets statistical requirements (basic set of data and information necessary for actuarial valuation and of monitoring performance of the social protection scheme).

A « powerful simplification » of the accounting approach associated with a new Swedish pension system has to be highly appreciated as an excellent way to monitor pension scheme’s finance in an easy understandable way. All countries adopting notional defined contribution schemes should be advised to adapt similar approach. Unfortunately, Swedish accounting approach is not directly applicable to pension schemes other than NDC. Switching to NDC is not necessary an acceptable policy option for all the countries as not everybody wants to give up contribution rate as a policy instrument and income redistribution via the pension system (and NDC means exactly giving up these two things). There exists however a number of other indicators that can be used to monitor financial position of defined benefit, PAYG schemes. One could develop a standard set of assumptions necessary for required actuarial valuations to be done on a regular basis, every year – similar to the implicit assumptions governing the “accounting” approach. Like with the accounting approach, this will be very demanding with respect to the data availability. Data gaps and low data quality are in most of the social security schemes the main reason preventing actuarial valuation to be done often and regularly, it is also the main reason why actuaries have to make heroic and thus questionable assumption. Major improvement in the scope and quality of statistics available on social protection schemes is certainly a first step to be taken on the way to improve their financial governance. In this respect Swedish “best practice” example should be followed with no hesitation.

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<sup>3</sup> Plamondon, Pierre; Drouin, Anne; Binet, Gylles; Cichon, Michael; McGillivray, Warren; Bédard, Michel; Perez Montas, Hernando, Actuarial Practice in Social Security, Geneva 2002: ILO/ISSA