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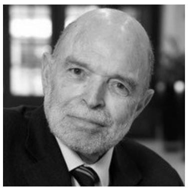
Less choice is better: LSE research guides Swedish pension reform

Published 12 May 2022



Professor Nicholas Barr is a Professor of Public Economics in the European Institute at LSE. His research interests include economic theory of the welfare state, social insurance, pensions, health finance, the finance of higher education.

How can governments manage the financial pressures that aging populations are placing on their pension systems? Professor **Nicholas Barr** has advised governments around the world, with Sweden the latest country to enact legislative change as a result.

The day after I speak to Nick Barr, Professor of Public Economics at LSE, a senior official at the Swedish Pensions Agency emails him with a delighted message that the pensions bill on which he's been advising has finally been passed into legislation by the Swedish Parliament.

The conclusion of nearly a decade of discussion and collaboration, the Law Council referral (preliminary bill or "lagrådsremiss" in Swedish) "quotes the extraordinary consultation of the London School of Economics", the email continues. While, inevitably, compromises have been made along the way, a system facing significant stresses is now more sustainable, with changes that will benefit ordinary citizens. As the official puts it – "the dream is alive!"

Professor Barr's work with the Swedish government is just one chapter in a long career advising policymakers on how their pension systems can pay adequate benefits while remaining on a sound financial footing. Over an 18-year partnership, Professor Barr and Nobel Prize winner and MIT Professor Peter Diamond have brought their expertise to governments in countries as diverse as China, Australia, Finland and Chile. But it is their work in Sweden, with its timely legislation, that he's come to speak about today.

> We spent a huge amount of time explaining why limiting a worker's choice for pensions is actually a good thing to do.

Long life – good news, but a thorn in the side of pension schemes

One of the difficulties Sweden has been grappling with, Professor Barr explains, is a universal one. "A key issue – and I tell students they will fail the exam if they refer to this as a problem – is that people are living longer," he laughs. "This is of course wonderful news, but it does mean that unless the system adapts, pensions will either get more and more expensive or benefits lower and lower, and eventually the system will explode."

The problem, he explains, is not that people are living longer. It's that they are retiring too soon. But while that is a common issue and the necessary adaptation – higher pension age – is clear, specific adjustments are complicated because countries have very different pension arrangements. In the face of these pressures, Sweden wanted to take the opportunity of a broader assessment of their pension system and therefore called in Professors Barr and Diamond to advise.

The importance of cross-party collaboration in long-term policymaking

The story in Sweden goes back to the mid-1990s.

"Sweden did something very clever in seeking to change its pension system," says Professor Barr. "Having realised its existing structure was unsustainable, it set up a cross-party group to draft the outlines of a pension reform."

Making this a cross-party decision helped buy-in across the board. And once the broad outlines of the reform had been enacted, the group was then tasked with setting out the detailed design.

After the new system was introduced in 1998, the government decided to keep the pensions group in place. "They became the guardians of the new system, with the result that the reforms with which Peter and I were involved are essentially the first significant pension reforms for 20 years," says Professor Barr.

> "Pensions are much more like pharmaceutical drugs than like restaurant meals or smartphones."

As a result of professors Barr and Diamond's evidence, Sweden made two major changes.

First, the minimum pension age will in future be linked to life expectancy. This change, explains Professor Barr, avoids the need to cut pensions as the country's population continues to age.

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The second change relates to the Premium Pension – the part of the system in which workers use a small part of their overall contribution to pay into a pension fund of their choice. Prior to the reforms, workers could choose from over 800 private pension providers, a choice, argued Professor Barr, that was too complicated for most people to engage with.

When it comes to pensions, too much choice is a bad thing

A major part of professors Barr and Diamond's advice was to highlight the importance of reducing choice as part of helping people to make better decisions about their retirement funds.

"The findings of behavioural economics explain why many people make bad pension choices, partly because of a tendency to postpone making difficult choices and partly because what they are faced with is a horribly difficult problem – how can one tell which pension fund is well managed and will perform well?" Professor Barr explains.

"We spent a huge amount of time explaining why limiting a worker's choice for pensions is actually a good thing to do. Simple economic theory says that choice always raises a person's welfare, and so it can never be bad to have more choice. But that isn't always right – in particular it is incorrect when products are complex. For example, we all understand why we are not allowed to go to the chemist and buy whatever pharmaceutical drugs we like.

"I think pensions are much more like pharmaceutical drugs than like restaurant meals or smartphones. They are highly complicated. Presenting people with too many choices creates two problems: firstly, many people do not want to have to use time and energy to make those choices, and secondly, the choices in question are those that virtually nobody – myself included – is capable of handling."

Creating a cost-effective system for the state and individual

For Swedish workers, having to choose from over 800 funds meant that the majority did not make any choice, and so went into the government-run default fund. As a result of Professor Barr's recommendations, two changes will now pass into law: there will be stronger quality assurance over which funds are on offer and – connected – workers will have fewer options. Though at first glance the change looks restrictive, in reality it helps workers to make better decisions over their future.

Sweden centralises administration, so administrative costs are not an issue there. But in other countries reducing the number of options has the added advantage of helping to contain costs. "Ultimately, less choice means better pensions," Professor Barr says. "And since choices are administratively expensive, giving less choice makes administration cheaper."

Reducing administrative costs has a huge impact. "Take a pension fund that charges one per cent of your accumulation per year to manage it," he explains. "That doesn't sound like much. But over a 40 year career, your accumulation will be 20 per cent smaller – just because of that one per cent change. That's 20 per cent of your savings that won't reach you in old age. And quite a few funds charge more than one per cent. That is why Peter and I have put so much focus on explaining how behavioural economics justifies less choice."

"The purpose of pensions is to give pensioners a comfortable old age," he concludes. And as a result of legislative reforms based on his recommendations, Swedish workers will have a more secure retirement. ■

Professor Nicholas Barr was speaking to Jess Winterstein, Acting Head of Media Relations at LSE.

Professor Barr's research features in a REF 2021 impact case study, **Reforming pensions to protect adequate and sustainable benefits**.

Read Nicholas Barr's "**Pensions: how much choice?**", and in Spanish, "**Pensiones: ¿Cuántas opciones hay?**", CENIE International Centre on Aging, 21 April 2022.